BY CLASSRICH

FOREIGN EXCHANGE

A Beginner's Guide

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"Risk comes from not knowing what you're doing."

- *Warren Buffett*

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Risk Warning: Trading Contracts for Difference (CFDs) on margin carries a high level of risk and may not be suitable for all investors. Before deciding to trade Contracts for Difference (CFDs), you should carefully consider your trading objectives, level of experience and risk appetite. It is possible for you to sustain losses that exceed your invested capital and therefore you should not deposit money that you cannot afford to lose. Please ensure you fully understand the risks and take appropriate care to manage your risk.

What is the Forex Market?

The foreign exchange market is where currencies are traded. Currencies are important to most people around the world, whether they realize it or not, because currencies need to be exchanged in order to conduct foreign trade and business. If you are living in the U.S. and want to buy cheese from France, either you or the company that you buy the cheese from has to pay the French for the cheese in euros (EUR). This means that the U.S. importer would have to exchange the equivalent value of U.S. dollars (USD) into euros. The same goes for traveling. A French tourist in Egypt can't pay in euros to see the pyramids because it's not the locally accepted currency. As such, the tourist has to exchange euros for the local currency, in this case the Egyptian pound, at the current exchange rate.

One unique aspect of this international market is that there is no central marketplace for foreign exchange. Rather, currency trading is conducted electronically over-the-counter (OTC), which means that all transactions occur via computer networks between traders around the world, rather than on one centralized exchange. The market is open 24 hours a day, five and a half days a week, and currencies are traded worldwide in the major financial centers of London, New York, Tokyo, Zurich, Frankfurt, Hong Kong, Singapore, Paris and Sydney—across almost every time zone. This means that when the trading day in the U.S. ends, the forex market begins anew in Tokyo and Hong Kong. As such, the forex market can be extremely active any time of the day, with price quotes changing constantly.

A Brief History of Forex

Unlike stock markets, which can trace their roots back centuries, the forex market as we understand it today is a truly new market. Of course, in its most basic sense—that of people converting one currency to another for financial advantage—forex has been around since nations began minting currencies. But the modern forex markets are a modern invention. After the accord at Bretton Woods in 1971, more major currencies were allowed to float freely against one another. The values of individual currencies vary, which has given rise to the need for foreign exchange services and trading.

Commercial and investment banks conduct most of the trading in the forex markets on behalf of their clients, but there are also speculative opportunities for trading one currency against another for professional and individual investors.

Spot Market and the Forwards & Futures Markets

There are actually three ways that institutions, corporations and individuals trade forex: the spot market, the forwards market, and the futures market. Forex trading in the spot market has always been the largest market because it is the "underlying" real asset that the forwards and futures markets are based on. In the past, the futures market was the most popular venue for traders because it was available to individual investors for a longer period of time. However, with the advent of electronic trading and numerous forex brokers, the spot market has witnessed a huge surge in activity and now surpasses the futures market as the preferred trading market for individual investors and speculators. When people refer to the forex market, they usually are referring to the spot market. The forwards and futures markets tend to be more popular with companies that need to hedge their foreign exchange risks to a specific date in the future.

More specifically, the spot market is where currencies are bought and sold according to the current price. That price, determined by supply and demand, is a reflection of many things, including current interest rates, economic performance, sentiment towards ongoing political situations (both locally and internationally), as well as the perception of the future performance of one currency against another. When a deal is finalized, this is known as a "spot deal." It is a bilateral transaction by which one party delivers an agreed-upon currency amount to the counterparty and receives a specified amount of another currency at the agreed-upon exchange rate value. After a position is closed, the settlement is in cash. Although the spot market is commonly known as one that deals with transactions in the present (rather than the future), these trades actually take two days for settlement.

Unlike the spot market, the forwards and futures markets do not trade actual currencies. Instead they deal in contracts that represent claims to a certain currency type, a specific price per unit and a future date for settlement.

In the forwards market, contracts are bought and sold OTC between two parties, who determine the terms of the agreement between themselves.

In the futures market, futures contracts are bought and sold based upon a standard size and settlement date on public commodities markets, such as the Chicago Mercantile Exchange. In the U.S., the National Futures Association regulates the futures market. Futures contracts have specific details, including the number of units being traded, delivery and settlement dates, and minimum price increments that cannot be customized. The exchange acts as a counterpart to the trader, providing clearance and settlement.

Both types of contracts are binding and are typically settled for cash at the exchange in question upon expiry, although contracts can also be bought and sold before they expire. The forwards and futures markets can offer protection against risk when trading currencies. Usually, big international corporations use these markets in order to hedge against future exchange rate fluctuations, but speculators take part in these markets as well.

Note that you'll often see the terms: FX, forex, foreign-exchange market, and currency market. These terms are synonymous and all refer to the forex market.

The Forex Market for Beginners

It seems like something that most people would find easy, except, in this particular industry, there is a high rate of failure among new traders because there is quite a steep learning curve.

Even traders that are aware of that tend to start out with the attitude of "It happened to them, but it won't happen to me." In the end, 96 percent of these traders walk away empty-handed, not quite sure what happened to them, or maybe even feeling a bit scammed.

Forex trading is not a scam; it's just an industry that is primarily set up for insiders that understand it. The goal for new traders should be to survive long enough to understand the inner workings of foreign exchange trading and become one of those insiders, and this will come with studying the market, understanding the terminology, and learning trading strategies.

Forex and Leverage

The number one thing that hangs most traders out to dry is the ability to use a trading feature called forex trading leverage. Using leverage allows traders to trade in the market using more money than what they have in their accounts.

For example, if you were trading 2:1, you could have a $1,000 deposit in your brokerage account, and yet control and trade $2,000 of currency on the market. Many forex brokers offer as much as 50:1 leverage. This can be dangerous, as new traders tend to jump in and start trading with that 50:1 leverage immediately without being prepared for the consequences.

Trading with leverage sounds like a really good time, and it's true that it can increase how easily you can make money, but the thing that is less talked about is it also increases your risk for losses.

If a trader with $1,000 in their account is trading with 50:1, this means they would be trading $50,000 on the market, with each pip being worth around $5. If the average daily move of a currency pair's price is 70 to 100 pips in a day your average loss could be around $350. If you made a really bad trade, you could lose your entire account in three days, and of course, that is assuming that conditions are normal.

Most new traders, being optimistic, might say "but I could also double my account in just a matter of days." While that is indeed true, watching your account fluctuate that seriously is very difficult to do. Many people start out assuming that they can handle it, but when it comes down to it, they don't, forex trading mistakes are made, and accounts are emptied.

Forex for Hedging

Companies doing business in foreign countries are at risk due to fluctuations in currency values when they buy or sell goods and services outside of their domestic market. Foreign exchange markets provide a way to hedge currency risk by fixing the rate at which the transaction will be completed.

To accomplish this, a trader can buy or sell currencies in the forward or swap markets in advance, which locks in an exchange rate. For example, imagine that a company plans to sell U.S.-made blenders in Europe when the exchange rate between the euro and the dollar (EUR/USD) is €1 to $1 at parity.

The blender costs $100 to manufacture, and the U.S. firm plans to sell it for €150—which is competitive with other blenders that were made in Europe. If this plan is successful, the company will make $50 in profit because the EUR/USD exchange rate is even. Unfortunately, the USD begins to rise in value versus the euro until the EUR/USD exchange rate is 0.80, which means it now costs $0.80 to buy €1.00.

The problem the company faces is that while it still costs $100 to make the blender, the company can only sell the product at the competitive price of €150, which when translated back into dollars is only $120 (€150 X 0.80 = $120). A stronger dollar resulted in a much smaller profit than expected.

The blender company could have reduced this risk by shorting the euro and buying the USD when they were at parity. That way, if the dollar rose in value, the profits from the trade would offset the reduced profit from the sale of blenders. If the USD fell in value, the more favorable exchange rate will increase the profit from the sale of blenders, which offsets the losses in the trade.

Hedging of this kind can be done in the currency futures market. The advantage for the trader is that futures contracts are standardized and cleared by a central authority. However, currency futures may be less liquid than the forward markets, which are decentralized and exist within the interbank system throughout the world.

Forex for Speculation

Factors like interest rates, trade flows, tourism, economic strength, and geopolitical risk affect supply and demand for currencies, which creates daily volatility in the forex markets. An opportunity exists to profit from changes that may increase or reduce one currency's value compared to another. A forecast that one currency will weaken is essentially the same as assuming that the other currency in the pair will strengthen because currencies are traded as pairs.

Imagine a trader who expects interest rates to rise in the U.S. compared to Australia while the exchange rate between the two currencies (AUD/USD) is 0.71 (it takes $0.71 USD to buy $1.00 AUD). The trader believes higher interest rates in the U.S. will increase demand for USD, and therefore the AUD/USD exchange rate will fall because it will require fewer, stronger USD to buy an AUD.

Assume that the trader is correct and interest rates rise, which decreases the AUD/USD exchange rate to 0.50. This means that it requires $0.50 USD to buy $1.00 AUD. If the investor had shorted the AUD and went long the USD, he or she would have profited from the change in value.

Currency as an Asset Class

There are two distinct features to currencies as an asset class:

- You can earn the interest rate differential between the two currencies.
- You can profit from changes in the exchange rate.

An investor can profit from the difference between the two interest rates in two different economies by buying the currency with the higher interest rate and shorting the currency with the lower interest rate. Prior to the 2008 financial crisis, it was very common to short the Japanese yen (JPY) and buy British pounds (GBP) because the interest rate differential was very large. This strategy is sometimes referred to as a "carry trade."

Why We Can Trade Currencies

Currency trading was very difficult for individual investors prior to the internet. Most currency traders were large multinational corporations, hedge funds or high-net-worth individuals because forex trading required a lot of capital. With help from the internet, a retail market aimed at individual traders has emerged, providing easy access to the foreign exchange markets, either through the banks themselves or brokers making a secondary market. Most online brokers or dealers offer very high leverage to individual traders who can control a large trade with a small account balance.

Forex Trading Risks

Trading currencies can be risky and complex. The interbank market has varying degrees of regulation, and forex instruments are not standardized. In some parts of the world, forex trading is almost completely unregulated.

The interbank market is made up of banks trading with each other around the world. The banks themselves have to determine and accept sovereign risk and credit risk, and they have established internal processes to keep themselves as safe as possible. Regulations like this are industry-imposed for the protection of each participating bank.

Since the market is made by each of the participating banks providing offers and bids for a particular currency, the market pricing mechanism is based on supply and demand. Because there are such large trade flows within the system, it is difficult for rogue traders to influence the price of a currency. This system helps create transparency in the market for investors with access to interbank dealing.

Most small retail traders trade with relatively small and semi-unregulated forex brokers/dealers, which can (and sometimes do) re-quote prices and even trade against their own customers. Depending on where the dealer exists, there may be some government and industry regulation, but those safeguards are inconsistent around the globe.

Most retail investors should spend time investigating a forex dealer to find out whether it is regulated in the U.S. or the U.K. (dealers in the U.S. and U.K. have more oversight) or in a country with lax rules and oversight. It is also a good idea to find out what kind of account protections are available in case of a market crisis, or if a dealer becomes insolvent.

Pros and Challenges of Trading Forex

Pro: The forex markets are the largest in terms of daily trading volume in the world and therefore offer the most liquidity.[2] This makes it easy to enter and exit a position in any of the major currencies within a fraction of a second for a small spread in most market conditions.

Challenge: Banks, brokers, and dealers in the forex markets allow a high amount of leverage, which means that traders can control large positions with relatively little money of their own. Leverage in the range of 100:1 is a high ratio but not uncommon in forex. A trader must understand the use of leverage and the risks that leverage introduces in an account. Extreme amounts of leverage have led to many dealers becoming insolvent unexpectedly.

Pro: The forex market is traded 24 hours a day, five days a week—starting each day in Australia and ending in New York. The major centers are Sydney, Hong Kong, Singapore, Tokyo, Frankfurt, Paris, London, and New York.

Challenge: Trading currencies productively requires an understanding of economic fundamentals and indicators. A currency trader needs to have a big-picture understanding of the economies of the various countries and their inter-connectedness to grasp the fundamentals that drive currency values.

The Market and Your Emotions

Assuming that you can manage not to fall into the leverage trap, the next big challenge is to get a handle on your emotions. The biggest thing that you'll tackle is your emotion when trading forex. The forex market can behave like a rollercoaster, and it takes a steel gut to cut your losses at the right time and not fall into the trap of holding trades for too long. Forex trading should be a formula and a method that is enacted consistently and without emotion.

When traders become fearful because they have money in a trade and the market's not moving their way, the professional sticks to her trading method and closes out her trade to limit her losses. The novice, on the other hand, stays in the trade, hoping the market will come back. This emotional response can cause novice traders to lose all of their money very quickly.

The availability of leverage will tempt you to use it, and if it works against you, your emotions will weigh on your decision making, and you will probably lose money. The best way to avoid all of this is to develop a trading plan that you can stick to, with methods and strategies you've tested and that result in profitable trades at least 50 percent of the time. In fact, not only should you have a trading plan, but you should keep a forex trading journal as well to keep track of your progress.

The Bottom Line

For traders—especially those with limited funds—day trading or swing trading in small amounts is easier in the forex market than other markets. For those with longer-term horizons and larger funds, long-term fundamentals-based trading or a carry trade can be profitable. A focus on understanding the macroeconomic fundamentals driving currency values and experience with technical analysis may help new forex traders to become more profitable.The forex market works very much like any other market that trades assets such as stocks, bonds or commodities. The way you choose to trade the forex market will determine whether or not you make a profit. You might feel when searching online that it seems other people can trade forex successfully and you can't. It's not true; it's just your self-perception that makes it seem that way.

A lot of people trading foreign exchange are struggling, but their pride keeps them from admitting their problems, and you'll find them posting in online forums or on Facebook about how wonderful they are doing when they are struggling just like you.

Understanding the forex market and winning at trading forex online is an achievable goal if you get educated and keep your head together while you're learning. Practice on a forex trading demo first, and start small when you start using real money. Always allow yourself to be wrong and learn how to move on from it when it happens. People fail at forex trading every day because they lack the ability to be honest with themselves. If you learn to do that, you've solved half of the equation for success in forex trading.