

Ins and outs of forex trading

Understanding the product and risks and having a stringent risk and money management strategy are paramount

BY CHRIS WESTON



LEARNING how forex markets work can be an extremely interesting, albeit dynamic journey, and one that will fully test you as a trader. On a pure fundamental basis there are many key differences from equity or commodity trading. However, more technical-focused traders would find the prospect of excellent liquidity and 24-hour, five days a week markets quite a compelling proposition.

As with anything in trading, understanding the product and risks and having a stringent risk and money management strategy are paramount for those involved in the forex market.

Technical analysis

I just don't see how anyone can trade currencies without looking at price action. There are many traders in the market: exporters, insurance/pension funds (real money), leveraged funds, macro-focused accounts, retail traders and reserves managers (who transact on behalf of central banks). This means that there are many opinions and varying thought processes, so the only way to rationalise these human behaviours is through price action and looking at supply, demand and trends.

Some people will argue that you can't look at a chart and make an argument that it will predict future moves. A chart tells you what the market feels about future policy moves by a central bank and the general underlying economy. It also paints a picture about global capital flows, which is the basis of what currency markets are.

Going by gut feeling about an event or action from a central bank can often be wrong, so let price guide you. It's perfectly OK to be wrong, just as long as you don't stay wrong, and you effectively make more on your winning trades than you lose on your losing trades. It is also important to know where supply and demand has been in order to know where it could be again; thus shaping your understanding of where to place stops and limits as part of your risk management strategy.

Fundamentally, the forex market takes time to fully comprehend and harness, and even the most seasoned traders are always learning. Currencies are driven by the perception of inflation and the impact it will have on central bank policy, and ultimately the value of money. However, there is so much more that goes into a currency valuation. An investment bank, for example, when calculating "fair value", will use a blend of variables such as swap rates, bond yields, equity markets and volatility measurements to feed into their models.

Bond markets and currency valuation

Forex traders who incorporate fundamentals into their views will have a thorough understanding of the bond market. Put simply, good data in an economy will lead to the perception of economic growth, or in most economies these days, less disinflation and therefore a more positive stance from a central bank.

Ultimately, this will cause selling in the bond market (as inflation is a bondholder's worst nightmare), which in turn will push down prices and push up yields (on a bond there is a price and a yield and they move

conversely to each other). The higher the yield, the more compelling it becomes to hold the underlying currency of that nation.

On a more advanced note, if one nation's bond yields move aggressively higher against the country on the other side of the forex ledger, this would cause the exchange rate to move in favour of the nation which had the bigger reaction. The concept of looking at the diverging yield levels in bond markets is what we call a "yield spread" and it is extremely influential in driving currencies.

International flows

It is very important to understand what the key drivers of currencies are. For example, countries that source a significant amount of revenue – and subsequent growth – from exporting raw materials (or terms of trade) such as the Australian dollar (AUD), Canadian dollar (CAD) and New Zealand dollar (NZD), will usually underperform when commodities are sold.

On the other hand, countries that run sizeable current account surpluses (that is, they are global creditors) will usually outperform in times of risk aversion on the perception that organisations or

individuals could repatriate funds home. Two countries that stand out here are Japan and Switzerland; both are bought as "safe havens" when traders express concern, although the latter has been extremely volatile of late. Remember, currencies are driven by international flows and if the market feels that there could be an inflow into an economy, then speculative traders will usually buy before the event.

Here are some important issues which should be considered when trading forex (FX):

- FX trading carries a high degree of leverage.
- Use leverage wisely and always trade with stops.
- Volatility is usually a good thing for FX traders, don't be scared of it.
- Always get a good understanding of either technical analysis, fundamental analysis or better yet, both.
- I personally like to use a mixture of technicals and fundamentals in the FX market. If the technicals and fundamentals disagree, back the technicals. If they both paint the same story, then that can be a powerful sign.
- Currencies can trend really well. My preference is to buy strength and sell weakness. A currency in motion tends to stay in motion. You will greatly increase your chances of bringing in profits by trading with the trend.
- Each pair carries a differing degree of volatility and traders need to be aware of this. For example, EUR/JPY will generally have bigger daily moves than AUD/NZD.
- Don't fight a central bank when they are aggressively easing. Generally, what a central bank wants, they usually get. If the Bank of Japan is aggressively easing policy, look to trade the Japanese yen against a currency whose central bank policy is less accommodative – for example the US dollar (USD).
- Don't restrict yourself to the majors; look at the crosses (that is, anything not traded against the USD). **W**

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