Forex Godfather Elite

www.forexgodfather.com

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GODFATHERS LESSONS ON PIPSOLOGY

Forex education is crucial for beginners

Godfathers **Lessons on Pipsology** are designed to help you acquire the skills, knowledge, and abilities to become a successful trader in the foreign exchange market. Our definition of a successful trader is having the ability to do three things:

1. **Make pips**
2. **Keep pips**
3. **Repeat**

If you can repeatedly do these three things, then you're on your way! But it's no cakewalk.

Remember when you attended grade school? No? Well, according to our memories, here's how it worked.

You start schooling at the age of five and enter Kindergarten. The next year you enter 1st Grade. If you pass, the next year you enter 2nd Grade, and so on, all the way up to the 12th Grade. Depending on what grade you're in, you'd attend one of three *schools*:

1. **Elementary school** (Kindergarten - 5th grade)
2. **Middle school** (6th grade - 8th grade)
3. **High school** (9th grade - 12th grade)

This is how our lessons are broken apart, so you can relive the past and also be able to learn and study Forex trading techniques at your own pace – my lessons go beyond the 12th grade!

My Lessons will make a bold attempt to cover all aspects of Forex trading. You will learn how to identify trading opportunities, how to time the market (aka smart guessing), and when to take profits or close a trade.

But that's not all!.

You will also learn how to predict the future and never have a losing trade.

Yeah right. In your dreams pal. But there is plenty more to learn and you'll just have to see for yourself!

GODFATHERS CURRICULUM:

ELEMENTARY SCHOOL	
Kindergarten	Types Of Charts
1st Grade	Japanese Candlesticks
2nd Grade	Support and Resistance, Trend Lines, and Channels
3rd Grade	Fibonacci
4th Grade	Moving Averages
5th Grade	Common Chart Indicators Bollinger Bands, MACD, Stochastics, RSI, and Parabolic SAR

MIDDLE SCHOOL	
6th Grade	Oscillators and Momentum Indicators
7th Grade	Important Chart Patterns
8th Grade	Forex Pivot Points

HIGH SCHOOL	
9th Grade	Multiple time frames
10th Grade	Elliott Wave Theory
11th Grade	Create Your Own Trading System
12th Grade	Market Hours - **Know When to Trade**
13th Grade	Money Management
14th Grade	Plan Your Trade and Trade Your Plan

COLLEGE
Multiple Trading Personality Disorder
Trading News
Market Sentiment
U.S. Dollar Index
Carry Trade
The Lazy Forex Trader's Way to Riches
Be a Forex Trader, Not a Forex Sucker
The Number One Cause of Death for Forex Traders
Commodity Currencies
Currency Crosses
Divergence Trading

THE SKINNY ON FOREX TRADING

- ## What is FOREX?

The Foreign Exchange market, also referred to as the "FOREX" or "Forex" or "Retail forex" or "FX" or "Spot FX" or just "Spot" is the largest financial market in the world, with a volume of over $4 trillion a day. If you compare that to the $25 billion a day volume that the New York Stock Exchange trades, you can easily see how enormous the Foreign Exchange really is. It actually equates to more than three times the total amount of the stocks and futures markets combined! Forex rocks!

- ## What is traded on the Foreign Exchange market?

The simple answer is money. Forex trading is the simultaneous buying of one currency and the selling of another. Currencies are traded through a broker or dealer, and are traded in pairs; for example the euro and the US dollar **(EUR/USD)** or the British pound and the Japanese Yen **(GBP/JPY).**

Because you're not buying anything physical, this kind of trading can be confusing. Think of buying a currency as buying a share in a particular country. When you buy, say, Japanese Yen, you are in effect buying a share in the Japanese economy, as the price of the currency is a direct reflection of what the market thinks about the current and future health of the Japanese economy.

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

Unlike other financial markets like the New York Stock Exchange, the Forex spot market has neither a physical location nor a central exchange. The Forex market is considered an Over-the-Counter (OTC) or 'Interbank' market, due to the fact that the entire market is run electronically, within a network of banks, continuously over a 24-hour period.

Until the late 1990's, only the "big guys" could play this game. The initial requirement was that you could trade only if you had about ten to fifty million bucks to start with! Forex was originally intended to be used by bankers and large institutions - and not by us "little guys". However, because of the rise of the Internet, online Forex trading firms are now able to offer trading accounts to 'retail' traders like us.

All you need to get started is a computer, a high-speed Internet connection, and the Godfathers lessons.

- ## What is a Spot Market?

A spot market is any market that deals in the **current price** of a financial instrument.

- ## Which Currencies Are Traded?

The most popular currencies along with their symbols are shown below:

SYMBOL	COUNTRY	CURRENCY	NICKNAME
USD	United States	Dollar	Buck
EUR	Euro members	Euro	Fiber
JPY	Japan	Yen	Yen
GBP	Great Britain	Pound	Cable
CHF	Switzerland	Franc	Swissy
CAD	Canada	Dollar	Loonie
AUD	Australia	Dollar	Aussie
NZD	New Zealand	Dollar	Kiwi

Forex currency symbols are always three letters, where the first two letters identify the name of the country and the third letter identifies the name of that country's currency.

- ## When Can Currencies Be Traded?

The spot FX market is unique within the world markets. It's like a Super Wal-Mart where the market is open 24-hours a day. At any time, somewhere around the world a financial center is open for business, and banks and other institutions exchange currencies every hour of the day and night with generally only minor gaps on the weekend.

The foreign exchange markets follow the sun around the world, so you can trade late at night (if you're a vampire) or in the morning (if you're an early bird). Keep in mind though, the early bird doesn't necessarily get the worm in this market - you might get the worm but a bigger, nastier bird of prey can sneak up and eat you too...

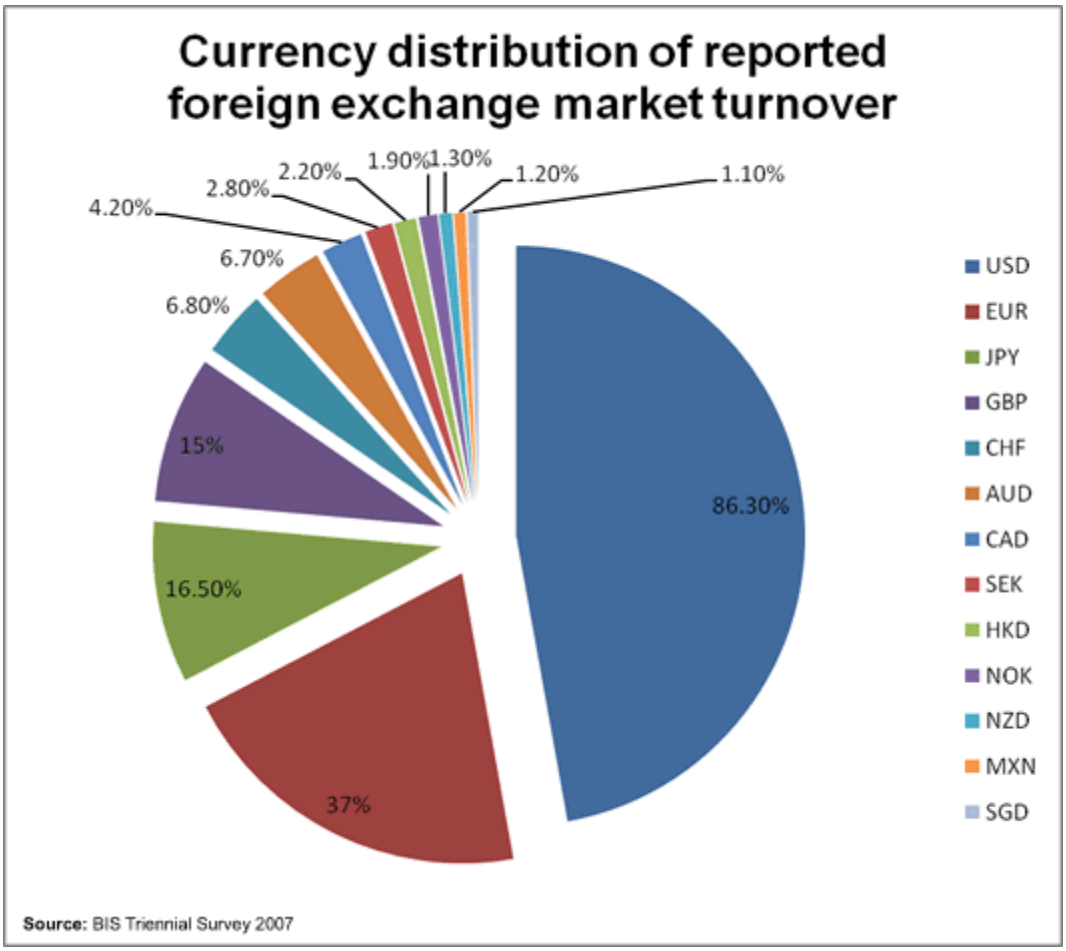
TIME ZONE	NEW YORK	GMT
Tokyo Open	7:00 pm	0:00
Tokyo Close	4:00 am	9:00
London Open	3:00 am	8:00
London Close	12:00 pm	17:00
New York Open	8:00 am	13:00
New York Close	5:00 pm	22:00

- ## The Forex market (OTC)

The Forex OTC market is by far the biggest and most popular financial market in the world, traded globally by a large number of individuals and organizations. In the OTC market,

participants determine who they want to trade with depending on trading conditions, attractiveness of prices and reputation of the trading counterpart.

The chart below shows global foreign exchange activity. The dollar is the most traded currency, being on one side of 86% of all transactions. The euro's share is second at 37%, while that of the yen is third at 16.5%.



- ## Why Trade Foreign Currencies?

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

- **No commissions.**
  No clearing fees, no exchange fees, no government fees, no brokerage fees. Brokers are compensated for their services through something called the bid-ask spread.
- **No middlemen.** Spot currency trading eliminates the middlemen, and allows you to trade directly with the market responsible for the pricing on a particular currency pair.
- **No fixed lot size.**
  In the futures markets, lot or contract sizes are determined by the exchanges. A standard-size contract for silver futures is 5000 ounces. In spot Forex, you determine your own lot size. This allows traders to participate with accounts as small as $250 (although we explain later why a $250 account is a bad idea).

- **Low transaction costs.**
  The retail transaction cost (the bid/ask spread) is typically less than 0.1 percent under normal market conditions. At larger dealers, the spread could be as low as .07 percent. Of course this depends on your leverage and all will be explained later.
- **A 24-hour market.**
  There is no waiting for the opening bell - from Sunday evening to Friday afternoon EST, the Forex market never sleeps. This is awesome for those who want to trade on a part-time basis, because you can choose when you want to trade--morning, noon or night.
- **No one can corner the market.**
  The foreign exchange market is so huge and has so many participants that no single entity (not even a central bank) can control the market price for an extended period of time.
- **Leverage.**
  In Forex trading, a small margin deposit can control a much larger total contract value. Leverage gives the trader the ability to make nice profits, and at the same time keep risk capital to a minimum. For example, Forex brokers offer 200 to 1 leverage, which means that a $50 dollar margin deposit would enable a trader to buy or sell $10,000 worth of currencies. Similarly, with $500 dollars, one could trade with $100,000 dollars and so on. But leverage is a double-edged sword. Without proper risk management, this high degree of leverage can lead to large losses as well as gains.
- **High Liquidity.**
  Because the Forex Market is so enormous, it is also extremely liquid. This means that under normal market conditions, with a click of a mouse you can instantaneously buy and sell at will. You are never "stuck" in a trade. You can even set your online trading platform to automatically close your position at your desired profit level (a limit order), and/or close a trade if a trade is going against you (a stop loss order).
- **Free "Demo" Accounts, News, Charts, and Analysis.** Most online Forex brokers offer 'demo' accounts to practice trading, along with breaking Forex news and charting services. All free! These are very valuable resources for "poor" and SMART traders who would like to hone their trading skills with 'play' money before opening a live trading account and risking real money.
- **"Mini" and "Micro" Trading:**
  You would think that getting started as a currency trader would cost a ton of money. The fact is, compared to trading stocks, options or futures, it doesn't. Online Forex brokers offer "mini" and "micro" trading accounts, some with a minimum account deposit of $300 or less. Now we're not saying you *should* open an account with the bare minimum but it does makes Forex much more accessible to the average (poorer) individual who doesn't have a lot of start-up trading capital.

- ## What Tools Do I Need to Start Trading Forex?

A computer with a high-speed Internet connection and all the information on this site is all that is needed to *begin* trading currencies.

- ## What Does It Cost to Trade Forex?

An online currency trading (a "micro account") may be opened with a couple hundred bucks. Do not laugh – micro accounts and its bigger cousin, the mini account, are both good ways to get your feet wet without drowning. For a micro account, we'd recommend at least $1,000 to start. For a mini account, we'd recommend at least $10,000 to start.

HOW YOU MAKE MONEY TRADING FOREX

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

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

Example of making money by buying Euros

TRADER'S ACTION	EUR	USD
You purchase 10,000 Euros at the EUR/USD exchange rate of **1.18**	+10,000	-11,800*
Two weeks later, you exchange your 10,000 Euros back into US dollars at the exchange rate of **1.2500.**	-10,000	+12,500**
You earn a **profit of $700.**	0	**+700**

*** EUR 10,000 x 1.18 = US $11,800**
**** EUR 10,000 x 1.25 = US $12,500**

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

- ## How to Read an FX Quote

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

GBP/USD = 1.7500

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

When buying, the exchange rate tells you how much you have to pay in units of the quote currency to buy one unit of the base currency. In the example above, you have to pay 1.7500 U.S. dollar to buy 1 British pound.

When selling, the exchange rate tells you how many units of the quote currency you get for selling one unit of the base currency. In the example above, you will receive 1.7500 U.S. dollars when you sell 1 British pound.

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

You would buy the pair if you believe the base currency will appreciate (go up) relative to the quote currency. You would sell the pair if you think the base currency will depreciate (go down) relative to the quote currency.

Long/Short

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

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

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

Bid/Ask Spread

All Forex quotes include a two-way price, the **bid** and **ask**. The bid is always lower than the ask price.

The **bid** is the price in which the dealer is willing to buy the base currency in exchange for the quote currency. This means the bid is the price at which you (as the trader) will sell.

The ask is the price at which the dealer will sell the base currency in exchange for the quote currency. This means the ask is the price at which you will buy.

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

Let's take a look at an example of a price quote taken from a trading platform:

On this GBP/USD quote, the bid price is 1.7445 and the ask price is 1.7449. Look at how this broker makes it so easy for you to trade away your money.

If you want to sell GBP, you click "Sell" and you will sell pounds at 1.7445. If you want to buy GBP, you click "Buy" and you will buy pounds at 1.7449.

In the following examples, we're going to use fundamental analysis to help us decide whether to buy or sell a specific currency pair. If you always fell asleep during your economics class or just flat out skipped economics class, don't worry! We will cover fundamental analysis in a later lesson. For right now, try to pretend you know what's going on...

EUR/USD

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

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

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

USD/JPY

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

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

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

GBP/USD

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

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

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

USD/CHF

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

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

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

- ## I don't have enough money to buy 10,000 Euros. Can I still trade?

You can with margin trading! Margin trading is simply the term used for trading with borrowed capital. This is how you're able to open $10,000 or $100,000 positions with as little as $50 or $1,000. You can conduct relatively large transactions, very quickly and cheaply, with a small amount of initial capital.

Margin trading in the foreign exchange market is quantified in "lots". We will be discussing these in depth in our next lesson. For now, just think of the term "lot" as the minimum amount of currency you have to buy. When you go to the grocery store and want to buy an egg, you can't just buy a single egg; they come in dozens or "lots" of 12. In Forex, it would

be just as foolish to buy or sell 1 euro, so they usually come in "lots" of 10,000 (Mini) or 100,000 (Standard) depending on the type of account you have.

For Example:

- You believe that signals in the market are indicating that the British Pound will go up against the US dollar.
- You open one lot (100,000), buying with the British pound at 1% margin and wait for the exchange rate to climb. When you buy one lot (100,000) of GBP/USD at a price of 1.5000, you are buying 100,000 pounds, which is worth US$150,000 (100,000 units of GBP * 1.50 (exchange rate with USD)). If the margin requirement was 1%, then US$1500 would be set aside in your account to open up the trade (US$150,000 * 1%). You now control 100,000 pounds with US$1500. Your predictions come true and you decide to sell.
- You close the position at 1.5050. You earn 50 pips or about $500. (A pip is the smallest price movement available in a currency).

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

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

We will also be discussing margin more in-depth in the next lesson, but hopefully you're able to get a basic idea of how margin works.

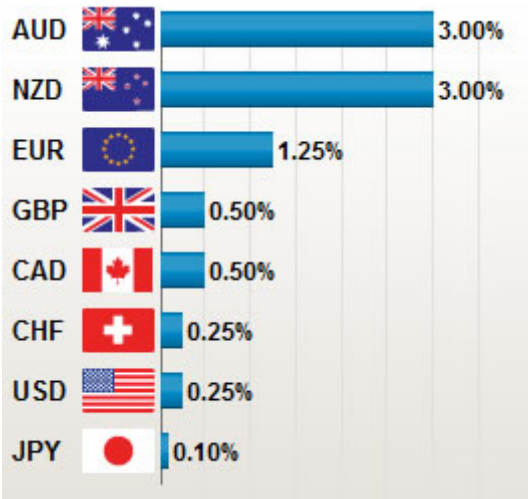
Rollover

No, this is not the same as rollover minutes from your cell phone carrier! For positions open at your broker's "cut-off time" usually 5pm EST, there is a daily rollover interest rate that a trader either pays or earns, depending on your established margin and position in the market. If you do not want to earn or pay interest on your positions, simply make sure they are all closed before 5pm EST, the established end of the market day.

Since every currency trade involves borrowing one currency to buy another, interest rollover charges are part of Forex trading. Interest is paid on the currency that is borrowed, and earned on the one that is bought. If a client is buying a currency with a higher interest rate than the one he/she is borrowing, the net differential will be positive (i.e. USD/JPY) - and the client will earn funds as a result. Ask your broker or dealer about specific details regarding rollover.

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

Don't know what the interest rates are for each currency? Here is a chart to help you out. Accurate as of 04/19/09.



Demo Trading

You can open a demo account for free with most Forex brokers. This account has the full capabilities of a "real" account. Why is it free? It's because the broker wants you to learn the ins and outs of their trading platform, and have a good time trading without risk, so you'll fall in love with them and deposit real money. The demo account allows you to learn about the Forex markets and test your trading skills with ZERO risk.

MESSAGE FROM THE GODFATHER:

YOU SHOULD DEMO TRADE FOR AT LEAST 3 MONTHS BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

I REPEAT - YOU SHOULD DEMO TRADE FOR AT LEAST 3 MONTHS BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

Place your hand on your heart and say...

"I will demo trade for at least 3 months before I trade with real money."

Now touch your head with your index finger and say...

"I am a smart and patient Forex trader!"

KNOW YOUR P'S AND L'S

He

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

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

- ## What the heck is a Pip?

The most common increment of currencies is the Pip. If the EUR/USD moves from 1.2250 to 1.2251, that is ONE PIP. A pip is the last decimal place of a quotation. The Pip is how you measure your profit or loss.

As each currency has its own value, it is necessary to calculate the value of a pip for that particular currency. In currencies where the US Dollar is quoted first, the calculation would be as follows.

Let's take USD/JPY rate at 119.80 (notice this currency pair only goes to two decimal places, most of the other currencies have four decimal places)

In the case of USD/JPY, 1 pip would be .01

Therefore,

USD/JPY:

119.80
.01 divided by exchange rate = pip value
.01 / 119.80 = 0.0000834

This looks like a very long number but later we will discuss lot size.

USD/CHF:

1.5250
.0001 divided by exchange rate = pip value
.0001 / 1.5250 = 0.0000655

USD/CAD:

1.4890
.0001 divided by exchange rate = pip value
.0001 / 1.4890 = 0.00006715

In the case where the US Dollar is not quoted first and we want to get the US Dollar value, we have to add one more step.

EUR/USD:

1.2200

.0001 divided by exchange rate = pip value

so

.0001 / 1.2200 = EUR 0.00008196

but we need to get back to US dollars so we add another calculation which is

EUR x Exchange rate

So

0.00008196 x 1.2200 = 0.00009999

When rounded up it would be 0.0001

GBP/USD:

1.7975

.0001 divided by exchange rate = pip value

So

.0001 / 1.7975 = GBP 0.0000556

But we need to get back to US dollars so we add another calculation which is

GBP x Exchange rate

So

0.0000556 x 1.7975 = 0.0000998

When rounded up it would be 0.0001

You're probably rolling your eyes back and thinking do I really need to work all this out and the answer is NO. Nearly all Forex brokers will work all this out for you automatically. It's always good for you to know how they work it out.

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

- ## What the heck is a Lot?

Spot Forex is traded in lots. The standard size for a lot is $100,000. There is also a mini lot size and that is $10,000. As you already know, currencies are measured in pips, which is the smallest increment of that currency. To take advantage of these tiny increments, you need to trade large amounts of a particular currency in order to see any significant profit or loss.

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

USD/JPY at an exchange rate of 119.80
(.01 / 119.80) x $100,000 = $8.34 per pip

USD/CHF at an exchange rate of 1.4555
(.0001 / 1.4555) x $100,000 = $6.87 per pip

In cases where the US Dollar is not quoted first, the formula is slightly different.

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

GBP/USD at an exchange rate or 1.8040
(.0001 / 1.8040) x GBP 100,000 = 5.54 x 1.8040 = 9.99416 rounded up will be $10 per pip.

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

- ## How the heck do I calculate profit and loss?

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

Let's buy US dollars and Sell Swiss Francs.

The rate you are quoted is 1.4525 / 1.4530. Because you are buying US you will be working on the 1.4530, the rate at which traders are prepared to sell.

So you buy 1 lot of $100,000 at 1.4530.

A few hours later, the price moves to 1.4550 and you decide to close your trade.

The new quote for USD/CHF is 1.4550 / 14555. Since you're closing your trade and you initially bought to enter the trade, you now sell in order to close the trade so you must take the 1.4550 price. The price traders are prepared to buy at.

The difference between 1.4530 and 1.4550 is .0020 or 20 pips.

Using our formula from before, we now have (.0001/1.4550) x $100,000 = $6.87 per pip x 20 pips = $137.40

Remember, when you enter or exit a trade, you are subject to the spread in the bid/offer quote.

When you **buy a currency you will use the offer price** and when **you sell you will use the bid price**.

So when you **buy** a currency, you pay the spread as you **enter** the trade but not as you exit. And when you **sell** a currency you don't pay the spread when you enter but only when you **exit**.

- ## What the heck is Leverage?

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

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

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

For example, for every $1,000 you have, you can trade 1 lot of $100,000. So if you have $5,000 they may allow you to trade up to $500,000 of Forex.

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

- ## What the heck is a Margin Call?

In the event that money in your account falls below margin requirements (usable margin), your broker will close some or all open positions. This prevents your account from falling into a negative balance, even in a highly volatile, fast moving market.

Example#1

Let's say you open a regular Forex account with $2,000 (not a smart idea). You open 1 lot of the EUR/USD, with a margin requirement of $1000. Usable Margin is the money available to open new positions or sustain trading losses. Since you started with $2,000, your usable margin is $2,000. But when you opened 1 lot, which requires a margin requirement of $1,000, your usable margin is now $1,000.

If your losses exceed your usable margin of $1,000 you will get a margin call.

Example#2

Let's say you open a regular Forex account with $10,000. You open 1 lot of the EUR/USD, with a margin requirement is $1000. Remember, usable margin is the money you have available to open new positions or sustain trading losses. So prior to opening 1 lot, you have a usable margin of $10,000. After you open the trade, you now have $9,000 usable margin and $1,000 of used margin.

If your losses exceed your usable margin of $9,000, you will get a margin call.

Make sure you know the difference between **usable margin** and **used margin**.

If the equity (the value of your account) falls below your usable margin due to trading losses, you will either have to deposit more money or your broker will close your position to limit your risk and his risk. As a result, you can never lose more than you deposit.

If you are going to trade on a margin account, it's vital that you know what your broker's policies are on margin accounts.

You should also know that most brokers require a higher margin during the weekends. This may take the form of 1% margin during the week and if you intend to hold the position over the weekend it may rise to 2% or higher.

The topic of margin is a touchy subject and some argue that too much margin is dangerous. It all depends on the individual. The important thing to remember is that you thoroughly understand your broker's policies regarding margin and that you understand and are comfortable with the risks involved.

Some brokers describe their leveraging in terms of a leverage ratio and other in terms of a margin percentage. The simple relationship between the two terms is:

Leverage = 100 / Margin Percent

Margin Percent = 100 / Leverage

Leverage is conventionally displayed as a ratio, such 100:1 or 200:1.

Would You Like Fries With Your Pips?

The term "order" refers to how you will enter or exit a trade. Here we discuss the different types of orders that can be placed into the foreign exchange market. Be sure that you know which types of orders your broker accepts. Different brokers accept different types of orders.

Order Types

Basic Order Types: There are some basic order types that all brokers provide and some others that sound weird. The basic ones are:

- **Market order**
  A market order is an order to buy or sell at the current market price. For example, EUR/USD is currently trading at 1.2140. If you wanted to buy at this exact price, you would click buy and your trading platform would instantly execute a buy order at that exact price. If you ever shop on Amazon.com, it's (kinda) like using their 1-Click ordering. You like the current price, you click once and it's yours! The only difference is you are buying or selling one currency against another currency instead of buying Britney Spears CDs.

- **Limit order**
  A limit order is an order placed to buy or sell at a certain price. The order essentially contains two variables, price and duration. For example, EUR/USD is currently trading at 1.2050. You want to go long if the price reaches 1.2070. You can either sit in front of your monitor and wait for it to hit 1.2070 (at which point you would click a buy *market order*), or you can set a buy *limit order* at 1.2070 (then you could walk away from your computer to attend your ballroom dancing class). If the price goes up to 1.2070, your trading platform will automatically execute a buy order at that exact price. You specify the price at which you wish to buy/sell a certain currency pair and also specify how long you want the order to remain active (GTC or GFD).

- **Stop-loss Order**
  A stop-loss order is a limit order linked to an open trade for the purpose of preventing additional losses if price goes against you. A stop-loss order remains in effect until the position is liquidated or you cancel the stop-loss order. For example, you went long (buy) EUR/USD at 1.2230. To limit your maximum loss, you set a stop-loss order at 1.2200. This means if you were dead wrong and EUR/USD drops

to 1.2200 instead of moving up, your trading platform would automatically execute a sell order at 1.2200 and close out your position for a 30 pip loss (eww!). Stop-losses are extremely useful if you don't want to sit in front of your monitor all day worried that you will lose all your money. You can simply set a stop-loss order on any open positions so you won't miss your basket weaving class.

Weird Sounding Order Types

- **GTC (Good 'til cancelled)**
  A GTC order remains active in the market until you decide to cancel it. Your broker will not cancel the order at any time. Therefore it's your responsibility to remember that you have the order scheduled.
- **GFD (Good for the day)**
  A GFD order remains active in the market until the end of the trading day. Because foreign exchange is a 24-hour market, this usually means 5pm EST since that that's U.S. markets close, but I'd recommend you double check with your broker.
- **OCO (Order cancels other)**
  An OCO order is a mixture of two limit and/or stop-loss orders. Two orders with price and duration variables are placed above and below the current price. When one of the orders is executed the other order is cancelled. Example: The price of EUR/USD is 1.2040. You want to either buy at 1.2095 over the resistance level in anticipation of a breakout or initiate a selling position if the price falls below 1.1985. The understanding is that if 1.2095 is reached, you will buy order will be triggered and the 1.1985 sell order will be automatically cancelled.

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

Summary

The basic order types (market, stop loss, and limit) are usually all that most traders ever need. Unless you are a veteran trader (yeah right), don't get fancy and design a system of trading requiring a large number of orders sandwiched in the market at all times – stick with the basic stuff first.

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

MESSAGE FROM THE GODFATHER:

DO NOT: make a trade with real money *until* you have an extremely high comfort level with the trading platform and order entry system.

CHOOSING A FOREX BROKER

Before trading Forex you need to set up an account with a Forex broker. So what exactly is a broker? In simplest terms, a broker is an individual or a company that buys and sells orders according to the trader's decisions. Brokers earn money by charging a commission or a fee for their services.

You may feel overwhelmed by the number of brokers who offer their services online. Deciding on a broker requires a little bit of research on your part, but the time spent will give you insight into the services that are available and fees charged by various brokers.

- **Is the Forex broker regulated?**

When selecting a prospective Forex broker, find out with which regulatory agencies it is registered with. The Forex market is labelled as an **"unregulated"** market, and it basically is. Regulation is typically reactive, meaning only after you've been bamboozled out of your entire savings will something be done.

In the United States a broker should be registered as a Futures Commission Merchant (FCM) with the Commodity Futures Trading Commission (CFTC) and a NFA member. The CFTC and NFA were made to protect the public against fraud, manipulation, and abusive trade practices.

You can verify Commodity Futures Trading Commission (CFTC) registration and NFA membership status of a particular broker and check their disciplinary history by phoning NFA at (800) 621-3570 or by checking the broker/firm information section (BASIC) of NFA's Web site at www.nfa.futures.org/basicnet/.

Among the registered firms, look for those with clean regulatory records and solid financials. Stay away from non-regulated firms!

The NFA is stepping up their efforts in educating investors about retail Forex trading. They've created a brochure fit for a Pulitzer Prize called, "**Trading in the Retail Off-Exchange Foreign Currency Market**". The NFA recommends you read it before taking the Forex plunge.

They've also developed a **Forex Online Learning Program,** an interactive self-directed program explaining how retail Forex contracts are traded, the risks inherent in Forex trading and steps individuals should take before opening a Forex account. Both the brochure and the online learning program are available at no charge to the public.

Customer Service

Forex is a 24-hour market, so 24-hour support is a must! Can you contact the firm by phone, email, chat, etc.? Do the reps seem knowledgeable? The quality of support can vary drastically from broker to broker, so be sure to check them out before opening an account.

Here's a good tip: choose several online brokers and contact their help desks. Seeing how quickly they respond to your questions can be key in gauging how they will respond to your needs. If you don't get a speedy reply and a satisfactory answer to your question, you certainly wouldn't want to trust them with your business. Just be aware that as in other types of businesses, pre-sales service might be better than post-sales service.

Online Trading Platform

Most, if not all, Forex brokers allow you to trade over the Internet relatively easy. The backbone of any trading platform is their ordering system. So trading software is very important. Get a feel for the options that are available by trying out a demo account at a few online brokers.

Closely examine the broker's screen layout. It should include:

- the ability to view real-time currency exchange rate quotes,
- an account summary showing your current account balance with realized and unrealized profit and loss, margin available, and any margin locked in open positions.

Most trading platforms are either Web based (in Java), or a client-based program you can install on your computer, and which version you choose is your personal preference:

- Web based software is hosted on your broker's web site. You won't have to install any software on your own computer, and you'll be able to log in from any computer that has an Internet connection.
- A client-based software program, or one that you download and install, will only allow you to trade on your own computer (unless you install the program on every computer you use).

Usually, the "download and install" program runs faster, but most programs are operating system specific. For example, most brokers only offer their trading platform application to run on Microsoft Windows. If heaven forbid you are a Mac user (!), you won't be able to install the application and will have to use your broker's Web based or Java-based trading platform. These two (the Web or Java-based) will run on any computer since they run through your internet browser.

Java-based software programs are preferred by most brokers, who think they are more safe and reliable. Java-based software tends to be less vulnerable to attack from viruses and hackers during transmissions than "download and install" software.

But always be sure to open a demo account and test out the broker's platform before opening a real account!

Don't forget your high speed Internet connection

The Forex market is a fast moving market and you will need up-to-the second information to make informed trading decisions. Make sure you have a high speed Internet connection. **If you don't, you might as well not even bother trading.** Dial-up will absolutely not work for Forex! If you plan to trade online you will need a modern computer and high speed Internet connection, and we can't stress this enough!

Bells and Whistles

Any Forex broker worth his salt should offer you real-time quotes and allow you to quickly enter and exit the market. These are minimal requirements of any trading software. Upgraded software packages are usually offered as an extra monthly fee by brokers.

Most brokers now offer integrated charting and technical analysis packages with their trading platforms. The level of integration with the trading platforms varies and is worth understanding carefully.

Mini/Micro Accounts

Most brokers offer very small "mini-accounts" and even smaller "micro-account" for as little as a couple hundred bucks. These little cute accounts are a great way to get started and test your trading skills and gain experience.

Broker Policies

Before selecting an online Forex broker, you should closely examine their features and policies. These include:

- **Available Currency Pairs**
  You should confirm that the prospective broker offers, at minimum, the seven major currencies **(AUD, CAD, CHF, EUR, GBP, JPY, and USD).**
- **Transaction Costs**
  Transaction costs are calculated in pips. The lower the number of pips required per trade by the broker, the greater the profit that the trader makes. Comparing pip spreads of half dozen brokers will reveal different transaction costs. For example, the bid/ask spread for EUR/USD is usually 3 pips, but if you can find 2 pips, that's even better.
- **Margin Requirement**
  The lower the margin requirement (meaning the higher the leverage), the greater the potential for higher profits *and* losses. Margin percentages vary from .25% and up. Low margin requirements are great when your trades are good, but not so great when you are wrong. Be realistic about margins and remember that they swing both ways.
- **Minimum Trading Size Requirement**
  The size of one lot may differ from broker to broker, spanning 1,000, 10,000, and 100,000 units. A lot consisting of 100,000 units is called a "standard" lot. A lot

consisting of 10,000 units is called a "mini" lot. A lot consisting of 1,000 units is called a "micro" lot. Some brokers even offer fractional unit sizes (called odd lots) which allow you create your own unit size.

- **Rollover Charges**
  Rollover charges are determined by the difference between the interest rate of the country of the base currency and the interest rates of the other country. The greater the interest rate differential between the two currencies in the currency pair, the greater the rollover charge will be. For example, when trading GBP/USD, if the British pound has the greater interest differential with the U.S. dollar, then the rollover charge for holding British pound positions would be the most expensive. On the other hand, if the Swiss Franc were to have the smallest interest differential to the U.S. dollar, then overnight charges for USD/CHF would be the least expensive of the currency pairs.
- **Margin Account Interest Rate**
  Most brokers pay interest on a trader's margin account. The interest rates normally fluctuate with the prevailing national rates. If you decide to take an extended break from trading, the money in your margin account will be accruing interest. Keep in mind that most brokers DO NOT allow you to accrue interest unless your margin requirement is at least 2% (50:1).
- **Trading Hours**
  Nearly all brokers align their hours of operation to coincide with the hours of operation of the global Forex market: 5:00 pm EST Sunday through 4:00 pm EST Friday.

Other Policies

Be sure to scrutinize a prospective broker's "fine print" section to be fully aware of all the nuances that a specific broker may impose on a new trader.

Finding the right broker is a critical part of the process. It's not easy and requires some real work on your part. Don't pick the first one that looks good to you. Keep looking and trying different demo accounts.

Summary

What to look for in an online Forex broker/dealer:

1. **Low Spreads.**
   In Forex trading the 'spread' is the difference between the buy and sell price of any given currency pair. Lower spreads save you money.
2. **Low minimum account openings.**
   For those that are new to Forex trading and for those that don't have millions of dollars in risk capital to trade, being able to open a micro trading account with only $250 (we recommend at least $1,000) is a great feature for new traders.
3. **Instant automatic execution of your orders.**
   This is very important when choosing a Forex broker. Don't settle with a firm that re-quotes you when you click on a price or a firm that allows for price 'slippage'. This is very important when trading for small profits. You want what we call a WYSIWYG (pronounced wiz-ee-wig) broker! This means you want instant execution of your

orders and the price you see and "click" is the price that you should get...WYSIWYG = **W**hat **Y**ou **S**ee **I**s **W**hat **Y**ou **G**et!

4. **Free charting and technical analysis**
   Choose a broker that gives you access to the best charting and technical analysis available to active traders. Look for a broker that provides free professional charting services and allows traders to trade directly on the charts.
5. **Leverage**
   Leverage can either make you super rich or super broke. Most likely, it will be the latter. As an inexperienced trader, you don't want too much leverage. A good rule of thumb is to not use more than 100:1 leverage for Standard (100k) accounts and 200:1 for Mini (10k) accounts.

OPENING A FOREX TRADING ACCOUNT

Opening a new online trading account with a Forex broker can be done in three simple steps:

1. **Selecting an account type**
2. **Registration**
3. **Activating your account**

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

Account Types

When you're ready to open a live account, you have the choice of opening a Forex trading account under your personal name or a business name. Also, you will have to decide whether or not you want to open a "standard" account or a "mini" account (or "micro" account if available). Inexperienced traders or traders with a small amount of capital to trade should always open a mini account. Only experienced traders with lots of money should open a standard account.

Always read the fine print.

Some brokers have a "managed account" option in their applications. If you want the broker to trade your account for you, pick this, but obviously you're here to learn how to trade the Forex for yourself. Besides, opening a managed account typically requires a pretty big minimum deposit - $25,000 or higher - and the broker also takes a portion of the profits.

Also, make sure you open a **Forex *spot* account** and not a "forwards" or "futures" account.

Registration

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

Account Activation

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

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

But wait a darn minute!!

STOP!

We strongly advise you spend some time reading the GODFATHERS Lessons On Pipsology before you start risking real money.

Why?

Because If You Don't, You Will Lose All Of Your Money!

You're probably thinking, "So if I read through GODFATHERS Lessons On Pipsology first, I will not lose any money?"

No, we're not saying that. You *will* still probably lose money...

But you'll lose **LESS**, much less, *and* probably feel fine that you lost money. Study the GODFATHERS lessons and you'll understand what we mean.

FOREX VERSUS STOCKS

Forex versus Stocks Advantages		
Advantage	Forex	Stocks
24-hour Trading	YES	NO
Commission Free Trading	YES	NO
Instant Execution of Market Orders	YES	NO
Short-Selling without an Uptick	YES	NO

24-Hour Market

The Forex market is a seamless 24-hour market. Most brokers are open from Sunday at 2PM EST until Friday at 4 PM EST with customer service available 24/7. With the ability to trade during the U.S., Asian, and European market hours, you can customize your own trading schedule.

Commission Free Trading

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

Instantaneous Execution of Market Orders

Your trades are instantly executed under normal market conditions. You also have price certainty on every market order under normal market conditions. What you click is the price you get. You're able to execute directly off real-time streaming prices (Yeeeaah!). There's no discrepancy between the displayed price shown on the platform and the

execution price to enter your trade. Keep in mind that most brokers only guarantee stop, limit, and entry orders are only guaranteed under normal market conditions. Fills are instantaneous most of the time, but under extraordinarily volatile market conditions order execution may experience delays.

Short-Selling without an Uptick

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

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

More Reasons to Like Forex

No Middlemen

Centralized exchanges provide many advantages to the trader. However, one of the problems with any centralized exchange is the involvement of middlemen. Any party located in between the trader and the buyer or seller of the security or instrument traded will cost them money. The cost can be either in time or in fees. Spot currency trading does away with the middlemen and allows clients to interact directly with the market-maker responsible for the pricing on a particular currency pair. Forex traders get quicker access and cheaper costs.

Buy/Sell programs do not control the market

How many times have you heard that "fund A" was selling "X" or buying "Z"? Rumor had it that the funds were taking profits because of the end of the financial year or because today is "triple witching day", all as an explanation of why this stock is up or the market in general is down or positive on the session. The stock market is very susceptible to large fund buying and selling.

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

Analysts and brokerage firms are less likely to influence the market

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

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

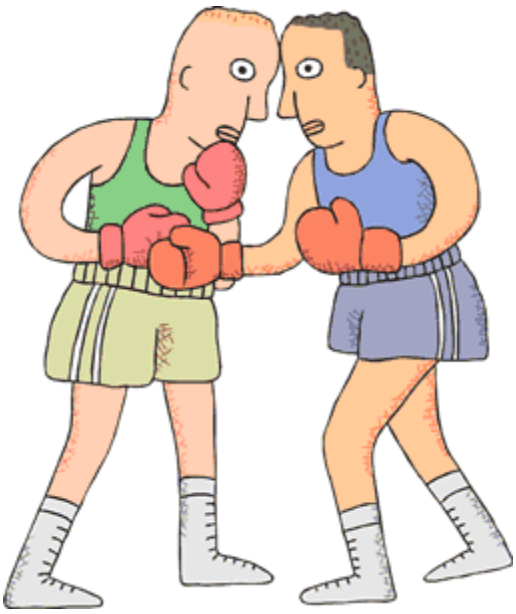
Foreign exchange, as the prime market, generates billions in revenue for the world's banks and is a necessity of the global markets. Analysts in foreign exchange don't drive the deal flow, they just analyze the Forex market.

8,000 stocks versus 4 major currency pairs

There are approximately 4,500 stocks listed on the New York Stock exchange. Another 3,500 are listed on the NASDAQ. Which one will you trade? Got the time to stay on top of so many companies? In spot currency trading, there are dozens of currencies traded, but the majority of the market trades the 4 major pairs. Aren't four pairs much easier to keep an eye on than thousands of stocks? I'd say so.

FOREX VERSUS FUTURES

Forex versus Futures Advantages		
Advantage	Forex	Futures
24-hour Trading	YES	NO
Commission Free Trading*	YES	NO
Up to 400:1 Leverage	YES	NO
Price Certainty	YES	NO
Guaranteed Limited Risk	YES	NO



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

Liquidity

In the spot Forex market, almost $2 trillion is traded daily, making it the largest and most liquid market in the world. This market can absorb trading volume and transaction sizes that dwarf the capacity of any other market. The futures market traders a puny $30 billion per day. Thirty billion?!! Peanuts! The futures markets can't compete with its limited liquidity. The Forex market is always liquid, meaning positions can be liquidated and stop orders executed without slippage except in extremely volatile market conditions.

24-Hour Market

At 2:15 p.m. EST Sunday, trading begins as markets open in Sydney and Singapore. At 7 p.m. EST the Tokyo market opens, followed by London at 2 a.m. EST. And finally, New York opens at 8 a.m. EST and closes at 5 p.m. EST. So, before New York trading closes the Sydney and Singapore markets are back open - it's a 24 hour seamless market! As a trader, this allows you to react to favorable or unfavorable news by trading immediately. If important data comes in from England or Japan while the U.S. futures market is closed, the next day's opening could be a wild ride. (Overnight markets in futures currency contracts

exist, but they are thinly traded, not very liquid, and are difficult for the average investor to access).

Commission Free Trading

You know what's great about trading currencies? You pay NO commissions! Because you deal directly with the market maker via a purely electronic online exchange, you eliminate both ticket costs and middleman brokerage fees. There is still a cost to initiating any trade, but that cost is reflected in the bid/ask spread that is also present in futures or equities trading. Brokers are compensated for their services through the bid-ask spread instead of via commissions.

Price Certainty

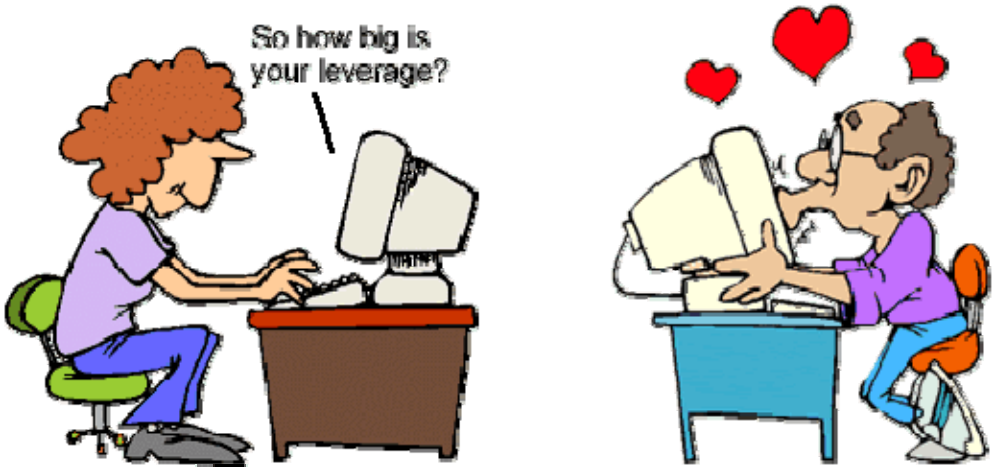
When trading Forex, you get rapid execution and price certainty under normal market conditions. In contrast, the futures and equities markets do not offer price certainty or instant trade execution. Even with the advent of electronic trading and limited guarantees of execution speed, the prices for fills for futures and equities on market orders are far from certain. The prices quoted by brokers often represent the LAST trade, not necessarily the price for which the contract will be filled.

Guaranteed Limited Risk

Traders must have position limits for the purpose of risk management. This number is set relative to the money in a trader's account. Risk is minimized in the spot FX market because the online capabilities of the trading platform will automatically generate a margin call if the required margin amount exceeds the available trading capital in your account. All open positions will be closed immediately, regardless of the size or the nature of positions held within the account. In the futures market, your position may be liquidated at a loss, and you will be liable for any resulting deficit in the account. That sucks.

IMPRESS YOUR DATE WITH YOUR FOREX LINGO

As in any new skill that you learn, you need to learn the lingo...especially if you wish to woo your love's heart. You, the newbie, must know certain terms like the back of your hand before making your first trade. Some of these terms you've already learned, but it never hurts to have a little review.



Major and Minor Currencies

The eight most frequently traded currencies **(USD, EUR, JPY, GBP, CHF, CAD, NZD and AUD)** are called the **major currencies**. All other currencies are referred to as **minor currencies**. Do not worry about the minor currencies, they are for professionals only. Actually, on this site we'll mostly cover what we call the **Fab Five (USD, EUR, JPY, GBP, and CHF).** These pairs are the most liquid and the most sexy.

Base Currency

The **base currency** is the first currency in any currency pair. It shows how much the base currency is worth as measured against the **second currency**. For example, if the USD/CHF rate equals 1.6350, then one USD is worth CHF 1.6350. In the Forex markets, the U.S. dollar is normally considered the "base" currency for quotes, meaning that quotes are expressed as a unit of $1 USD per the other currency quoted in the pair. The primary exceptions to this rule are the British pound, the Euro, and the Australian and New Zealand dollar.

Quote Currency

The **quote currency** is the second currency in any currency pair. This is frequently called the **pip currency** and any unrealized profit or loss is expressed in this currency.

Pip

A **pip** is the smallest unit of price for any currency. Nearly all currency pairs consist of five significant digits and most pairs have the decimal point immediately after the first digit, that is, EUR/USD equals 1.2538. In this instance, a single pip equals the smallest change in

the fourth decimal place - that is, 0.0001. Therefore, if the quote currency in any pair is USD, then one pip always equal 1/100 of a cent.
One notable exception is the USD/JPY pair where a pip equals $0.01.

Bid Price

The **bid** is the price at which the market is prepared to buy a specific currency pair in the Forex market. At this price, the trader can sell the base currency. It is shown on the left side of the quotation.

For example, in the quote GBP/USD 1.8812/15, the **bid price** is 1.8812. This means you sell one British pound for 1.8812 U.S. dollars.

Ask Price

The **ask** is the price at which the market is prepared to sell a specific currency pair in the Forex market. At this price, you can buy the base currency. It is shown on the right side of the quotation.

For example, in the quote EUR/USD 1.2812/15, the **ask price** is 1.2815. This means you can buy one Euro for 1.2815 U.S. dollars. The ask price is also called the **offer price**.

Bid/Ask Spread

The **spread** is the difference between the bid and ask price. The "**big figure quote**" is the dealer expression referring to the first few digits of an exchange rate. These digits are often omitted in dealer quotes. For example, the USD/JPY rate might be 118.30/118.34, but would be quoted verbally without the first three digits as "30/34".

Quote Convention

Exchange rates in the Forex market are expressed using the following format:

Base currency / Quote currency Bid / Ask

Transaction Cost

The critical characteristic of the bid/ask spread is that it is also the **transaction cost** for a round-turn trade. Round-turn means both a buy (or sell) trade and an offsetting sell (or buy) trade of the same size in the same currency pair. For example, in the case of the EUR/USD rate of 1.2812/15, the transaction cost is three pips.

The formula for calculating the transaction cost is:

Transaction cost = Ask Price – Bid Price

Cross Currency

A **cross currency** is any pair in which neither currency is the U.S. dollar. These pairs exhibit erratic price behaviour since the trader has, in effect, initiated two USD trades. For example, initiating a long (buy) EUR/GBP is equivalent to buying a EUR/USD currency pair and selling a GBP/USD. Cross currency pairs frequently carry a higher transaction cost.

Margin

When you open a new **margin** account with a Forex broker, you must deposit a minimum amount with that broker. This minimum varies from broker to broker and can be as low as $100 to as high as $100,000.

Each time you execute a new trade, a certain percentage of the account balance in the margin account will be set aside as the **initial margin requirement** for the new trade based upon the underlying currency pair, its current price, and the number of units (or lots) traded. The lot size always refers to the base currency.

For example, let's say you open a mini account which provides a 200:1 leverage or 0.5% margin. Mini accounts trade mini lots. Let's say one mini lot equals $10,000. If you were to open one mini-lot, instead of having to provide the full $10,000, you would only need $50 ($10,000 x 0.5% = $50).

Leverage

Leverage is the ratio of the amount capital used in a transaction to the required security deposit (margin). It is the ability to control large dollar amounts of a security with a relatively small amount of capital. Leveraging varies dramatically with different brokers, ranging from 2:1 to 400:1.

Margin + Leverage = Possible Deadly Combination

Trading currencies on margin lets you increase your buying power. Meaning that if you have $5,000 cash in a margin account that allows 100:1 leverage, you could purchase up to $500,000 worth of currency because you only have to post one percent of the purchase price as collateral. Another way of saying this is that you have $500,000 in buying power.

With more buying power, you can increase your total return on investment with less cash outlay. But be careful, trading on margin magnifies your profits AND losses.

Margin Call

All traders fear the dreaded **margin call**. This occurs when your broker notifies you that your margin deposits have fallen below the required minimum level because an open position has moved against you.

While trading on margin can be a profitable investment strategy, it is important that you take the time to understand the risks. Make sure you fully understand how your margin

account works, and be sure to read the margin agreement between you and your broker. Always ask any questions if there is anything unclear to you in the agreement.

Your positions could be partially or totally liquidated should the available margin in your account fall below a predetermined threshold. You may not receive a margin call before your positions are liquidated (the ultimate unexpected birthday gift).

Margin calls can be effectively avoided by monitoring your account balance on a very regular basis and by utilizing stop-loss orders (discussed later) on every open position to limit risk.

PROTECT YO SELF BEFORE YOU WRECK YO SELF

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

1. **All Forex traders, and we mean all traders LOSE money on trades.**
   Ninety percent of traders lose money, largely due to lack of planning and training and having poor money management rules. Also, if you hate to lose or are a super perfectionist, you'll probably have a hard time adjusting to trading.
2. **Trading Forex is not for the unemployed, those on low incomes, or who can't afford to pay their electricity bill or afford to eat.**
   You should have at least $10,000 of trading capital (in a mini account) that you can afford to lose. Don't expect to start an account with a few hundred dollars and expect to become a kazillionaire.

The Forex market is one of the most popular markets for speculation, due to its enormous size, liquidity and tendency for currencies to move in strong trends. You would think traders all over the world would make a killing, but success has been limited to very small percentage of traders.

Many traders come with the misguided hope of making a gazillion bucks, but in reality, lack the discipline required for trading. Most people usually lack the discipline to stick to a diet or to go to the gym three times a week. If you can't even do that, how do you think you're going to succeed trading?

Short term trading IS NOT for amateurs, and it is rarely the path to "get rich quick". You can't make gigantic profits without taking gigantic risks. A trading strategy that involves taking a massive degree of risk means suffering inconsistent trading performance and often suffering large loss. A trader who does this probably doesn't even *have* a trading strategy - unless you call gambling a trading strategy!

Forex Trading is not a Get-Rich-Quick Scheme!

Forex trading is a SKILL that takes TIME to learn.

Skilled traders can and do make money in this field. However, like any other occupation or career, success doesn't just happen overnight.

Forex trading isn't a piece of cake (as some people would like you to believe). Think about it, if it was, everyone trading would already be millionaires. The truth is that even expert traders with years of experience still encounter periodic losses.

Drill this in your head: there are NO shortcuts to Forex trading. It takes lots and lots of TIME to master.

There is no substitute for hard work and diligence. Practice trading on a **DEMO ACCOUNT** and pretend the virtual money is your own real money.

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

If you can't wait until you're profitable on a demo account, at least demo trade for 2 months. Hey, at least you were able to hold off losing all your money for two months right? If you can't hold out for 2 months, cut your hands off.

Concentrate on ONE major currency pair.

It gets far too complicated to keep tabs on more than one currency pair when you first start trading. Stick with one of the majors because they are the most liquid which makes their spreads cheap.

MESSAGE FROM THE GODFATHER

You can be a winner at currency trading, but as in all other aspects of life, it will take hard work, dedication, a little luck, a lot of common sense, and a whole lot of good judgment.

TYPES OF TRADING

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

We know what you're thinking...**BORING! SHOW ME HOW TO MAKE MONEY ALREADY!**

Well, say no more my friend; because here is where your journey as a Forex trader begins...

This is your last chance to turn back... Take the red pill, and we take you back to where you were and you will forget all about this. You can go back to living your average life in your 9-5 job and work for someone else for the rest of your life.

OR

You can take the green pill (green for money! Yeah!) And learn how you can make money for yourself in the most active market in the world, simply by using a little brain power. Just remember, your education will never stop. Even after you graduate from BabyPips.com, you must constantly pursue as much knowledge as you can, so that you can become a true FOREX MASTER! Now pop that green pill in, wash it down with some chocolate milk, and grab your lunchbox...School of Pipsology is now in session!

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

Two Types of Trading

There are 2 basic types of analysis you can take when approaching the Forex:

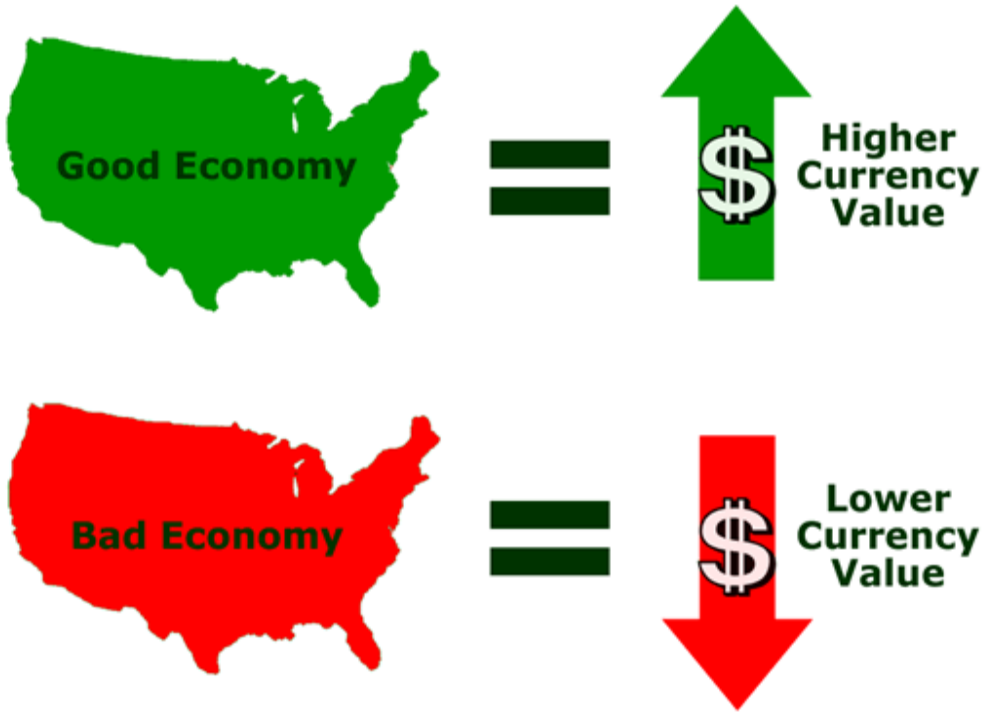
1. Fundamental analysis
2. Technical analysis.

There has always been a constant debate as to which analysis is better, but to tell you the truth, you need to know a little bit of both. So let's break each one down and then come back and put them together.

Fundamental Analysis

Fundamental analysis is a way of looking at the market through economic, social and political forces that affect supply and demand. (Yada yada yada.) In other words, you look at whose economy is doing well, and whose economy sucks. The idea behind this type of analysis is that if a country's economy is doing well, their currency will also be doing well. This is because the better a country's economy, the more trust other countries have in that currency.

For example, the U.S. dollar has been gaining strength because the U.S. economy is gaining strength. As the economy gets better, interest rates get higher to control inflation and as a result, the value of the dollar continues to increase. In a nutshell, that is basically what fundamental analysis is.



Later on in the course you will learn which specific news events drive currency prices the most. For now, just know that the fundamental analysis of the Forex is a way of analyzing a currency through the strength of that country's economy.

Technical Analysis

Technical analysis is the study of price movement. In one word, technical analysis = charts. The idea is that a person can look at historical price movements, and, based on the price action, can determine at some level where the price will go. By looking at charts, you can identify trends and patterns which can help you find good trading opportunities.

The most **IMPORTANT** thing you will ever learn in technical analysis is the trend! Many, many, many, many, many, many people have a saying that goes, "The trend is your friend". The reason for this is that you are much more likely to make money when you can find a trend and trade in the same direction. Technical analysis can help you identify these trends in its earliest stages and therefore provide you with very profitable trading opportunities.

Now I know you're thinking to yourself, "Geez, these guys are smart. They use crazy words like "technical" and "fundamental" analysis. I can never learn this stuff!" Don't worry yourself too much. After you're done with the School of Pipsology, you too will be just as....uhmmm..."smart?" as us.

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

So which type of analysis is better?

Ahh, the million dollar question. Throughout your journey as an aspiring Forex trader you will find strong advocates for both fundamental and technical trading. You will have those who argue that it is the **fundamentals** alone that drive the market and that any patterns found on a chart are simply coincidence. On the other hand, there will be those who argue that it is the **technical's** that traders pay attention to and because traders pay attention to it, common market patterns can be found to help predict future price movements.

Do not be fooled by these one sided extremists! One is not better than the other...

In order to become a true Forex master you will need to know how to effectively use **both** types of analysis. Don't believe me? Let me give you an example of how focusing on only one type of analysis can turn into a disaster.

- Let's say that you're looking at your charts and you find a good trading opportunity. You get all excited thinking about the money that's going to be raining down from the sky. You say to yourself, "Man, I've never seen a more perfect trading opportunity. I love my charts."

- You then proceed to enter your trade with a big fat smile on your face (the kind where all your teeth are showing).

- But wait! All of a sudden the trade makes a 30 pip move in the OTHER DIRECTION! Little did you know that there was an interest rate decrease for your currency and now everyone is trading in the opposite direction.

- Your big fat smile turns into mush and you start getting angry at your charts. You throw your computer on the ground and begin to pulverize it. You just lost a bunch of money, and now your computer is broken. And it's all because you completely ignored fundamental analysis.

(Note: This was ***not*** based on a real story. This did ***not*** happen to me. I was ***never*** this naive. I was ***always*** a smart trader.... From the overused sarcasm, I think you get the picture)

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

The Forex is like a big flowing ball of energy, and within that ball is a balance between fundamental and technical factors that play a part in determining where the market will go.

Remember how your mother or father used to tell you as a kid that too much of anything is never good? Well you might've thought that was just hogwash back then but in the Forex, the same applies when deciding which type of analysis to use. Don't rely on just one. Instead, you must learn to balance the use of both of them, because it is only then that you can really get the most out of your trading.

TYPES OF FOREX CHARTS

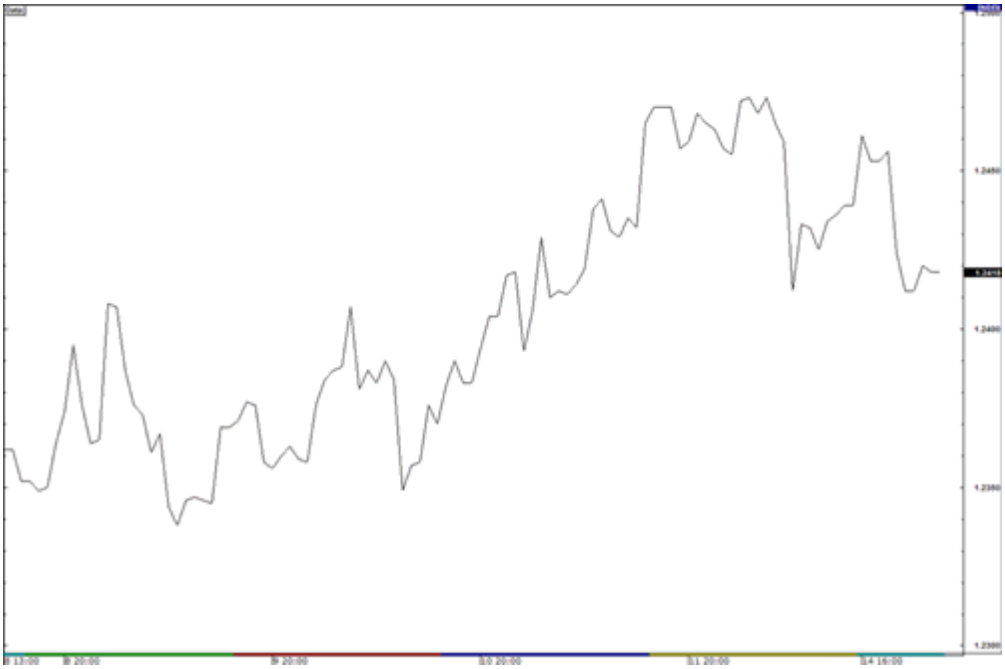
Let's take a look at the three most popular types of charts:

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

Line Charts

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

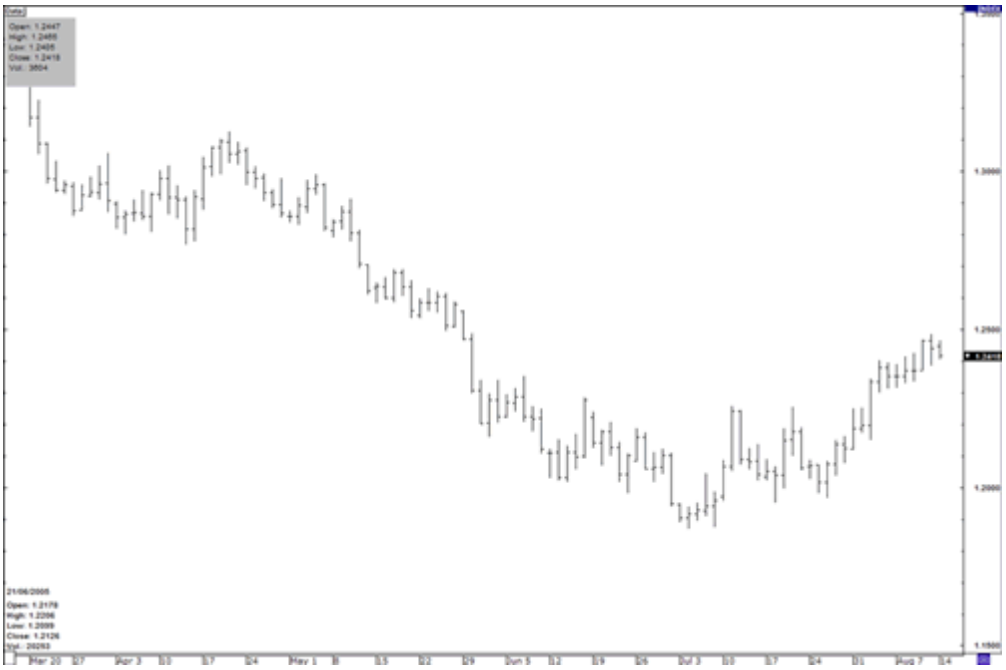
Here is an example of a line chart for EUR/USD:



Bar Charts

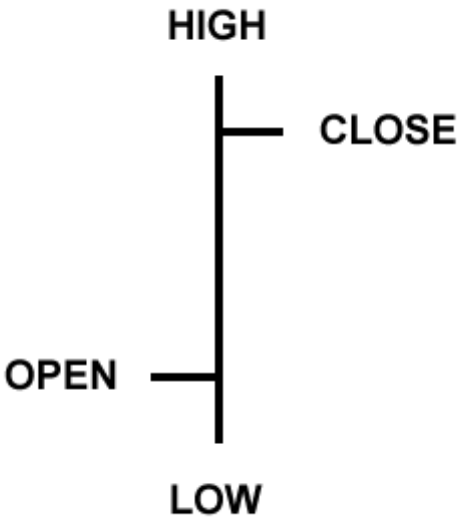
A **bar chart** also shows closing prices, while simultaneously showing opening prices, as well as the highs and lows. The bottom of the vertical bar indicates the lowest traded price for that time period, while the top of the bar indicates the highest price paid. So, the vertical bar indicates the currency pair's trading range as a whole. The horizontal hash on the left side of the bar is the opening price, and the right-side horizontal hash is the closing price.

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



NOTE: Throughout our lessons, you will see the word "bar" in reference to a single piece of data on a chart. A bar is simply one segment of time, whether it is one day, one week, or one hour. When you see the word 'bar' going forward, be sure to understand what time frame it is referencing.

Bar charts are also called "OHLC" charts, because they indicate the **O**pen, the **H**igh, the **L**ow, and the **C**lose for that particular currency. Here's an example of a price bar:



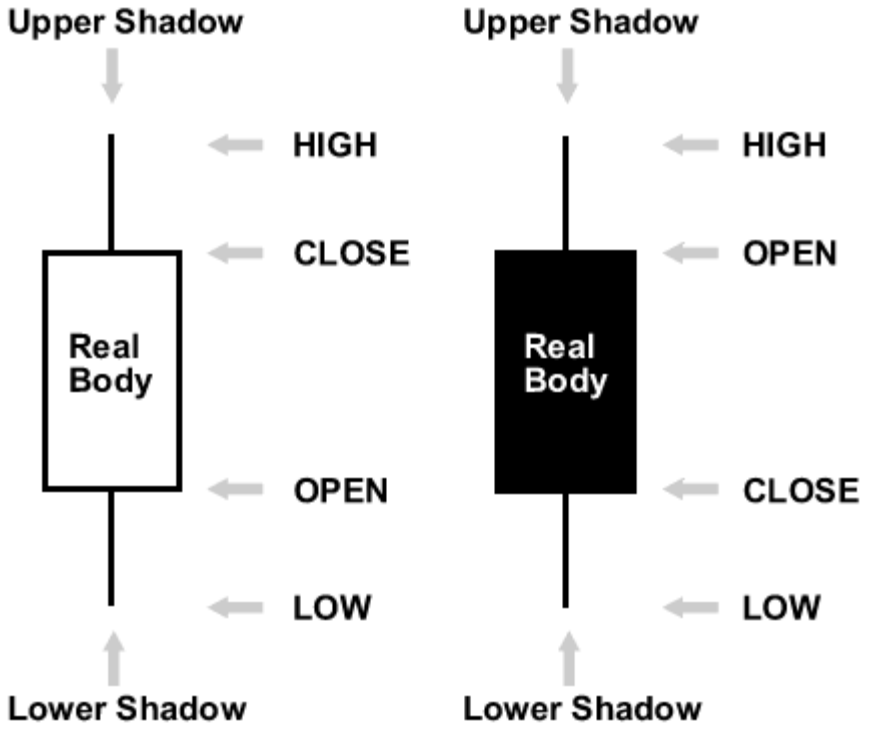
Open: The little horizontal line on the left is the opening price
High: The top of the vertical line defines the highest price of the time period
Low: The bottom of the vertical line defines the lowest price of the time period
Close: The little horizontal line on the right is the closing price

Candlestick Charts

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

Candlestick bars still indicate the high-to-low range with a vertical line. However, in candlestick charting, the larger block in the middle indicates the range between the opening and closing prices. Traditionally, if the block in the middle is filled or colored in, then the currency closed lower than it opened.

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

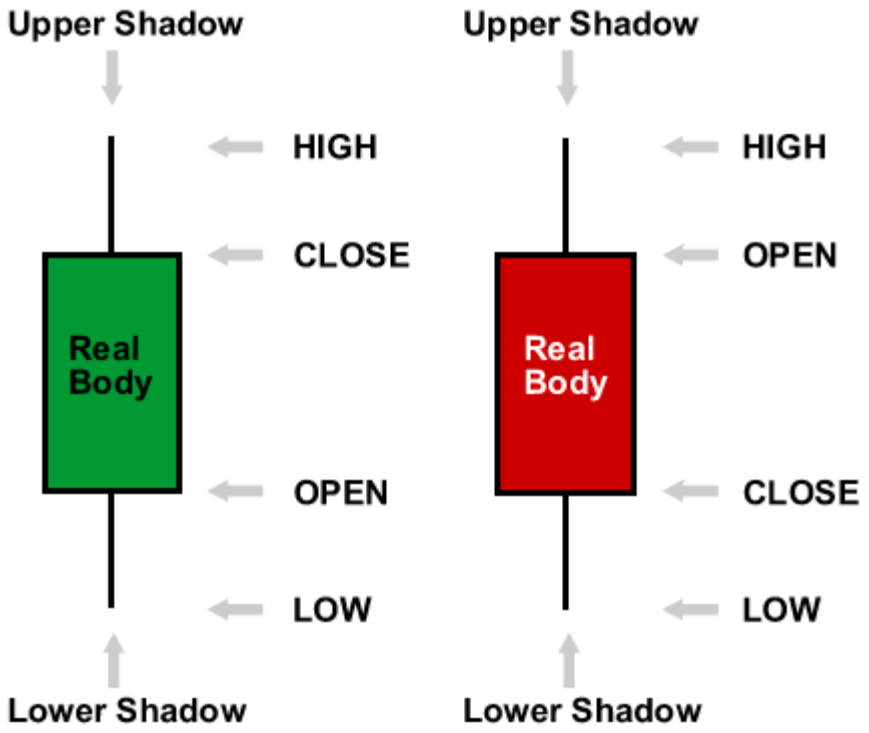


We don't like to use the traditional black and white candlesticks. We feel it's easier to look at a chart that's colour. A colour television is much better than a black and white television, so why not in candlestick charts?

We simply substituted green instead of white, and red instead of black. This means that if the price closed higher than it opened, the candlestick would be green. If the price closed lower than it opened, the candlestick would be red. In our later lessons, you will see how using green and red candles will allow you to "see" things on the charts much faster, such as uptrend/downtrends and possible reversal points.

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

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



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

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

- Candlesticks are easy to interpret, and are a good place for a beginner to start figuring out chart analysis.
- Candlesticks are easy to use. Your eyes adapt almost immediately to the information in the bar notation.
- Candlesticks and candlestick patterns have cool names such as the shooting star, which helps you to remember what the pattern means.
- Candlesticks are good at identifying marketing turning points – reversals from an uptrend to a downtrend or a downtrend to an uptrend. You will learn more about this later.

Now that you know why candlesticks are so cool, it's time to let you know that we will be using candlestick charts for most, if not all of chart examples on this site. Also, make sure you check out our Forex Charts Guide.

Summary of Analysis & Charts

Types of Trading:

- There are 2 types of analysis: Fundamental and Technical
- Fundamental analysis is the analysis of a market through the strength of its economy. (i.e. the dollar gets stronger because the US economy is getting stronger)
- Technical analysis is the analysis of price movements. Technical analysis = charts.
- Technical analysis also helps us identify trends which can help us find profitable trading opportunities.
- To become a successful trader, you must always incorporate both types of analysis.

Types of Charts:

- There are three types of charts:
    1. Line charts
    2. Bar charts
    3. Candlestick charts

We will be using candlesticks from now on

WHAT IS A JAPANESE CANDLESTICK?

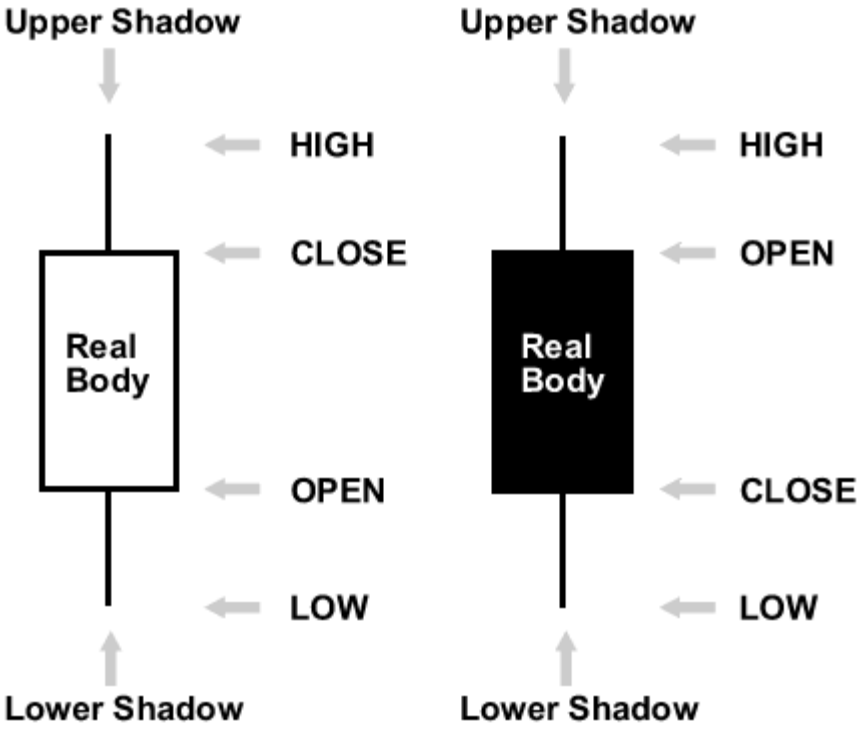
While we briefly covered candlestick charting analysis in the previous lesson, we'll now dig in a little and discuss them more in detail. First let's do a quick review.

- **What is Candlestick Trading?**

Back in the day when Godzilla was still a cute little lizard, the Japanese created their own old school version of technical analysis to trade rice. A westerner by the name of Steve Nison "discovered" this secret technique on how to read charts from a fellow Japanese broker and Japanese candlesticks lived happily ever after. Steve researched, studied, lived, breathed, ate candlesticks, began writing about it and slowly grew in popularity in 90s. To make a long story short, without Steve Nison, candle charts might have remained a buried secret. Steve Nison is Mr. Candlestick.

Okay so what the heck are Forex candlesticks?

The best way to explain is by using a picture:



Candlesticks are formed using the open, high, low and close.

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.
- The hollow or filled section of the candlestick is called the "real body" or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the "high".
- The bottom of the lower shadow is the "low".

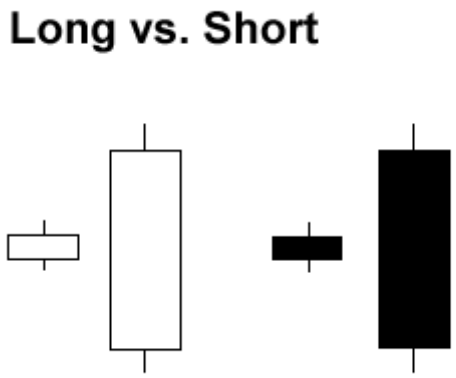
SEXY BODIES AND STRANGE SHADOWS

Sexy Bodies

Just like humans, candlesticks have different body sizes. And when it comes to forex trading, there's nothing naughtier than checking out the bodies of candlesticks!

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure.

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



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

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

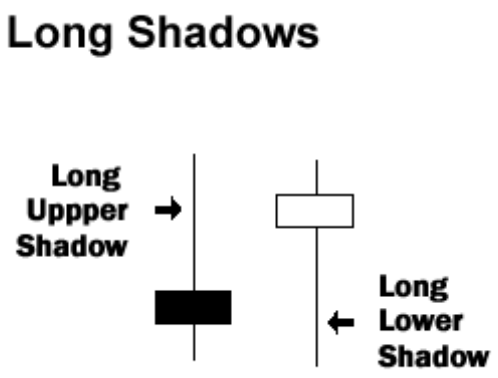
Mysterious Shadows

The upper and lower shadows on candlesticks provide important clues about the trading session.

Upper shadows signify the session high. Lower shadows signify the session low.

Candlesticks with long shadows show that trading action occurred well past the open and close.

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



If a candlestick has a *long upper shadow and short lower shadow*, this means that buyers flexed their muscles and bid prices higher, but for one reason or another, sellers came in and drove prices back down to end the session back near its open price.

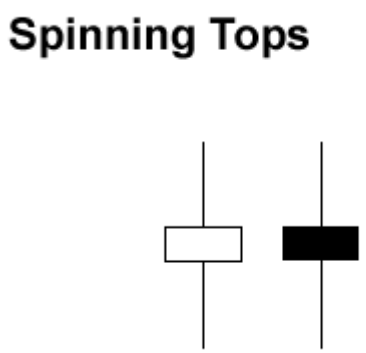
If a candlestick has a *long lower shadow and short upper shadow*, this means that sellers flashed their washboard abs and forced price lower, but for one reason or another, buyers came in and drove prices back up to end the session back near its open price.

BASIC CANDLESTICK PATTERNS

Spinning Tops

Candlesticks with a long upper shadow, long lower shadow and small real bodies are called spinning tops. The color of the real body is not very important.

The pattern indicates the **indecision** between the buyers and sellers



The small real body (whether hollow or filled) shows little movement from open to close, and the shadows indicate that both buyers and sellers were fighting but nobody could gain the upper hand.

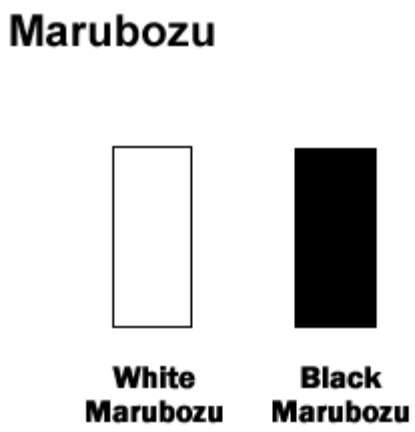
Even though the session opened and closed with little change, prices moved significantly higher and lower in the meantime. Neither buyers nor sellers could gain the upper hand, and the result was a standoff.

If a spinning top forms during an uptrend, this usually means there aren't many buyers left and a possible reversal in direction could occur.

If a spinning top forms during a downtrend, this usually means there aren't many sellers left and a possible reversal in direction could occur.

Marubozu

Sounds like some kind of voodoo magic huh? "I will cast the evil spell of the Marubozu on you!" Fortunately, that's not what it means. Marubozu means there are no shadows from the bodies. Depending on whether the candlestick's body is filled or hollow, the high and low are the same as it's open or close. If you look at the picture below, there are two types of Marubozus.



A **White Marubozu** contains a long white body with no shadows. The **open price equals the low price** and the **close price equals the high price**. This is a very bullish candle as it shows that buyers were in control the whole entire session. It usually becomes the first part of a bullish continuation or a bullish reversal pattern.

A **Black Marubozu** contains a long black body with no shadows. The **open equals the high** and the **close equals the low**. This is a very bearish candle as it shows that sellers controlled the price action the whole entire session. It usually implies bearish continuation or bearish reversal.

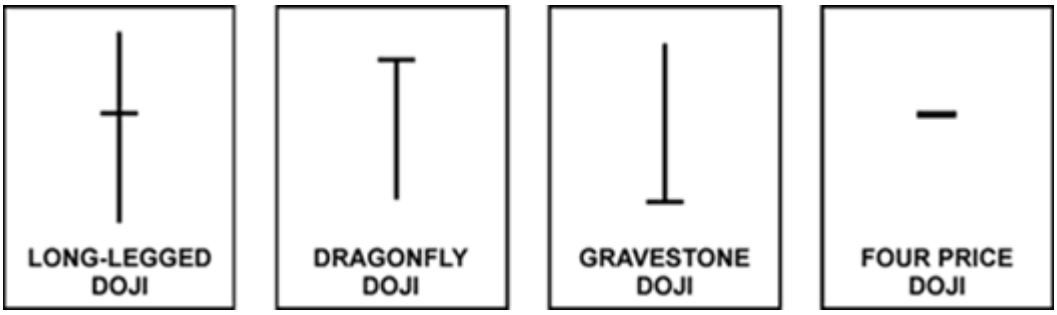
Doji

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

Doji suggest indecision or a struggle for turf positioning between buyers and sellers. Prices move above and below the open price during the session, but close at or very near the open price.

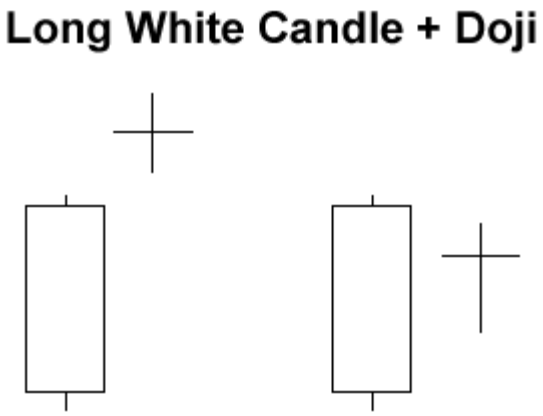
Neither buyers nor sellers were able to gain control and the result was essentially a draw.

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



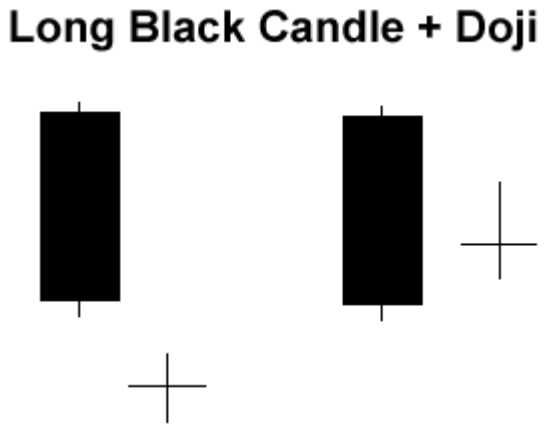
When a doji forms on your chart, pay special attention to the preceding candlesticks.

If a doji forms after a series of candlesticks with long hollow bodies (like white marubozus), the doji signals that the buyers are becoming exhausted and weakening. In order for price to continue rising, more buyers are needed but there aren't anymore! Sellers are licking their chops and are looking to come in and drive the price back down.



Keep in mind that even after a doji forms, this doesn't mean to automatically short. Confirmation is still needed. Wait for a bearish candlestick to close below the long white candlestick's open.

If a doji forms after a series of candlesticks with long filled bodies (like black marubozus), the doji signals that sellers are becoming exhausted and weakening. In order for price to continue falling, more sellers are needed but sellers are all tapped out! Buyers are foaming in the mouth for a chance to get in cheap.



While the decline is sputtering due to lack of new sellers, further buying strength is required to confirm any reversal. Look for a white candlestick to close above the long black candlestick's open.

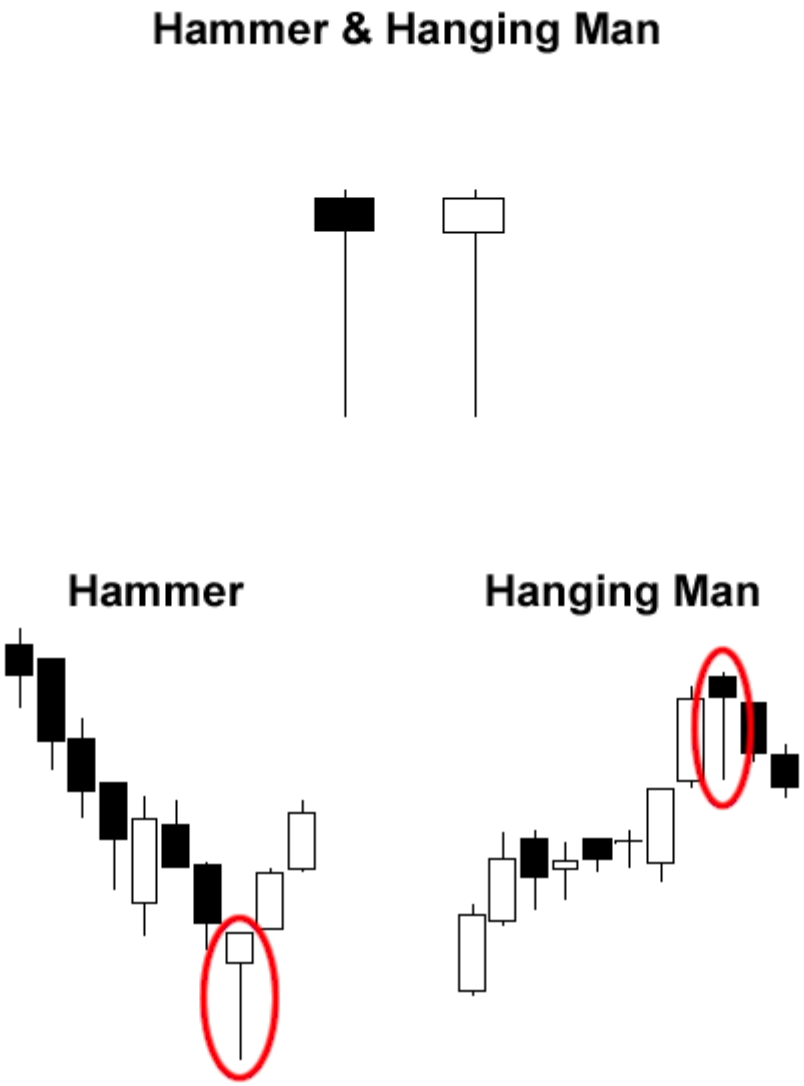
REVERSAL PATTERNS

Prior Trend

For a pattern to qualify as a reversal pattern there should be a prior trend to reverse. Bullish reversals require a preceding downtrend and bearish reversals require a prior uptrend. The direction of the trend can be determined using trend lines, moving averages, or other aspects of technical analysis.

Hammer and Hanging Man

The hammer and hanging man *look* exactly alike but have totally different meaning depending on past price action. Both have cute little bodies (black or white), long lower shadows and short or absent upper shadows.



The **hammer** is a bullish reversal pattern that forms during a downtrend. It is named because the market is hammering out a bottom.

When price is falling, hammers signal that the bottom is near and price will start rising again. The long lower shadow indicates that sellers pushed prices lower, but buyers were able to overcome this selling pressure and closed near the open.

Word to the wise… just because you see a hammer form in a downtrend doesn't mean you automatically place a buy order! More bullish confirmation is needed before it's safe to pull the trigger. A good confirmation example would be to wait for a white candlestick to close above the open of the candlestick on the left side of the hammer.

Recognition Criteria:

- The long shadow is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the real body is not important.

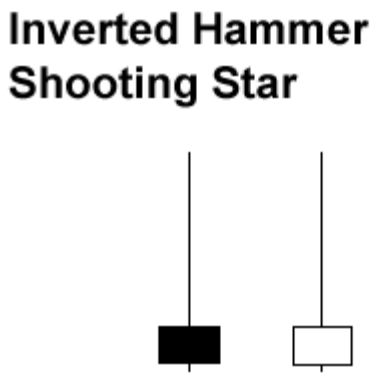
The **hanging man** is a bearish reversal pattern that can also mark a top or strong resistance level. When price is rising, the formation of a hanging man indicates that sellers are beginning to outnumber buyers. The long lower shadow shows that sellers pushed prices lower during the session. Buyers were able to push the price back up some but only near the open. This should set off alarms since this tells us that there are no buyers left to provide the necessary momentum to keep raising the price. .

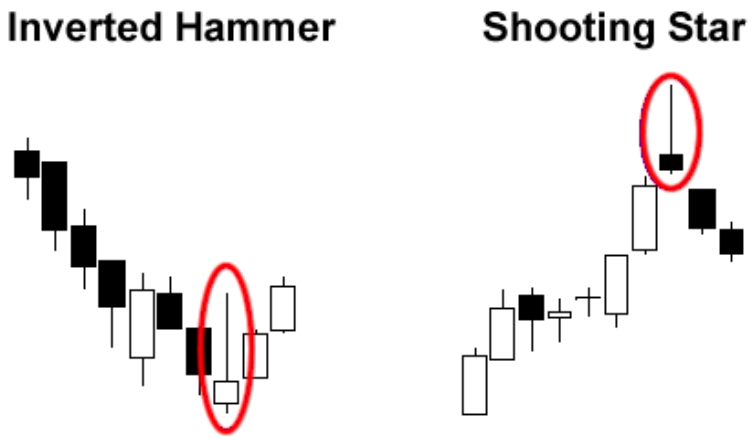
Recognition Criteria:

- A long lower shadow which is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the body is not important, though a black body is more bearish than a white body.

Inverted Hammer and Shooting Star

The inverted hammer and shooting star also look identical. The only difference between them is whether you're in a downtrend or uptrend. Both candlesticks have petite little bodies (filled or hollow), long upper shadows and small or absent lower shadows.





The **inverted hammer** occurs when price has been falling suggests the possibility of a reversal. Its long upper shadow shows that buyers tried to bid the price higher. However, sellers saw what the buyers were doing, said "oh hell no" and attempted to push the price back down. Fortunately, the buyers had eaten enough of their Wheaties for breakfast and still managed to close the session near the open. Since the sellers weren't able to close the price any lower, this is a good indication that everybody who wants to sell has already sold. And if there's no more sellers, who is left? Buyers.

The **shooting star** is a bearish reversal pattern that looks identical to the inverted hammer but occurs when price has been rising. Its shape indicates that the price opened at its low, rallied, but pulled back to the bottom. This means that buyers attempted to push the price up, but sellers came in and overpowered them. A definite bearish sign since there are no more buyers left because they've all been murdered.

Summary of Candlesticks

Candlesticks are formed using the **open, high, low** and **close**.

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.
- The hollow or filled section of the candlestick is called the "real body" or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the "high".
- The bottom of the lower shadow is the "low".

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure.

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

Upper shadows signify the session high.

Lower shadows signify the session low.

Candlesticks with a long upper shadow, long lower shadow and small real bodies are called spinning tops. The pattern indicates the **indecision** between the buyers and sellers

Marubozu means there are no shadows from the bodies. Depending on whether the candlestick's body is filled or hollow, the high and low are the same as it's open or close.

Doji candlesticks have the same open and close price or at least their bodies are extremely short.

The hammer is a bullish reversal pattern that forms during a downtrend. It is named because the market is hammering out a bottom.

The hanging man is a bearish reversal pattern that can also mark a top or strong resistance level.

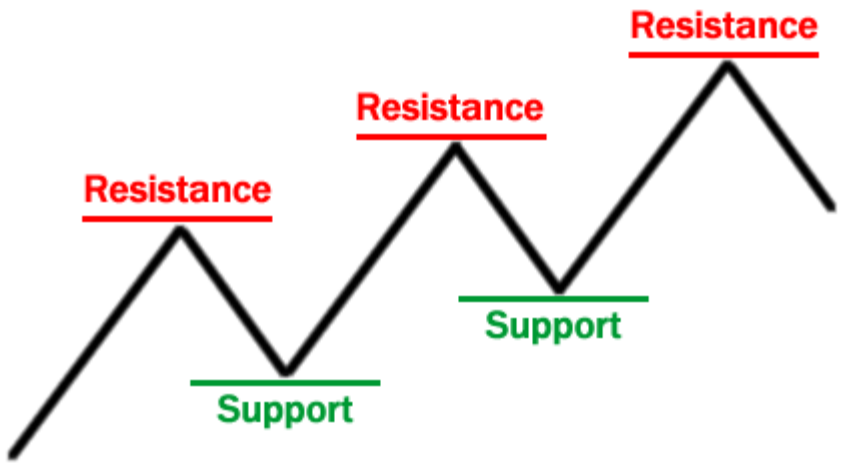
The inverted hammer occurs when price has been falling suggests the possibility of a reversal.

The shooting star is a bearish reversal pattern that looks identical to the inverted hammer but occurs when price has been rising.

SUPPORT AND RESISTANCE

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

Let's just take a look at the basics first.



Look at the diagram above. As you can see, this zigzag pattern is making its way up (bull market). When the market moves up and then pulls back, the highest point reached before it pulled back is now resistance.

As the market continues up again, the lowest point reached before it started back is now support. In this way resistance and support are continually formed as the market oscillates over time. The reverse of course is true of the downtrend

Plotting Support and Resistance

One thing to remember is that support and resistance levels are not exact numbers. Often times you will see a support or resistance level that appears broken, but soon after find out that the market was just testing it. With candlestick charts, these "tests" of support and resistance are usually represented by the candlestick shadows.

Notice how the shadows of the candles tested the 2500 resistance level. At those times it seemed like the market was "breaking" resistance. However, in hindsight we can see that the market was merely testing that level.

So how do we truly know if support or resistance is broken?

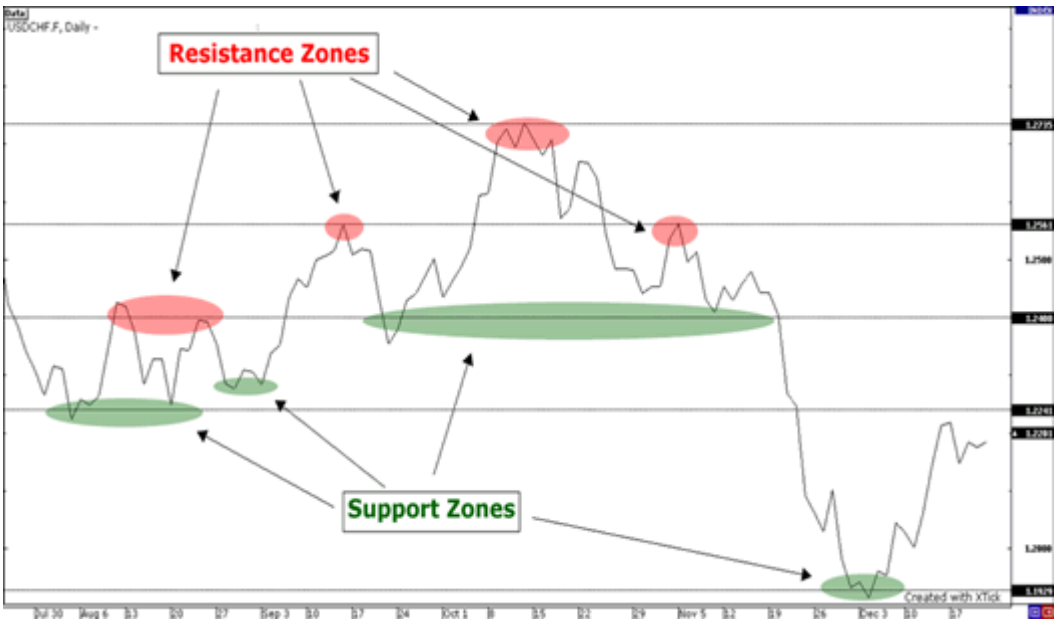
There is no definite answer to this question. Some argue that a support or resistance level is broken if the market can actually close past that level. However, you will find that this is not always the case. Let's take our same example from above and see what happened when the price actually closed past the 2500 resistance level.

In this case, the price had closed twice above the 2500 resistance level but both times ended up falling back down below it. If you had believed that these were real breakouts and bought this pair, you would've been seriously hurtin! Looking at the chart now, you can visually see and come to the conclusion that the resistance was not actually broken; and that it is still very much in tact and now even stronger.

So to help you filter out these false breakouts, you should think of support and resistance more of as "zones" rather than concrete numbers. One way to help you find these zones is to plot support and resistance on a line chart rather than a candlestick chart. The reason is that line charts only show you the closing price while candlesticks add the extreme highs and lows to the picture. These highs and lows can be misleading because often times they are just the "knee-jerk" reactions of the market. It's like when someone is doing something really strange, but when asked about it, they simply reply, "Sorry, it's just a reflex."

When plotting support and resistance, you don't want the reflexes of the market. You only want to plot its intentional movements.

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



Other interesting tidbits about support and resistance:

1. When the market passes through resistance, that resistance now becomes support.
2. The more often price tests a level of resistance or support without breaking it the stronger the area of resistance or support is.

TREND LINES

Trend lines are probably the most common form of technical analysis used today. They are probably one of the most underutilized as well.

If drawn correctly, they can be as accurate as any other method. Unfortunately, most traders don't draw them correctly or they try to make the line fit the market instead of the other way around.

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).

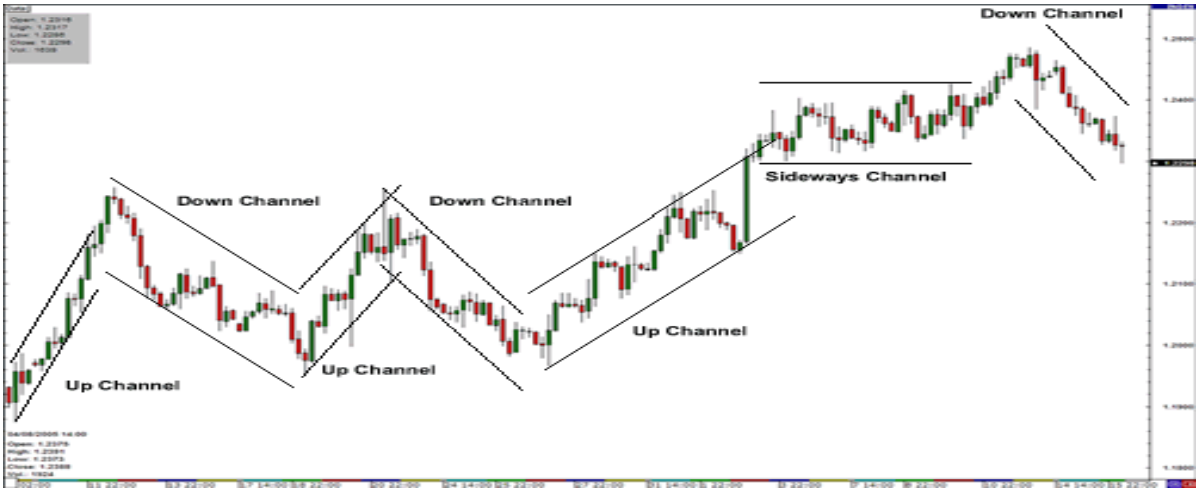
CHANNELS

If we take this trend line theory one step further and draw a parallel line at the same angle of the uptrend or downtrend, we will have created a channel.

To create an up (ascending) channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak. This should be done at the same time you create the trend line.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley. This should be done at the same time you created the trend line.

When prices hit the bottom trend line this may be used as a buying area. When prices hit the upper trend line this may be used as a selling area.



Summary of Support and Resistance

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

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

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).

To create an up (ascending) channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley.

FIBONACCI WHO?

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

Let me first start by introducing you to the Fib man himself…Leonard Fibonacci.

Leonard Fibonacci was a famous Italian mathematician, also called a super duper uber geek, who had an "aha!" moment and discovered a simple series of numbers that created ratios describing the natural proportions of things in the universe

The ratios arise from the following number series: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144 ……

This series of numbers is derived by starting with 1 followed by 2 and then adding 1 + 2 to get 3, the third number. Then, adding 2 + 3 to get 5, the fourth number, and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to that of the next higher number you get .618. For example, 34 divided by 55 equals 0.618.

If you measure the ratio between alternate numbers you get .382. For example, 34 divided by 89 = 0.382 and that's as far as into the explanation as we'll go.

These ratios are called the "golden mean." Okay that's enough mumbo jumbo. Even I'm about to fall asleep with all these numbers. I'll just cut to the chase; these are the ratios you have to know:

Fibonacci Retracement Levels

0.236, 0.382, 0.500, 0.618, 0.764

Fibonacci Extension Levels

0, 0.382, 0.618, 1.000, 1.382, 1.618

You won't really need to know how to calculate all of this. Your charting software will do all the work for you. But it's always good to be familiar with the basic theory behind the indicator so you'll have knowledge to impress your date.

Traders use the Fibonacci retracement levels as **support and resistance levels**. Since so many traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels become a self-fulfilling expectation.

Traders use the Fibonacci extension levels as **profit taking levels**. Again, since so many traders are watching these levels and placing buy and sell orders to take profits, this tool usually works due self-fulfilling expectations.

Most charting software includes both Fibonacci retracement levels and extension level tools. In order to apply Fibonacci levels to your charts, you'll need to identify Swing High and Swing Low points.

A Swing High is a candlestick with at least two lower highs on both the left and right of itself.

A Swing Low is a candlestick with at least two higher lows on both the left and right of itself.

Let's take a closer look at Fibonacci retracement levels...

Fibonacci Retracement

In an uptrend, the general idea is to go long the market on a retracement to a Fibonacci support level. In order to find the retracement levels, you would click on a significant Swing Low and drag the cursor to the most recent Swing High. This will display each of the Retracement Levels showing both the ratio and corresponding price level. Let's take a look at some examples of markets in an uptrend.

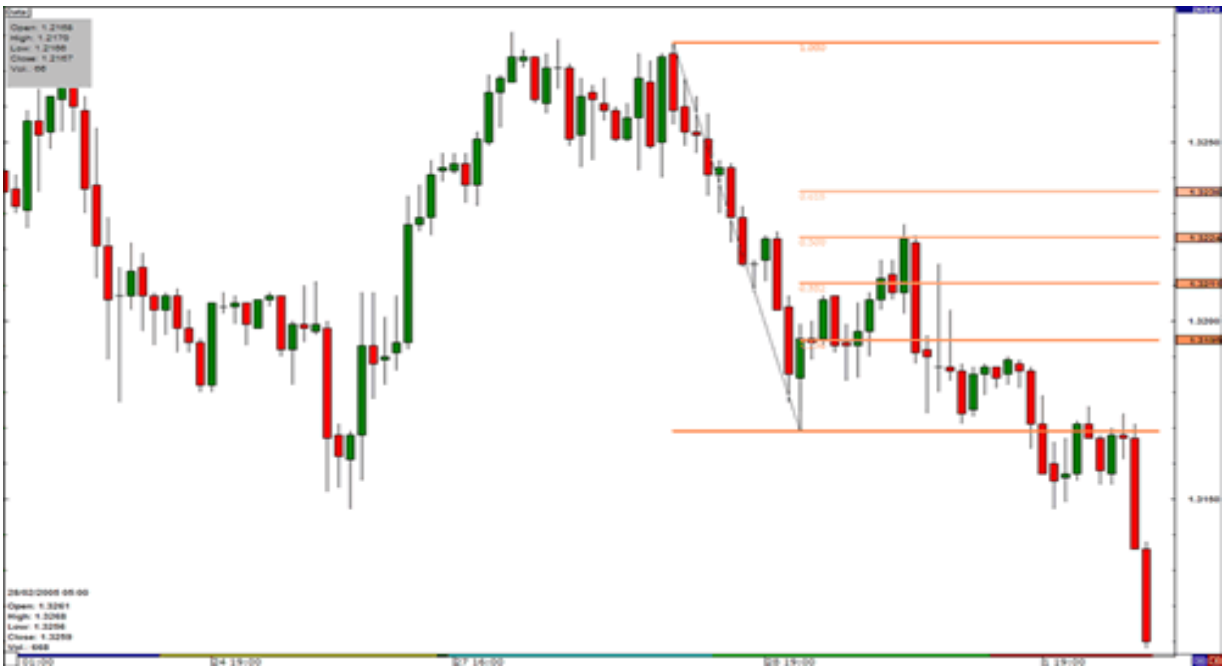
Watch how to draw Fibonacci retracement levels on a chart

This is an hourly chart of **USD/JPY**. Here we plotted the Fibonacci Retracement Levels by clicking on the Swing Low at 110.78 on 07/12/05 and dragging the cursor to the Swing High at 112.27 on 07/13/05. You can see the levels plotted by the software. The Retracement Levels were 111.92 (0.236), 111.70 (0.382), 111.52 (0.500), and 111.35 (0.618). Now the expectation is that if USD/JPY retraces from this high, it will find support at one of the Fibonacci Levels because traders will be placing buy orders at these levels as the market pulls back.

Now let's look at what actually happened after the Swing High occurred. The market pulled back right through the 0.236 level and continued the next day piercing the 0.382 level but never actually closing below it. Later on that day, the market resumed its upward move. Clearly buying at the 0.382 level would have been a good short term trade.

Now let's see how we would use Fibonacci Retracement Levels during a downtrend. This is an hourly chart for EUR/USD. As you can see, we found our Swing High at 1.3278 on 02/28/05 and our Swing Low at 1.3169 a couple hours later. The Retracement Levels were 1.3236 (0.618), 1.3224 (0.500), 1.3211 (0.382), and 1.3195 (.236). The expectation for a downtrend is if it retraces from this high, it will encounter resistance at one of the Fibonacci Levels because traders will be placing sell orders at these levels as the market attempts to rally.

Let's check out what happened next. Now isn't that a thing of beauty! The market did try to rally but it barely past the 0.500 level spiking to a high 1.3227 and it actually closed below it. After that bar, you can see that the rally reversed and the downward move continued. You would have made some nice dough selling at the 0.382 level.



Here's another example. This is an hourly chart for GBP/USD. We had a Swing High of 1.7438 on 07/26/05 and a Swing Low of 1.7336 the next day. So our Retracement Levels are: 1.7399 (0.618), 1.7387 (0.500), 1.7375 (0.382), and 1.7360 (0.236). Looking at the chart, the market looks like it tried to break the 0.500 level on several occasions, but try as it may, it failed. So would putting a sell order at the 0.500 level be a good trade?

If you did, you would have lost some serious cheddar! Take a look at what happened. The Swing Low looked to be the bottom for this downtrend as the market rallied above the Swing High point.

You can see from these examples the market *usually* finds at least temporary support (during an uptrend) or resistance (during a downtrend) at the Fibonacci Retracements Levels. It's apparent that there a few problems to deal with here. There's no way of knowing which level will provide support. The 0.236 seems to provide the weakest support/resistance, while the other levels provide support/resistance at about the same frequency. Even though the charts above show the market usually only retracing to the 0.382 level, it doesn't mean the price will hit that level every time and reverse. Sometimes it'll hit the 0.500 and reverse, other times it'll hit the 0.618 and reverse, and other times the price will totally ignore Mr. Fibonacci and blow past all the levels like similar to the way Allen Iverson blows past his defenders with his nasty first step. Remember, the market will not always resume its uptrend after finding temporary support, but instead continue to decline below the last Swing Low. Same thing for a downtrend. The market may instead decide to continue above the last Swing High.

The placement of stops is a challenge. It's probably best to place stops below the last Swing Low (on an uptrend) or above the Swing High (on a downtrend), but this requires taking a high level of risk in proportion to the likely profit potential in the trade. This is called reward-to-risk ratio. In a later lesson, you will learn more money management and risk control and how you would only take trades with certain reward-to-risk ratios.

Another problem is determining which Swing Low and Swing High points to start from to create the Fibonacci Retracement Levels. People look at charts differently and so will have their own version of where the Swing High and Swing Low points should be. The point is, there is no one right way to do it, but the bad thing is sometimes it becomes a guessing game.

FIBONACCI EXTENSION

The next use of Fibonacci you will be applying is that of targets. Let's start with an example in an uptrend.

In an uptrend, the general idea is to take profits on a long trade at a Fibonacci Price Extension Level. You determine the Fibonacci extension levels by using three mouse clicks. First, click on a significant Swing Low, then drag your cursor and click on the most recent Swing High. Finally, drag your cursor back down and click on the retracement Swing Low. This will display each of the Price Extension Levels showing both the ratio and corresponding price levels.

Watch how to draw Fibonacci extension levels on a chart

On this 1-hour **USD/CHF** chart, we plotted the Fibonacci extension levels by clicking on the Swing Low at 1.2447 on 08/14/05 and dragged the cursor to the Swing High at 1.2593 on 08/15/05 and then down to the retracement Swing Low of 1.2541 on 08/15/05. The following Fibonacci extension levels created are 1.2597 (0.382), 1.2631 (0.618), 1.2687 (1.000), 1.2743 (1.382), 1.2760 (1.500), and 1.2777 (1.618).

Now let's look at what actually happened after the retracement Swing Low occurred.

- The market rallied to the 0.500 level
- fell back to the retracement Swing Low
- then rallied back up to the 0.500 level
- fell back slightly
- rallied to the 0.618 level
- fell back to the 0.382 level which acted as support
- then rallied all the way to the 1.382 level
- consolidated a bit

- then rallied to the 1.500 level

You can see from these examples that the market often finds at least temporary resistance at the Fibonacci extension levels - not always, but often. As in the examples of the retracement levels, it should be apparent that there are a few problems to deal with here as well. First, there is no way of knowing which level will provide resistance. The 0.500 level was a good level to cover any long trades in the above example since the market retraced back to its original level, but if you didn't get back in the trade, you would have left a lot of profits on the table.

Another problem is determining which Swing Low to start from in creating the Fibonacci Extension Levels. One way is from the last Swing Low as we did in the examples; another is from the lowest Swing Low of the past 30 bars. Again, the point is that there is no one right way to do it, and consequently it becomes a guessing game.

Alright, let's see how Fibonacci extension levels can be used during a downtrend. In a downtrend, the general idea is to take profits on a short trade at a Fibonacci price extension level since the market often finds at least temporary support at these levels.

On this 1-hour **EUR/USD** chart, we plotted the Fibonacci extension levels by clicking on the Swing High at 1.21377 on 07/15/05 and dragged the cursor to the Swing Low at 1.2021 on 08/15/15 and then down to the retracement High of 1.2085. The following Fibonacci extension levels created are 1.2041 (0.382), 1.2027 (0.500), 1.2013 (0.618), 1.1969 (1.000), 1.1925 (1.382), 1.1911 (1.500), and 1.1897 (1.618).

Now let's look at what actually happened after the retracement Swing Low occurred.

- The market fell down almost to the 0.382 level which for right now is acting as a support level
- The market then traded sideways between the retracement Swing High level and 0.382 level
- Finally, the market broke through the 0.382 and rested on the 0.500 level
- Then it broke the 0.500 level and fell all the way down to the 1.000 level

Alone, Fibonacci levels will not make you rich. However, Fibonacci levels are definitely useful as part of an effective trading method that includes other analysis and techniques. You see, the key to an effective trading system is to integrate a few indicators (not too many) that are applied in a way that is not obvious to most observers.

All successful traders know it's how you use and integrate the indicators (including Fibonacci) that makes the difference. The lesson learned here is that Fibonacci Levels can be a useful tool, but never enter or exit a trade based on Fibonacci Levels alone.

Summary of Fibonacci Trading

Fibonacci retracement levels are 0.236, 0.382, 0.500, 0.618, 0.764

Traders use the Fibonacci retracement levels as **support and resistance levels**. Since so many traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels become a self-fulfilling expectation.

Fibonacci extension levels are 0, 0.382, 0.618, 1.000, 1.382, 1.618

Traders use the Fibonacci extension levels as **profit taking levels**. Again, since so many traders are watching these levels and placing buy and sell orders to take profits, this tool usually works due self-fulfilling expectations.

In order to apply Fibonacci levels to your charts, you'll need to identify Swing High and Swing Low points.

A Swing High is a candlestick with at least two lower highs on both the left and right of itself.

A Swing Low is a candlestick with at least two higher lows on both the left and right of itself.

PRICE SMOOTHIES

A moving average is simply a way to smooth out price action over time. By "moving average", we mean that you are taking the average closing price of a currency for the last 'X' number of periods.

Like every indicator, a moving average indicator is used to help us forecast future prices. By looking at the slope of the moving average, you can make general predictions as to where the price will go.

As we said, moving averages smooth out price action. There are different types of moving averages, and each of them has their own level of "smoothness". Generally, the smoother the moving average, the slower it is to react to the price movement. The choppier the moving average, the quicker it is to react to the price movement.

We'll explain the pros and cons of each type a little later, but for now let's look at the different types of moving averages and how they are calculated.

SIMPLE MOVING AVERAGE

Simple Moving Average (SMA)

A simple moving average is the simplest type of moving average (DUH!). Basically, a simple moving average is calculated by adding up the last "X" period's closing prices and then dividing that number by X. Confused??? Allow me to clarify.

If you plotted a 5 period simple moving average on a 1 hour chart, you would add up the closing prices for the last 5 hours, and then divide that number by 5. Voila! You have your simple moving average.

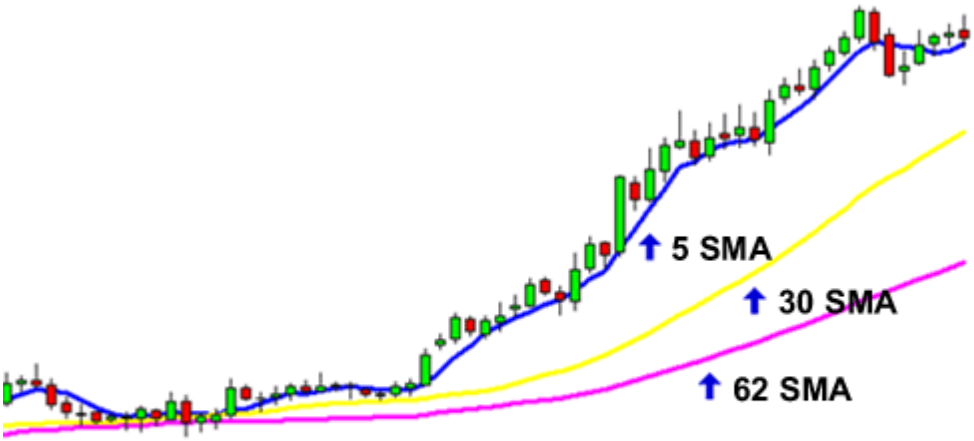
If you were to plot a 5 period simple moving average on a 10 minute chart, you would add up the closing prices of the last **50** minutes and then divide that number by 5.

If you were to plot a 5 period simple moving average on a 30 minute chart, you would add up the closing prices of the last **150** minutes and then divide that number by 5.

If you were to plot the 5 period simple moving average on the a 4 hr. chart.....OK OK, I think you get the picture! Let's move on.

Most charting packages will do all the calculations for you. The reason we just bored you (yawn!) with how to calculate a simple moving average is because it is important that you understand **how** the moving averages are calculated. If you understand how each moving average is calculated, you can make your own decision as to which type is better for you.

Just like any indicator out there, moving averages operate with a delay. Because you are taking the **averages** of the price, you are really only seeing a "forecast" of the future price and not a concrete view of the future. Disclaimer: Moving averages will not turn you into Ms. Cleo the psychic!



Here is an example of how moving averages smooth out the price action.

On the previous chart, you can see 3 different SMAs. As you can see, the longer the SMA period is, the more it lags behind the price. Notice how the 62 SMA is farther away from the current price than the 30 and 5 SMA. This is because with the 62 SMA, you are adding up the closing prices of the last **62** periods and dividing it by 62. The higher the number period you use, the slower it is to react to the price movement.

The SMA's in this chart show you the overall sentiment of the market at this point in time. Instead of just looking at the current price of the market, the moving averages give us a broader view, and we can now make a general prediction of its future price.

EXPONENTIAL MOVING AVERAGE

Exponential Moving Average (EMA)

Although the simple moving average is a great tool, there is one major flaw associated with it. Simple moving averages are very susceptible to spikes. Let me show you an example of what I mean:

Let's say we plot a 5 period SMA on the daily chart of the EUR/USD and the closing prices for the last 5 days are as follows:

Day 1: 1.2345
Day 2: 1.2350
Day 3: 1.2360
Day 4: 1.2365
Day 5: 1.2370

The simple moving average would be calculated as
(1.2345+1.2350+1.2360+1.2365+1.2370)/5= 1.2358

Simple enough right?

Well what if Day 2's price was 1.2300? The result of the simple moving average would be a lot lower and it would give you the notion that the price was actually going down, when in reality, Day 2 could have just been a one time event (maybe interest rates decreasing).

The point I'm trying to make is that sometimes the simple moving average might be *too* simple. If only there was a way that you could filter out these spikes so that you wouldn't get the wrong idea. Hmmmm…I wonder….Wait a minute……Yep, there is a way!

It's called the Exponential Moving Average!

Exponential moving averages (EMA) give more weight to the most recent periods. In our example above, the EMA would put more weight on Days 3-5, which means that the spike on Day 2 would be of lesser value and wouldn't affect the moving average as much. What this does is it puts more emphasis on what traders are doing NOW.

When trading, it is far more important to see what traders are doing now rather than what they did last week or last month.

SMA VS. EMA

Which is better: Simple or Exponential?

First, let's start with an exponential moving average. When you want a moving average that will respond to the price action rather quickly, then a short period EMA is the best way to go. These can help you catch trends very early, which will result in higher profit. In fact, the earlier you catch a trend, the longer you can ride it and rake in those profits!

The downside to the choppy moving average is that you might get faked out. Because the moving average responds so quickly to the price, you might think a trend is forming when in actuality; it could just be a price spike.

With a simple moving average, the opposite is true. When you want a moving average that is smoother and slower to respond to price action, then a longer period SMA is the best way to go.

Although it is slow to respond to the price action, it will save you from many fake outs. The downside is that it might delay you too long, and you might miss out on a good trade.

	SMA	EMA
Pros:	Displays a smooth chart, which eliminates most fakeouts.	Quick moving, and is good at showing recent price swings.
Cons:	Slow moving, which may cause a lag in buying and selling signals.	More prone to cause fakeouts and give errant signals.

So which one is better? It's really up to you to decide. Many traders plot several different moving averages to give them both sides of the story. They might use a longer period simple moving average to find out what the overall trend is, and then use a shorter period exponential moving average to find a good time to enter a trade.

In fact, many trading systems are built around what is called "Moving Average Crossovers". Later in this course, we will give you an example of how you can use moving averages as part of your trading system.

Time for recess! Go find a chart and start playing with some moving averages. Try out different types and look at different periods. In time, you will find out which moving averages work best for you. Class dismissed!

Summary

- A moving average is a way to smooth out price action.
- There are many types of moving averages. The 2 most common types are: Simple Moving Average and Exponential Moving Average.
- Simple moving averages are the simplest form of moving averages, but they are susceptible to spikes.
- Exponential moving averages put more weight to recent prices and therefore show us what traders are doing now.
- It is much more important to know what traders are doing now than to see what they did last week or last month.
- Simple moving averages are smoother than Exponential moving averages.
- Longer period moving averages are smoother than shorter period moving averages.
- Choppy moving averages are quicker to respond to price action and can catch trends early. However, because of their quick reaction, they are susceptible to spikes and can fake you out.
- Smooth moving averages are slower to respond to price action but will save you from spikes and fake outs. However, because of their slow reaction, they can delay you from taking a trade and may cause you to miss some good opportunities.
- The best way to use moving averages is to plot different types on a chart so that you can see both long term movement and short term movement.

BOLLINGER BANDS

Congratulations on making it to the 5th grade! Each time you make it to the next grade you continue to add more and more tools to your trader's toolbox. "What's a trader's toolbox?" you say... Simple! Your trader's toolbox is what you will use to "build" your trading account. The more tools (education) you have in your trader's toolbox (YOUR BRAIN), the easier it will be for you to build.

So for this lesson, as you learn each of these indicators, think of them as a new tool that you can add to that toolbox of yours. You might not necessarily use all of these tools, but it's always nice to have the option, right? Now, enough about tools already! Let's get started!

Bollinger Bands

Bollinger bands are used to measure a market's volatility. Basically, this little tool tells us whether the market is quiet or whether the market is LOUD! When the market is quiet, the bands contract; and when the market is LOUD, the bands expand. Notice on the chart below that when the price was quiet, the bands were close together, but when the price moved up, the bands spread apart.

That's all there is to it. Yes, we could go on and bore you by going into the history of the Bollinger band, how it is calculated, the mathematical formulas behind it, and so on and so forth, but we really didn't feel like typing it all out.

In all honesty, you don't need to know any of that junk. We think it's more important that we show you some ways you can apply the Bollinger bands to your trading.

Note: If you really want to learn about the calculations of a Bollinger band, then you can go to **www.bollingerbands.com**

The Bollinger Bounce

One thing you should know about Bollinger Bands is that price tends to return to the middle of the bands. That is the whole idea behind the Bollinger bounce (smart, huh?). If this is the case, then by looking at the chart below, can you tell us where the price might go next?

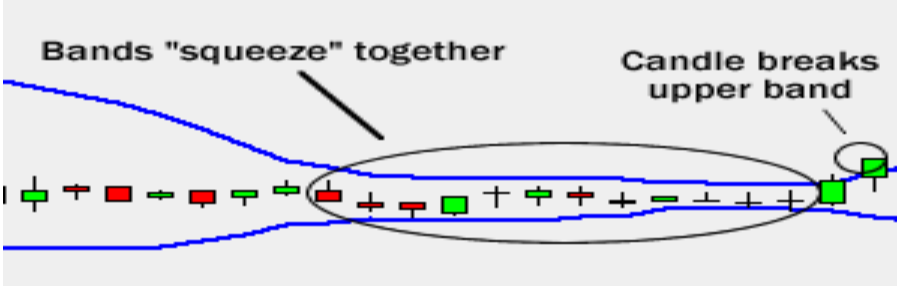
If you said down, then you are correct! As you can see, the price settled back down towards the middle area of the bands.

That's all there is to it. What you just saw was a classic Bollinger bounce. The reason these bounces occur is because Bollinger Bands act like mini support and resistance levels. The longer the time frame you are in, the stronger these bands are. Many traders have developed systems that thrive on these bounces, and this strategy is best used when the market is ranging and there is no clear trend.

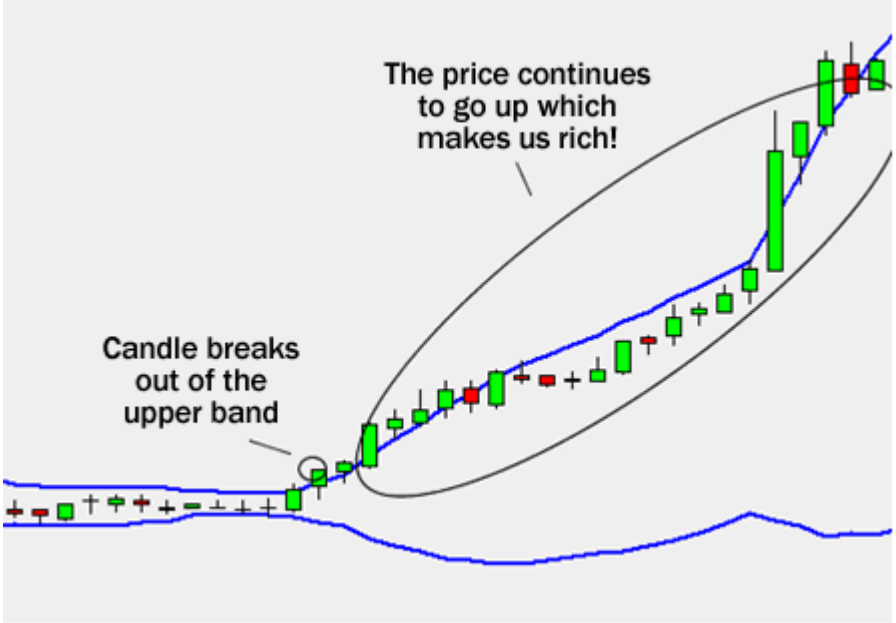
Now let's look at a way to use Bollinger Bands when the market **does** trend.

Bollinger Squeeze

The Bollinger squeeze is pretty self explanatory. When the bands "squeeze" together, it usually means that a breakout is going to occur. If the candles start to break out above the top band, then the move will usually continue to go up. If the candles start to break out below the lower band, then the move will usually continue to go down.



Looking at the chart above, you can see the bands squeezing together. The price has just started to break out of the top band. Based on this information, where do you think the price will go?



If you said up, you are correct! This is how a typical Bollinger Squeeze works. This strategy is designed for you to catch a move as early as possible. Setups like these don't occur everyday, but you can probably spot them a few times a week if you are looking at a 15 minute chart.

So now you know what Bollinger Bands are, and you know how to use them. There are many other things you can do with Bollinger Bands, but these are the 2 most common strategies associated with them. So now you can put this in your trader's toolbox, and we can move on to the next indicator.

MACD

MACD is an acronym for **M**oving **A**verage **C**onvergence **D**ivergence. This tool is used to identify moving averages that are indicating a new trend, whether it's bullish or bearish. After all, our #1 priority in trading is being able to find a trend, because that is where the most money is made.

With an MACD chart, you will usually see three numbers that are used for its settings.

- The first is the number of periods that is used to calculate the faster moving average.
- The second is the number of periods that are used in the slower moving average.
- And the third is the number of bars that is used to calculate the moving average of the difference between the faster and slower moving averages.

For example, if you were to see "12,26,9" as the MACD parameters (which is usually the default setting for most charting packages), this is how you would interpret it:

- The 12 represents the previous 12 bars of the faster moving average.
- The 26 represents the previous 26 bars of the slower moving average.
- The 9 represents the previous 9 bars of the difference between the two moving averages. This is plotted by vertical lines called a histogram (The blue lines in the chart above).

There is a common misconception when it comes to the lines of the MACD. The two lines that are drawn are NOT moving averages of the price. Instead, they are the moving averages of the DIFFERENCE between two moving averages.

In our example above, the faster moving average is the moving average of the difference between the 12 and 26 period moving averages. The slower moving average plots the average of the previous MACD line. Once again, from our example above, this would be a 9 period moving average.

This means that we are taking the average of the last 9 periods of the faster MACD line, and plotting it as our "slower" moving average. What this does is it smoothes out the original line even more, which gives us a more accurate line.

The histogram simply plots the difference between the fast and slow moving average. If you look at our original chart, you can see that as the two moving averages separate, the histogram gets bigger. This is called divergence, because the faster moving average is "diverging" or moving away from the slower moving average.

As the moving averages get closer to each other, the histogram gets smaller. This is called convergence because the faster moving average is "converging" or getting closer to the slower moving average. And that, my friend, is how you get the name, **M**oving **A**verage **C**onvergence **D**ivergence! Whew, we need to crack our knuckles after that one!

Ok, so now you know what **MACD** does. Now I'll show you what **MACD** can do for **YOU.**

MACD Crossover

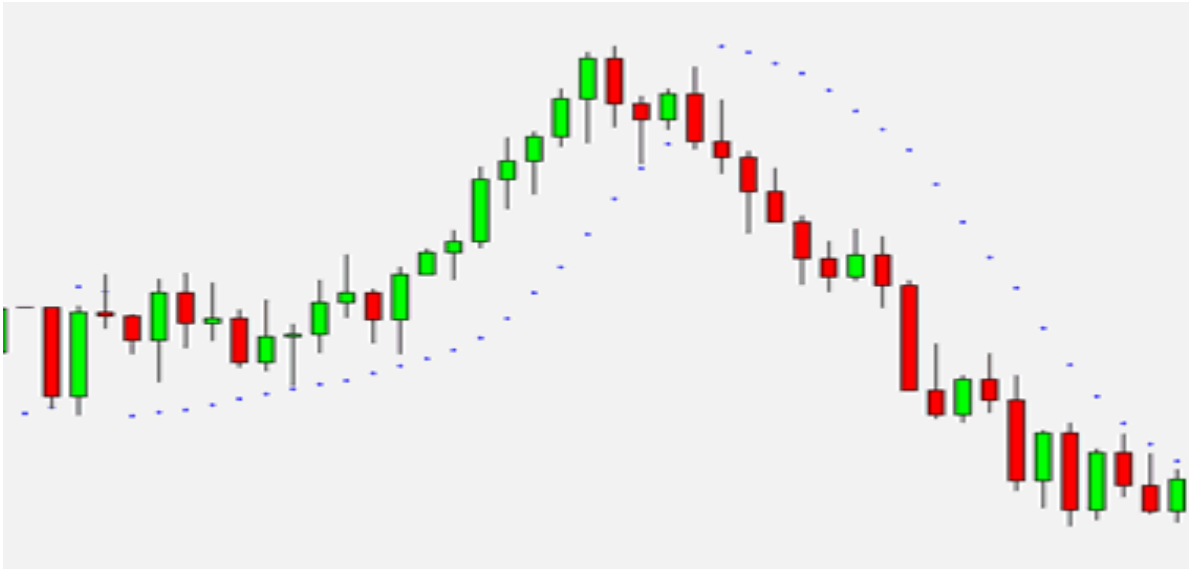
Because there are two moving averages with different "speeds", the faster one will obviously be quicker to react to price movement than the slower one. When a new trend occurs, the fast line will react first and eventually cross the slower line. When this "crossover" occurs, and the fast line starts to "diverge" or move away from the slower line, it often indicates that a new trend has formed.

From the chart above, you can see that the fast line crossed under the slow line and correctly identified a new downtrend. Notice that when the lines crossed, the histogram temporarily disappears. This is because the difference between the lines at the time of the cross is 0. As the downtrend begins and the fast line diverges away from the slow line, the histogram gets bigger, which is good indication of a strong trend.

There is one drawback to MACD. Naturally, moving averages tend to lag behind price. After all, it's just an average of historical prices. Since the MACD represents moving averages of **other** moving averages and is smoothed out by another moving average, you can imagine that there is quite a bit of lag. However, it is still one of the most favored tools by many traders.

PARABOLIC SAR

Up until now, we've looked at indicators that mainly focus on catching the beginning of new trends. And although it is important to be able to identify new trends, it is equally important to be able to identify where a trend ends. After all, what good is a well-timed entry without a well-timed exit?



One indicator that can help us determine where a trend might be ending is the Parabolic SAR (**S**top **A**nd **R**eversal). A Parabolic SAR places dots, or points, on a chart that indicate potential reversals in price movement. From the chart above, you can see that the dots shift from being below the candles during the uptrend, to above the candles when the trend reverses into a downtrend.

Using Parabolic SAR

The nice thing about the Parabolic SAR is that it is really simple to use. Basically, when the dots are below the candles, it is a buy signal; and when the dots are above the candles, it is a sell signal. This is probably the easiest indicator to interpret because it assumes that the price is either going up or down. With that said, this tool is best used in markets that are trending, and that have long rallies and downturns. You DON'T want to use this tool in a choppy market where the price movement is sideways.

STOCHASTICS

Stochastics

Stochastics are another indicator that helps us determine where a trend might be ending. By definition, a stochastic is an oscillator that measures overbought and oversold conditions in the market. The 2 lines are similar to the MACD lines in the sense that one line is faster than the other.

How to Apply Stochastics

Like I said earlier, stochastics tells us when the market is overbought or oversold. Stochastics are scaled from 0 to 100. When the stochastic lines are above 70 (the red dotted line in the chart above), then it means the market is overbought. When the stochastic lines are below 30 (the blue dotted line), then it means that the market is oversold. As a rule of thumb, we buy when the market is oversold, and we sell when the market is overbought.

Looking at the chart above, you can see that the stochastics has been showing overbought conditions for quite some time. Based upon this information, can you guess where the price might go?

If you said the price would drop, then you are absolutely correct! Because the market was overbought for such a long period of time, a reversal was bound to happen.

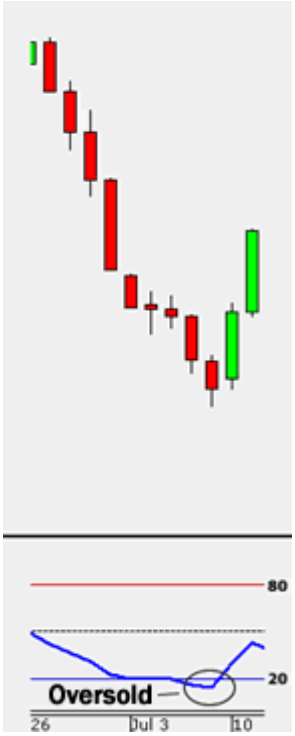
That is the basics of stochastics. Many traders use stochastics in different ways, but the main purpose of the indicator is to show us where the market is overbought and oversold. Over time, you will learn to use stochastics to fit your own personal trading style. Okay, let's move on to RSI.

RELATIVE STRENGTH INDEX

Relative Strength Index, or RSI, is similar to stochastics in that it identifies overbought and oversold conditions in the market. It is also scaled from 0 to 100. Typically, readings below 20 indicate oversold, while readings over 80 indicate overbought.

Using RSI

RSI can be used just like stochastics. From the chart above you can see that when RSI dropped below 20, it correctly identified an oversold market. After the drop, the price quickly shot back up.



RSI is a very popular tool because it can also be used to confirm trend formations. If you think a trend is forming, take a quick look at the RSI and look at whether it is above or below 50. If you are looking at a possible uptrend, then make sure the RSI is above 50. If you are looking at a possible downtrend, then make sure the RSI is below 50.

In the beginning of the chart above, we can see that a possible uptrend was forming. To avoid fakeouts, we can wait for RSI to cross above 50 to confirm our trend. Sure enough, as RSI passes above 50, it is a good confirmation that an uptrend has actually formed. Okey dokey, we've covered a smorgasbord of indicators, let's see how we can put all of what you just learned together...

PUTTING IT ALL TOGETHER

In a perfect world, we could take just one of these indicators and trade strictly by what that indicator told us. The problem is that we DON'T live in a perfect world, and each of these indicators has imperfections. That is why many traders combine different indicators together so that they can "screen" each other. They might have 3 different indicators and they won't trade unless all 3 indicators give them the same answer.

As you continue your journey as a trader, you will discover what indicators work best for you. We can tell you that we like using MACD, Stochastics, and RSI, but you might have a different preference. Every trader out there has tried to find the "magic combination" of indicators that will always give them the right signals, but the truth is that there is no such thing.

We urge you to study each indicator on its own until you know EXACTLY how it reacts to price movement, and then come up with your own combination that fits **your** trading style. Later on in the course, we will show you a system that combines different indicators to give you an idea of how they can compliment each other.

Summary of Chart Indicators

Everything you learn about trading is like a tool that is being added to your trader's toolbox. Your tools will make it easier for you to "build" your trading account.

Bollinger Bands

- Used to measure the market's volatility
- They act like mini support and resistance levels
- **Bollinger Bounce**
    - A strategy that relies on the notion that price tends to always return to the middle of the Bollinger Bands
    - You buy when the price hits the lower Bollinger band
    - You sell when the price hits the upper Bollinger band
    - Best used in ranging markets
- **Bollinger Squeeze**
    - A strategy that is used to catch breakouts early
    - When the Bollinger bands "squeeze" the price, it means that the market is very quiet, and a breakout is eminent. Once a breakout occurs, we enter a trade on whatever side the price made its breakout.

MACD

- Used to catch trends early and can also help us spot trend reversals
- It consists of 2 moving averages (1 fast, 1 slow) and vertical lines called a histogram, which measures the distance between the 2 moving averages.

- Contrary to what many people think, the moving average lines are NOT moving averages of the price. They are moving averages of other moving averages.
- MACD's downfall is its lag because it uses so many moving averages.
- One way to use MACD is to wait for the fast line to "cross over" or "cross under" the slow line and enter the trade accordingly because it signals a new trend.

Parabolic SAR

- This indicator is made to spot trend reversals; hence the name Parabolic **S**top **A**nd **R**eversal (SAR)
- This is the easiest indicator to interpret because it only gives bullish and bearish signals.
- When the dots are above the candles, it is a sell signal.
- When the dots are below the candles, it is a buy signal.
- These are best used in trending markets that consist of long rallies and downturns.

Stochastics

- Used to indicate overbought and oversold conditions
- When the moving average lines are above 70, it means that the market is overbought and we should look to sell.
- When the moving average lines are below 30, it means that the market is oversold and we should look to buy.

Relative Strength Index (RSI)

- Similar to stochastics in that it indicates overbought and oversold conditions.
- When RSI is above 80, it means that the market is overbought and we should look to sell.
- When RSI is below 20, it means that the market is oversold and we should look to buy.
- RSI can also be used to confirm trend formations. If you think a trend is forming, wait for RSI to go above or below 50 (depending on if you're looking at an uptrend or downtrend) before you enter a trade.

Each indicator has its imperfections. This is why traders combine many different indicators to "screen" each other. As you progress through your trading career, you will learn which indicators you like the best and can combine them in a way that fits **your** trading style.

MESSAGE FROM THE GODFATHER

We know this has been a very looooooooooooonnnnng lesson, and we do encourage you to go back and read over anything you haven't fully understood yet. Sometimes it just takes a couple times of reading before you truly grasp something.

Once you understand the concepts of these indicators, go to a chart and start playing with them. Really study how each indicator reacts to the price movement.

When you fully understand an indicator, then it will become another tool for your trader's toolbox. For now you should just take a break. Grab some coffee or get something to eat. We know your eyes are hurting! Let this lesson soak in, and then come back when you're refreshed!

Extra Credit!

Use Bollinger Bands as S&R Levels and Trade Breakouts
Learn this simple technique to trade breakouts by using Bollinger Bands as dynamic support and resistance levels.

Watch the bollinger band breakout movie.

LEADING VS. LAGGING INDICATORS

We've covered a lot of tools that can help you analyze charts and identify trends. In fact, you may now have too much information to use effectively.

In this lesson, we're going to look at streamlining your use of these chart indicators. We want you to fully understand the strengths and weaknesses of each tool, so you'll be able to determine which ones work for you and your trading plan… and which ones don't.

Leading versus Lagging Indicators

Let's discuss some concepts first. There are two types of indicators: **leading** and **lagging**.

A leading indicator gives a buy signal **before** the new trend or reversal occurs.

A lagging indicator gives a signal after the trend has started and basically informs you "hey buddy, pay attention, the trend has started, you're missing the boat."

You're probably thinking, "Ooooh, I'm going to get rich with leading indicators!" since you would be able to profit from a new trend right at the start. You're right – you would "catch" the entire trend every single time, IF the leading indicator was correct every single time. But it's not.

When you use leading indicators, you will experience a lot of fake-outs. Leading indicators are notorious for giving bogus signals which will "mislead" you. Get it? Leading indicators that "mislead" you? Ha-ha. Man we're so funny we even crack ourselves up.

The other option is to use lagging indicators, which aren't as prone to bogus signals. Lagging indicators only give signals after the price change is clearly forming a trend. The downside is that you'd be a little late in entering a position. Often the biggest gains of a trend occur in the first few bars, so by using a lagging indicator you could potentially miss out on much of the profit. Which sucks.

Oscillators and Trend Following Indicators

For the purpose of this lesson, let's broadly categorize all of our technical indicators into one of two categories:

1. Oscillators
2. Trend following or momentum indicators

Oscillators are leading indicators.

Momentum indicators are lagging indicators.

While the two can be supportive of each other, they're more likely to conflict with each other. We're not saying that one or the other should be used exclusively, but you must understand the potential pitfalls of each.

OSCILLATORS / LEADING INDICATORS

An oscillator is any object or data that moves back and forth between two points. In other words, it's an item that is going to always fall somewhere between point A and point B. Think of when you hit the oscillating switch on your electric fan.

Think of our technical indicators as either being "on" or "off". More specifically, an oscillator will usually signal "buy" or "sell", with the only exception being instances when the oscillator is not clearly at either end of the buy/sell range.

Does this sound familiar? It should! Stochastics, Parabolic SAR, and the Relative Strength Index (RSI) are all oscillators. Each of these indicators is designed to signal a possible reversal, where the previous trend has run its course and the price is ready to change direction.

Let's take a look at a few examples.

On the 1-hour chart of USD/EUR below, we have added a Parabolic SAR indicator, as well as an RSI and Stochastic oscillator. As you have already learned, when the Stochastic and RSI begin to leave their "oversold" region that is a buy signal.

Here we get buy signals between the hours 3:00 am EST and 7:00 am EST on 08/24/05. All three of these buy signals occurred within one or two hours of each other, and this would have been a good trade.

We also got a sell signal from all three indicators between the hours of 2:00 am EST and 5:00 am EST on 08/25/05. As you can see, the Stochastic indicator remained in the overbought for a pretty long time - about 20 hours. Usually when an oscillator remains in the overbought or oversold levels for a long period of time, that means there is a strong trend occurring. In this example, since Stochastic stayed overbought, you see there was a strong uptrend present.

Now let's take a look at the same leading oscillators messing up, just so you know these signals aren't perfect. Looking at the chart below, you can quickly see that there were a lot of false buy signals popping up. You'll see how one indicator says to buy, while the other one is still saying sell.

Around 1 am EST on 08/16/05, both RSI and Stochastic gave buy signals, while Parabolic SAR still showed a sell signal. Yes, Parabolic SAR gave a buy signal 3 hours later at 4 am EST, but then Parabolic SAR turned into a sell signal one bar later. If you actually look at the bar with the Parabolic SAR below it, notice how it's a strong looking red bar with very short shadows. Also, notice how the next bar closed below it. This would not have been a good long trade.

On the last two oversold (buy) signals given by Stochastic, notice how there is no indicator at all for RSI, but Parabolic SAR is giving sell signals. What's going on here? They are each giving you different signals!

What happened to such a good set of indicators?

The answer lies in the method of calculation for each one. Stochastic is based on the high-to-low range of the time period (in this case, it's hourly), yet doesn't account for changes from one hour to the next. The Relative Strength Index (RSI) uses change from one closing price to the next. And Parabolic SAR has its own unique calculations that can further cause conflict.

That's the nature of oscillators – they assume that a particular chart pattern always results in the same reversal. Of course, that's hogwash.

While being aware of why a leading indicator may be in error, there's no way to avoid them. If you're getting mixed signals, you're better off doing nothing than taking a 'best guess'. If a chart doesn't meet all your criteria, don't force the trade! Move on to the next one that does meet your criteria.

MOMENTUM / LAGGING INDICATORS

So how do we spot a trend? The indicators that can do so have already been identified as MACD and moving averages. These indicators will spot trends once they have been established, at the expense of delayed entry. The bright side is that there's less chance of being wrong.

On this 1-hour chart of EUR/USD, there was a bullish crossover for MACD at 3:00 am EST on 08/03/05 and the 10 period EMA crossed over the 20 period EMA at 5:00 am. These two signals were all accurate, but if you waited for both indicators to give you a bull signal, you would have missed out on the big move. If you calculate from the start of the uptrend at 10:00 pm EST on 08/02/05 to the close of the candle at 5:00 am EST on 08/03/05, you would have watched a gain of 159 pips while sitting on the sidelines.

Let's take a look at the same chart so you can see how these crossover signals can sometimes give false signals. We like to call them "fake-outs". Look at how there was a bearish MACD crossover after the uptrend we just discussed.

Ten hours later, the 20 EMA crossed below the 10 EMA giving a "sell" signal. As you can see, the price didn't drop but stayed pretty much sideways, then continued its uptrend. By the time both indicators were in agreement, you would've entered a short trade at the bottom and set yourself up for a loss. Bummer, dude!

Summary of Leading & Lagging Indicators

The Million Dollar Question???

How do you figure out whether to freakin' use oscillators, or trend following indicators, or both? After all, we know they don't always work in tandem.

This is probably the most challenging part about technical analysis. And why I call it the million dollar question.

We will provide the million dollar answer in a future lesson.

For now, just know that once you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

This is no piece of cake. But it's a skill you will slowly improve upon as your experience grows.

Summary

- There are two types of indicators: leading and lagging.
- A leading indicator gives a buy signal before the new trend or reversal occurs.
- A lagging indicator gives a signal after the trend has started
- Technical indicators into one of two categories: Oscillators and trend following or momentum indicators.
- Oscillators are leading indicators.
- Momentum indicators are lagging indicators.
- If you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

PATTERN SCHMATTERNS

By now you have an arsenal of weapons to use when you battle the market. In this lesson you will add yet another weapon: **CHART PATTERNS!**

Think of chart patterns as a land mine detector, because once you learn this, you will be able to spot "explosions" on the charts before they even happen, making you a lot of money in the process.

In this lesson, we will teach you basic chart patterns and formations. When correctly identified, it usually leads to a huge breakout or "explosion" in this case.

Remember, our whole goal is to spot big movements before they happen so that we can ride them out and rake in the cash! Chart formations will greatly help us spot conditions where the market is ready to break out.

Here's the list of patterns that we're going to cover:

- Symmetrical Triangles
- Ascending Triangles
- Descending Triangles
- Double Top
- Double Bottom
- Head and Shoulders
- Reverse Head and Shoulders

SYMMETRICAL TRIANGLES

Symmetrical triangles are chart formations where the slope of the price's highs and the slope of the price's lows converge together to a point where it looks like a triangle. What is happening during this formation is that the market is making lower highs and higher lows. This means that neither the buyers nor the sellers are pushing the price far enough to make a clear trend. If this was a battle between the buyers and sellers, then this would be a draw.

This type of activity is called consolidation.

In the chart above, we can see that neither the buyers nor the sellers could push the price in their direction. When this happens we get lower highs and higher lows. As these two slopes get closer to each other, it means that a breakout is getting near. We don't know what direction the breakout will be, but we do know that the market **will** break out. Eventually, one side of the market will give in.

So how can we take advantage of this? Simple. We can place entry orders above the slope of the lower highs and below the slope of the higher lows. Since we already know that the price is going to break out, we can just hitch a ride in whatever direction the market moves.

Symmetrical Triangle

In this example, if we placed an entry order above the slope of the lower highs, we would've been taken along for a nice ride up. If you had placed another entry order below the slope of the higher lows, then you would cancel it as soon as the first order was hit.

Forex Training Class Lessons in 7TH GRADE: Important Chart Patterns

1. Pattern Schmatterns
2. Symmetrical Triangles
3. Ascending Triangles
4. Descending Triangles
5. Double Top
6. Double Bottom
7. Head and Shoulders
8. Reverse Head and Shoulders
9. Summary of Chart Formations

ASCENDING TRIANGLES

This type of formation occurs when there is a resistance level and a slope of higher lows. What happens during this time is that there is a certain level that the buyers cannot seem to exceed. However, they are gradually starting to push the price up as evident by the higher lows.

In the chart above, you can see that the buyers are starting to gain strength because they are making higher lows. They keep putting pressure on that resistance level and as a result, a breakout is bound to happen. Now the question is, "Which direction will it go? - Will the buyers be able to break that level or will the resistance be too strong?"

Many charting books will tell you that in most cases, the buyers will win this battle and the price will break out past the resistance. However, it has been my experience that this is not always the case. Sometimes the resistance level is too strong, and there is simply not enough buying power to push it through.

Most of the time the price will in fact go up. The point we are trying to make is that we do not care which direction the price goes, but we want to be ready for a movement in EITHER direction. In this case, we would set an entry order above the resistance line and below the slope of the higher lows.

In this scenario, the buyers won the battle and the price proceeded to skyrocket!

DESCENDING TRIANGLES

As you probably guessed, descending triangles are the exact opposite of ascending triangles (we knew you were smart!). In descending triangles, there is a string of lower highs which forms the upper line. The lower line is a support level in which the price cannot seem to break.

In the chart above, you can see that the price is gradually making lower highs which tell us that the sellers are starting to gain some ground against the buyers. Now most of the time, and we did say MOST - the price will eventually break the support line and continue to fall.

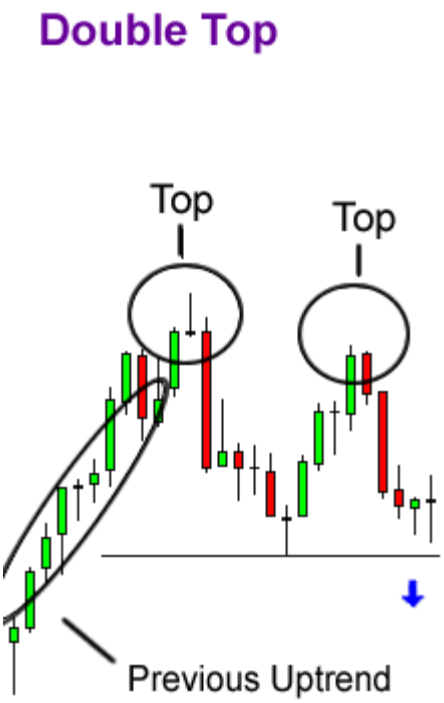
However, in some cases the support line is too strong, and the price will bounce off of it and make a strong move up.

The good news is that we don't care where the price goes. We just know that it's about to go *somewhere*. In this case we would place entry orders above the upper line (the lower highs) and below the support line.

In this case, the price did end up breaking the support line and proceeded to drop rather quickly. (*note- The market tends to fall faster than it rises which means you usually make money faster when you are short).

DOUBLE TOP

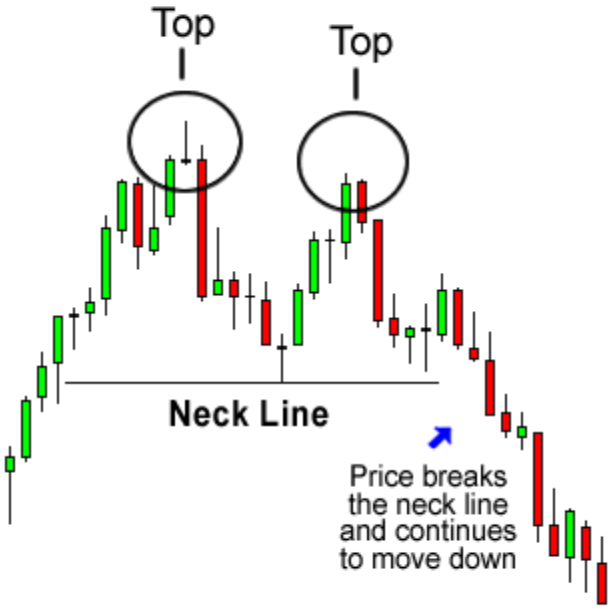
A double top is a reversal pattern that is formed after there is an extended move up. The "tops" are peaks which are formed when the price hits a certain level that can't be broken. After hitting this level, the price will bounce off it slightly, but then return back to test the level again. If the price bounces off of that level again, then you have a DOUBLE top!



In the chart above you can see that two peaks or "tops" were formed after a strong move up. Notice how the 2nd top was not able to break the high of the 1st top. This is a strong sign that a reversal is going to occur because it is telling us that the buying pressure is just about finished.

With double tops, we would place our entry order below the neckline because we are anticipating a reversal of the uptrend.

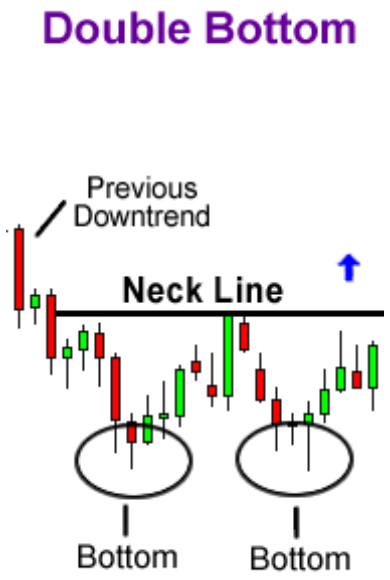
Double Top



Wow! We must be psychic or something because we always seem to be right! Looking at the chart you can see that the price breaks the neckline and makes a nice move down. Remember, double tops are a trend reversal formation. You'll want to look for these after there is a strong uptrend.

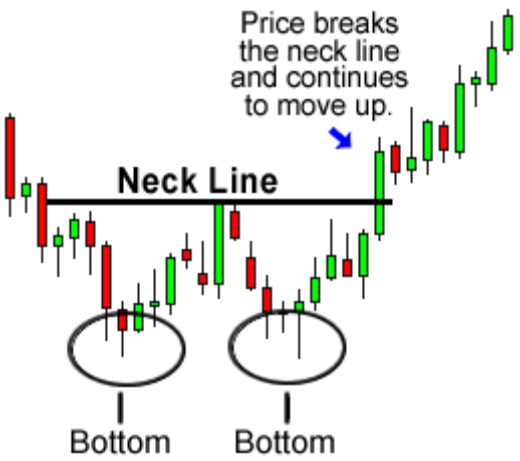
DOUBLE BOTTOM

Double bottoms are also trend reversal formations, but this time we are looking to go long instead of short. These formations occur after extended downtrends when two valleys or "bottoms" have been formed.



You can see from the chart above that after the previous downtrend, the price formed two valleys because it wasn't able to go below a certain level. Notice how the 2nd bottom wasn't able to significantly break the 1st bottom.

This is a sign that the selling pressure is about finished, and that a reversal is about to occur. In this situation, we would place an entry order above the neckline.

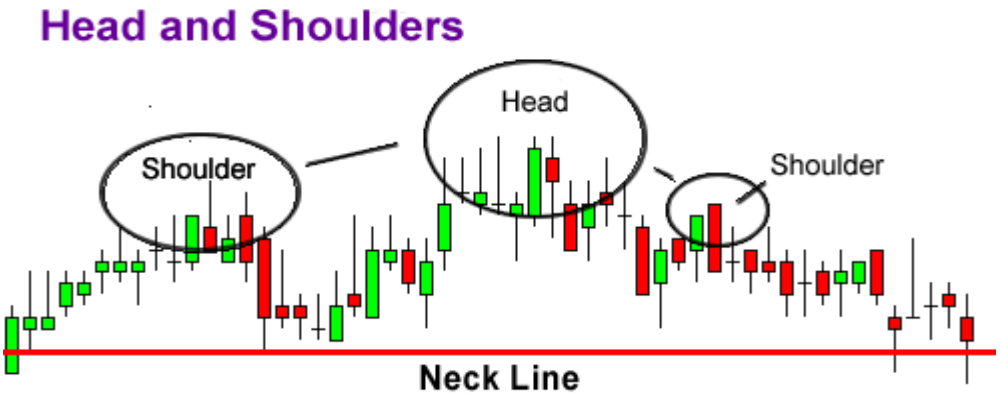


Would you look at that!

The price breaks the neckline and makes a nice move up. Remember, just like double tops, double bottoms are also trend reversal formations. You'll want to look for these after a strong downtrend.

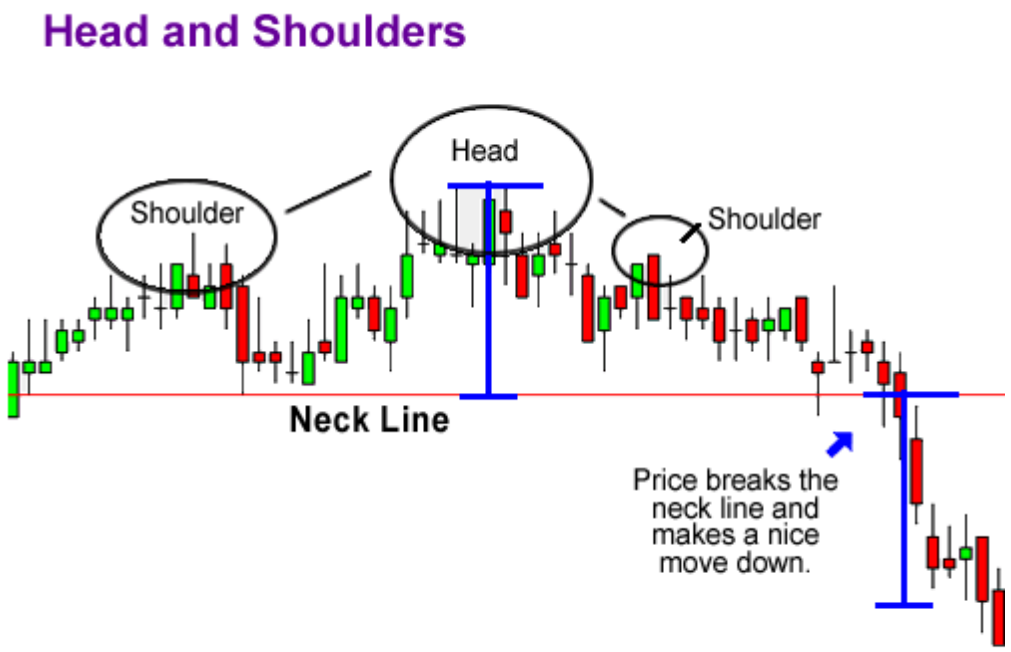
HEAD AND SHOULDERS

A head and shoulders pattern is also a trend reversal formation. It is formed by a peak (shoulder), followed by a higher peak (head), and then another lower peak (shoulder). A "neckline" is drawn by connecting the lowest points of the two troughs. The slope of this line can either be up or down. In my experience, when the slope is down, it produces a more reliable signal.



In this example, we can visibly see the head and shoulders pattern. The head is the 2nd peak and is the highest point in the pattern. The two shoulders also form peaks but do not exceed the height of the head.

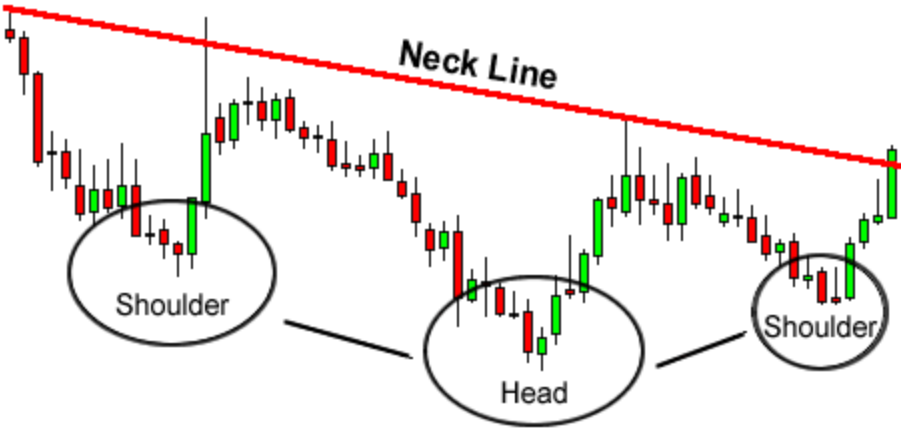
With this formation, we look to make an entry order below the neckline. We can also calculate a target by measuring the high point of the head to the neckline. This distance is approximately how far the price will move after it breaks the neckline.



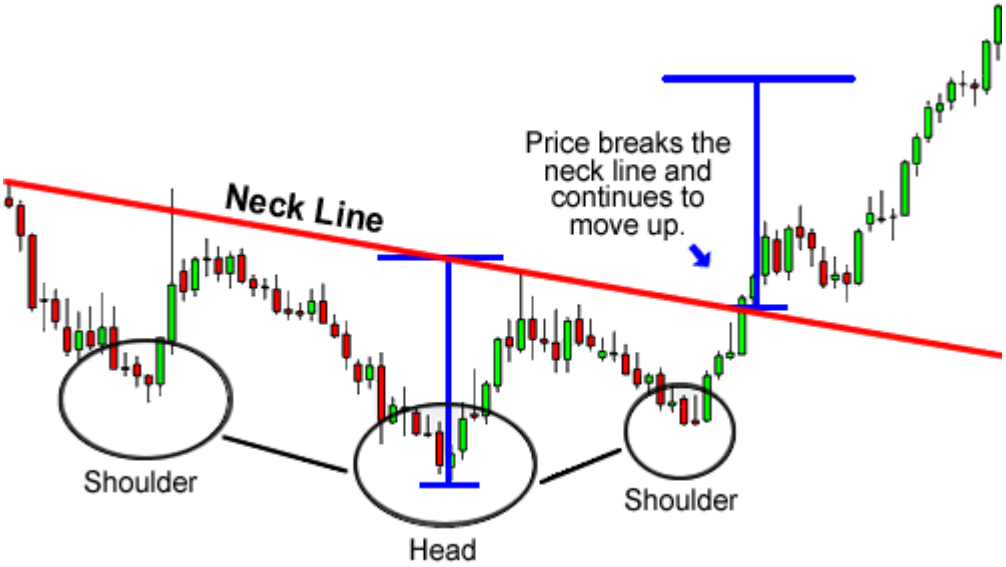
You can see that once the price goes below the neckline it makes a move that is about the size of the distance between the head and the neckline.

REVERSE HEAD AND SHOULDERS

Reverse Head and Shoulders



Here you can see that this is just like a head and shoulders pattern, but it's flipped upside down. With this formation, we would place a long entry order above the neckline. Our target is calculated just like the head and shoulders pattern. Measure the distance between the head and the neckline, and that is approximately the distance that the price will move after it breaks the neckline.



You can see that the price moved up nicely after it broke the neckline. WE know you're thinking to yourself, "the price kept moving even after it reached the target."

And our response is, **"DON"T BE GREEDY!"**

If your target is hit, then be happy with your profits. However, there are strategies where you can lock in some of your profits and still keep your trade open in case the price continues to move your way. You will learn about those later on in the course.

Summary of Chart Formations

Chart formations are like bazookas because they often create huge explosions on the chart.

Triangles

Symmetrical triangles

- Consist of lower highs and higher lows
- Place entry orders above the lower highs and below the higher lows

Ascending triangles

- Consist of higher lows and a resistance line
- It usually means that the price will break the resistance line and go higher but you should place entry orders on both sides just in case the resistance line is too strong.
- Place your entry orders above the resistance line and below the higher lows.

Descending triangles

- Consist of lower highs and a support line
- Usually mean that the price will break the support line and go lower but you should place entry orders on both sides just in case the support line is too strong.
- Place your entry orders above the lower highs and below the support line.

Trend Reversal formations

Double Top

- Happens after an extended uptrend.
- Formed by 2 peaks that can't break a certain level. This level becomes a resistance line.
- Place our short entry order below the low point of the valley in between the 2 peaks.

Double Bottom

- Happens after an extended downtrend.
- Formed by 2 valleys that can't break a certain level. This level becomes a support line.
- Place our long entry order above the high point of the peak in between the 2 valleys.

Head and Shoulders

- Happens after an extended uptrend.
- Formed by a peak, followed by a higher peak, and then another lower peak. A neckline is formed by connecting the low points of the two troughs or "valleys".
- Place your short entry order below the neckline.
- We calculate our target by measuring the distance between the high point of the head and the neckline. This is the approximate distance that the price will move after it breaks the neckline.

Reverse Head and Shoulders

- Happens after an extended downtrend.
- Formed by a valley, followed by a lower valley, and then another higher valley. A neckline is formed by connecting the high points of the 2 peaks.
- Place your long entry order above the neckline.
- We calculate our target by measuring the distance between the low point of the head and the neckline. This is the approximate distance that the price will move after it breaks the neckline.

FOREX PIVOT POINTS

Professional traders and market makers use pivot points to identify important support and resistance levels. Simply put, a pivot point and its support/resistance levels are areas at which the direction of price movement can possibly change.

Pivot points are especially useful to short-term traders who are looking to take advantage of small price movements.

Pivot points can be used by both range-bound traders and breakout traders. Range-bound traders use pivot points to identify reversal points. Breakout traders use pivot points to recognize key levels that need to be broken for a move to be classified as a real deal breakout.

Here is an example of pivot points plotted on a 1-hour EUR/USD chart:

HOW TO CALCULATE PIVOT POINTS

The pivot point and associated support and resistance levels are calculated by using the last trading session's open, high, low, and close. Since Forex is a 24-hour market, most traders use the New York closing time of 4:00pm EST as the previous day's close.

The calculation for a pivot point is shown below:

Pivot point (PP) = (High + Low + Close) / 3

Support and resistance levels are then calculated off the pivot point like so:

First level support and resistance:

First support (S1) = (2*PP) – High

First resistance (R1) = (2*PP) – Low

Second level of support and resistance:

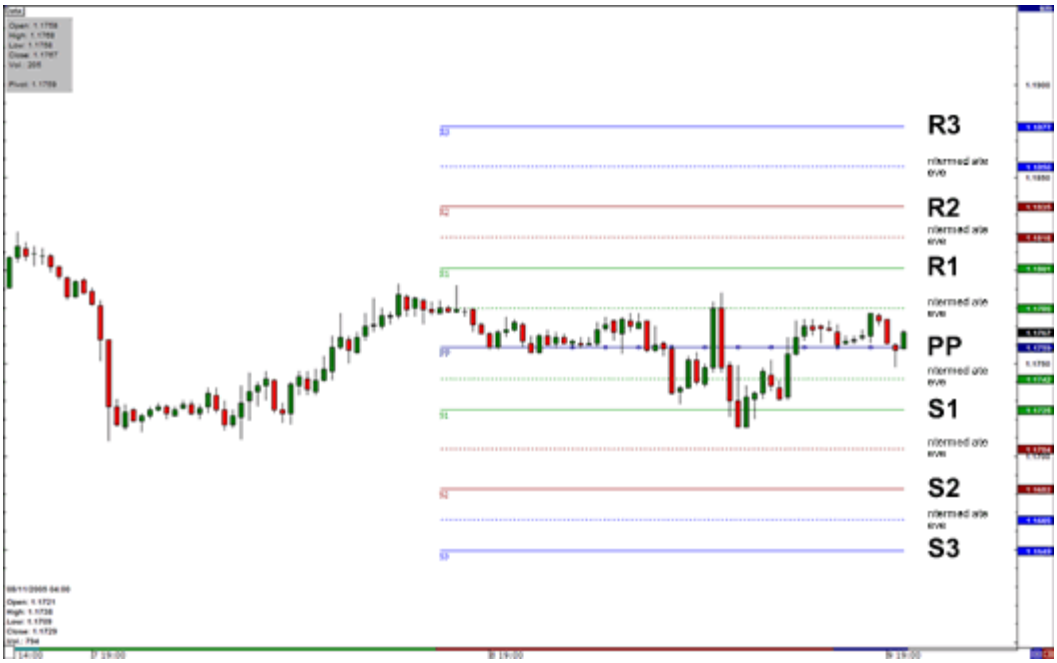
Second support (S2) = PP – (High – Low)

Second resistance (R2) = PP + (High - Low)

Don't worry you don't have to perform these calculations yourself. Your charting software will automatically do it for you and plot it on the chart.

Also keep in mind that some charting software also provides additional pivot point features such as a third support and resistance level and intermediate levels or mid-point levels (levels in between the main pivot point and support and resistance level).

These "extra levels" aren't as significant as the main five but it doesn't hurt to pay attention to them. Here's an example:



HOW TO TRADE WITH PIVOT POINTS

Breakout Trades

The pivot point should be the first place you look at to enter a trade, since it is the primary support/resistance level. The biggest price movements usually occur at the price of the pivot point.

Only when price reaches the pivot point will you be able to determine whether to go long or short, and set your profit targets and stops. Generally, if prices are above the pivot it's considered bullish, and if they are below it's considered bearish.

Let's say the price is hovering around the pivot point and closes below it so you decide to go short. Your stop loss would be above PP and your initial profit target would be at S1.

However, if you see prices continue to fall below S1, instead of cashing out at S1, you can move your existing stop-loss order just above S1 and watch carefully. Typically, S2 will be the expected lowest point of the trading day and should be your ultimate profit objective.

The converse applies during an uptrend. If price closed above PP, you would enter a long position, set a stop loss below PP and use the R1 and R2 levels as your profit objectives.

Range-bound Trades

The strength of support and resistance at the different pivot levels is determined by the number of times the price bounces off the pivot level.

The more times a currency pair touches a pivot level then reverses, the stronger the level is. Pivoting simply means reaching a support or resistance level and then reversing. Hence, the word "pivot".

If the pair is nearing an upper resistance level, you could sell the pair and place a tight protective stop just above the resistance level.

If the pair keeps moving higher and breaks out above the resistance level, this would be considered an upside "breakout". You would also get stopped out of your short order but if you believe that the breakout has good follow-through buying strength, you can reenter with a long position. You would then place your protective stop just below the former resistance level that was just penetrated and is now acting as support.

If the pair is nearing a lower support level, you could buy the pair and place a stop below the support level.

Theoretically Perfect?

In theory, it sounds pretty simple huh? Dream on, pal!

In the real world, pivot points don't work all the time. Price tends to hesitate around pivot lines and at times it's just ridiculously hard to tell what it will do next.

Sometimes the price will stop just before reaching a pivot line and then reverse meaning your profit target doesn't get reached. Other times, it looks like a pivot line is a strong support level so you go long only to see the price fall, stop you out, then reverse back into your direction.

You must be very selective and create a pivot point trading strategy that you intend to strictly follow.

Let's go look at a chart to see just how difficult and easy pivot points might be.

Ooooh pretty colors! We like...

Look at the orange oval. Notice how the PP was a strong support but if you went long on PP, it never was able to rise up to R1.

Look at the first purple circle. The pair broke down through PP but failed to reach S1 before reversing back to PP. On the second break down though (second purple circle), the pair did manage to reach S1 before once again reversing back to PP.

Look at the pink oval. Again, PP acted as strong support but never was able to rise up to R1.

On the yellow circle, the pair broke out to the downside again, sliced right through S1, and managed to fall all the way down to S2.

If you ever attempted to go long on this chart, you would have been stopped out every single time.

Personally, we would have not even thought about buying this pair - Why not? Well we have a little secret. What we didn't show you regarding this chart was that this pair was trending down for quite some time now.

Remember the trend is your friend. We don't like to backstab our friends, so we try our best to never trade against the trend.

In the next lesson, you will learn how to use multiple time frames to trade with the correct trend direction so you're able to minimize possible mistakes such as the one above.

FOREX PIVOT POINT TRADING TIPS

Here are some easy to memorize tips that will help you to make smart pivot point trading decisions.

- If price at PP, watch for a move back to R1 or S1.
- If price is at R1, expect a move to R2 or back towards PP.
- If price is at S1, expect a move to S2 or back towards PP.
- If price is at R2, expect a move to R3 or back towards R1.
- If price is at S2, expect a move to S3 or back towards S1.
- If there is no significant news to influence the market, price will usually move from P to S1 or R1.
- If there is significant news to influence the market price may go straight through R1 or S1 and reach R2 or S2 and even R3 or S3.
- R3 and S3 are a good indication for the maximum range for extremely volatile days but can be exceeded occasionally.
- Pivot lines work well in sideways markets as prices will most likely range between the R1 and S1 lines.
- In a strong trend, price will blow through a pivot line and keep going.

Summary of Forex Pivot Points

- Pivot points are a technique used by professional traders and market makers to determine entry and exit points for the trading day based on the previous day's trading activity. It's best to use this technique after determining the direction of the trend.
- Pivots can be extremely useful in Forex since many currency pairs usually fluctuate between these levels.
- Range-bound traders will enter a buy order near identified levels of support and a sell order when the pair nears resistance.
- Pivot points also allow breakout traders to identify key levels that need to be broken for a move to qualify as a bona fide breakout.

- The simplicity of pivot points definitely makes them a useful tool to add to your trading toolbox. It allows you to see possible areas that are likely to cause price movement. You'll become more in sync to market movements and make better trading decisions.
- Learn to use pivot points along with other technical analysis tools such candlestick patterns, MACD crossover, moving average crossovers, Stochastics overbought/oversold levels. The greater the confirmation, the greater your probability of success!
-

WHICH TIME FRAME SHOULD I TRADE?

Which time frame Should You Trade?

One of the main reasons traders don't do well as they should is because they're usually trading the wrong time frame for their personality. New traders will want to learn how to get rich quick so they'll start trading small time frames like the 1-minute or 5-minute charts. Then they end up getting frustrated when they trade because it's the wrong time frame for their personality.

Finally after a long period of time frame unfaithfulness, we felt we were most comfortable trading the 1-hour charts. This time frame is longer, but not too long, and trade signals were fewer, but not too few. We now have more time to analyze the market and didn't feel rushed anymore.

On the other hand, we have a friend who could never, ever, trade in a 1-hour time frame. It would be way too slow for him and he'd probably think he was going to rot and die before he could get in a trade. He prefers trading a 10-minute chart. It still gives him enough time (but not too much) to make decisions based on his trading plan.

Another buddy of ours can't figure out how we can trade a 1-hour chart because he thinks it's too fast! He trades only daily, weekly, and monthly charts. His name is Warren Buffet. You might know him

Okay, so you're probably asking what the right time frame is for you. Well, buddy, if you had been paying attention, it depends on your personality. You have to feel comfortable with the time frame you're trading in.

You'll always feel some kind of pressure or sense of frustration when you're in a trade because real money is involved. But you shouldn't feel that the reason for the pressure is because things are happening so fast that you find it difficult to make decisions or so slowly that you get frustrated.

When we first started trading, we couldn't stick to a time frame. We started with the 15-minute chart. Then the 5-minute chart. Then we tried the 1-hour chart, the daily chart, and 4-hour chart.

Trading time frames are usually categorized into three types:

1. Long-term
2. Short-term or swing
3. Intraday or day-trading

Which one is better? It depends on....

TIME FRAME BREAKDOWNS

Which one is better?

It depends on your personality!

Let me give you a breakdown of the three to help you choose:

TIME FRAME	DESCRIPTION	ADVANTAGES	DISADVANTAGES
Long-term	Long-term traders will usually refer to daily and weekly charts. The weekly charts will establish the longer term perspective and assist in placing entries in the shorter term daily. Trades usually from a few weeks to many months, sometimes years.	Don't have to watch markets intraday Fewer transactions means less paying of spreads	Large swings which require large stops Usually 1 or 2 good trades a year so patience is required Bigger account needed to ride longer term swings Frequent losing months
Short-term	Short-term traders use hourly time frames and hold trades for several hours to a week.	More opportunities for trades Less chance of losing months Less reliance on one or two trades a year to make money	Transaction costs will be higher (more spreads to pay) Overnight risk becomes a factor
Intraday	Intraday traders use minute charts such as 1-minute or 5-minute. Trades are held intraday and exited by market close.	Lots of trading opportunities Less chance of losing months No overnight risk	Transaction costs will be much higher (more spreads to pay) Mentally more difficult due to frequency of trading Profits are limited by needing to exit at the end of the day.

You have to decide what the correct time frame is for **YOU.**

You also have to consider the amount of capital you have to trade. Shorter time frames allows you to make better use of margin and have tighter stop losses. Larger time frames require a bigger account so you can handle the market swings without facing a margin call.

When you finally decide on your preferred time frame is when the fun begins. This is when you start looking at multiple time frames to help you analyze the market.

'LONG OR SHORT?'

If you ever look at a currency pair on different time frames, you probably noticed that markets can move in different directions at the same time. A moving average may rise on a weekly chart, giving a buy signal, but fall on a daily chart, giving a sell signal. It may rally on an hourly chart, telling us to go long, but sink on a 10 minute chart, telling us to short. What the hell is going on?

Let's play a quick game called "Long or Short". The rules of the game are easy. You look at a chart and you decide whether to go long or short. Easy. Okay ready?

5 Minute Chart

Let's a take a look at a EUR/USD 5-minute chart on 11/03/05 around 4 am EST. Oooh it's so nice. It's trading above its 100 simple moving average which is bullish and look! It just broke out and closed above it's previous resistance! Perfect time to go long right? I'll take that as a yes.

Oh! You are **WRONG!** Look what happens next! It's goes up a little bit but then drops like rock. Oh too bad.

60 Minute Chart

Let's look at the same exact chart on a higher time frame. It's the same date, 11/03/05 and the same time, around 4 am EST.

Holy cow! The pair broke out of its down channel which is bullish. It's trading above its 100 simple moving average which is bullish. The last candle broke and closed above its previous resistance which is bullish. Looks like a bull, smells like a bull. Nothing but up from here right? You say long.

OOOHHHHH! Zero for two! How do you like your steak cooked? Because from the looks of this chart…the bull got slaughtered. The pair even dropped back into its old down channel. Look at that last candle, it was dropping so much, it couldn't even stay inside my chart! Amazing!

4 Hour Chart

Okay, we've now moved up to an even higher time frame chart. A 4-hour chart. It's still the same date and time, just a higher time frame. If you had looked at this chart first, would you still have been quick to go long on either the 5-minute or 1-hour chart?

It's currently trading in a down channel which is bearish. The pair is hitting the upper trend line of the down channel which is extremely bearish. Yes, it's still trading above the 100 simple moving average which would count as bullish, but that channel would still make me cautious. Especially since it's trading around the upper trend line.

Look what happens! Droppin' like its hot! The pair stayed true to its channel. It hit the upper trend line and traveled down.

Daily Chart

For fun's sake, let's go up one more time frame to the daily chart.

Wow, will you look at that? The pair is trading in an obvious down trend. It's below its 100 simple moving average and its in a down channel. On this chart, the trend direction is so obvious! Do you also notice the last candle? It tested the upper trend line and reversed. Not a very good bullish sign. Let's look at what happens next.

Hallelujah! The downtrend continues!

So what's the point?

All of the charts were showing the same date and time. They were just different time frames. Do you see now the importance of looking at multiple time frames?

We used to just trade off 15-minute charts and that was it. We could never understand why when everything looked good the market would suddenly stall or reverse. It never crossed our minds to take a look at a larger time frame to see what was happening. When the market did stall or reverse on my 15-minute chart, it was often because it had hit support or resistance on a larger time frame.

It took me a couple of hundred bucks to learn that the larger the time frame, the more important support and resistance levels were. Trading using multiple time frames has probably made us more money than any other one thing alone. It will allow you to stay in a trade longer because you're able to identify where you are relative to the big picture.

Most beginners look at only one time frame. They grab a single time frame, apply their indicators and ignore other time frames. The problem is that a new trend, coming from another time frame, often hurts traders who don't look at the big picture.

Take a broad look at what's happening. Don't try to get your face closer to the market, but push yourself further away.

Select your preferred time frame and then go up to the next higher time frame. There you make a strategic decision to go long or short based on the direction of the trend. You would then return to your preferred time frame to make tactical decisions about where to enter and exit (place stop and profit target). Adding the dimension of time to your analysis gives you an edge over the other tunnel vision traders who trade off on only one time frame.

There is obviously a limit to how many time frames you can study. You don't want a screen full of charts telling you different things. Use at least two, but not more than three time frames because adding more will just confuse the geewillikers out of you and you'll suffer from analysis paralysis and go crazy.

We like to use three time frames. The largest time frame we consider our main trend, the next time frame down as my medium trend and the smallest time frame as the short-term trend.

You can use any time frame you like as long as there is enough time difference between them to see a difference in their movement. You might use:

- 1 minute, 5 minute, and 30 minute
- 5 minute, 30 minute, and 4 hour
- 15 minute, 1 hour, and 4 hour
- 1 hour, 4 hour, and daily
- 4 hour, daily, and weekly and so on.

When you're trying to decide how much time in between charts, just make sure there is enough difference for the smaller time frame to move back and forth without every move reflecting in the larger time frame. If the time frames are too close, you won't be able to tell the difference which would be pretty useless.

Summary of Multiple Time Frames

- You have to decide what the correct time frame is for YOU.
- Once you've found your preferred time frame, go up to the next higher time frame. There you make a strategic decision to go long or short based on the direction of the trend. You would then return to your preferred time frame to make tactical decisions about where to enter and exit (place stop and profit target).
- Adding the dimension of time to your analysis gives you an edge over the other tunnel vision traders who only trade off on only one time frame.
- Make it a habit to look at multiple time frames when trading.
- Choose a set of time frames that you are going to watch, and only concentrate on those time frames. Pick three time frames: 1hr, 4hr, daily; 5 min, 15min, 1hr, and so on. And only use those time frames. Learn all you can about how the market works during those time frames.

- Don't look at too many time frames, you'll be overloaded with too much information and your brain will explode.
- Stick to two or three time frames, any more than that is overkill.
- We can't repeat this enough: Get a bird's eye view. Using multiple time frames resolves contradictions between indicators and time frames. Always begin your market analysis by stepping back from the markets and looking at the big picture.
- Use a long-term chart to find the trend, and then return closer to the market to make decisions about entries and exits.

ELLIOTT WAVE THEORY

Back in the old school days during the 1920-30s, there was this mad genius named Ralph Nelson Elliott. Elliott discovered that stock markets, thought to behave in a somewhat chaotic manner, actually, did not.

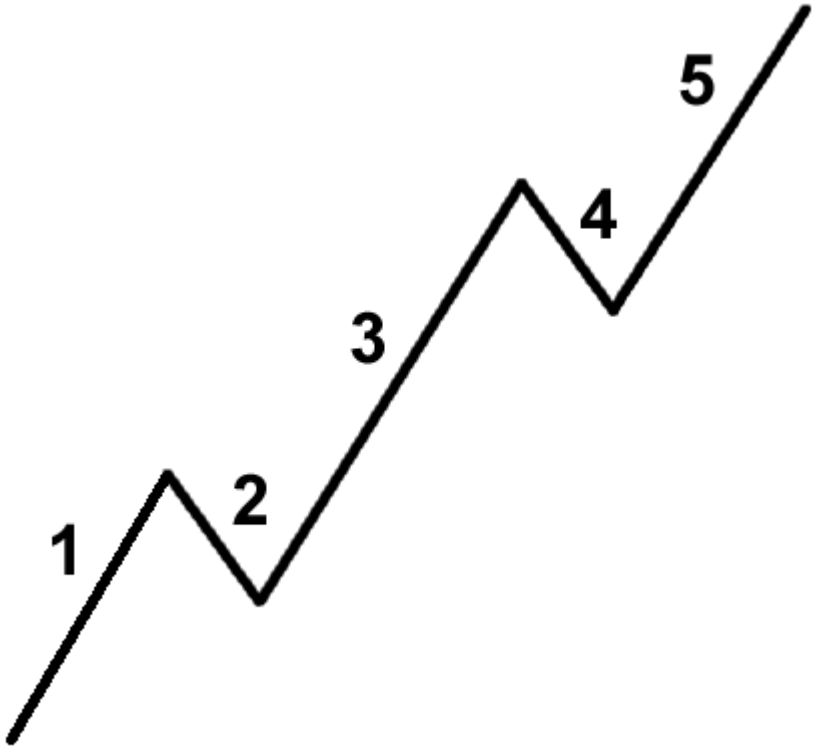
They traded in repetitive cycles, which he pointed out were the emotions of investors and traders caused by outside influences (ahem, CNBC) or the predominant psychology of the masses at the time.

Elliott explained that the upward and downward swings of the mass psychology always showed up in the same repetitive patterns, which were then divided into patterns he called "waves". He needed to claim this observation and so he came up with a super original name: The Elliott Wave Theory.

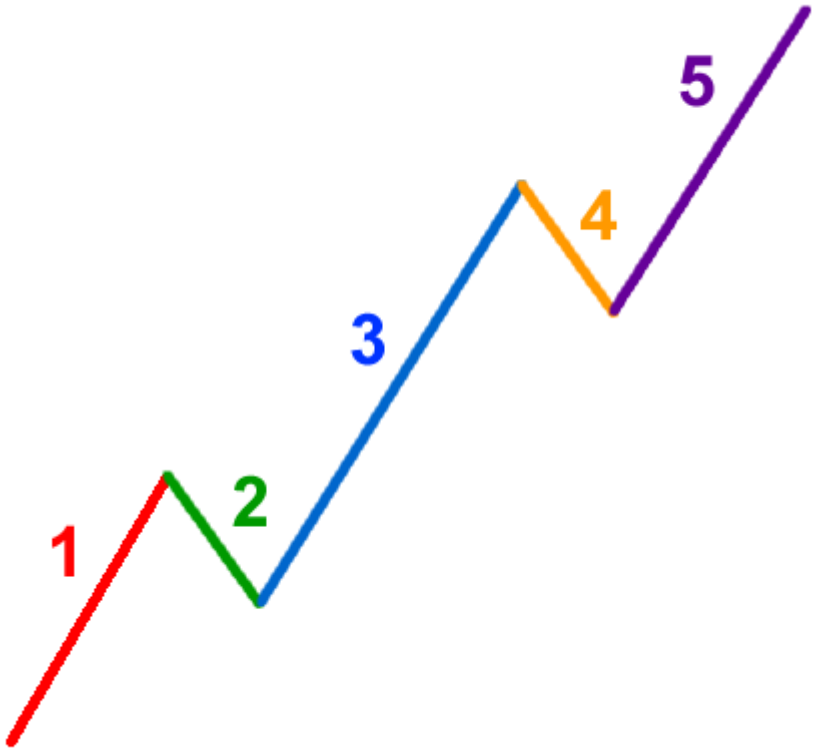
The 5 – 3 Wave Patterns

Mr. Elliott showed that a trending market moves in what he calls a 5-3 wave pattern. The first 5-wave pattern is called **impulse waves** and the last 3-wave pattern is called **corrective waves**.

Let's first take a look at the 5-wave impulse pattern. It's easier if you see it as a picture:



That still looks kind of confusing. Let's splash some color on this bad boy.



Ah magnefico! Me likes colors. It's so pretty! I've color-coded each wave along with its wave count.

Here is a short description of what happens during each wave. I am going to use stocks for my example since stocks is what Mr. Elliott used but it really doesn't matter what it is. It can easily be currencies, bonds, gold, oil, or Tickle Me Elmo dolls. The important thing is the Elliott Wave Theory can also be applied to the foreign exchange market.

Wave 1

The stock makes its initial move upwards. This is usually caused by a relatively small number of people that all of the sudden (for a variety of reasons real or imagined) feel that the price of the stock is cheap so it's a perfect time to buy. This causes the price to rise.

Wave 2

At this point enough people who were in the original wave consider the stock overvalued and take profits. This causes the stock to go down. However, the stock will not make it to its previous lows before the stock is considered a bargain again.

Wave 3

This is usually the longest and strongest wave. The stock has caught the attention of the mass public. More people find out about the stock and want to buy it. This causes the stock's price to go higher and higher. This wave usually exceeds the high created at the end of wave 1.

Wave 4

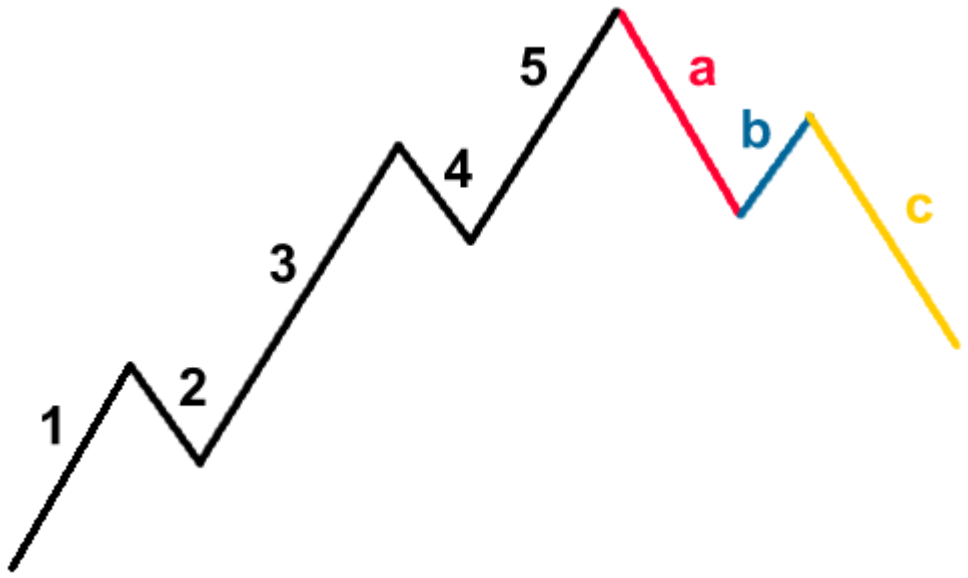
People take profits because the stock is considered expensive again. This wave tends to be weak because there are usually more people that are still bullish on the stock and are waiting to "buy on the dips".

Wave 5

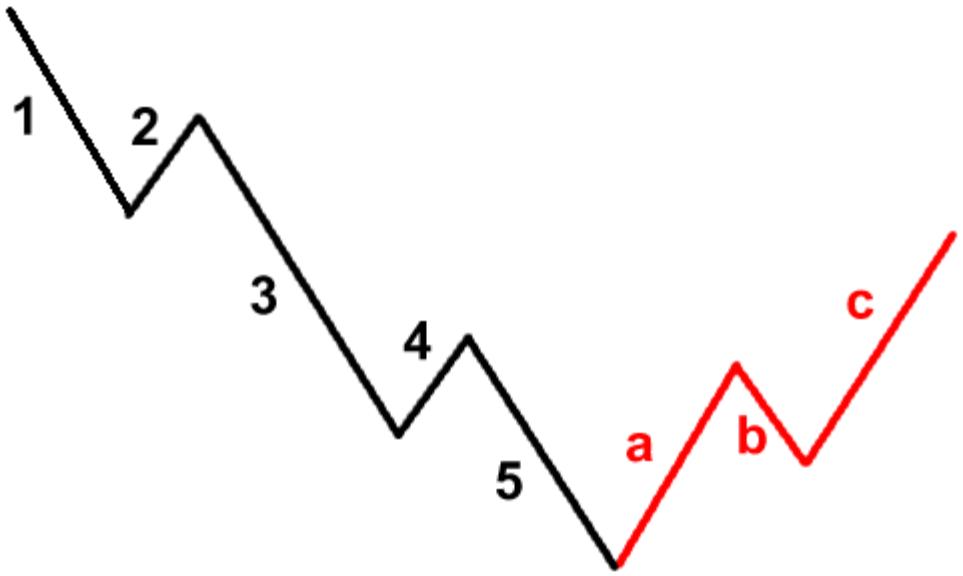
This is the point that most people get on the stock, and is most driven by hysteria. You usually start seeing the CEO of the company on the front page of major magazines as the Person of the Year. People start coming up with ridiculous reasons to buy the stock and try to choke you when you disagree with them. This is when the stock becomes the most overpriced. Contrarians start shorting the stock which starts the ABC pattern.

ABC CORRECTION

The 5-wave trends are then corrected and reversed by 3-wave countertrends. Letters are used instead of numbers to track the correction. Check out this example of smokin' hot 3-wave corrective wave pattern!

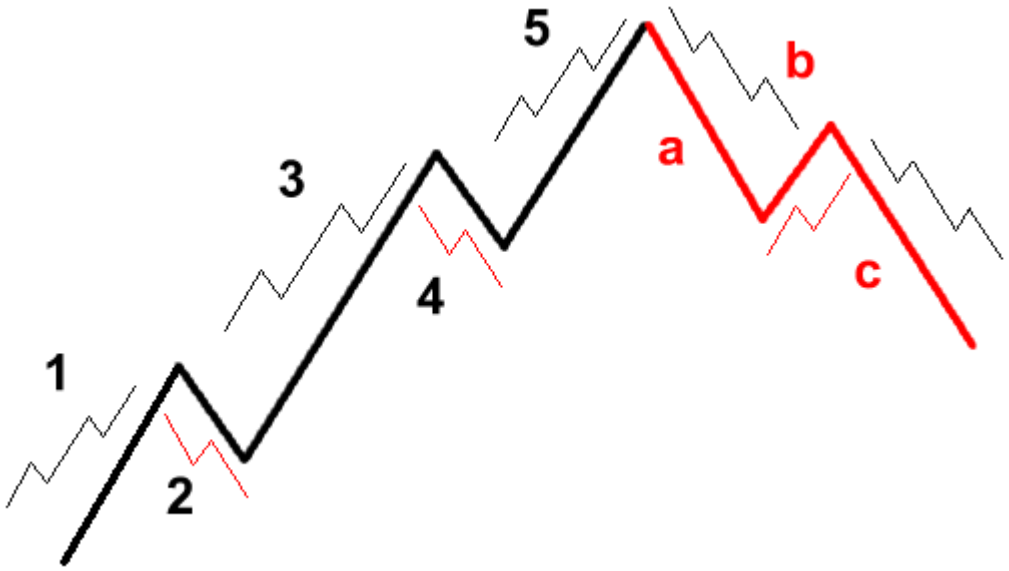


Just because I've been using a bull market as my primary example doesn't mean the Elliott Wave theory doesn't work on bear markets. The same 5 - 3 wave pattern can look like this:



Waves within a Wave

The other important thing you have to know about the Elliot Wave Theory is that a wave is made of sub-waves? Huh? Let me show you another picture. Pictures are great aren't they? Yee-haw!



Do you see how Wave 1 is made up of a smaller 5-wave impulse pattern and Wave 2 is made up of smaller 3-wave corrective pattern? Each wave is always comprised of smaller wave patterns.

Okay, let's look at a real example.

As you can see, waves aren't shaped perfectly in real life. You'll also learn its sometimes difficult to label waves. But the more you stare at charts the better you'll get.

Okay, that's all you need to know about the Elliott Wave Theory. Remember the market moves in waves. Now when you hear somebody say "Wave 2 is complete." You'll know what the heck he is talking about.

If you wish to become an Elliott Wave Theory guru, you can learn more about it at www.elliottwave.com.

Summary of Elliot Waves

- According to the Elliott Wave Theory, the market moves in repetitive patterns called waves.
- A trending market moves in a 5-3 wave pattern. The first 5-wave pattern are called impulse waves. The second 3-wave pattern are called corrective waves.
- If you look hard enough at a chart, you'll see that the market really does move in waves.

CAN YOU HANDLE THE TRUTH?

Forex Trading Systems

Let's get into our favorite part of trading...creating your own trading system!

If you do a simple search in Google for "Forex trading systems" you'll find many many many people out there who claim to have the "Holy Grail" system that you can purchase for "only" a few thousand dollars.

These systems supposedly make thousands of pips a week and never lose. They will show you supposed "results" of their perfect system and it will make your eyeballs turn into dollar signs as you sit there and say to yourself, "Wow I can make all this money if I just give this guy $3,000. Besides, if his system making thousands of pips a week, I'll be able to make my money back in no time."

Slowww down cowboy. There are some things you should know before you give them your credit card number and make that impulse buy.

The truth is that many of these systems DO in fact work. The problem is that traders lack the discipline to follow the rules that go along with the system.

The second truth (there's such thing as a second truth?) is that instead of paying thousands of dollars to buy a system, you can spend your time developing your own system for free, and use that money you were going to spend as capital for your trading account.

The third truth is that creating systems is not even that difficult. What is difficult is following the rules that you set when you do develop your system.

There are many articles that sell systems, but we haven't seen any that teach you how to create your own system. This lesson will guide you through the steps you need to take to develop a system that is right for you. At the end of the lesson, we will give you an example of a system that we trade just so we can show you how awesome we are! (Insert evil laugh here.)

Goals of your trading system

I know you're saying, "DUH, my goal of my trading system is to make a billion dollars!" While that is a wonderful goal, it's not exactly the kind of goal that will make you a successful trader.

When developing your system, you want to achieve 2 very important goals:

1. Your system should be able to identify trends as early as possible.
2. Your system should be able to avoid you from whipsaws.

If you can accomplish those two things with your trading system, we GUARANTEE you will be successful. The hard part about those goals is that they contradict each other. If you have a system in which its sole purpose is to catch trends early, then you will probably get faked out many times.

On the other hand, if you have a system in which its sole purpose is to avoid whipsaws, then you will be late on many trades and will also probably miss out on a lot of trades.

Your task, when developing your system, is to find a compromise between the two goals. Find a way to identify trends early, but also find ways that will help you distinguish the fake signals from the real ones.

Always remember these two goals when you create your system. They will make you a lot of money!

SIX STEPS TO SETTING UP YOUR SYSTEM

The main focus of this article is to guide you through the process of developing your system. While it doesn't take long to come up with a system, it does take some time to extensively test it. So be patient; in the long run, a good system can potentially make you a lot of money.

Step 1: Time Frame

The first thing you need to decide when creating your system is what kind of trader you are. Are you a day trader or a swing trader? Do you like looking at charts every day, every week, every month, or even every year? How long do you want to hold on to your positions?

This will help determine which time frame you will use to trade. Even though you will still look at multiple time frames (go back to 7th grade if you forgot), this will be the main time frame you will use when looking for a trade signal.

Step 2: Find indicators that help identify a new trend.

Since one of our goals is to identify trends as early as possible, we should use indicators that can accomplish this. Moving averages are one of the most popular indicators that traders use to help them identify a trend. Specifically, they will use 2 moving averages (one slow and one fast) and wait until the fast one crosses over or under the slow one. This is the basis for what's known as a "moving average crossover" system.

In its simplest form, moving average crossovers are the fastest ways to identify new trends. It is also the easiest way to spot a new trend.

Of course there are many other ways traders' spot trends, but moving averages are one of the easiest to use.

Step 3: Find indicators that help CONFIRM the trend.

Our second goal for our system is to have the ability to avoid whipsaws, meaning that we don't want to be caught in a "false" trend. The way we do this is by making sure that when we see a signal for a new trend, we can confirm it by using other indicators.

There are many good indicators for confirming trends, but I really like MACD, Stochastics, and RSI. As you become more familiar with various indicators, you will find ones that you prefer over others, and can incorporate those into your system.

Step 4: Define Your Risk

When developing your system, it is very important that you define how much you are willing to lose on each trade. Not many people like to talk about losing, but in actuality, a good trader thinks about what they could potentially lose BEFORE thinking about how much they can win.

The amount you are willing to lose will be different than everyone else. You have to decide how much room is enough to give your trade some breathing space, but at the same time, not risk too much on one trade. You'll learn more about money management in a later lesson. Money management plays a big role in how much you should risk in a single trade.

Step 5: Define Entries & Exits

Once you define how much you are willing to lose on a trade, your next step is to find out where you will enter and exit a trade in order to get the most profit.

Some people like to enter as soon as all of their indicators match up and give a good signal, even if the candle hasn't closed. Others like to wait until the close of the candle.

In my experience, I have found that it is best to wait until a candle closes before entering. I have been in many situations where I will be in the middle of a candle and all my indicators match up, only to find that by the close of the candle, the trade has totally reversed on me!

It's all really just a matter of trading style. Some people are more aggressive than others and you will eventually find out what kind of trader you are.

For exits, you have a few different options. One way is to trail your stop, meaning that if the price moves in your favor by 'X' amount, you move your stop by 'X' amount.

Another way to exit is to have a set target, and exit when the price hits that target. How you calculate your target is up to you. Some people choose support and resistance levels as their targets. Others just choose to go for the same amount of pips on every trade. However you decide to calculate your target, just make sure you stick with it. Never exit early no matter what happens. Stick to your system! After all, YOU developed it!

One more way you can exit is to have a set of criteria that, when met, would signal you to exit. For example, you could make it a rule that if your indicators happen to reverse to a certain level, you would then exit out of the trade.

Step 6: Write down your system rules and FOLLOW IT!

This is the most important step of creating your trading system. You MUST write your trading system rules down and ALWAYS follow it. Discipline is one of the most important characteristics a trader must have, so you must always remember to stick to your system! No system will ever work for you if you don't stick to the rules, so remember to be disciplined. Oh yea, did I mention you should ALWAYS stick to your rules?

How to Test Your System

The fastest way to test your system is to find a charting software package where you can go back in time and move the chart forward one candle at a time. When you move your chart forward one candle at a time, you can follow your trading system rules and take your trades accordingly. Record your trading record, and BE HONEST with yourself! Record your wins, losses, average win, and average loss. If you are happy with your results then you can go on to the next stage of testing: trading live on a demo account.

Trade your new system live on a demo account for at least two months. This will give you a feel for how you can trade your system when the market is moving. Trust me, it is a lot different trading live than when you're backtesting.

After two months of trading live on a demo account, you will see if your system can truly stand its ground in the market. If you are still getting good results, then you can choose to trade your system live on a REAL account. At this point, you should feel very confident with your system and feel comfortable taking trades with no hesitation. At this point, **YOU'VE MADE IT!**

SETUP YOUR SYSTEM IN SIX STEPS

My "So Easy It's Ridiculous" System

In this section I will give you an idea of what a trading system should look like. This should give you an idea of what you should be looking for when you develop your system.

Trading Setup

- Trade on daily chart (swing trading)
- 5 EMA applied to the close
- 10 EMA applied to the close
- Stochastic (10,3,3)
- RSI (14)

Trading Rules

- **Stop Loss = 30 pips**

Entry Rules

1. **Enter long if:**
    - The 5 EMA crosses above the 10 EMA and both stochastic lines are heading up (do not enter if the stochastic lines are already in the overbought territory)
    - RSI is greater than 50
2. **Enter short if:**
    - The 5 EMA crosses below the 10 EMA and both stochastic lines are heading down AND (do not enter if the stochastic lines are already in oversold territory)
    - RSI is less than 50

Exit Rules

- Exit when the 5 EMA crosses the 10 EMA in the opposite direction of your trade OR if RSI crosses back to 50

Okay, let's take a look at some charts and see this baby in action...

MY 'SO EASY IT'S RIDICULOUS' SYSTEM

As you can see, we have all the components of a good trading system. First, we've decided that this is a swing trading system, and that we will trade on a daily chart. Next, we use moving averages to help us identify a new trend as early as possible.

The Stochastics help us determine if it's still ok for us to enter a trade after a moving average crossover, and it also helps us avoid oversold and overbought areas. The RSI is an extra confirmation tool that helps us determine the strength of our trend.

After figuring out our trade setup, we then determined our risk for each trade. For this system, we are willing to risk 30 pips on each trade. Usually, the higher the time frame, the more pips you should be willing to risk because your gains will typically be larger than if you were to trade on a smaller time frame.

Next, we clearly defined our entry and exit rules. At this point, we would begin the testing phase by starting with manual back tests.

Here are a couple of examples:

If we went back in time and looked at this chart, we would see that according to our system rules, this would be a good time to go long. To backtest, you would write down at what price you would've entered, your stop loss, and your exit strategy. Then you would move the chart one candle at a time to see how the trade unfolds.

In this particular case, you would've made a massive pip gain.* You could've bought yourself something nice after this trade! You can see that when the moving averages cross in the opposite direction, it was a good time for us to exit. Of course, not all your trades will look this sexy. Some will look like ugly heifers, but you should always remember to stay disciplined and stick to your trading system rules.

In this example, we can see that our criteria is met and at this point we would enter short. Now we would record our entry price, our stop loss and exit strategy, and then move the chart forward one candle at a time to see what happens. I'll bet you a $1000 that I'm right on this trade.

Well, isn't that amazing?! It just so happens that I'm right again! You can see that we would've stayed in this trade until the moving averages crossed again and RSI went back to 50.

We know you're probably thinking that this system is too simple to be profitable. Well the truth is that it is simple. You shouldn't be scared of something that's simple. In fact, there is an acronym that you will often see in the trading world called KISS. It stands for Keep It Simple Stupid!

It basically means that trading systems don't have to be complicated. You don't have to have a zillion indicators on your chart. In fact, keeping it simple will give you less of a headache.

The most important thing is discipline. We can't stress it enough. Well, yes we can.

YOU MUST ALWAYS STICK TO YOUR TRADING SYSTEM RULES!

If you have tested your system thoroughly through back testing and by trading it live on a demo for at least 2 months, then you should feel confident enough to know that as long as you follow your rules, you will end up profitable in the long run.

Trust your system and trust yourself!

Summary of Trading Systems

There are many systems out there that work, but many traders lack the discipline to follow the rules and as a result, still end up losing money.

Your trading system should attempt to accomplish 2 goals:

1. Be able to identify a trend as early as possible
2. Be able to find ways to avoid whipsaws (confirm your trend)

If it is profitable, then you trade your system live on a demo account for at least 2 months. This will help you get an idea of how you would trade your system when the market is moving. It is a lot different trading live than manually backtesting.

Once you've demo traded your system for at least 2 months and you are still profitable, you are then ready to trade your system live with real money. However, you must always remember to stick to your rules no matter what!

There are 6 steps to developing your system:

1. Find your time frame
2. Find indicators to help you identify trends early
3. Find indicators to help you avoid whipsaws and confirm your trend
4. Define your risk
5. Define your entry and exit
6. Write your trading system rules down and ALWAYS stick to those rules!

There are 3 phases to testing your system:

1. Back test- go back and time and move your chart forward one candle at a time. Trade your system according to its rules and record your trades to see if it ends up being profitable.
2. If it is profitable, then you trade your system live on a demo account for at least 2 months. This will help you get an idea of how you would trade your system when the market is moving. It is a lot different trading live than manually back testing.

3. Once you've demo traded your system for at least 2 months and you are still profitable, you are then ready to trade your system live with real money. However, you must always remember to stick to your rules no matter what!

Okay now legal stuff our lawyers asked us to add:

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

FOREX MARKET HOURS

So far, all the lessons we have taught you deal with "***how***" to trade the Forex market. But another important lesson that you need to learn is "***when***" to trade the Forex market.

Yes, it is true that the Forex is open 24 hours a day, but that doesn't mean it's always active the whole day. You can make money in the Forex when the market moves up, and you can even make money when the market moves down. However, you will have a very difficult time trying to make money when the market doesn't move at all. This lesson will help determine when the best times of the day are to trade.

Market Hours

Before looking at the best times to trade, we must look at what a 24hr. day in the forex world looks like. The forex can be broken up into three major trading sessions: the Tokyo Session, the London Session, and the U.S. Session. Below is a table of the open and close times for each session:

Market Hours		
Time Zone	**EST**	**GMT**
Tokyo Open	7 PM	0:00
Tokyo Close	4 AM	9:00
London Open	3 AM	8:00
London Close	12 PM	17:00
U.S. Open	8 AM	13:00
U.S. Close	5 PM	22:00

Market Hours		
Time Zone	EST	GMT
Tokyo Open	7 PM	0:00
Tokyo Close	4 AM	9:00
London Open	3 AM	8:00
London Close	12 PM	17:00
U.S. Open	8 AM	13:00
U.S. Close	5 PM	22:00

You can see that in between each session there is a period of time where two sessions are open at the same time. From 3-4 a.m. EST, both the Tokyo and London markets are open, and from 8-12 p.m. EST, both the London and U.S. markets are open. Naturally, these are the busiest times during the market because there is more volume when two markets are open at the same time.

Trading Sessions - Average pip range of the 4 majors during each session.

Session	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Tokyo	66	79	100	66
London	80	99	121	74
U.S.	67	78	101	60

Trading Sessions				
Session	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Tokyo	66	79	100	66
London	80	99	121	74
U.S.	67	78	101	60

Average pip range of the 4 majors during each session

As you can see, the London session usually shows the most movement.

Now let's see which days of the week are best for trading...

BEST DAYS OF THE WEEK TO TRADE

Best Days of the Week to Trade Forex

Ok, so now we know that the London session is the busiest out of all the other sessions, but there are also certain days in the week where all the markets tend to show more movement. Below is a chart of average pip range for the 4 major pairs for each day of the week:

Trading Sessions - Average pip range of the 4 majors for each day of the week

Day of the week	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Sunday	24	31	36	25
Monday	92	110	141	95
Tuesday	102	128	162	104
Wednesday	101	123	158	106
Thursday	83	98	121	77
Friday	80	96	117	72

You can see that during the middle of the week is where the most movement is seen on all 4 major pairs. Fridays are usually busy until **12pm EST** and then the market pretty much drops dead until it closes at **5pm EST.** This means we only work half-days on Fridays. The weekend always starts early! Yippee!

So based on these three simple pieces, we've learned when the busiest times of the market are. These are the best times to trade because they give us a higher chance of success.

When to Trade if You Want to Lose Money

Here at BabyPips.com, we don't like to force our opinions on you. Instead, we want you to make your own decisions when it comes to your own trading. If you really do not want to trade during the busier times of the market when trade volume and pip movement is highest and where you will make money *easier*, then by all means, feel free to trade on these times mentioned below. We guarantee you'll have a more **difficult** time trading!

Fridays: Fridays are very unpredictable. This is a good day to trade if you want to lose all the profit you made during the rest of the week.

Sundays: There is very little movement on these days. Trade this day if you want to start off your week with NEGATIVE pips.

Holidays: Banks are closed which means very little volume for whatever country is having the holiday. Holidays are great to trade when you would rather lose your money than take a day off and enjoy the other finer things in life.

News Reports: No one really knows where the price will go when a news report comes out. You could lose a fortune trading during news releases if you don't know what you're doing. Price acts like a drunken monkey during these times and become unpredictable.

Can't Trade During Busy Market Hours?

What to do if you can't trade during the busy market hours

If you live in a crappy time zone or you have a day job, then you probably can't sit in front of a computer during the busy market hours. If this describes you, then I have a few solutions for you:

- **Move to a better time zone.** Move to London preferably. Sure you'd have to pack up and start a whole new life, but hey, at least you can trade right?
- **Trade at work** (be sure you have some "real" work ready just in case your boss sneaks up behind you and asks what you're working on). I also recommend you master the ALT-TAB key combination (if you use Windows) so you can quickly switch windows at a moment's notice. This option can be the ultimate perk because your employer is basically paying you while you trade Forex. Gettin' paid while gettin' paid if you know what I'm sayin'.
- **Become a swing or position trader.** As a swing/position trader, you won't have to constantly monitor the markets and you can check or look at them when you get off work.

- **Trade a different session** even if it's not the busiest one. If you can't trade the London or U.S. session, then trade the Tokyo session. However, you should be disciplined and trade it every day. You will start to learn how it moves and can develop strategies that are specific to that session.

We think 3 and 4 are your best options, but again, the choice is up to you.

Even if you can't trade, it's good to watch the charts for a full session. By getting use to seeing the price movement in action, you can actually see the real story of the currency. Watching the charts live is very different then looking at past charts.

Even if you can't actually trade the market, make mental notes of when you would take trades while you're watching the charts live. Practice makes perfect, and the more you do it, the better you'll get at it.

The Choice Is Yours

There you have it! We've given you all the information you need regarding when the best times to trade are. All you have to do now is decide whether or not you would rather trade when it's easier to make money, or if you'd rather do it the hard way.

Summary of Market Hours

Busiest/Best times to trade:

- When 2 sessions are overlapping: 3-4am EST and 8am-12pm EST
- The London session is the busiest out of the other two.
- The middle of the week typically shows the most movement.

Worst times to trade:

- Fridays
- Sundays
- Holidays
- News Events
- During Desperate Housewives or American Idol episodes

MONEY MANAGEMENT

This section is one of the most important sections you will ever read about trading.

Why is it important? Well, we are in the business of making money, and in order to make money we have to learn how to manage it. Ironically, this is one of the most overlooked areas in trading. Many traders are just anxious to get right into trading with no regards to their total account size. They simply determine how much they can stomach to lose in a single trade and hit the "trade" button. There's a term for this type of investing....it's called GAMBLING!

When you trade without money management rules, you are in fact gambling. You are not looking at the long term return on your investment. Instead you are only looking for that "jackpot". Money management rules will not only protect us, but they will make us very profitable in the long run. If you don't believe me, and you think that "gambling" is the way to get rich, then consider this example:

People go to Las Vegas all the time to gamble their money in hopes to win a big jackpot, and in fact, many people *do* win. So how in the world, are casino's still making money if many individuals are winning jackpots? The answer is that while even though people win jackpots, in the long run, casino's are still profitable because they rake in more money from the people that *don't* win. That is where the term "the house always wins" comes from.

The truth is that casinos are just very rich statisticians. They know that in the long run, they will be the ones making the money—not the gamblers. Even if Joe Schmoe wins $100,000 jackpot in a slot machine, the casinos know that there will be 100 more gamblers who WON'T win that jackpot and the money will go right back in their pockets.

This is a classic example of how statisticians make money over gamblers. Even though both lose money, the statistician, or casino in this case, knows how to control their losses. Essentially, this is how money management works.If you learn how to control your losses, you will have a chance at being profitable.

You want to be the rich statistician...NOT the gambler because in the long run, you want to "always be the winner."

So how do you become this rich statistician instead of a loser?

DRAWDOWN AND MAXIMUM DRAWDOWN?

So we know that money management will make us money in the long run, but now we'd like to show you the other side of things. What would happen if you didn't use money management rules?

Consider this example:

Let's say you have a $100,000 and you lose $50,000. What percentage of your account have you lost? The answer is 50%. Simple enough. Now, what percentage of that $50,000 do you have to make in order to get back to your original $100,000? It's not 50%--you'd have to make back 100% of your $50,000 to get back to your original $100,000. This is called drawdown. For this example, we would've had a 50% drawdown.

The point of that little illustration is that it is very easy to lose money and a lot harder to make it back. We know you're saying to yourself, "I'm not going to lose 50% of my account in one trade." Well we would certainly hope not!

However, what if you lost 3, 4, or even 10 trades in a row? That couldn't possibly happen to you, right? (Sarcasm used) You have a trading system that wins 70% of the time, so there is NO way you could lose 10 trades in a row. (Even more sarcasm used)

Well, while you may have a good system, consider this example:

In trading, we are always looking for an edge. That is the whole reason why traders develop systems. A trading system that is 70% profitable sounds like a very good edge to have. But just because your trading system is 70% profitable, does that mean for every 100 trades you make, you will win 7 out of every 10?

Losing Streak

Not necessarily! How do you know which 70 out of those 100 trades will be winners?

The answer is that you don't. You could lose the first 30 trades in a row and win the remaining 70. That would still give you a 70% profitable system, but you have to ask yourself, "Would you still be in the game if you lost 30 trades in a row?"

This is why money management is so important. No matter what system you use, you will eventually have a losing streak. Even professional poker players who make their living through poker go through horrible losing streaks, and yet they still end up profitable.

The reason is that the good poker players practice money management because they know that they will not win every tournament they play. Instead, they only risk a small percentage of their total bankroll so that they can survive those losing streaks.

This is what you must do as a trader. Only risk a small percentage of your "trading bankroll" so that you can survive your losing streaks. Remember that if you practice strict money management rules, you will become the casino and in the long run, "you will always win."

Let me illustrate what happens when you use proper money management and when you don't...

DON'T LOSE YOUR SHIRT

Here is a little illustration that will show you the difference between risking a small percentage of your capital compared to risking a higher percentage.

Trade #	Total Account	2% risk on each trade
1	$20,000	$400
2	$19,600	$392
3	$19,208	$384
4	$18,824	$376
5	$18,447	$369
6	$18,078	$362
7	$17,717	$354
8	$17,363	$347
9	$17,015	$340
10	$16,675	$333
11	$16,341	$327
12	$16,015	$320
13	$15,694	$314
14	$15,380	$308
15	$15,073	$301
16	$14,771	$295
17	$14,476	$290
18	$14,186	$284
19	**$13,903**	$278

Trade #	Total Account	10% risk on each trade
1	$20,000	$2,000
2	$18,000	$1,800
3	$16,200	$1,620
4	$14,580	$1,458
5	$13,122	$1,312
6	$11,810	$1,181
7	$10,629	$1,063
8	$9,566	$957
9	$8,609	$861
10	$7,748	$775
11	$6,974	$697
12	$6,276	$628
13	$5,649	$565
14	$5,084	$508
15	$4,575	$458
16	$4,118	$412
17	$3,706	$371
18	$3,335	$334
19	**$3,002**	$300

You can see that there is a big difference between risking 2% of your account compared to risking 10% of your account on a single trade. If you happened to go through a losing streak and lost only 19 trades in a row, you would've went from starting with $20,000 to having only $3,002 left if you risked 10% on each trade. You would've lost over 85% of your account! If you risked only 2% you would've still had $13,903 which is only a 30% loss of your total account.

Of course, the last thing we want to do is lose 19 trades in a row, but even if you only lost 5 trades in a row, look at the difference between risking 2% and 10%. If you risked 2% you would still have $18,447. If you risked 10% you would only have $13,122. That's less than what you would've had even if you lost all 19 trades and risked only 2% of your account!

The point of this illustration is that you want to setup your money management rules so that when you do have a drawdown period (losing streak) you will still have enough capital to stay in the game. Can you imagine if you lost 85% of your account? You would have to make 566% on what you are left with in order to get back to break even. Trust me, you do NOT want to be in that position. In fact, here is a chart that will illustrate what percentage you would have to make to breakeven if you were to lose a certain percentage of your account.

Loss of Capital	% required to get back to breakeven
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%

You can see that the more you lose, the harder it is to make it back to your original account size. This is all the more reason that you should do everything you can to protect your account.

So by now, I hope you have gotten it drilled in your head that you should only risk a small percentage of your account in each trade so that you can survive your losing streaks and also to avoid a large drawdown in your account. Remember, you want to be the casino...NOT the gambler!

RISK TO REWARD

Another way you can increase your chances of profitability is to trade when you have the potential to make 3 times more than you are risking. If you give yourself a 3:1 reward/risk ratio, you have a significantly greater chance of ending up profitable in the long run. Take a look at this chart as an example:

10 trades	Loss	Win
1	$1,000	
2		$3,000
3	$1,000	
4		$3,000
5	$1,000	
6		$3,000
7	$1,000	
8		$3,000
9	$1,000	
10		$3,000
Total	$5,000	**$15,000**

In this example, you can see that even if you only won 50% of your trades, you would still make a profit of $10,000. Just remember that whenever you trade with a good risk to reward ratio, your chances of being profitable are much greater even if you have a lower win percentage.

Summary of Money Management

Be the casino, not the gambler! Remember, casinos are just very rich statisticians!

Drawdown is a reality and WILL happen to you at some point. The less you risk in a trade, the less your maximum drawdown will be.

The more you lose in your account, the harder it is to make it back to breakeven.

Trade only a small percentage of your account. The smaller the better. 3% or less is recommended.

It is desirable to trade when you have a high risk to reward ratio. The higher the ratio, the less you have to be right.

WHY HAVE A TRADING PLAN?

Uh oh! You've learned so much and have come so far in your education, and yet you're still haven't graduated high school. No, you're not dumb, BUT you didn't have a trading plan.

Our point is that you can fill your mind with plenty of information, but without a good trading plan and the discipline to stick to it, you will NEVER be profitable.

Think of your trading plan as your map to success. It will be a constant reminder of how you will make money in this market. Of course it's not required, and if you can make your living by trading without a plan, we will bow down and hail you as the Market Zeus of the Forex.

So you CAN trade without a plan if you want, but before you make that decision, let us give you a few reasons WHY you should have one.

Why Have a Trading Plan?

Reason 1: It keeps you in the right direction

Consistency is very important to have in your trading routine because it allows you to truly measure how successful you are as a trader. If you have a sound trading system but always break your rules, how can you ever really know how good your system really is? Your trading plan will keep you on target. Read it every day and stick to it.

Reason 2: Trading is a business and successful businesses ALWAYS have plans

I have never seen a successful business not start out with a plan. Do you honestly think Walmart was just created on a whim and then magically became successful? Or what about McDonalds? I'm sure almost anyone can make a better hamburger than McDonalds, but the difference between them and the individual is that they have a successful business plan that guides them to success.

In the same way, you can relate the McDonald's story to your trading career. Whether it's by luck or experience, everyone can make money in the forex. However, the difference between a losing trader and a successful trader is the PLAN. If you have a good trading plan and you are disciplined enough to stick to it, you will be successful!

Now you know *why* you should have a trading plan. Let's find out *what* makes up a trading plan...

WHAT SHOULD BE IN YOUR TRADING PLAN?

Trading plans can be as simple or complex as you want it, but the most important thing is that you actually HAVE a plan and you FOLLOW the plan. With that said, here are some of the essentials that every trading plan should have.

1. A trading system

This is the heart of your trading plan. This system should be one that you have thoroughly backtested, and have traded for at least two months on a demo account.

Include all the necessary information about your system such as: time frames you use, criteria for entries and exits, how much you risk during each trade, which currency pair(s) you trade and how many lots you trade.

Example: I am an intraday trader and I trade off of the 10 minute charts. I enter when there is a moving average crossover and all my indicators support the direction. I only trade the EUR/USD and I risk no more than 2% of my account on each trade. For now, I trade 5 mini lots and will increase my lot size according to my 2% money matrading systemnagement rules.

2. Your trading routine

This is a crucial part of your plan because it will determine three very important things: when you will analyze the market and plan your trades, when you will actually watch the market to take trades, and when you will evaluate your actions during your trading day.

3. Your mindset

Ask any trader out there and they will all tell you that one of the hardest things to do when trading is to take out your emotions from it. This section of your trading plan will describe what frame of mind you will be in when you are trading.

Example:

- I will see what is on the charts and not what I want to see.
- No matter how biased I am towards a direction, I will make sure to trade only what my eyes see and not what my feelings tell me.
- I will not get "revenge" on the market if I lose on a trade.
- I will not beat myself up if I make a losing trade. Instead I will take it as a learning experience and move on.

4. Your weaknesses

Yes, we all have our weaknesses. We just don't like talking about them. But ask yourself this, "How will you ever get better, if you don't admit to what you need to work on?" This section will be an objective way to keep track of things that you need to work on in order to become a better trader.

Example:

- I tend to overtrade. Whenever I lose on a position, I get upset and immediately try to get "revenge" on the market.
- I tend to exit early on trades.
- I don't stick to the rules of my system every time
- I don't stick to my money management rules every time

5. Your goals

"To make a lot of money" is not a good goal. Sit down and really think about what you want to accomplish as a trader. Do you want to trade for a living? How much return can you realistically expect from trading based on your knowledge and experience? Your goals don't even have to be about making money. Maybe you would like to be more disciplined or gain more confidence. These goals can be personal. What do YOU want to get out of this? Use these goals as your motivation when times get tough. These goals will be your vision, and you must always keep your eyes on the prize!

6. Your trading journal

This will be a valuable tool to helping you become a better trader. Make sure you log all your trades and why you took them. Later down the road you can look back and evaluate your trades and see how you are progressing. I've looked back at my trade journal and have seen just how much I've grown as a trader. My first entries were very basic and as I've

progressed, my trades make more sense to me now. I've gained a lot of confidence throughout my career and by looking back at my trades, I've really been able to evaluate myself and see if I am getting closer to my goals. This tool will help you tremendously in the long run, so take a few minutes each day and log your trades. You'll be happy you did!

Summary of Trading Plans

Your trading plan will be your trading "bible".

Read it everyday and stick to it.

You can have all the trading tools in the world, but if you don't have a plan on how you will use them, you will never be successful.

Remember, you are starting a business, and if you want your business to succeed, you need to have a PLAN!

DISCOVERING YOUR TRADING PERSONALITY

Forex traders come in many different shapes and sizes. There are male traders, female traders, fat traders, skinny traders, beautiful traders, ugly traders, slow traders, fast traders, professional traders, amateur traders, fur traders ... and the list goes on.

Each trader has their own personality, their own personal schedule, their own appetite for risk, their own pain threshold and their own bankroll.

Some traders might have several things in common, but most will be different. The point is each of you are unique. And depending on your personality, personal preferences, and situation, how you trade will be a driving factor in determining your success.

In order to figure out how you should trade, you must first uncover your own "trading personality." Your trading personality will determine the trading style and method that's compatible for you.

Trading is not like a t-shirt. There is no one-size-fits-all. There is no single plan for all traders.

I challenge you to perform a self-assessment on your personality, behaviors, beliefs, and mindset. Do you consider yourself disciplined? Are you risk averse or a big risk taker? Are you indecisive or spontaneous? Are you patient or a firecracker? Would you prefer to go bungee jumping or visit a museum? Do you like your martini shaken or stirred?

An excellent way to help you with your self-assessment is to keep a trading journal. It will help you to analyze your thought processes after the trade, and identify your strengths and weaknesses in your trading. Understanding your personality is one thing, but

understanding it while you trade is a totally different story. A trading journal allows you to review your wining and losing trades and pinpoint specific reasons on why you won or lose.

Now, before we dive in to the different components of trading styles, let's look at the profiles of a few traders, their trading personalities, and how it's affected their lives outside of trading.

TRADING PERSONALITY TYPES

Pete the Position Trader

Pete is a busy man with a demanding wife, eight kids, four dogs, three cats, two hamsters, and a pet komodo dragon. It would be impossible to support such a large family on a meager salary, so fortunately, Pete is a successful doctor.

Pete doesn't like to sit in front of the computer all day. But he does enjoy reading about the world's economies and has a short list of countries which he keeps up with their economic data releases. Pete prefers to position trade. This means when he enters a trade, his holding period is between a few weeks to a couple of months. He only trades several times a year. Often, at the end of the year, he can recount his number of trades on one hand.

In order to do this, he uses discretionary fundamental analysis. This means he takes an hour or two every week to see what the economic reports (like GDP, employment data, CPI, etc.) are indicating to him. He then makes a decision on which way to trade, but does not automatically go with the signals. Because Pete's trades are longer term in nature, his profit targets are huge – but so are his stop losses! His stop losses usually range between 100-500 pips while his profit targets range from 500-1,000 pips or more. His trades have a big reward-to-risk ratio, which allows him to minimize his losses when he's wrong, but hit the jackpot when he's right.

Pete really enjoys being a position trader because it allows him to have a life. With his current work and family obligations, Pete clearly doesn't have the time to devote to being a day trader. His trading personality doesn't require him to make a decision in the heat of the moment and allows him to look for longer-term trends. As a position trader, he can juggle a busy career with his demanding wife, eight kids, four dogs, three cats, two hamsters and Komodo dragon.

Sam the Swing Trader

Sam is a single guy who owns a small coffee shop around the corner, where he works part time. He has also been trading on the side for a while now, and now his schedule is at the point where he is able to watch the market an hour or two a day.

Sam prefers to hold trades in a shorter time frame than Pete the Position Trader. He attempts to predict the short-term fluctuation in a currency pair's price, and is willing to hold his trades open for more than a day, or even a few days, to give the price movements

some time and capture additional momentum. On some trades Sam will generally be in a position from several days to even a week.

Sam dedicates an hour each day and/or evening to go over the market. The first half of his hour is spent reading the major economic news of the day and what news reports are coming out within the next 24 hours. Based on what's going on globally, he determines whether the currencies he is watching will see volatility or not. Since he only watches two or three pairs at the most, it doesn't take him long to read the major reports of the day.

After Sam has finished reading the economic news and reports, he determines if the market will trend or range for the next few days, or even weeks. He pulls up his charts and uses technical analysis to find good entry and exit points. His tools to find support and resistance include Fibonacci retracements, channels, trend lines, moving averages, etc. He then sets limit orders with stops and profit target levels, so it's all practically automated when he enters and exits a trade.

Sam has been pretty successful. He is able to mentally weather the daily swings a swing trader has to go through. His losses have been limited to 50–100 pips, while his gains have ranged between 100–500 pips.

Sam usually checks his position once or twice a day just to make sure unforeseen events haven't significantly affected his positions, and the rest of his day is spent doing whatever he wants, whether it's working, hanging with buddies, or browsing internet auction websites for comic books to add to his collection.

Diona the Day Trader

Diona is extremely impatient and feels she always "needs to be doing something." Her trading style consists of trade positions that are opened and closed in one day or less. Some days, she may only trade once. Other days, she may trade several times before the market closes. The bottom line is that she exits all positions by market close (5 p.m. EST) or when a session, such as the European or Asian session, ends. As a day trader, Diona feels the need to be in the market at all times because she's afraid of missing a good trade. She is also risk averse and is scared of losing too much per trade, so she uses small stop losses.

Diona has spent years developing a consistent method of taking profits out of the market. Her account is big enough where she could quit her job, and she watches the market full time now. While she is aware of news releases on any given day, Diona mainly relies on technical analysis when trading. She has been using technical tools such as oscillators (MACD, RSI, Stochastic) and moving averages, which automatically signal her to enter and exit high probability trades. She just follows the signals.

Most days, Diona goes for 10–50 pips or more while limiting her losses to 10–20 pips, but occasionally she will scalp the market. Scalping is a method where she trades larger lots and takes less pips (usually 5-10) out of the market. Most of her scalp trades last for a few minutes or even seconds!

The day trading and scalping methods allows Diona to make one to several trades per day and satisfy that "need to be doing something." Her confidence in the system allows her to stay with the plan and stick with the rules. She does not have to decide whether or not to

enter a trade – the charts do it for her! However, Diona knows that her system is not perfect. She loses a little less than half of her trades, but her average win is almost twice her average loss. Over the long run she has consistently profited from the market. She is now able to work from home, be her own boss and take time off to travel whenever she chooses.

WHAT KIND OF TRADER AM I?

So, what kind of trader am I?

Well, one of the first questions to ask is, "how much time do I have to trade currencies and how long can I comfortably be in a position?"

We can identify different trading personalities by time frame. Take a look at these different styles and see which one may fit you.

- **Scalping** – Scalpers are very short-term traders, usually in and out of trades within seconds. Most Forex brokers discourage this type of trading. It's also extremely dangerous due the high number of lots required to make a decent profit off a couple pips. Not for the faint of heart or shallow pockets.
- **Day traders** – Day traders open and close positions in the same trading session.
- **Swing traders** – Swing trading holds trades for days.
- **Position trading** – Long term position traders hold trades from weeks to months at a time.

Next question to ask is, "how do I want to analyze the market and decide on which trades to take?"

- **Technical Analysis** – using charts and technical indicators to analyze the past price movements of a currency pair to possibly see where the price may go in the future.
- **Fundamental Analysis** – Watching and analyzing economic news reports and indicators such as GDP, CPI, Employment data, or any political news that may affect a country's economy and their currency.

And finally are you a system trader, or are you a discretionary trader?

- **System Trader** – a system trader or mechanical trader tends to take to signals from system of technical indicators to automatically enter and exit trades. For instance, if the stochastic indicator shows that the currency pair is oversold, the system trader will automatically enter a buy on the currency pair.
- **Discretionary trader** – this trading style usually refers to traders who use both technical and fundamental analysis. A trader's technical method may signal a possible trade entry, but his or her analysis of the fundamental landscape may show a different story on the same pair.

Summary of Trading Personalities

Succeeding in forex trading takes hard work, lots of time, and some blood, sweat and tears. New traders need to be realistic right from the start. Beginners should start small and constantly evaluate their profitable trades as well as their failures.

Like I said earlier, trading is not like buying a t-shirt. One size does not fit all. Before you can succeed in trading, you must spend time doing homework, learning your personal strengths and weaknesses, and assessing your personal schedule, trading capital and trading experience.

Take the time to answer these questions, and also look back at your trading journal to see how you fared in different trading situations. Only then will you be able to decide on a trading personality that's compatible for you.

TRADING THE NEWS

Trading the news is becoming a popular technique to trade the forex markets ... and why shouldn't it be? Time and time again you see currency pairs move 50 to 100 pips within minutes or even seconds after a major news release. When you see that, I bet you're thinking, "50 to 100 pips!? That's easy money!" Maybe it is, and maybe it isn't. It all depends on how prepared you are to trade a news release.

The goal of this lesson isn't to give you a specific "Trading the News" strategy. The goal is to point you in the right direction and show some of the risks involved with trading these events, because here at BabyPips.com, we want to help you help yourself in developing your own methods that fit YOU best.

Why Trade the News?

Trading news releases can be a significant tool in your trading arsenal. If you want, it can be your only weapon altogether. Economic news reports often spur strong short-term moves in the market, which are great trading opportunities for breakout traders. And with the forex being open 24 hours a day and a true worldwide market, there are plenty of opportunities almost every trading day to catch market volatility (aka a lot of pips!) kicked off by an economic news report

Which Pairs Should I Trade?

Here is a list of the top currencies and countries in which you should focus on for news trading:

Symbol	Country	Currency	Nickname
USD	United States	Dollar	Buck
EUR	European Union	Euro	Fiber
JPY	Japan	Yen	Yen
GBP	Great Britain	Pound	Cable
CHF	Switzerland	Franc	Swissy
CAD	Canada	Dollar	Loonie
AUD	Australia	Dollar	Aussie
NZD	New Zealand	Dollar	Kiwi

Now, there are plenty more currencies available to trade, but this list is based on the size of each country's economy, frequency of news releases and the trading liquidity of their currency.

When are News Releases uh Released?

The list below displays the times when the most important economic data are released for each of the countries. Make sure you know them or go broke.

Symbol	Country	Time (GMT)
USD	United States	13:30 - 15:00
EUR	Germany	07:00 - 11:00
EUR	France	07:45 - 09:00
EUR	Italy	08:45 - 10:00
JPY	Japan	23:50 - 04:30
GBP	Great Britain	07:00 - 09:30
CHF	Switzerland	06:45 - 10:30
CAD	Canada	12:00 - 13:30
AUD	Australia	22:30 - 00:30
NZD	New Zealand	21:45 - 02:00

TRADEABLE REPORTS

With all of these countries to choose from, there are easily five to ten economic news releases almost every day! Also, the great thing about focusing on news releases is that they are scheduled in advance, so you know exactly when you can schedule your trading hours.

You may be thinking that five to ten news releases per day may be a lot to keep up with, but you really do not have to pay attention to every single report – you can pick and choose. There are a few key reports, most of which come out every month, that produce a significant amount of pip movement.

For this lesson, we will focus on U.S. news and economic reports, mostly because the U.S. dollar is involved in a majority of currency trades, and therefore tends to have the most significant impact on the currency markets. Here is a list of some of the top U.S. market moving reports:

- Employment Growth
- Interest Rate decisions
- Trade Balance
- Gross Domestic Product
- Retail Sales
- Durable Goods
- Inflation reports (Consumer Price Index and Producer Price Index)
- Foreign Purchases report (TIC Data)

Every country has a set of major reports similar to this list and can be as potentially volatile. Again, since these reports are scheduled in advance there are plenty of websites on the Internet with schedules and potential volatility rankings.

Things to Know When Trading News Reports

Now that we know "how" and "when" you can trade news reports, there are a few key concepts you should know before placing your first news trade.

- While the actual news number or report is essential to the long-term movement of a currency pair, in the short-term the difference between the market expectations and the actual release is what causes potential breakout opportunities. This means economic numbers and reports that come out as the market expected generally do not cause a strong market reaction.
- The quieter the market is before a news release, the more the market is poised for a significant move. Think about it: In a quiet market, less and less traders are buying and selling, possibly waiting for some sort of catalyst (like a news report maybe?). When this "catalyst" takes place, all of these traders waiting on the sidelines jump in at the same time causing a huge move in the market. So, the more traders wait (the quieter the market), the more will jump in after a news report (huge pips and a new Ferrari, right?).
- Depending on the significance of the economic report, and the amount of deviation of the actual to the forecasted number, news breakout opportunities are generally

short-lived and may last for only a few minutes or even a few seconds. Trading news releases may be better suited for scalpers and day traders.

TRADE FOREX AT YOUR OWN RISK

Before I pursue anything, I like to know exactly what I'm getting into. The same especially goes for trading. We've heard the benefits and why we should "trade the news," but more importantly we should know the risks.

Slippage

Market volatility can increase geometrically during news releases, which means the price can move as little as 5 pips to 20 pips (or even 50 pips and more during major news releases) in the matter of seconds. If you try to get your order filled during this type of volatility, you will probably get filled at a much different price than you anticipated. This is especially risky with limit entry orders.

For example, I once placed an order with a broker (one that guaranteed fixed spreads, but not execution) 15 minutes before a major news release on EUR/USD. Right before the release, the market was at 1.2320. I set my limit order to go long at 1.2360, with a profit level of 1.2383. The news came out bad for the U.S. dollar, which caused the market to shoot up 80 pips as soon as it was released. My long order was triggered, but unfortunately, I got filled in at 1.2390 – 30 pips above my limit price!! After the market settled for a bit, my profit target price was executed at a loss because it was set below the price at which I got filled in. Fortunately, it was only a 7 pips loss, but it was a costly lesson learned.

Order Freeze

Some brokers prevent limit and market orders right before a major news release (some up to 30 minutes to an hour beforehand). This usually occurs with brokers who guarantee fixed spreads.The reason your trading platform "locks up" is not because the platform "crashed", it's because the spread is too wide and if the brokers offered them with their fixed spreads, they would lose money.

Volatility/ Whipsaws

During major news reports and economic releases the market can swing 20 to 50 pips in a second! News volatility can be very dangerous, even for experienced traders. You may catch the strong initial move, but like so many times in these situations, it can turn against you into a losing trade just as fast.

Spreads

Some brokers may guarantee execution but do not guarantee spreads, and during news events you'll see spreads widen dramatically (I've seen a 3-pip spread turn into a 14-pip spread during a report). If you like to take small profits like 5 to 10 pips, this will hurt your chances of profitability and possibly keep you in a potentially losing trade.

NEWS TRADING METHODS

Straddles

Straddles are really easy to set up and require very little thinking, but it is probably the riskiest method of trading the news. To set up a straddle, you basically put a limit order to go long a few pips above the market before a news report, and simultaneously put in a limit order to go short a few pips below the market. If the report creates enough volatility your orders will be automatically triggered, and your stops and profit levels will also be automatically executed if hit. Simple as that.

Again, it sounds easy, but be very cautious with this method in that both long and short orders can be triggered, and if profit targets and stops are set incorrectly, you can be stopped out for maximum loss on both orders. Also, you run the inherent risks of slippage.

"Trading the Numbers"

This seems to be a more preferred method by many, in that you determine whether or not the news report is worth trading at all – a lot less risky than straddles.

First, you must determine the significance of the news report being released. Not every news report release is tradeable; either it wouldn't cause a stir in the market, or that the initial volatility would be so crazy that it would be too dangerous to enter a trade.

Ask yourself what kind of environment the market has been in recently. In other words, what has been affecting the market lately?

For example, maybe the Federal Reserve has been concerned with inflation. In this scenario, any inflation-related data (consumer price index, hints on future monetary policy) would be closely watched by the Fed – and what the Fed is watching, traders are watching. Any news reports of this level may be great opportunities to trade, as long as you are conscious of the risks.

The second step is to watch the news release and see if the report or economic number being released is inline with what the market is expecting. Obviously, if the report or number was a good one and/or a good surprise for a country, then you would go long its currency, and vice versa.

For example, in the next U.S. employment report, the market was expecting 200K new jobs, and the number came out at 300K. It's a surprise to the upside, and more jobs signal strength and growth in the U.S. You would go long as soon as the report is released and hope to catch a portion of the move. If the report came in pretty much as expected, then there would be no trade.

Summary of Trading the News

That's pretty much it….is it really that easy??? Heck no!! Well, maybe not at first. You'll have to practice and trade many different reports before you get a feel of which news reports will make the market move, how much of a surprise is needed for the market to move, and which reports to avoid. Like in any other trading method, your success depends on your preparation and confidence in your systems and methods. This will take time and practice. Do a little homework and study the economic indicators on why they are important. Nothing worth having comes easy, so stick with it and you'll find that trading news reports will be very rewarding once you get the hang of it.

GETTING SENTIMENTAL WITH FOREX TRADING

Sentimental analysis is what it sounds like – gauging the market sentiment. What does that mean? Well, as traders, a part of our job is to determine if a market is bullish, bearish, overbought, oversold, and to plan a trade for those market conditions – basically putting all of the things we've learned up until this point all together.

So how do we do that? What tools can we use? And how do we react to certain conditions? Well, that's what we're going to find out today – we're going to take a look into sentiment analysis in forex trading.

Now there are a couple of ways to gauge different market conditions. Does anyone know what those two things are? You guessed it: technical and fundamental analysis. Now, in the School of Pipsology, we've covered most of the commonly used technical indicators out there for forex trading, so you should be an expert at that already right?

But how about the fundamental tools? What fundamental tools are available to gauge sentiment?

Well, in stocks and options, sentiment is measured using volume data. For instance, if a declining stock suddenly reversed on high volume that means the market sentiment may have changed from bearish to bullish. Or if a stock price was rising on gradually declining volume, then that may be a sign of an overbought market.

But have you ever seen volume data on any forex charts?

Probably not.

Being that the foreign exchange does not have a centralized market, volume data cannot be accurately calculated. So, where's a trader to go to get such valuable data? That's where the COT report comes in.

COMMITMENT OF TRADERS REPORT

The Commodity Futures Trading Commission publishes the Commitment of Traders report (COT) every Friday, and it measures the net long and short positions taken by traders in the futures market. It is a great resource to gauge market sentiment from the "big players" because of their large positions they are required to report to the government. Of course, it is very important to see what the "smart money" is up to because they move the markets and it may have an impact on your positions.

Below, we have an example of the Swiss Franc COT report taken from August 22, 2006 Check it out:

```
SWISS FRANC - CHICAGO MERCANTILE EXCHANGE                          Code-092741
FUTURES ONLY POSITIONS AS OF 08/22/06                          |
-------------------------------------------------------------| NONREPORTABLE
      NON-COMMERCIAL      |   COMMERCIAL    |      TOTAL      |   POSITIONS
--------------------------|-----------------|-----------------|-----------------
  LONG  | SHORT  |SPREADS |  LONG  | SHORT  |  LONG  | SHORT  |  LONG  | SHORT
-------------------------------------------------------------------------------
(CONTRACTS OF 125,000 SWISS FRANCS)                  OPEN INTEREST:       68,484
COMMITMENTS
  16,847   27,312      506   38,181   27,544   55,534   55,362   12,950   13,122

CHANGES FROM 08/15/06 (CHANGE IN OPEN INTEREST:      2,463)
   3,765   -1,017      506   -2,753    5,023    1,518    4,512      945   -2,049

PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS
    24.6     39.9      0.7     55.8     40.2     81.1     80.8     18.9     19.2

NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS:       46)
      14       15        1        8       12       22       28
```

The report is pretty straight forward, but here's a quick rundown of what each category is.

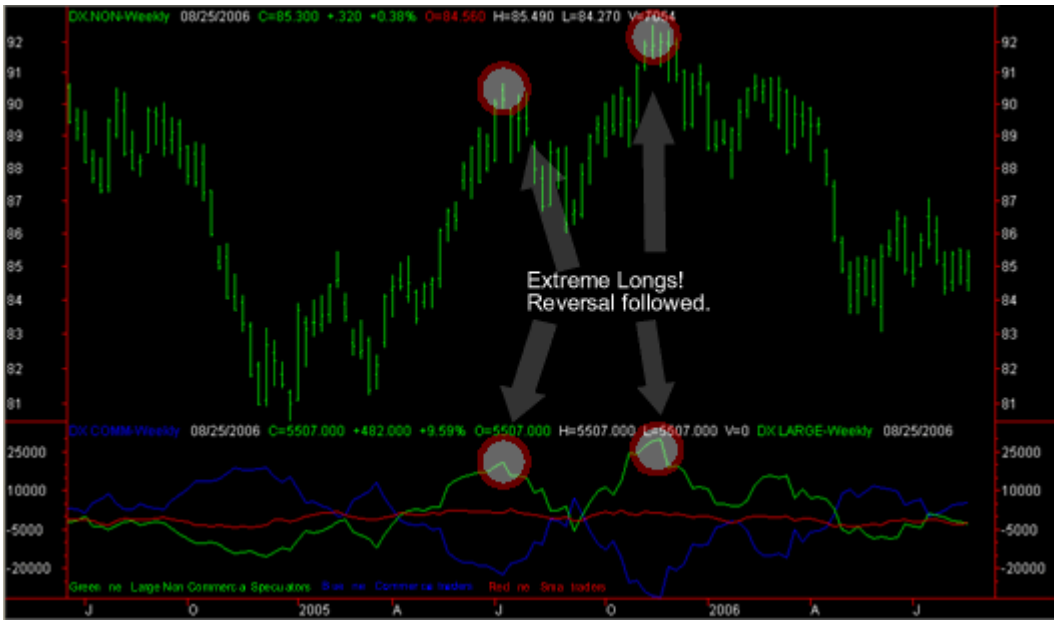
- **Non-Commercial** - This is a mixture of individual traders, hedge funds, and financial institutions. For the most part, these are traders who looking to trade for speculative gains.
- **Commercial -** These are the big businesses that use currency futures to hedge.
- **Long** - number of long contracts reported to the Commodity Futures Trading Commission (CFTC).
- **Short** - number of short contracts reported to the CFTC.
- **Open interest**- this column represents the number of contracts out there that have not been exercised or delivered.
- **Non-reportable positions;-** These are the open interest positions of traders that do not meet the reportable requirements of the CFTC.
- **Number of traders**- total number of traders who are required to report positions to the CFTC.

- **Reportable positions;-** the number of options and futures positions that required to report according to CFTC regulations.

In the center of the report we see "**CHANGES FROM 08/15/06.**" This section shows the change in Open Interest and the changes in the Long and Short positions from the previous week.

HOW TO USE THE COT REPORT

Because the COT report is published weekly, it would be more suitable for longer term traders to use as a market sentiment indicator. So, how do we do that? Well, besides using the changes in open interest and changes in the number of long and short contracts as a volume indicator, my favorite way to use the COT report is to find extreme net long and net short positions. This can be great indicator that a market reversal is around the corner because if everyone is long a currency, who is left to buy? No one. And if everyone is short a currency, who is left to sell? Again, no one. The only thing a market can do is go the other direction. Here's a chart example:



This is an example chart of the US Dollar Index from freecotcharts.com. In the top half of the chart we have the price action of the USD index futures with each bar representing weekly data. On the bottom half of the chart we have data on the net long/short positions broken down into three categories: Commercial (Blue), Large Non-commercial (Green), and Small Non-commercial (Red). We will pay attention to the Large Non-commercial positions since commercial positions are for hedging and small retail traders aren't really a factor.

Let's examine this chart and see what it can tell us. We can see that the US Dollar began a nice little bull run at the start of 2005. As the value of the net long positions of large speculative traders (green line) rose, so did the price of the USD futures index. In the first week of July 2005, net long positions grew to over 20K contracts. This was an extreme area of longs and soon after the market began to sell off USD index futures. The USD index price

dropped from 91 to 86, but it only proved to be a retracement as the index rallied to a new high of about 93.16 and higher level of 29K net long contracts.

As you have probably already asked yourself, "with this many longs who is left to buy?" Not too many traders really. With the market appearing overbought in November 2005, we began to see the number of long USD index futures contracts decline and a drop in the index price from 93 all the way down to about 84. Wow, can you imagine if you positioned yourself before this move?

By now I bet you're asking, "I trade the spot Forex market not futures. How does this apply to my trading?" Great question! Since we're already taking a look at the US Dollar, let's look at one of the best vehicles to trade the Greenback in the spot Forex market: **EUR/USD.**

Here's a weekly chart of **EUR/USD:**

If we had applied what we learned in the previous section by positioning ourselves for market reversals, we could have caught two significant moves from July 2005 to May 2006 in **EUR/USD.**

First, in July 2005, if a trader saw the extreme levels of net longs in the USD index futures, this trader would catch the possible upcoming selloff of the Greenback by buying **EUR/USD.** This trader would've been proven right, and paid off handsomely as this position could have caught a maximum of 700 pips. Again, if this trader were so astute to catch the extreme level of long USD index futures contracts in November 2005, buying **EUR/USD** would have been the best bet as the pair rallied from about 1.1650 to almost 1.3000....wowzers!!! That's over 1300 pips gained! So, from July 2005 to May 2006, a trader could have caught almost 2000 pips just using the COT report as a market reversal indicator. Pretty good, eh??

#

Summary of COT Reports

Now, before we get all excited and start betting the farm on what the COT reports says, let's remember a couple of things.

First, this is just one example of how the COT report can signal market reversals. I could sit here and post examples all day, but the best thing for your trading education is to review past COT data and charts, which is freely available all over the internet. I'm a firm believer in backtesting, not just to see if a strategy works, but how a strategy may fail me at certain times. This technique does not always correlate to market reversals, so take the time to study this report, and get your own feel of what works and what doesn't.

Second, market prices aren't driven by COT reports, MACD, Stochastics, Fibonacci numbers, or anything like that - the markets are driven by millions of people reacting to fundamental reports, economic analysis, and politics. Use these tools in conjunction with what's going on in the world, and you can gain a serious edge and insight to what the market is feeling and be prepared to act on it.

WHAT IS THE U.S. DOLLAR INDEX?

If you've traded stocks, you're familiar with all the indices available such as the Dow Jones Industrial Average (DJIA), NASDAQ Composite Index, Russell 2000, S&P 500, Wilshire 5000, and the Nimbus 2001. Oh wait, the last one is actually Harry Potter's broomstick.

Well if U.S. stocks have an index, the U.S. dollar can't be outdone. For currency traders like us, we have the U.S. Dollar Index (USDX).

The U.S. Dollar Index consists of a geometric weighted average of a basket of foreign currencies against the dollar.

Come again?! Okay before you fall asleep on us after that super geeky definition, let's break it down.

It's very similar to how the stock indices work in that it provides a general indication of the value of a basket of securities. Of course, the "securities" we're talking about here are other major world currencies.

The Basket

The U.S. Dollar Index consists of six foreign currencies. They are the:

1. Euro (EUR)
2. Yen (JPY
3. Cable (GBP)
4. Loonie (CAD)

5. Kronas (SEK)
6. Francs (CHF)

Here's a trick question. If the index is made up of 6 currencies, how many *countries* are included?

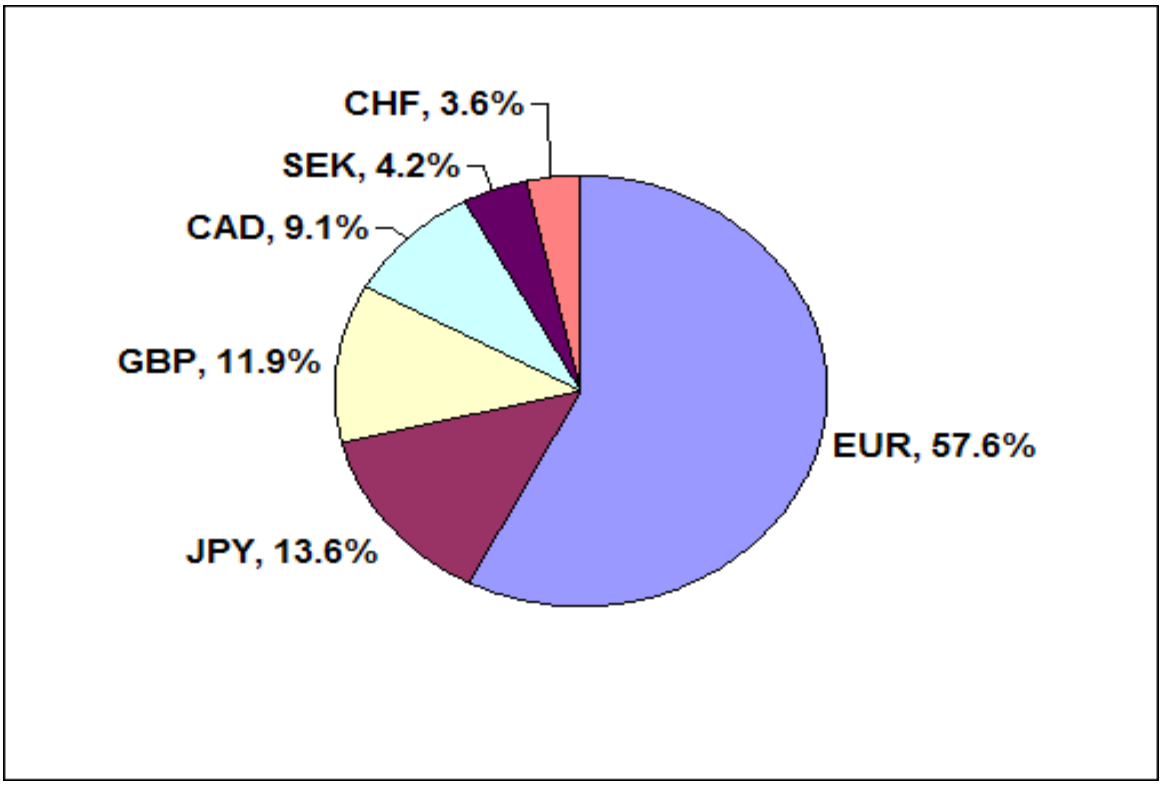
If you answered "6", you're wrong. If you answered "20", you're a genius.

There are 20 countries total, because there are 15 members of the European Union that have adopted the euro as their sole currency, plus the other five countries (Japan, Great Britain, Canada, Sweden, and Switzerland) and their accompanying currencies.

It's obvious that 20 countries make up a small portion of the world but many other currencies follow the U.S. Dollar index very closely. This makes the USDX a pretty good tool for measuring the U.S. dollar's global strength.

THE USDX COMPONENTS

Now that we know what the basket of currencies are, let's get back to that "geometric weighted average" part. Because not every country is the same size, it's only fair that each is given appropriate weights when calculating the U.S. Dollar Index. Check out the current weights:



As you can see, with its 12 countries, Euros make up a big chunk of the U.S. Dollar Index. The other five make up less than 43 percent.

Here's something interesting: When the euro falls, which way does the U.S Dollar Index move?

The euro makes up such a huge portion of the U.S. Dollar Index, they might as well call this index the "Anti-Euro Index". Because the USDX is so heavily influenced by the euro, people have looked for a more "balanced" dollar index. More on that later though. First, let's go to the charts!

HOW TO READ THE U.S. DOLLAR INDEX

Here's a chart of the U.S. Holler at the Dollar Index:

First, notice that the index is calculated 24 hours a day, seven days a week. The USDX measures the dollar's general value relative to a base of 100.000. Huh?!

Okay. For example, the current reading says 86.212. This means that the dollar has fallen 13.788% since the start of the index. (86.212 - 100.000).

If the reading was 120.650, it means the dollar's value has risen 20.650% since the start of the index. (120.650 – 100.00)

The start of the index is March 1973. This is when the world's biggest nations met in Washington D.C. and all agreed to allow their currencies to float freely against each. The start of the index is also known as the "base period".

The U.S. Dollar Index Formula

This is strictly for the grown and geeky. Here is the formula to calculating USDX:

USDX = 50.14348112 × EURUSD^(-0.576) × USDJPY^(0.136) × GBPUSD^(-0.119) × USDCAD^(0.091) × USDSEK^(0.042) × USDCHF^(0.036)

TRADE-WEIGHTED U.S. DOLLAR INDEX

There is also another kind of dollar index used by the Federal Reserve. It is called the "trade-weighted U.S. dollar index".

The Fed wanted to create an index that could more accurately reflect the dollar's value against foreign currencies based on how competitive U.S. goods are compared against other countries.

The main difference between the USDX and the trade-weighted dollar index is the basket of currencies used and their relative weights. The weights are based on annual trade data.

Currencies and Weights

Here is the current weighting of the index:

Euro area	**17.191**
Canada	15.550
Japan	9.220
Mexico	9.826
China	16.269
United Kingdom	4.500
Taiwan	2.436
Korea	3.520
Singapore	2.057
Hong Kong	1.838
Malaysia	2.124
Brazil	1.987
Switzerland	1.404
Thailand	**1.435**
Philippines	0.713
Australia	1.189
Indonesia	0.961
India	1.417
Israel	1.056
Saudi Arabia	0.818
Russia	1.152
Sweden	1.025
Argentina	0.485
Venezuela	0.486
Chile	0.841
Colombia	0.499
Total	100

***Weights as of June 17, 2008**

For more information on exchange rate indexes for the U.S. dollar, see "Indexes of the Foreign Exchange Value of the Dollar"

Weights for the broad index can be found at
http://www.federalreserve.gov/releases/H10/Weights

If you'd like to see historical data, check out
http://www.federalreserve.gov/releases/h10/Summary/

- ## What is the Carry Trade?

Did you know there is a trading system that can make money if price stayed exactly the same for long periods of time?

Well there is and it's one the most popular ways of making money by many of the biggest and baddest money manager mamajamas in the financial universe!

It's called the Carry Trade.

A carry trade involves borrowing or selling a financial instrument with a low interest rate, then using it to purchase a financial instrument with a higher interest rate. While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Thus your profit is the money you collect from the interest rate differential. For example:

Let's say you go to a bank and borrow $10,000. Their lending fee is 1% of the $10,000 every year. With that borrowed money, you turn around and purchase a $10,000 bond that pays 5% a year.

What's your profit?

Anyone?

You got it! It's 4% a year! The difference between interest rates!

By now you're probably thinking, "That doesn't sound as exciting or profitable as catching swings in the market." However, when you apply it to the spot forex market, with its higher leverage and daily interest payments, sitting back and watching your account grow daily can get pretty sexy.

HOW DOES THE CARRY TRADE WORK FOR FOREX?

In the Forex market, currencies are traded in pairs (for example, if you buy the USDCHF pair, you are actually buying the US dollar and selling Swiss Francs at the same time). Just like the example above, you pay interest on the currency position you sell, and collect interest on the currency position you buy.

What makes the carry trade special in the spot Forex market is that interest payments happen every trading day based on your position. Technically, all positions are closed at the end of the day in the spot Forex market - you just don't see it happen if you hold a position to the next day.

Brokers close and reopen your position, and then they debit/credit you the overnight interest rate difference between the two currencies. This is the cost of "carrying" (also known as "rolling over") a position to the next day.

The amount of leverage available from Forex brokers has made the carry trade very popular in the spot Forex market. Forex trading is completely margin based, meaning you only have to put up a small amount of the position and you broker will put up the rest. Many brokers ask as little as 1% - 2% of a position - what a deal, eh?

Let's take a look at a **generic** example to show how awesome this can be.

For this example we'll take a look at Joe the newbie Forex trader. It's Joe's birthday and his grandparents, being the sweet and generous people they are, give him $10,000. Schweeeet!

Now, instead of going out and blowing his birthday present on video games and posters of bubble gum pop stars, he decides to save it for a rainy day. Joe goes to the local bank to open up a savings account and the bank manager tells him, "Joe, your savings account will pay 1% a year on your account balance. Isn't that fantastic?" Joe pauses and thinks to himself, "At 1%, my $10,000 will earn me $100 in a year. Man, that sucks!"

Joe, being the smart guy he is, has been studying BabyPips.com and knows of a better way to invest his money. So, Joe kindly responds to the bank manager, "Thank you sir, but I think I'll invest my money somewhere else, yo."

Joe has been demo trading several systems, including the carry trade, for over a year, so he has a pretty good understanding of how Forex trading works. He opens up a real account, deposits his $10,000 birthday gift, and puts his plan into action. Joe finds a currency pair whose interest rate differential is +5% a year and he purchases $100,000 worth of that pair. Since his broker only requires a 1% deposit of the position, they hold $1,000 in margin (100:1 leverage). So, Joe now controls $100,000 worth of a currency pair that is receiving 5% a year in interest.

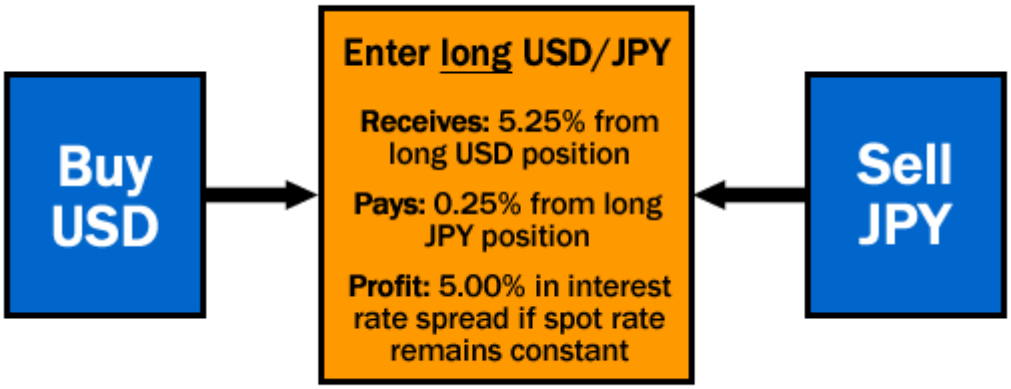
What will happen to Joe's account if he does nothing for a year?

Well, here are 3 possibilities. Let's take a look at each one:

1. **Currency position loses value.** The currency pair Joe buys drops like a rock in value. If the loss brings the account down to the amount set aside for margin, then the position is closed and all that's left in the account is the margin - $1000.
2. **The pair ends up at the same rate at the end of the year**. In this case, Joe did not gain or lose any value on his position, but he collected 5% interest on the $100,000. That means on interest alone, Joe made $5,000 off of his $10,000. That's a 50% gain! Sweet!
3. **Currency position gains value.** Joe's pair shoots up like a rocket! So, not only does Joe collect $5000 in interest on his position, but he also takes home any gains! That would be a nice present to himself for his next birthday!

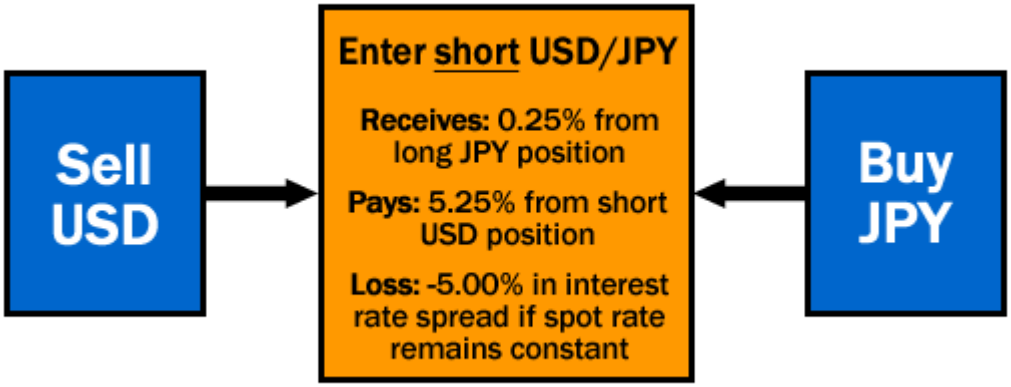
Because of 100:1 leverage, Joe has the potential to earn around 50% a year from his initial $10,000.

Here is an example of a currency pair that offers a 5% differential rate based on current interest rates:



If you **buy USD/JPY** and held it for a year, you earn a "positive carry" of 5%.

Of course, if you **sell USD/JPY**, it works the opposite way:



If you sold **USD/JPY** and held it for a year, you would earn a "negative carry" of 5%.

Again, this is a generic example of how the carry trade works. Any questions on the concepts? No? I knew you could catch on quick! So, now it's time to move on to the most important part of this lesson: Carry Trade Risk.

CARRY TRADE RISK

Being that you are a professional trader, you already know what the first question you should ask before entering a trade is, right?

"What is my risk?"

Correct! Before entering a trade you must always assess your max risk and whether or not it is acceptable according to your risk management rules.

In the previous example with Joe the Newbie Trader, his maximum risk would have been $9000. His position would be automatically closed out once his losses hit $9000.

Eh?

That doesn't sound very good, does it?

Remember, this is the worst possible scenario and Joe is a newbie, so he hasn't fully appreciated the value of stop losses.

When doing a carry trade, you can still limit your losses like a regular directional trade. For instance, if Joe decided that he wanted to limit his risk to $1000, he could set a stop order to close his position at whatever the price level would be for that $1000 loss. He would still keep any interest payments he received while holding onto the position.

CARRY TRADE CRITERIA

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

1. Find a high interest differential.
2. Find a pair that has been in an uptrend – where the currency you are long has been gaining value against the currency you are short.

Pretty simple, huh? Let's take a real life example of the carry trade in action:

This is a weekly chart of GBP/JPY. Up until recently, the Bank of Japan has maintained a Zero Interest Rate Policy (current interest rate is 0.25% as of this writing - 11/01/2006). With the Bank of England touting one of the higher interest rates among the major currencies (currently at 4.75% as of this writing), many traders have flocked to this pair (one of the factors creating a nice little uptrend in the pair). From the end of 2000 to mid-2006, this pair moved from a price of 150.00 to 223.00 – that's 7300 pips! If you couple that with interest payments from the interest rate differential of the two currencies, this pair has been a nice long term play for many investors and traders able to weather the volatile up and down movements of the currency market.

Of course, economic and political factors are changing the world daily. The interest rates and interest rate differentials between currencies may change as well, bringing popular carry trades (such as the Yen carry trade) out of favor with investors.

Summary of the Carry Trade

As you can see there are other ways to make money in the Forex market without having to buy low and sell high, which can be pretty tough to do day after day.

If you catch the right pair (one with a positive interest rate differential) at the right time, then you'll be sure to do well collecting money out of the market.

When properly applied, the carry trade can add significant income to your account, along with your directional trading strategies.

ARE YOU WILLING TO PAY THE PRICE?

HA! Made you click!

If you really thought there actually was a way for a lazy Forex trader to get rich, SHAME ON YOU!

No such thing exists. The word "lazy" and "trader" is an oxymoron. You have to be willing to pay the price to become a trader.

Which brings us to our next lesson....

So, you've gone through the School of Pipsology...five times, learned basic analysis and money management techniques, and maybe even opened up a demo account and started trading a plan you've created. (You do have a trading plan, right?) Now you can sit back and relax because it's easy money from here on out, right?

Wrong!

You've just taken the first step.

You've only familiarized yourself with the very basic fundamentals of what it takes to become a professional trader. Now it's time to get on to the real work.

I'm sure you're now thinking, "There's more to learn?!"

Well, my friend, the learning never ends.

As with any profession, whether you're a doctor, lawyer, athlete, assassin, spy, ninja, ultimate fighter, musician or any other occupation that requires a high level of skill, you can never stop learning and practicing. Otherwise, your skills will deteriorate and you'll slowly forget what you've learned

This lesson will give you a peek into what it takes – education, time, money and psychological stamina – to enter the most financially rewarding career on the planet: a professional trader.

EDUCATION

Imagine yourself in a legal situation and you decide to hire the cheapest lawyer you can find. On the day you have to stand in front of a jury, your lawyer says to you, "Don't worry, while this is my first time, I've read 'How to be an Awesome Lawyer in 28 Days for Idiots' a couple of times, so I know what I'm doing. You'll be fine."

Do you think your investment in that lawyer will pay off?

Probably not.

You'll probably end up in prison with a tattoo covered cellmate named "Killer" for the rest of your life.

Now I'm not a professional lawyer, but I'm pretty sure that it takes more than one book to become one. More likely, lawyers have read and studied a wide range of books, journals and case studies in order to fine-tune their practice. So why should it be any different to become a professional trader?

Trading involves becoming proficient in a multitude of disciplines, including fundamental analysis, technical analysis, sentiment analysis and self-awareness (also known as trading psychology or what I call "mental analysis").

Within those disciplines are different topics that should be studied individually.

For instance, while the School of Pipsology does a fantastic job of introducing the Elliot Wave theory and making it easy to understand, there's abundant amount of entire books written on that single subject. The same thing goes with many other technical tools (i.e. candlestick charting, Fibonacci numbers, pivot points, etc.), fundamentals and trading psychology.

If you limit your education to a basic high-level overview of a few subjects, how do you think that will help you acquire the skills needed to become a successful trader?

I'm not saying go out there and read everything there is to read on trading. While that would be ideal, realistically it's not possible.

What I am saying is this…

Before you enter a single trade, read and study enough to know why a tool works, how it works and how well it has worked in many different situations. After you start trading your live account, continue reading and studying some more. The forex market is dynamic and continuously changing. (What market isn't?) Being well versed in all the disciplines of trading gives you the ability to adapt and make quick decisions in this fast-paced market.

TIME

Have you ever told yourself there's never enough time in the day? I think we've all thought that to ourselves at one point, but if you're not willing to shift your priorities to make time for trading, then forget about becoming a trader.

Sorry to put it so bluntly, but contrary to popular belief, trading is not a hobby.

Trading is not a hobby.

Trading is not a hobby unless you want to lose money.

Golf is my hobby. I pay to play golf. Golf is Tiger Wood's business. Tiger Woods is paid to play golf.

See the difference?

Trading is a business

You have to devote yourself to trading just like you would with any other business in order to be successful.

So, it's time (pun intended) to ask yourself this: "Can I balance my time and change my lifestyle to make room for trading?"

I'd better hear a resounding "YES!"

But before you can even truly answer that question, you need to first figure out what your daily priorities are and determine whether or not you can make trading THE number one priority.

A good way to find this out for yourself is to list your daily activities, and then prioritize them. If your daily priorities take up all of your time, then forget about trading.

So, take a moment to figure out what is going on in your life because it's very important to balance your time and priorities, not just to become a successful trader, but also to live a content, meaningful life. We all want to be wildly profitable, and initially we may drop everything else to get there, but in the end an unbalanced life will lead to personal and/or professional failure.

CAPITAL AKA CASH MONEY

It takes money to make money. Everyone knows that, but how much does one need to get started in trading? The answer largely depends on how you are going to approach your new start-up business.

First, consider how you are going to be educated. There are many different approaches in learning how to trade: classes, mentors, on your own, or any combination of the three.

While there are many classes and mentors out there willing to teach Forex trading, most will charge a fee. The benefit of this route is that a well-taught class or great mentor can significantly shorten your learning curve and get you on your way to profitability in a much shorter amount of time compared to doing everything yourself.

The downside is the upfront cost for these programs, which can range from a few hundred to a few thousand dollars, depending on which program you go with. For many of those new to trading, the resources (cash money) required to purchase these programs are not available.

For those of you unable or unwilling to pony up the cash for education, the good news is that most of the information you need to get started can be found for FREE on the internet through forums, brokers, articles and websites like BabyPips.com. We should all thank Al Gore for inventing the Internet. Without him, there would be no BabyPips.com

This is no one "correct" path.

As long as you are disciplined and laser focused on learning the markets, your chances of success increase exponentially. You have to be a gung ho student. If not, you'll end up in the poor house.

Second, is your approach to the markets going to require special tools such as news feeds or charting software? As a technical trader, most of the charting packages that come with your broker's trading platform are sufficient (and some are actually quite good). For those who need special indicators or better functionality, higher end charting software can start at around $100 per month. Maybe you're a fundamental trader and you need the news the millisecond it is released, or even before it happens (wouldn't that be nice!). Well, instantaneous and accurate news feeds run from a few hundred to a few thousand dollars per month. Again, you can get a complimentary news feed from your broker, but for some, that extra second or two can be the difference between a profitable or unprofitable trade.

Finally, you need money/capital/funds to trade. How much exactly? Well, let's be honest here. If you're consistent and practice proper money management techniques, and without even knowing your monthly expenses, then you can probably start off with $50k to $100k in trading capital. It's common knowledge that most businesses fail due to undercapitalization, which is especially true in the Forex trading business. So, if you are unable to start with a large amount that you can afford to lose, be patient, save up and learn to trade the right way until you are financially ready.

PSYCHOLOGY

Once you've made the time to get properly educated, demo trade, and save up sufficient capital, the time will come where you will have to tackle the markets. By this time you should've have learned the mechanics of trading and methods to analyze the market that you are most confident using.

But are you ready to risk your hard-earned money?

Can you put your money where your mouth is?

Can you handle the (emotional, psychological and financial/economic) pressure of the occasional losing streak and account drawdown?

Will you be able to control your excitement on a profitable trade?

Can you let go of your last trade and completely focus on your next opportunity?

What separates the profitable traders from the unprofitable ones is that profitable traders can handle the pressure of risk and control their emotions. They realize that losing is just a part of business. Those who have enough confidence in their methods and systems know that a drawdown is a short-term setback and they will soon recover.

This final crucial lesson can't really be taught. It will take time and experience. You have to put in the hours. You will have to go through a gazillion different trades and different market environments before you grasp and live these concepts. If you can't do this or aren't willing to, then ultimately, trading may not be for you.

Additionally, be sure to check out our Forex Psychology Blog: Pipsychology.

Summary of Forex Challenges

For those willing to take the challenge and follow through, professional trading can be a worthwhile goal. But before you dive too deep into Forex trading, dip your toe or get your feet wet in the shallow end first, and become familiar with the water. As you get more comfortable, make your way slowly to the deeper end. Take your time.

- Be honest with yourself.
- Be ready to sacrifice your time and money.
- Never stop learning and, most importantly, never quit.
- Winners never quit and quitters never win.
- The price of becoming top trader is extremely high, but certainly worth it.

FOREX TRADING SCAMS

Don't be a sucker.

One of the first things you must learn about the Forex market is that although it is enjoyable and exciting, there is no magic button that will instantly turn your pennies into millions of dollars. You may have already heard about Forex scams that are filling the marketplace. These companies purposely mislead people into thinking that making money in the Forex is easy and that they have found the "Magic Solution" to raking in booku bucks with a simple click of a button.

Sadly, the number of Forex scams is rising. The Commodities Futures Trading Commission (CFTC) released a report citing that in recent years, they have seen a sharp increase in the rise of Foreign Exchange scams. The CFTC warns consumers to be cautious of sales solicitations in newspapers, radio or television. You've probably even seen some of these companies. I hear about them all the time from people whenever I try to explain the Forex. The first thing they say is that they think the Forex is a scam. That makes me so angry! The Forex is a tremendous investment opportunity for people and because of these scammers, they miss out on a good way to make money.

The truth is that no matter how you slice or dice it, education is the only fool proof way to consistently make money in the Foreign Exchange. Even after you finish reading through BabyPips.com, your journey as a FX trader is only the beginning. I have never met a successful Forex trader who stopped learning. There is always something new to learn and you must actively seek out as much information as you can.

The best investment you can ever make is in yourself.

Don't spend your money on a company that promises huge returns; even if they show you their track record. It might look pretty and colorful; and I'm sure that the line on the graph that seems to keep going higher and higher makes it look like there is no way you could lose money, but don't let them fool you. In fact, I could take my broker statement right now, touch it up with Photoshop and voila! – I have now just become the most successful trader on the planet. Pretty impressive huh? I know I'm laying it on pretty thick, but I really want to prevent you from falling into any traps. Instead of giving your hard earned money to someone else, you could put that money aside into a trading account and take the time to educate yourself.

Notice that I didn't say you should put your money into a trading account and start trading.

Keep that money in your account and gradually add to it as you continue to learn. Before you know it, your account size will be bigger than you realized, and to top it off, you'll have a wealth of Forex education under your "traders" belt.

So remember, Forex scams **DO** exist. Be wary of them and hold onto your money. The good news is that there ARE legitimate Forex companies out there. Make sure you do thorough research on a company if you are thinking about giving them a shot. Ask other

traders on the forums if they've had experiences with them. There is a wealth of information on the Internet so do your homework and you'll be just fine.

Related Links:

Rising Number In Forex Scams
http://www.cftc.gov/enf/enfforex.htm

Public Warnings For Forex Scams
http://www.cftc.gov/opa/enf98/opaforexa15.htm

A List Of Known Forex Scammers
http://www.quatloos.com/forex-bulletins.htm

How To Report A Forex Scam
http://www.quatloos.com/forex-problems.htm

Check Yo Broker!

We discussed this issue in our Pre-School but we feel it's so important that we will repeat what we've said....

MAKE SURE YOUR FOREX BROKER IS REGULATED!

When selecting a prospective Forex broker, find out with which regulatory agencies it is registered with. The Forex market is labelled as an "unregulated" market, and it basically is. Regulation is typically reactive, meaning only after you've been bamboozled out of your entire savings will something be done.

In the United States a broker should be registered as a Futures Commission Merchant (FCM) with the Commodity Futures Trading Commission (CFTC) and a NFA member. The CFTC and NFA were made to protect the public against fraud, manipulation, and abusive trade practices.

In December 2007, the NFA raised its capital requirements for retail brokerages to $5 million. This move was made to eliminate companies without enough cash reserves to guarantee customer funds in the case of fraud, trading losses, or bankruptcy.

Firms without the minimum net capital can still do business, but undercapitalization usually hurts their chances to attract new customers because they're not accepted as members of the NFA.

Be careful, it's often difficult to distinguish between regulated and unregulated Forex brokers!

According to the NFA Web site, there are about 2,000 retail Forex brokerages and solicitors of accounts that are not subject to the new rules.

Out of that 2,000, the NFA has only **24** registered member firms!

You can verify Commodity Futures Trading Commission (CFTC) registration and NFA membership status of a particular broker and check their disciplinary history by phoning NFA at (800) 621-3570 or by checking the broker/firm information section (BASIC) of NFA's Web site at **www.nfa.futures.org/basicnet/.**

Among the registered firms, look for those with clean regulatory records and solid financials.

Stay away from non-regulated firms!

The NFA is stepping up their efforts in educating investors about retail Forex trading. They've created a brochure fit for a Pulitzer Prize called, "Trading in the Retail Off-Exchange Foreign Currency Market". The NFA recommends you read it before taking the Forex plunge.

They've also developed a Forex Online Learning Program, an interactive self-directed program explaining how retail Forex contracts are traded, the risks inherent in Forex trading and steps individuals should take before opening a Forex account. Both the brochure and the online learning program are available at no charge to the public.

Leverage the Killer

Most professional traders and money managers trade one standard lot for every $50,000 in their account.

If they traded a mini account, this means they trade one mini lot for every $5,000 in their account.

Let that sink into your head for a couple seconds.

If pros trade like this, why do less experienced traders think they can succeed by trading 100K standard lots with a $2,000 account or 10K mini lots with $250?

No matter what the forex brokers tell you, don't ever open a "standard account" with just $2,000 or a "mini account" with $250. The number one reason new traders fail is not because they suck, but because they are undercapitalized from the start and don't understand how leverage really works.

Don't set yourself up to fail.

We recommend that you have at least have $100,000 of trading capital before opening a "standard account", $10,000 for a "mini account", or $1,000 for a "micro account".

So if you only have $60,000, open a "mini account. If you only have $8,000, open a "micro" account. If you only have $250, open a "demo account" and stick with it until you come up with the additional $750, then open a "micro account".

If you don't remember anything else in this lesson, I plead that you at least remember what you just read above.

Okay, please re-read the previous paragraph and ingrain it in your memory. Just because brokers allow you to open an account with *only* $250 doesn't mean you should and I'm going to explain why.

I believe most new traders who open a Forex trading account with the bare minimum deposit do so because they don't completely understand what the terms "leverage" and "margin" really are and how it affects their trading.

It's crucial that you're fully aware and free of ignorance of the significance of trading with leverage. If you don't have rock solid understanding of leverage and margin, I guarantee that you will blow your trading account.

LEVERAGE DEFINED

The textbook definition of "leverage" is having the ability to *control* a large amount of money using none or very little of your *own* money and *borrowing* the rest.

For example, in Forex, you can control $100,000 with a $1,000 deposit. Your leverage, which is expressed in ratios, is now 100:1. You're now controlling $100,000 with $1,000.

Let's say the $100,000 investment rises in value to $101,000 or $1,000. If you had to come up with the entire $100,000 capital yourself, your return would be a puny 1% ($1,000 gain / $100,000 initial investment). This is also called 1:1 leverage. Of course, I think 1:1 leverage is a misnomer because if you have to come up with the entire amount you're trying to control, where is the leverage in that?

Fortunately, you're not leveraged 1:1, you're leveraged 100:1. You only had to come up with $1,000 of your money, so your return is a groovy 100% ($1,000 gain / $1,000 initial investment).

Now I want you to do a quick exercise. Calculate what your return would be if you *lost* $1,000.

If you calculated it the same way I did, which is also called the correct way, you would have ended up with a -1% return using 1:1 leverage and a WTF! -100% return using 100:1 leverage.

You've probably heard the good ol' clichés like "Leverage is a double-edge sword." or "Leverage is a two-way street." Well....as you can see, these clichés weren't lying.

MARGIN DEFINED

So what about the term "**margin"?** Excellent question my bright padawan learner.

Let's go back to the earlier example:

"For example, in forex, you can control $100,000 with a $1,000 deposit. Your leverage, which is expressed in ratios, is now 100:1. You're now controlling $100,000 with $1,000."

The $1,000 deposit is "margin" you had to give in order to use leverage.

Margin is the amount of money needed as a "good faith deposit" to open a position with your broker. It is used by your broker to maintain your position. Your broker basically takes your margin deposit and pools them with everyone else's margin deposits, and uses this one "super margin deposit" to be able to place trades with the interbanks.

Margin is usually expressed as a percentage of the full amount of the position. For example, most forex brokers say they require 2%, 1%, .5% or .25% margin.

Based on the margin required by your broker, you can calculate the **maximum** leverage you can wield with your trading account.

If your broker requires 2% margin, you have a leverage of 50:1. Here are the other popular leverage "flavors" most brokers offer:

Margin Required	Maximum Leverage
5%	20:1
3%	33:1
2%	50:1
1%	100:1
.5%	200:1
.25%	400:1

Aside from "margin required", you will probably see other "margin" terms in your trading platform. There is much confusion about what these different "margins" mean so I will try my best to define each term:

Margin required: This is an easy one because I just talked about. It is the amount of money your brokers requires from you to open a position. It is expressed in percentages.

Account margin: This is just another phrase for your trading bankroll. It's the total amount of money you have in your trading account.

Used margin: The amount of money that your broker has "locked up" to keep your current positions open. While this money is still yours, you can't touch it until your broker gives it back to you either when you close your current positions or when you receive a margin call.

Usable margin: This is the money in your account that is available to open new positions.

Margin call: If the equity in the account drops below your usable margin, a margin call will occur and some or all open positions will be closed by the dealing desk at the market price.

MARGIN CALL EXAMPLE

Assume you are a successful retired British spy who now spends his time trading currencies. You open a mini account and deposit $10,000. When you first login, you will see the 10,000 in the "Equity" column of your "Account Information" window.

Usable Margin

You will also see that the "UsedMrg" ('Used Margin') is "$0.00", and that the "UsblMrg" ('Usable Margin') is 10,000, as pictured below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$0.00	$10,000.00

Your Usable Margin will always be equal to Equity less Used Margin.

Usable Margin = Equity – Used Margin

Therefore it is the Equity, NOT the Balance that is used to determine Usable Margin. Your Equity will also determine if and when a Margin Call is reached.

As long as your Equity is greater than your Used Margin, you will not have Margin Call.

(Equity > Used Margin) = NO MARGIN CALL

As soon as your Equity equals or falls below your Used Margin, you will receive a margin call.

(Equity =< Used Margin) = MARGIN CALL, go back to demo trading

Let's assume your margin requirement is 1%. You buy 1 lot of EUR/USD.

Your Equity remains $10,000. Used Margin is now $100, because the margin required in a mini account is $100 per lot. Usable Margin is now $9,900.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$100.00	$9,900.00

If you were to close out that 1 lot of EUR/USD (by selling it back) at the same price at which you bought it, your Used Margin would go back to $0.00 and your Usable Margin would go back to $10,000. Your Equity would remain unchanged at 10,000.

But instead of closing the 1 lot, you, the adrenalin junkie chopsocky retired spy that you are, get extremely confident and buy 79 more lots of EUR/USD for a total of 80 lots of EUR/USD. You will still have the same Equity, but your Used Margin will be $8,000 (80 lots at $100 margin per lot). And your Usable Margin will now only be $2,000, as shown below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$8,000.00	$2,000.00

With this insanely risky position on, you will make a ridiculously large profit if EUR/USD rises. But this example does not end with such a fairy tale.

Let me paint a horrific picture of a Margin Call which occurs when EUR/USD falls.

The EUR/USD starts to fall. You are long 80 lots, so you will see your Equity fall along with it. Your Used Margin will remain at $8,000. Once your equity drops below $8,000, you will have a Margin Call. This means that some or all of your 80 lot position will immediately be closed at the current market price.

Assuming you bought all 80 lots at the same price, a Margin Call will trigger if your trade moves 25 pips against you.

25 PIPS!

Humbug! The EUR/USD pair can move that much in its sleep!

How did I come up with 25 pips? Well each pip in a mini account is worth $1 and you have a position open consisting of 80 freakin' lots. So...

$1/pip X 80 lots = $80/pip

If EUR/USD goes up 1 pip, your equity increases by $80.

If EUR/USD goes down 1 pip, your equity decreases by $80.

$2,000 Usable Margin divided by $80/pip = 25 pips

Let's say you bought 80 lots of EUR/USD at $1.2000. This is how your account will look if it EUR/USD drops to $1.1975 or -25 pips.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$8,000.00	$8,000.00	$0.00

As you can see, your Usable Margin is now at $0.00 and you will receive a MARGIN CALL!

Of course, you're a veteran international spy, you've faced much bigger calamities. You've got ice in your veins and your heart rate is still **55 bpm.**

After the margin call this is how your account will look:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$8,000.00	$8,000.00	$0.00	$0.00

The EUR/USD moves 25 PIPS, or less than .22% ((1.2000 – 1.1975) / 1.2000) X 100% and you LOSE $2,000!

You blew 20% of your trading account! ($2,000 loss / $10,000 balance)) X 100%

In reality, it's normal for EUR/USD to move 25 pips in a couple seconds during a major economic data release.

Oh I almost forget…I didn't even factor in the SPREAD!

To simplify the example, I didn't even factor in the spread, but I will now to make this example super realistic.

Let's say the spread for EUR/USD is 3 pips. This means that EUR/USD really only has to move *22* pips, ***NOT*** *25* pips before a margin call.

Imagine losing $2,000 in 5 seconds?!

This is what happened to our popular British spy all because he didn't understand the mechanics of margin and how to use leverage.

The sad fact is….most new traders don't even open a mini account with $10,000. Because our spy friend had at least $10,000, he was at least able to weather 25 pips before his margin call.

If he only started off with $9,000, he could only weather a 10 pip drop (including spread) before receiving a margin call. 10 pips!

More on Forex Leverage

Hopefully I've done my job and you now have a better understanding of what **"margin"** is. Now I want to take a harder look at "leverage" and show you how it regularly wipes out unsuspecting or overzealous traders.

We've all seen or heard online Forex brokers advertising how they offer 200:1 leverage or 400:1 leverage. I just want to be clear that what they are really talking about is the **maximum** leverage you can trade with. Remember this leverage ratio depends on the margin required by the broker. For example, if a 1% margin is required, you have 100:1 leverage.

There is maximum leverage. And then there is your **true** leverage.

True leverage is the full amount of your position divided by the amount of money deposited in your trading account.

Huh?

Let me illustrate an example:

You deposit $10,000 in your trading account. You buy 1 standard 100K of EUR/USD at a rate of $1.0000. The full amount of your position is $100,000 and your account balance is $10,000. Your true leverage is 10:1 ($100,000 / $10,000)

Let's say you buy another standard lot of EUR/USD at the same price. The full amount of your position is now $200,000 and your account balance is still $10,000. Your true leverage is now 20:1 ($200,000 / $10,000)

You're feeling good so you buy three more standard lots of EUR/USD, again at the same rate. The full amount of your position is now $500,000 and your account balance is still $10,000. Your true leverage is now 50:1 ($500,000 / $10,000).

Assume the broker requires 1% margin. If you do the math, your account balance and equity are both be $10,000, the Used Margin is $5,000, and the Usable Margin is $5,000. For one standard lot, each pip is worth $10.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$5,000.00	$5,000.00

In order to receive a margin call, price would have to move 100 pips ($5,000 Usable Margin divided by $50/pip).

This would mean the price of EUR/USD would have to move from 1.0000 to .9900 – a price change of 1%.

After the margin call, your account balance would be $5,000. You lost $5,000 or 50% and the price only moved 1%.

Now let's pretend you ordered coffee at a McDonald's drive-thru, then spilled your coffee on your lap while you were driving, and then proceeded to sue and won against McDonald's because your legs got burned and you didn't know the coffee was hot. To make a long story long, you deposit $100,000 in your trading account instead of $10,000.

You buy just 1 standard lot of EUR/USD – at a rate of 1.0000. The full amount of your position is $100,000 and your account balance is $100,000. Your true leverage is 1:1.

Here's how it looks in your trading account:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$100,000.00	$100,000.00	$1,000.00	$99,000.00

In this example, in order to receive a margin call, price would have to move 9,900 pips ($99,000 Usable Margin divided by $10/pip)

This means the price of EUR/USD would have to move from 1.0000 to .0100! This is a price change of 99% or basically 100%!

Let's say you buy 19 more standard lots, again at the same rate as the first trade. The full amount of your position is $2,000,000 and your account balance is $100,000. Your true leverage is 20:1.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$100,000.00	$100,000.00	$20,000.00	$80,000.00

In order to be "margin called", price would have to move 400 pips ($80,000 Usable Margin divided by ($10/pip X 20 lots)

That means the price of EUR/USD would have to move from $1.0000 to $0.9600 – a price change of 4%.

If you did get margin called and your trade exited at the margin call price, this is how your account would like:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$20,000.00	$20,000.00	$0.00	$0.00

You would have realized an $80,000 loss! You' would've wiped out 80% of your account and the price only moved 4%!

Do you now see the effects of leverage?!

Leverage amplifies the movement in the relative prices of a currency pair by the factor of the leverage in your account.

Here's a chart of how much your account balance changes if prices moves depending on your leverage.

Leverage	% Change in Currency	% Change in Account
100:1	1%	100%
50:1	1%	50%
33:1	1%	33%
20:1	1%	20%
10:1	1%	10%
5:1	1%	5%
3:1	1%	3%
1:1	1%	1%

Let's say you bought USD/JPY and it goes up by 1% from 120.00 to 121.20. If you trade one standard $100K lot, here is how leverage would affect your return:

Leverage	Margin Required	Return (Gain)
100:1	$1,000	+100%
50:1	$2,000	+50%
33:1	$3,300	+33%
20:1	$5,000	+20%
10:1	$10,000	+10%
5:1	$20,000	+5%
3:1	$33,000	+3%
1:1	$100,000	+1%

Let's say you bought USD/JPY and it goes *down* by 1% from 120.00 to 118.80. If you trade one standard $100K lot, here is how leverage would affect your return (or loss):

Leverage	Margin Required	Return (Loss)
100:1	$1,000	-100%
50:1	$2,000	-50%
33:1	$3,300	-33%
20:1	$5,000	-20%
10:1	$10,000	-10%
5:1	$20,000	-5%
3:1	$33,000	-3%
1:1	$100,000	-1%

The more leverage you use, the less "breathing room" you have for the market to move before a margin call.

You're probably thinking I'm a day trader, I don't need no stinkin' breathing room. I only use 20-30 pip stop losses.

Okay let's take a look:

Example #1

You open a mini account with $500 which trades $10K mini lots and only requires .5% margin.

You buy 2 lots of EUR/USD. Your true leverage is 40:1 ($20,000 / $500). You place a 30 pip stop loss and it gets triggered. Your loss is $60 ($1/pip x 2 lots).

You've just lost 12% of your account ($60 loss / $500 account). Your account balance is now $440.

You believe you just had a bad day. The next day, you're feeling good and want to recoup yesterday losses, so you decide to double up and you buy 4 lots of EUR/USD. Your true leverage is about 90:1 ($40,000 / $440). You set your usual 30 pip stop loss and your trade loses. Your loss is $120 ($1/pip x 4 lots).

You've just lost 27% of your account ($120 loss/ $440 account). Your account balance is now $320.

You believe the tide will turn so you trade again. You buy 2 lots of EUR/USD. Your true leverage is about 63:1. You set your usual 30 pip stop loss and lose once again! Your loss is $60 ($1/pip x 2 lots).

You've just lost almost 19% of your account ($60 loss / $320 account). Your account balance is now $260.

You're getting frustrated. You try to think what you're doing wrong. You think your setting your stops too tight.

The next day you buy 3 lots of EUR/USD. Your true leverage is 115:1 ($30,000 / $260). You loosen your stop loss to 50 pips. The trade starts going against you and it looks like you're about to get stopped out yet again!

But what happens next is even worse! You get a margin call!

Since you opened 3 lots with a $260 account, your Used Margin was $150 so your Usable Margin was a measly $110. The trade went against you 37 pips and because you had 3 lots opened, you get margin called. Your position has been liquidated at market price.

The only money you have left in your account is $150, the Used Margin that was returned to you after the margin call.

After four total trades, your trading account has gone from $500 to $150. A 70% loss! It won't be very long until you lose the rest.

Trade No.	Starting Account Balance	Number of Lots Used	Stop Loss Size (pips)	Trade Result	Ending Account Balance
1	$500	2	30	-$60	$440
2	$440	4	30	-$120	$320
3	$320	2	30	-$60	$260
4	$260	5	50	Margin Call	$150

A four trade losing streak is not uncommon. Experienced traders have similar or even longer streaks. The reason they're successful is because they use low leverage. Most cap their leverage at 5:1 but rarely go that high and stay around 3:1.

The other reason experienced traders succeed is because their accounts are properly capitalized!

While learning technical analysis, fundamental analysis, building a system, trading psychology is important, I believe the biggest factor on whether you succeed as a Forex trader is making sure you **capitalize your account sufficiently** and **trade that capital with smart leverage**.

Your chances of becoming successful are greatly reduced below a minimum starting capital. It becomes impossible to mitigate the effects of leverage on too small an account.

Low leverage with proper capitalization allows you to realize losses that are very small which allows you to trade another day.

Example #2

Bill opens a $5,000 account trading $100,000 lots. He is trading with 20:1 leverage. The currency market moves on a regular basis anywhere from 70 to 200 pips in one day. In order to protect himself, he uses tight 30 pips stops. If the market goes 30 pips against him, he would be stopped out for a loss of $300.00. He felt that was reasonable but he underestimated how volatile this market is and found himself being stopped out frequently.

After being stopped out four times, he'd had enough. He's decided to give himself a little more room, handle the swings, increases his stop to 100 pips.

Bill's leverage is not 20:1 anymore, his account is down to $3,800 (his four loses at $300 each) and he's still trading one $100,000 lot. It's now over 26:1.

He decides to tighten his stops to 50 pips. He opens another trade using two lots and two hours later his 50 pip stop loss is hit and he losses $1,000. He now has $2,800 in his account. His leverage is over 35:1.

He tries again with two lots. This time the market goes up 10 pips. He cashes out with a $200 profit. His account grows slightly to $3,000.

He opens another position with two lots. The market drops 50 points and he gets out. Now he has $2,000 left.

He thinks what the hell and opens another position. The market proceeds to drop another 100 pips and because he has $1,000 locked up as margin deposit, he only has $1,000 margin available, so he receives a margin call and his position is instantly liquidated.

He now has $1,000 left which is not even enough to open a new position.

He lost $4,000 or 80% of his account with a total of 8 trades and the market only moved 280 pips. 280 pips! The market moves 280 pips pretty darn easy.

Are you starting to see why leverage is the top killer of forex traders?

HOW LEVERAGE AFFECTS TRANSACTION COSTS

Besides amplifying your losses, leverage also has another way of killing you. It's a much slower kind of death, though, kinda like being constantly exposed to high levels of radiation. Most traders don't see it coming and by the time they notice it, they're dead.

This killer I'm talking about is the **associated transaction cost of using high leverage**.

Not only does leverage amplify your losses, it also amplifies your transaction costs as a percentage of your account.

Let's say you open a mini account with $500. You buy five mini $10k lots of GBP/USD which has a 5 pip spread. Your true leverage is 100:1 ($50,000 total mini lots / $500 account). But check this....you paid $25 in transaction costs (($1/pip x 5 pip spread) x 5 lots)). That is 5% of your account! With one trade, and the market not even moving yet, you're already down 5%! If your trades lose, your account balance shrinks. As your account balance shrinks, your leverage increases. As your leverage increases, the faster your transaction costs eats away at the little money you have left. This is the slow and silent killer I'm talking about.

The higher your leverage, the higher your transaction cost as a percentage of your trading capital.

If you have a mini account, and open a trade with a 5 pip spread, which equals $5 transaction cost, look at how the relative value of your transaction costs increases with more leverage.

Leverage	Margin Required (MR)	Cost as % MR
200:1	$50	10%
100:1	$100	5%
50:1	$200	2.5%
33:1	$330	1.5%
20:1	$500	1%
10:1	$1,000	.5%
5:1	$2,000	.25%
3:1	$3,300	.10%
1:1	$10,000	.05%

Now you've learned how leverage can magnify your profits and losses, but also your transaction costs.

Leverage does not equal margin.

Leverage is how many times you lever your whole account.

The maximum amount that you are allowed to lever is dependent on your margin requirement.

Don't Underestimate Leverage

Most beginners underestimate the potentially devastating damage leverage can wreak on their accounts. Understanding leverage enough to know when to use it and when NOT to use it is critical to your success!

Leverage is a very powerful tool but both old and new traders use it to destroy their trading capital simply because they take too lightly its destructive force or ignore it altogether. It's a pity, but the more of them the easier it is for us smart traders to make money. Sad but true.

High leverage is a favourite selling point for most Forex brokers. Yes they pitch that you can make a huge killing using huge leverage, but know you could easily be killed by huge leverage as well.

Brokers want you to trade with a short-term mindset. They want you to trade as much as possible as often as possible. It's the only way they make money. One or two pips are important to them. The more you trade the more they make on the spread. It's not in their best interest to tell you to let your trades run longer than the same day.

If you want to give yourself the best chance to succeed, first learn to trade profitably *without* leverage.

Play it safe. Protect your capital.

When you can make more pips more than you lose *consistently, t*hen, and only then, should you use unleash this weapon of mass destruction called leverage. Destroy traders (or your broker) taking the opposite side of your trade. Don't destroy yourself.

Forex trading should be treated as a job or business. Don't think that just because brokers allow you to use high leverage with a low minimum deposit that you can "make a quick <insert choice of currency here>" or "get rich quick". Approach the currency markets with respect.

Be realistic in your expectations and be willing to properly educate yourself.

If you don't, you will die.

Okay, not really, but your account will die.

COMMODITY CURRENCIES

In today's lesson, we will be taking a look at commodities and how they relate to commodity currencies.

What is a commodity currency?

In this crazy trading universe we call the Forex, a commodity currency is a currency whose country's exports are largely comprised of raw materials (precious metals, oil, agriculture, etc.).

There are dozens of countries that fit this description, but the most actively traded currencies are the New Zealand Dollar, Australian Dollar, and the Canadian Dollar. Because their currencies are all called dollars, they are also known as the commodity dollars or "Comdolls" for short.

These three currencies are among the major currency pairs, which mean they have great liquidity and volatility for active trading.

How do commodities affect commodity currencies?

Raw materials compose such a large portion of these countries exports, a rise in commodity prices can possibly lead to a rise in the value of a country's currency, and vice versa.

Let's take a look at the major commodity currencies and see how much their movement correlates to certain commodities...

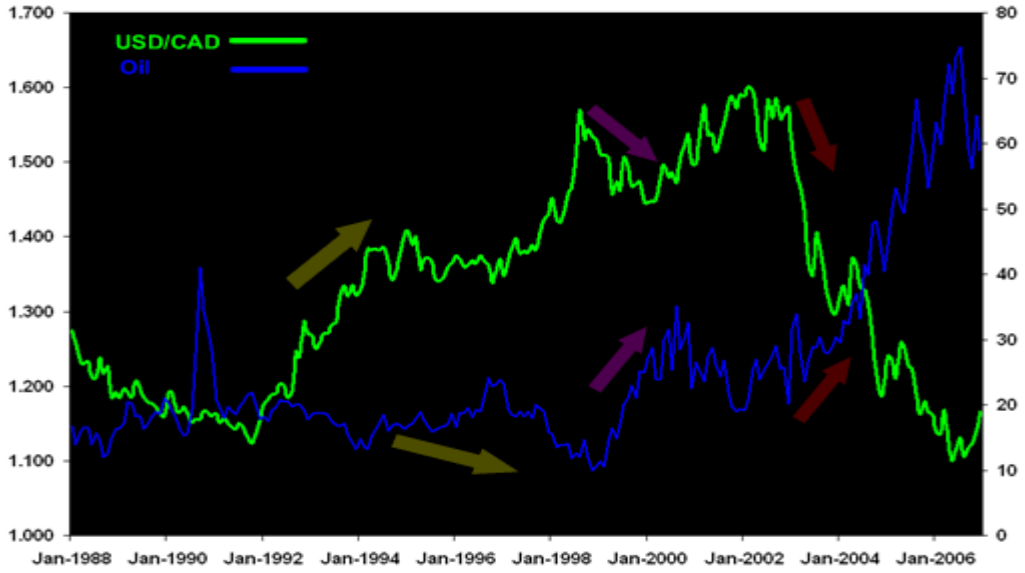
CANADIAN DOLLAR (CAD) AND OIL

Oil is the life blood of the industrialized world and thus a highly watched and traded commodity. While oil is often nicknamed "Black Gold", we prefer to call it "Black Crack".

Many countries that produce "black crack" and hold massive reserves of "black crack" tend to benefit from rises in oil prices, including Canada. We like to call these countries the Black Crack Mafia.

Canada is one of the world's largest producers of oil (black crack dealers) and holds oil reserves (black crack stash) second only to Saudi Arabia, which makes Canada very reliant on its most prized commodity. It is also the largest supplier to the world's biggest oil consumer (black crack addict) - the United States. Because oil is such a big part of the US economy, rising oil prices tend to have a negative affect on U.S. equities and the U.S. Dollar.

Wait a minute! Rising oil prices tend to be good for Canada/bad for the U.S., while falling oil prices tend to be bad for Canada/good for the U.S. - how can we play this idea in the Forex markets? Anyone? USD/CAD??? Right! In fact let's take a quick look at a chart overlaying oil prices and the USD/CAD:



As you can see from the chart above, price movements USD/CAD and Oil are inversely correlated from each other - meaning as oil trends higher, USD/CAD tends to trend lower and vice versa.

Since January 1988, USD/CAD and Oil have had about a 68% inverse correlation to each other. This is a pretty strong correlation. As a currency trader, knowing this can add another tool to your toolbox when analyzing USD/CAD and help you make longer term trading decisions.

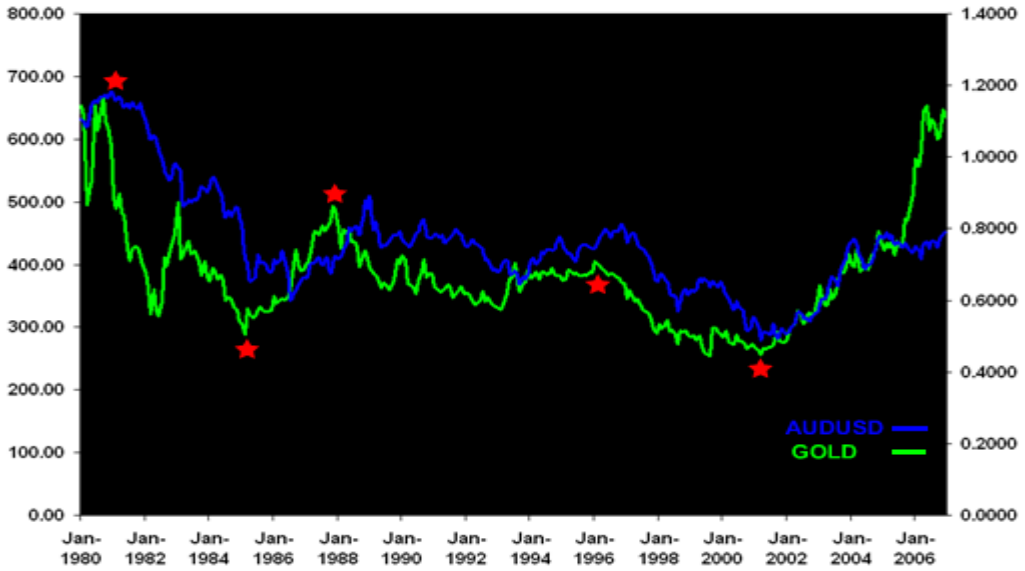
AUSTRALIAN DOLLAR (AUD) AND GOLD

Everyone loves gold - how can you not love it? It's metal, shiny and makes pretty cool jewellery. Besides that, gold is used in many, many applications like highly conductive wiring, reflective coating, and dentistry - you should check out Big Pippin's new grill!

In the financial world, gold is viewed as a safe haven against inflation and it is one of the most highly traded commodities. Okay, so how does all of this tie into Forex trading? Great question! To answer that, we'll take a look at the Australian Dollar.

For many traders out there, trading the Australian Dollar is just like trading gold. Australia is one of the world's largest producers of gold and it exports comprise over 50% of commodities, including precious metals.

These commodities account for a large portion of Australia's Gross Domestic Product; so many traders watch the rise and fall of commodity prices, especially gold, which can influence the direction of the Australian Dollar. Let's take a look at a comparison chart of gold and the "Aussie:"



This is a monthly chart that compares the price movement of gold and the AUD/USD all the way back to January 1980. As you can see, the two's movements were virtually the same, and from January 1980 to about January 2002 one can view gold as a leading indicator to AUD/USD.

The "red stars" above show major turning points in gold. These turning points seemed to occur before major turning points in AUD/USD. This relationship changed around 2002 as

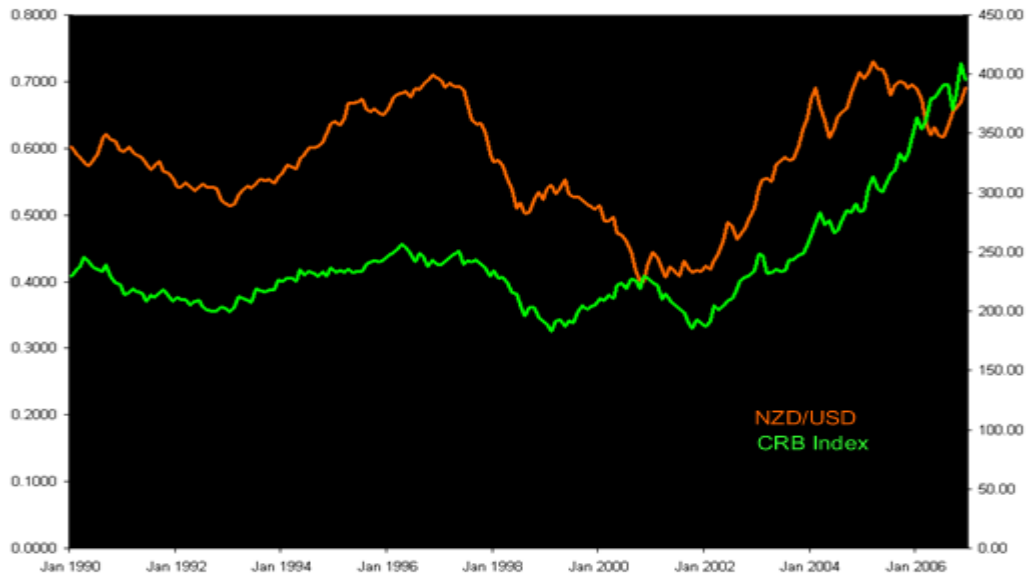
gold and AUD/USD movements were practically the same until gold shot up in value in 2005 to 2006.

Just as we learned with oil and USD/CAD, traders can watch gold prices to get an extra edge in their analysis of AUD/USD as gold movements can give possible clues to where AUD/USD is headed. For those who can't trade gold directly, AUD/USD's strong correlation to gold makes a great substitution. You can trade AUD/USD in the spot Forex market as a proxy for gold, which is traded in the futures market.

NEW ZEALAND DOLLAR (NZD)

Much like its neighbour to the west, Australia, New Zealand's economy is also export-driven with commodities comprising much of its exports. While most traders' view on the "Kiwi" is that it's not directly linked to one specific commodity, its correlation to commodities in general is a substantial one.

Since January 1990, its correlation is 63%, when compared to the Commodity Research Bureau Index (CRB Index), one of the world's standards for commodity prices.



This chart shows how commodity prices and the New Zealand Dollar have moved in tandem with each other over the past 25+ years.

Since January 1990, the NZD/USD and CRB Index has had approximately 60% correlation. So, as commodity prices rise and fall, traders can look for similar movements in the NZD/USD because of New Zealand's dependency on its commodity exports.

Like gold and oil, a trader can express their general views and ideas on commodities by trading **NZD/USD.**

Summary of Commodity Currency

We have just learned about relationships between commodities and commodity currencies. There are a few things to remember before you start applying the ideas learn here today.

Short term moves in commodities usually do not directly affect a commodity currency immediately. Analyzing commodities for use with currencies is probably best suited for longer term outlooks, trading, and investing.

Keep in mind that even though we see strong correlations between the commodity currencies and commodities, exports are only a portion of a country's economy. Always take a look a country's overall economy, interest rates, and political situation as well.

Combining all of these aspects and adding commodity movements in the mix can present a clearer picture and possibly better trading ideas in these currencies.

So, for those of you into Oil, Gold, and commodities in general, check out the "ComDolls." With the leverage and liquidity advantages available in spot Forex trading, currencies can be an awesome alternative to trading straight forward commodities or for hedging your commodity investments! Don't be scurrrrreedd...Check'em out!

CURRENCY CROSSES

After going through the School of Pipsology and doing a little demo trading, there's probably one thing you've noticed about trading currencies - it's all about the US Dollar! Or is it?

Well, with central banks across the world holding trillions in USD reserves, commodities priced in the Greenback, and other major financial transactions passing through the dollar daily, it pretty much IS all about the dollar.

In general, approximately 90% of all transactions in the almost US$2 trillion daily traded Foreign Exchange market involves the dollar. Wow!

Also, in your demo trading, I'm sure you've noticed that no matter what major pair you trade (i.e. EURUSD, AUDUSD, USDCHF, etc.) that US news pretty much dominates the movement regardless of data releases from anywhere else. So, why look at anything else besides the major currency pairs?

Well, serious trading opportunities can be found by following the other major currencies with currency crosses, especially if you want to avoid the unpredictable volatility that US dollar can bring.

Hopefully, this lesson will open up your outlook on Crosses and give you basic understanding on how to analyze them

What is a Currency-Cross?

Basically, a currency-cross is any currency pair in which the US Dollar is neither the base nor counter currency. For example, **GBPJPY, EURJPY, EURCAD**, and **AUDNZD** are all considered currency crosses.

BACK TO BASICS

When it comes down to it, currency trading is all about matching weak currencies and strong currencies.

Just find a country that has weak a fundamental outlook or maybe a distressful political situation, and then match it with a country with positive or better fundamentals (i.e. rising employment, growing trade surplus, etc) or maybe a positive political outlook, then you can match their currencies together to make an intelligent directional trade.

Let's take a look at a recent, real world example:

On January 11th, 2007, both the Bank of England and the European Central Bank were set to release their decisions on their interest rate policy. Leading up to that morning, the markets speculated that the ECB hint that they would raise interest rates soon and the BoE would hold any hikes. Well, what a surprise the market got as the Bank of England raised rates to 5.25% and the ECB held rates at 3.50% on concerns of slowing growth in the Eurozone.

So, why would a currency trading pro, such as yourself, play a currency cross instead of matching either the Euro or the British Pound with the US Dollar? Well, here are a couple of scenarios to think about:

1. US Retail sales numbers were coming out soon after the interest rate decisions. If you had a weak outlook on the Euro and went short EURUSD, then a weak US Retail report would probably been bad for your trade as the US dollar would sell off.
2. Or if you maintained a strong outlook on the British Pound and decided to go long GBPUSD, then a dollar rally on a strong US retail sales report would have been very bad for you trade.

After the interest rate releases, we know the outlook on the Euro is weaker and the outlook of the British Pound is stronger, why don't we just short EURGBP? By taking this trade you get rid of the event risk of upcoming US data, plus you get a positive carry on your position!

Here's how you may have faired taking a short trade on EURGBP using this analysis:

As you can see from the chart, had you shorted at 0.6650 an hour or so after the interest rate decisions were announced, you would have caught the slow and steady move to 0.6600, and possibly further until fundamentals change for either the Euro or the Pound.

Again, this is just one example of matching weak with relatively stronger currencies. With six major currencies other than the US dollar, there are plenty of possibilities to find profitable trades, and avoid erratic volatility with the US dollar.

SYNTHETIC PAIRS

You've done your analysis and you've come to the conclusion that the British Pound looks strong and the Swiss Franc may get weaker.

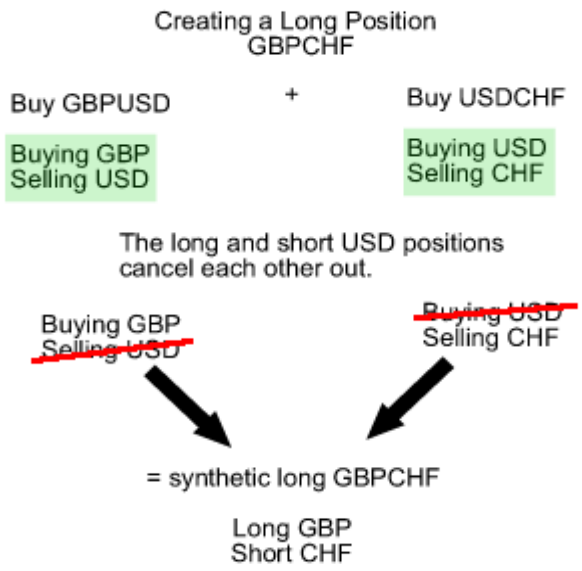
Or maybe the Australian dollar is looking pretty good against the Canadian dollar, but you look in your trading platform and see that your broker doesn't have GBPCHF or AUDCAD.

Oh no! I guess that's an opportunity missed, right? Heck No! You can create a "synthetic" pair to go long on GBPCHF or AUDCAD.

To create synthetic pairs using the four major currency pairs and three commodity currencies is relatively easy. All it takes is to buy or sell two pairs with equal position sizes.

Let's say you want to go long the British Pound against the Swiss Franc, or buy GBPCHF.

You would have to buy GBPUSD and buy USDCHF at the same time. Still not clear? Let me show you...



Pretty simple, right? The only trick to it is making sure you buy the same amount of each pair.

Using our GBPCHF example, let's say the current exchange rate for GBPUSD is 1.9000 and the exchange rate for USDCHF is 1.2500 and you want to buy US$10,000 worth of each pair. Here's how you do it:

For pairs with USD as the counter currency (i.e. AUDUSD, GBPUSD, EURUSD, etc.), then you would take the dollar amount you want to purchase and divide it by the exchange rate:

US$10,000 (desired position size) divided by 1.9000 (current rate of GBPUSD) = 5263 Units of GBPUSD

For pairs with USD as the base currency (i.e. USDCHF, USDJPY, USDCAD), just purchase amount of units you want to buy because you are buying US dollars

$10,000 (desired position size) * 1 Unit = 10,000 Units

So, to buy US$10,000 worth of GBPCHF, we purchase 5,263 units of GBPUSD (if your broker doesn't offer flexible lot sizes you can always round up or down) and 10,000 units of USDCHF. Got it? Great! I knew you would!

Summary of Currency Crosses

As you can see, there are many, many trade opportunities presenting themselves in the foreign exchange market other than figuring out what the Greenback will do any given day - and now you know how to find them! Just remember a few things:

- Do your due diligence/analysis and match the weak currencies with strong currencies.
- What if the pair you are looking to trade is not available with your broker, no sweat right? You now know how to create synthetic pairs by simultaneously going long or short two major pairs to create one currency cross.

- Last tip; please be conscientious of the pip value of the cross you are trading. For example, a standard lot (100,000 units) of EUR/GBP will be approximately $19.70 per pip. Some crosses will have a higher or lower pip value than the majors. This information is good to know for your risk analysis.
- So, on the days you many not see any opportunities in the major pairs, or if you want to avoid the volatility of a US news event, check out some the currency crosses. You may never know what you may find! Good luck!

DIVERGENCE TRADING

What if there was a low risk way to sell near the top or buy near the bottom of a trend?

What if you were already in a long position and you could know ahead of time the perfect place to exit instead of watching all your unrealized gains vanish before your eyes because your trade reverses direction?

What if you believe a currency pair will continue to fall but would like to go short at a better price or a less risky entry?

Well there is a way. It's called **divergence trading**.

Divergence is basically price action measured in relationship to an oscillator indicator. It doesn't really matter what type of oscillator you use. You can use RSI, Stochastic, MACD, CCI, etc. etc. The great thing about divergences is that you can use them as a leading indicator and after some practice, it's not too difficult to spot.

When traded properly, you can be *consistently* profitable with divergences. The best thing about divergences is that since you're usually buying near the bottom or selling near the top, your risk on your trades are very small relative to your potential reward. Cha ching!

Higher Highs and Lower Lows

Just think **"higher highs" and "lower lows".**

If price is making highs, the oscillator *should* also be making higher highs. If price is making lower lows, the oscillator *should* also be making lower lows.

If they are NOT, that means price and the oscillator are diverging from each other. Hence the term, divergence.

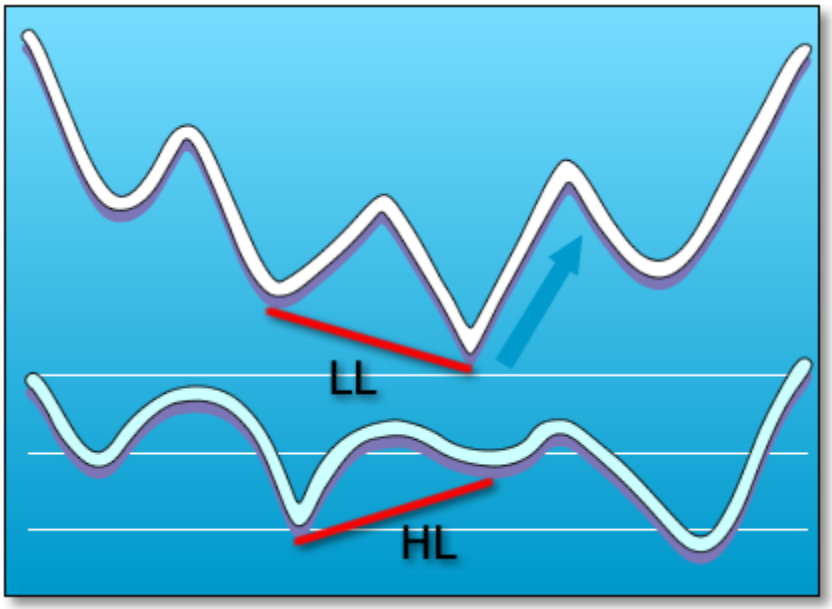
There are TWO types of divergence:

1. Regular
2. Hidden

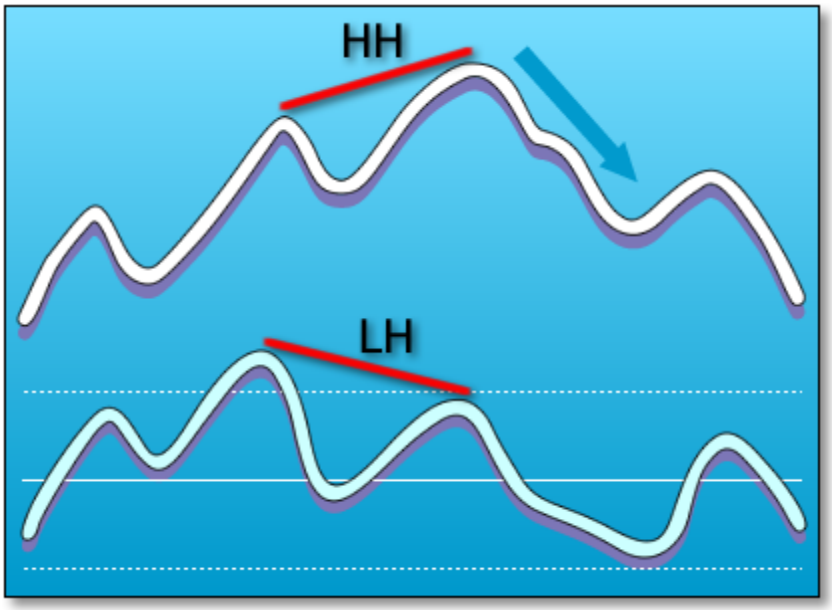
REGULAR DIVERGENCE

A regular divergence is used as a possible sign for **a trend reversal**.

If the price is making *lower lows* (LL), but the oscillator is making *higher lows* (HL), this is considered **regular bullish divergence**.



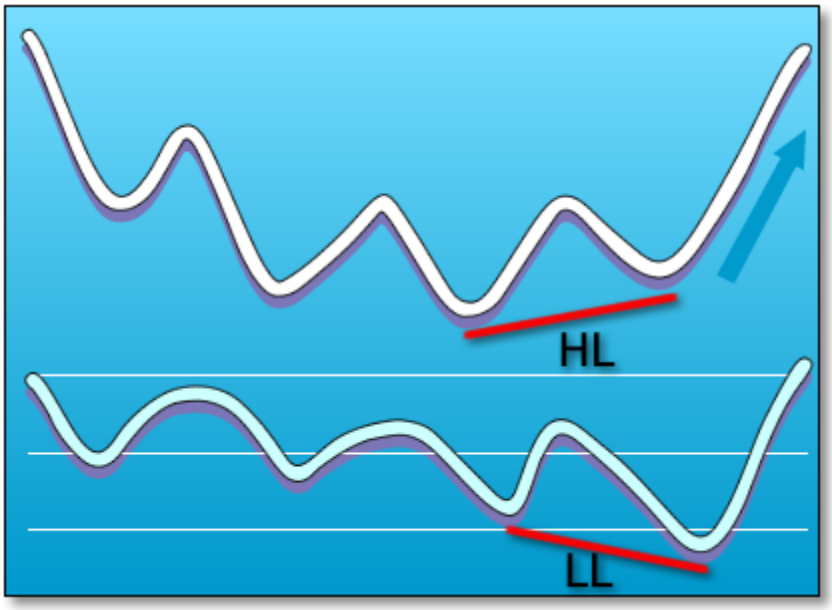
If the price is making a *higher high* (HH), but the oscillator is *lower high* (LH), then you have **regular bearish divergence**.



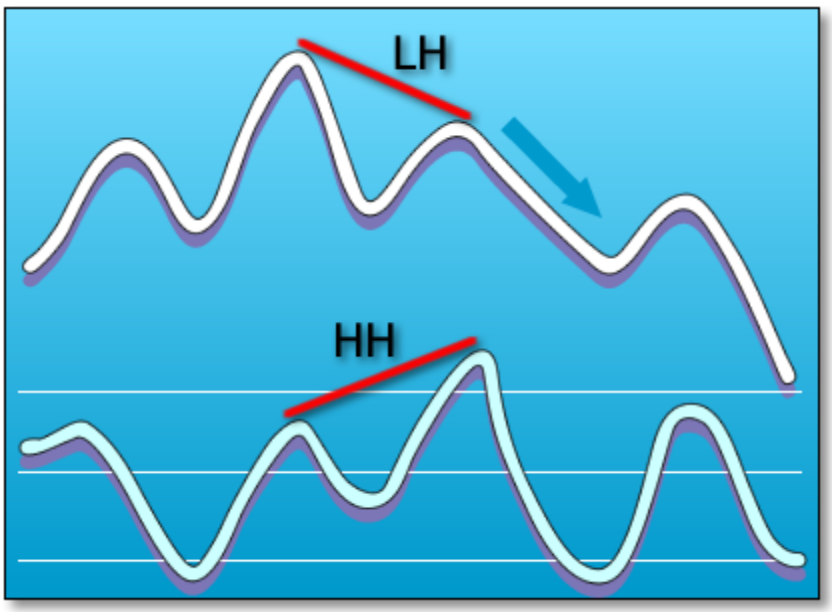
HIDDEN DIVERGENCE

A hidden divergence is used as a possible sign for a **trend continuation**.

If price is making a *higher low* (HL), but the oscillator is making a *lower low* (LL), this is considered **hidden bullish divergence**.



If price is making a *lower high* (LH), but the oscillator is making a *higher high* (HH), then you have **hidden bearish divergence**.



HOW TO TRADE DIVERGENCES

Here's how you could trade divergences:

Divergence Type	Price	Oscillator	Trade
Regular	Higher High	Lower High	SELL
Regular	Lower Low	Higher Low	BUY
Hidden	Higher Low	Lower Low	BUY
Hidden	Lower High	Higher High	SELL

Divergences act as an early warning system alerting you when the market *could* reverse. For example, if bulls have steadily pushed EUR/USD higher, the appearance of divergence between price and indicator could mean that bulls are running out of gas and price will soon fall

Please keep in mind that I use divergence as an *indicator*, not a signal to enter a trade! It wouldn't be smart to trade basely solely on divergences as too many false signals are given. It's not 100% foolproof, but when used as a setup condition and combined with additional confirmation tools, your trades have a high probability of winning with relatively low risk.

On the flip side, I think it is just as dangerous trade against this indicator. If you're unsure about which direction to trade, chill out on the sidelines.

Divergences don't appear that often, but when they *do* appear, it'd behoove you to pay attention. Regular divergences can help you collect a big chunk of profit because you're able to get in right when the trend changes. Hidden divergences can help you ride a trade longer resulting in bigger-than-expected profits by keeping you on the correct side of a trend.

The trick is to train your eye to spot divergences when they appear AND choose the proper divergences to trade. Just because you see a divergence, it doesn't necessarily mean you should automatically jump in with a position. Cherry pick your setups and you'll do well.

9 RULES FOR TRADING DIVERGENCES

There are nine cool rules for trading divergences. Learn 'em, apply 'em, and make money. Ignore them and go broke.

1.

In order for divergence to exist, price must have either formed one of the following:

Higher high than the previous high
Lower low than the previous low
Double top
Double bottom

Don't even bother looking at an indicator unless ONE of these four price scenarios have occurred. If not, you ain't trading divergence, buddy. You just imagining things. Immediately go see your optometrist and get some new glasses.

2.

Okay now that you got some action (recent price action that is), look at it. Remember, you'll only see one of four things: a higher high, a flat high, a lower low, or a flat low. Now draw a line backward from that high or low to the previous high or low. It HAS to be on successive major tops/bottom. If you see any little bumps or dips between the two major highs/lows, do what you do when your significant other shouts at you - ignore it.

3.

Once you see two swing highs are established, you connect the TOPS. If two lows are made, you connect the BOTTOMS. Don't make the mistake of trying to draw a line at the bottom when you see two higher highs. It sounds dumb but peeps regularly get confused.

4.

So you've connected either two tops or two bottoms with a trendline. Now look at your preferred indicator and compare it to price action. Whichever indicator you use, remember you are comparing its TOPS or BOTTOMS. Some indicators such as MACD or Stochastic have multiple lines all up on each other like teenagers with raging hormones. Don't worry about what these kids are doing.

5.

If you drew line connecting two highs on price, you MUST draw a line connecting the two highs on the indicator as well. Ditto for lows also. If you drew a line connecting two lows on price, you MUST draw a line connecting two lows on the indicator. They have to match!

6.

The highs or lows you identify on the indicator MUST be the ones that line up **VERTICALLY** with the price highs or lows.

7.

Divergence only exists if the SLOPE of the line connecting the indicator tops/bottoms DIFFERS from the SLOPE of the line connection price tops/bottoms. The slope must either be: Ascending (rising) Descending (falling) Flat (flat)

8.

If you spot divergence but price has already reversed and moved in one direction for some time, the divergence should be considered played out. You missed the boat this time. All you can do now is wait for another swing high/low to form and start your divergence search over.

9.

Divergences on longer time frames are more accurate. You get less false signals. You will also get less trades but your profit potential is huge. Divergences on shorter time frames will occur more frequently but are less reliable. I personally only look for divergences on 1-hour charts or longer. Other traders use 15-minute charts or even faster. On those time frames, there's just too much noise for my taste so I just stay away.

Divergence Cheat Sheet

Type	Bias	Price	Oscillator	Description	Example
	Bullish	Lower Low	Higher Low	Indicates underlying strength. Bears are exhausted. Warning of possible trend direction change from	

REGULAR				down to up.	
	Bearish	Higher High	Lower High	Indicates underlying weakness. Bulls are exhausted. Warning of possible trend direction change from up to down.	
HIDDEN	Bullish	Higher Low	Lower Low	Indicates underlying strength. Good entry or re-entry. Occurs during retracements in an uptrend. Nice to see during price retest of previous lows. “Buy the dips”	
	Bearish	Lower High	Higher High	Indicates underlying weakness. Found during retracements in a downtrend. Nice to see during price retests of previous highs. “Sell the rallies”	

Congratulations!
NOW WE ARE READY TO USE THE EA!
support@forexgodfather.com