CAPITAL
STREET|FX

INTRODUCTION TO FOREIGN EXCHANGE

CAPADEMY TUTORIAL SERIES

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The foreign exchange market known as “forex” for short is the market in which currencies or sovereign money of different nations is traded. The forex market allows you to buy and sell these currencies at constantly varying rates, in an attempt to make a profit by exploiting the difference between these constantly varying prices.

It is the biggest financial market in the world, with over $4 trillion worth of transactions occurring daily. In this market, trade is conducted by transacting in currency based instruments, each of which has its unique characteristics (see below), though all these products are inherently based on the same underlying currencies.

The forex market is open 24 hours a day, 5 days a week and currencies are traded worldwide among the major financial centers of London, New York, Tokyo, Zurich, Frankfurt, Sydney, Singapore, Hong Kong and Paris.

Forex is considered a truly global market, with many different currencies/currency pairs to trade in. Therefore, there is no one main marketplace where all currency trading is conducted. Rather, currency trading occurs electronically over the counter, over closed interbank dealer networks, as well as financial exchanges, located all over the world. This means transactions occur via multiple, and often interconnected networks, between investors from all over the world.

Currency pairs: is the term used to express one currency against another in terms of a rate of exchange between the two currencies. Currencies are always transacted in terms of an exchange rate. The buying and selling prices for a currency pair (the “Bid” and “Ask”) represent the rate at which one currency can be bought or sold in exchange for the other currency in the pair.

Currency Codes: Each currency is recognized by a three-letter code and currency pairs are named by combining the three-letter codes of two currencies. For example, EUR is the EURO and refers to the currency of the European Union. The world's leading currencies expressed as three-letter codes are:

EUR (Euro)

USD(United States Dollars)

JPY (Japanese Yen)

CHF (Swiss Franc)

GBP (British Pound or Sterling or Cable)

CAD (Canadian Dollar)

AUD (Australian Dollar)

There are actually three major ways that institutions, corporations and individuals transact in the currency market: The spot market, the futures/forwards market and the options market.

Currency trading in the spot market always has been and continues to hold the largest market share in terms of trading volumes in the currency trading market. The spot market is where currencies are bought and sold according to the current/cash/spot price.

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, at a specific price per unit, at a pre-destined future date of settlement. Forwards and futures markets are based on the cash market value of the currency as a starting point of reference.

In a currency options market, an FX option gives the buyer the right, but not the obligation, to buy or sell a specific quantity of one foreign currency in exchange for another at a specified exchange rate. The buyer pays a premium to the option seller. For example: If an investor believes that the USD/EUR rate is going to increase from 0.80 to 0.90 (meaning that it will become more expensive for a European investor to buy U.S dollars) the investor would want to buy a call option on USD/EUR so that he or she could stand to gain from an increase in the exchange rate (or the USD rise).

Since currencies are traded in pairs, to take advantage of an exchange rate move you need to buy the currency that you expect will appreciate against the other currency in the pair to make a profit.

For example, if you expect the Euro (EUR) to strengthen against the dollar (USD), you would buy the EUR/USD or in other words- you would buy the EUR and sell the USD. On the other hand, if you expect the EUR to depreciate against the USD then you would sell the EUR/USD or sell the EUR and buy the USD.

Buying one currency in a currency pair automatically implies that the other currency in the pair is sold against it, because the rate of buying/selling is quoted as an exchange rate. Therefore buying one currency equates to buying it by selling the other currency and converting it to the currency bought. For example, in the above case of the EUR/USD, what an investor is doing by buying the EUR (for example) is that he/she is exchanging US Dollars (USD) to receive Euros in return.

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