Intermediate Concepts in Currency Trading

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Welcome to the intermediate eBook for Currency /Forex trading. This eBook will help you to learn more about Forex trading and how trading is conducted, as it introduces Forex trading, advantages and risk factors.

1. INTRODUCTION

The Foreign exchange market (Forex) is a global, decentralized or over-the-counter (OTC) market in which currencies or sovereign money of different nations is traded.

In general words, Forex Trading is an activity where a trader can speculate if one currency will get stronger or weaker relative to another currency.

2. HOW IS FOREX TRADING CONDUCTED?

Forex trading enables to speculate on the changes in currency over time, trading currencies and buying or selling one against the other. Traders look for profit from fluctuations in the exchange rates between currency pairs.

For example, if the euro is going to rise against the U.S. dollar, the trader can buy the EUR/USD currency pair low and then (hopefully) sell it at a higher price to make a profit. Of course, if the trader buys the euro against the dollar (EUR/USD), and the U.S. dollar strengthens, the trader will then be in a losing position. So, it's important to be aware of the risk involved in trading Forex, and not only the reward.

Forex trading is done by trading currency pairs. The prices of these pairs are known as quotes or quotations.

For example EUR/USD 1.23456

In the quotation EUR / USD is at 1.23456 the following definitions apply:

EUR is the base currency - the currency that is actually traded.

USD is the quote currency - the currency that is used to determine the base currency value.

Price 1.23456 stands for the quote itself - it shows the amount of quote currency units needed to acquire one unit of the base currency.

3. FOREX TRADING IN OTC MARKET

The OTC (over-the-counter) market is a market where financial instruments such as currencies, stocks, and commodities are traded directly between two parties. For example:

OTC trading is a feature of many different financial markets, including shares, Forex, and bonds — as well as derivatives such as CFDs.

The most popular OTC market is Forex, where currencies are bought and sold via a network of banks instead of on exchanges. This means that Forex trading is decentralized, and can take place 24 hours a day — instead of being limited to an exchange's opening hours.

OTC dealers often communicate their bid- and ask-price quotes over the telephone, email or other forms of electronic messaging.

4. BASIC TERMINOLOGY USED IN FOREX TRADING

Exchange Rate: The value of one currency expressed in terms of another. For example, if EUR/USD is 1.3200, 1 Euro is worth US$1.3200.

Pip: In Forex trading the smallest increment of price movement a currency can make, also known as point or points. For example, 1 pip for the EUR/USD = 0.0001 and 1 pip for the USD/JPY = 0.01.

Base currency and Quote currency: The first currency in the pair is called as the base currency – it always has a value of 1. The second currency in the pair is the quote currency and is the amount needed to exchange into 1 unit of the base currency.

Lot size: In Forex trading Currencies are traded in lot size. Lot size refers to the number of currency units you will buy or sell. The standard size for a lot is 100,000 units of currency, and now, there are also a mini, micro, and nano lot sizes that are 10,000, 1,000, and 100 units respectively.

Spread: It is the difference in pips between the ask price and the bid price. The spread represents the brokerage service costs and replaces transaction fees. If a currency pair has a certain price, say - EUR/USD 1.3000, the broker will not sell the EUR/USD to you at 1.3000. Your broker will quote you a slightly higher price of, say, 1.3001. If you are looking to sell, they will not purchase the EUR/USD at 1.3000 but instead will only pay, say, 1.2999. There is a difference between the price of 1.2999 and 1.3001 – 2 pips.

Margin: Margin is the amount of money needed as a "good faith deposit" to open a position with your broker. The margin is the minimum amount of funds, expressed as a percentage that you will need if you want to open a position and keep your positions open. The 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.

5. PROFIT CALCULATION:

Before entering into Forex trading, it makes sense that you would want to know what you stand to gain or lose from it.

Assume that you have a 100,000 EUR/USD position currently trading at 1.6240. If the prices move from EUR/USD 1.6240 to 1.6255, then the prices have moved up by 15 pips. For a 100,000 EUR/USD position, the 15 pips movement equates to USD 150 (100,000 x 15).

We need to know whether we were long or short for each trade, to determine if there is a profit or loss in Forex trading:

Long position: In case of a long position, if the prices move up, it will be a profit, and if the prices move down it will be a loss. In our earlier example, if the position is long EUR/USD, then it would be a USD 150 profit. Alternatively, if the prices had moved down from EUR/USD 1.6240 to 1.6220, then it will be a USD 200 loss (100,000 x -0.0020).

Short position: In case of a short position, if the prices move up, it will be a loss, and if the prices move down it will be a profit. In the same example, if we had a short EUR/USD position and the prices moved up by 15 pips, it would be a loss of USD 150. If the prices moved down by 20 pips, it would be a USD 200 profit.

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6. WHY SHOULD INVESTOR CHOOSE FOREX TRADING?

There are several reasons why investors should choose Forex trading. The Forex market is the world's largest market in terms of daily transaction volume, and it's almost the most liquid. This market is highly accessible given that it's open 24 hours a day.

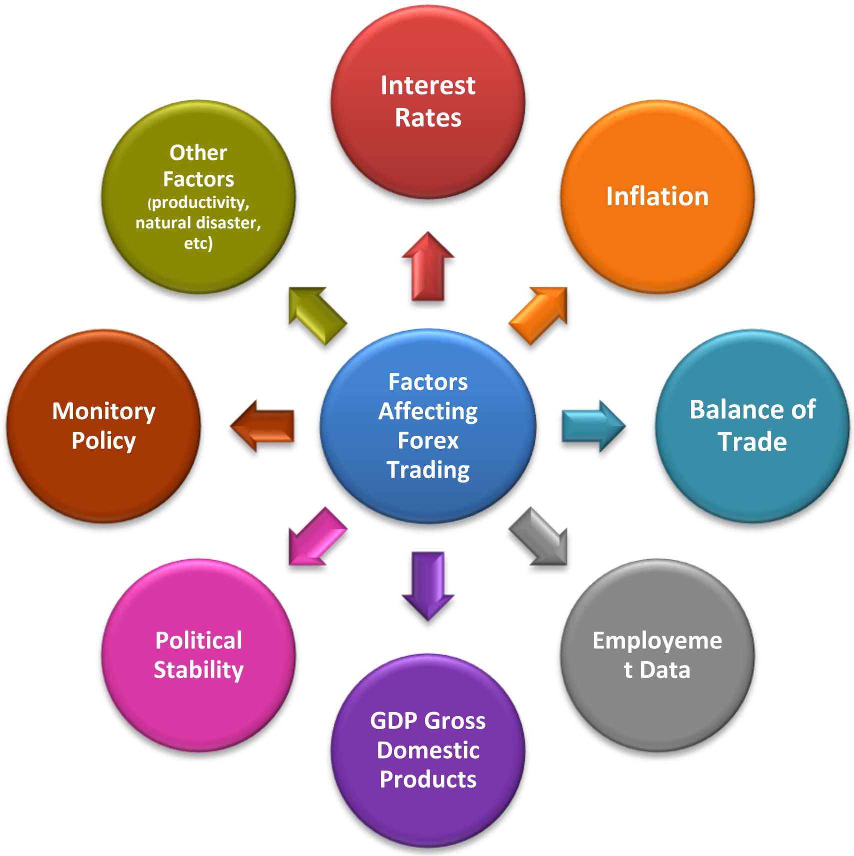
HIGH LIQUIDITY: Because the global Forex market is so large, it offers traders significant liquidity, which is the ease with which traders can exchange one asset for another. In this case, the Forex market's significant size makes it so traders can enter and exit positions very easily.

24-HOUR AVAILABILITY: One major draw of Forex trading is that the currency markets are open 24 hours a day. Investors around the world want to trade currencies. Investors will find it far easier to combine this kind of trading with part- or full-time work. For example, if a person works a traditional, full-time job between 9 AM and 5 PM in their time zone, they can trade after they get out of work.

SUBSTANTIAL LEVERAGE: Traders may prefer Forex trading, instead of stocks because when trading the former, they can obtain far greater leverage. By borrowing money to make trades, investors can potentially enjoy stronger returns.

For example, if a trader has access to 400:1 margin, they can make a £4,000,000 trade with just £10,000 in a margin. As a result, they would only need to put 0.25% of the trade down as margin. This can provide traders with stronger returns

7. FACTORS AFFECTING FOREX TRADING



1. Interest Rates: Changes in interest rates are always a major focus in the Forex trading. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates provide higher rates to lenders, thereby attracting more foreign capital, which causes a rise in exchange rates.

2. Inflation: This is the measure of increase or decrease in the price levels over a period of time. A country with a lower inflation rate than others will see an appreciation in the value of its currency. A country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates.

3. Balance of trade/balance of payments: Currency values can be significantly impacted by monetary flows that result from certain interactions between countries. When imports exceed exports, there is a tendency for the currency value to decline. Increased investments in a country can lead to the opposite result.

4. Employment data: Non-farm payrolls are the data that pertain to the number of people who are employed within the US economy, and it is released the first Friday of every month by the Bureau of Labor Statistics. Strong decreases in employment indicate a contracting economy, while strong increases are perceived indicators of a prosperous economy.

5. Gross Domestic Product (GDP): GDP represents the total market value of all goods and services produced in a country during a given year. A GDP growth rate higher than expected may mean the relative strengthening of the currency of that country, assuming everything else remaining the same.

6. Political Stability & Performance: A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. But, a country prone to political confusions may see depreciation in exchange rates.

7. Monetary Policy: Monetary policy deals with the relationship between interest rates in the economy and the total supply of money. When real interest on average goes up, demand for the local currency goes up because people holding foreign currency prefers to buy the local currency in order to buy the domestic financial goods (other things remaining same).

8. Other Factors: There are other factors that affect the Forex trading like:

Productivity: Productivity is an important factor for the nation. It is one of the foundations on which the country’s price structure is based. A workforce with higher productivity (more goods every hour or day) can afford to get higher wages and still price their products competitively.

Natural disaster: Serious natural disaster may disturb the growth potential of a country or even increase the amount of government debt. Furthermore, if a natural disaster has a strong impact on the growth potential of an economy it is likely that the Central Bank will decrease the level of interest rates in order to achieve faster recovery. Natural disasters have an unfavorable impact to domestic currency valuation.

Currency speculation: Currency speculation can affect highly the real value of a Forex currency. Large institutional speculators (i.e. hedge funds) have the power to bet against a particular currency aiming profits.

Demonitisation: It is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: The current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Demonitisation will result in a weaker home currency and a loss of foreign-exchange holdings with the central bank.

8. CONCLUSION

Forex market is literally a goldmine of opportunities for those who know how to trade like a professional.

One must be able to evaluate the effects of, and actively respond to, changes in exchange rates with respect to consumption decisions, investment portfolios, business plans, government policies, and other factors affecting the market.