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Darrell Jobman provides quality information about the benefits and pitfalls of trading foreign currencies



# FX Markets get even more Attractive

**W**ith the U.S. dollar under pressure following the Federal Reserve Board's about-face on cutting interest rates in September and the resulting new highs against the U.S. dollar made by the Canadian dollar, euro, Swiss franc and other currencies, the Forex markets have gotten a lot of attention from traders lately.

The ramifications of dropping the Fed fund and discount rates by 50 basis points have been felt in prices for gold, oil, grains and a number of other commodities.

"In today's increasingly volatile and interconnected global marketplace, the Forex market, by its very nature, is an ideal trading vehicle for intermarket analysis and trend-forecasting approaches," contends

Louis B. Mendelsohn, developer of VantagePoint Intermarket Analysis Software.

### Why Trade Forex?

The first question you may have is, "Why trade Forex? Isn't Forex something that should interest only bankers and big money managers?" Well, those players certainly are very interested in managing their Forex exposure, but Forex is a market for traders of all types and sizes for a variety of reasons:

**Diversification** – We live in a world where terrorist attacks can occur at any place at any time. It is a world where geopolitical tensions over nuclear power, oil, human rights and many other issues threaten to disrupt normal trade and economic relationships, where compa-

nies are investing internationally, where economic uncertainty seems to be a way of life. There is no way to express your investment concerns about many of these issues, whether for protection or speculation, in any individual nation's stock or interest rate markets. Forex is the only universal instrument that incorporates all of these areas of potential concern and serves as another asset class for speculators and investors.

**Global Market** – Markets such as equities or interest rates tend to be traded locally during the business day in their own time zone. Japanese traders tend to focus on Japanese stocks, European traders focus on European stocks and traders in the United States focus on stocks in the U.S. markets. All of these traders certain-

ly should be aware of what is happening elsewhere as the global integration of financial markets continues, but an event in Japan that directly affects Japanese stocks may not have the same effect in Europe, and traders of European stocks may not pay as much attention to what happens in the U.S. or Japanese stock markets.

Forex, on the other hand, has become an asset class that is truly a global investment reflecting every economic development on earth. Events or reports that influence currencies in Japan have an effect on what happens in the currency trade in London or Chicago. It is clear that intermarket relationships among currencies are extremely important in today's world.

**24-hour Trading** – Forex trading begins Monday morning in Sydney, Australia (Sunday afternoon in the United States) and moves around the globe as the business day begins in financial centers from Tokyo to London to New York, ending with the close of trading on Friday afternoon in New York. Anything that happens anywhere in the world at any time of the day or night affects the Forex market immediately without waiting for an exchange to open before the effects can be seen. The Forex market is always open for business.

**Electronic Trading** – With the advances in technology – specifically, the Internet and online trading with electronic trade-matching platforms – most Forex trade executions are instantaneous, getting you into and out of positions with the click of a mouse once you have made a trading decision. All of the benefits of electronic trading and position updates and status are available to today's Forex trader.

**Liquidity** – With the size of the Forex market, around-the-clock trading and electronic trade execution, illiquidity is not much of an issue in most venues of Forex trading. There is almost always a party to take the other side of a position you want to establish, no matter when you place your order. Forex bid/ask spreads tend to be tight with minimal slippage.

**Leverage** – Forex markets provide some of the highest leverage of any investment vehicle. A trader with limited funds may have to put up only a few hundred dol-

lars to control a sizable position worth \$10,000. As a result, a small move can produce big return. Of course, whenever you talk about the benefits of leverage, you also have to remember that leverage works both ways. A small move against your position can eat up the money in your account quickly if you are not a nimble trader who takes action quickly to cut losses before they become too large. What leverage gives, it can also take away.

**Abundance of Information** – Governments issue dozens of reports every month that influence the Forex market and this information is widely disseminated by the financial media. With advances in the Internet and financial news services, prices and economic data are delivered within moments of being released and are available to Forex traders of all types throughout the world. If anything, there may be too much information for traders to sort out at times, which has its own negative consequences.

**Simplicity** – You do not have to watch or analyze reports and price movements of hundreds of companies or mutual funds, trying to figure out which ones to buy or sell. With all of the fundamental information coming at you from many sources every day, you can make your trading life easier by concentrating on the Forex market. It is possible to easily limit yourself to monitoring movements of a half-dozen Forex pairs. In addition, you do not have to worry about going short or selling on a downtick as you do with equities because it is as easy to sell as it is to buy in the Forex market.

**Good Technical Market** – Once the basics of technical analysis are understood, you can extend that knowledge to all Forex markets without having to learn and understand a whole new set of market fundamentals. Because currencies are influenced by government policies and economic developments that usually stretch over longer periods of time, Forex markets have a reputation for trending well. As a result, if you keep an eye on economic conditions and charts as they evolve, you may find that Forex market moves are easier to follow and predict than movements in other markets.

**Active Price Movement** – Whether

looking at intraday price movement or movement over a number of days, currencies tend to have trading ranges that are wide enough to produce attractive trading opportunities. Volatility is necessary for a trader to make money in any market, and the Forex market usually provides more than enough volatility because there are new developments that affect the Forex market every day.

**But not too Volatile** – Forex markets can have abrupt price movements. But, as a 24-hour market where price changes always flow through the system, Forex markets rarely make the type of price moves sometimes seen in other markets. Stock prices can plunge or soar 10 percent or more on overnight earnings reports or other announcements, leaving gaps on price charts when an exchange opens. A \$3 change in the price of a \$30 stock is not that unusual, but a 10 percent move in a currency – for example, 14 cents if the euro were trading at \$1.40 – is quite unlikely.

In addition, while emerging markets may see some extreme currency price movements, the major currencies are not like Enron, Worldcom or a dotcom stock that flies all over the chart or plummets to zero when bankruptcy is declared. If you have thought that Forex trading was too volatile and risky, it may surprise you that the Forex market is often more stable than the equities markets.

### Where to Trade Forex

Forex trading can be accomplished in three main venues: the Interbank market, cash Forex trading firms or exchange-traded futures and options.

By far, the greatest share of Forex trading takes place in the interbank market in the form of currency swaps, forwards and other sophisticated transactions. The interbank market is a global over-the-counter network that includes, as its name suggests, the world's largest banks as its backbone along with other large financial institutions and corporations that have to be members of the network to participate.

There is no centralized marketplace in the interbank market, no standardized contracts and no central regulator. Transac-

tions are conducted between two parties over the phone or electronically. Based on a call-around tradition, deals may involve billions of dollars as price, delivery and other terms are negotiated, sometimes on behalf of customers but often for banks or institutions themselves as they speculate on the price movement of currencies.

However, unless you are a corporate treasurer or global money manager, the interbank market is probably not something that you will be involved with. It is a complex market reserved for sophisticated, professional – and nimble – traders. But there are a couple of places where you have easy access to the same type of Forex trading that the big boys have in the interbank market.

### Cash Forex Trading

One of the fastest-growing segments of trading in the United States in recent years has been in cash Forex market as dozens of new firms have sprouted up, taking advantage of online trading and less restrictive regulations. Sometimes, the biggest risk in cash Forex trading is not the market risk from fluctuating currency values but counter-party risk – that is, the risk that the cash Forex firm will perform on its obligations and deal fairly with its customers. Because your account depends on the creditworthiness and integrity of the cash Forex firm that you are dealing with, evaluating a firm carefully is one of the first essential steps for the cash Forex trader.

Nevertheless, cash Forex trading offers a number of advantages provided you are working with a reputable dealer and understand the risks associated with the high leverage available at some of these firms.

**Low entry cost** – In some cases, you can control a currency lot for only a few hundred dollars. A minimum account size of \$5,000 would be more typical, but in many cases you can open a cash Forex account for less money than an account to trade Forex futures, which have standardized contracts that are generally larger than the Forex lots traded in the cash market.

**High leverage** – A \$100,000 position can be controlled at a cash Forex firm with \$1,000 – that is, 100-to-1 leverage. Forex

futures may require 5 to 8 percent of the value of a Forex contract as a performance bond, but cash Forex trading requires as little as a 1 percent margin.

**Guaranteed limited risk** – The low initial funding requirements do not provide much leeway for adverse price moves. But should that occur, many cash Forex firms will close out your open positions immediately when your equity falls below the required minimum amount.

**Real-time quotes to trade** – The cash Forex firms provide two-way bid and ask prices for a number of Forex pairs via a free, streaming quote feed on a trading platform that usually has some analytical capabilities. Of course, this depends on the firm and the arrangement you have. If you click on the posted bid or ask price on the screen, the position is yours at that price instantly. There is no slippage or a partial fill.

**No commissions or fees** – Cash Forex firms do not charge commissions, as such. With stock or futures trading, you may have to pay \$3.95 or \$9.95 or even \$100 in commission charges for every trade. Cash Forex firms do not make their money on commissions but on the difference in the bid/ask spread (the price at which they will sell and the price at which they will buy).

### Forex Futures Trading

Although futures contracts generally developed after the well-entrenched cash markets, the opposite is true with Forex futures. The Chicago Mercantile Exchange (CME) introduced futures on currencies in May 1972, not long after President Nixon closed the gold window and before many currencies had achieved free-floating status. Forex futures traded in a floor setting with trading limited to regular trading hours during the day for more than 25 years, but most trading has moved to CME's Globex electronic trading platform in the last few years, and volume has been booming to make CME's currency market the world's largest regulated marketplace for Forex trading.

In addition to the benefits of Forex trading mentioned earlier, futures exchanges provide some other advantages that may encourage you to trade Forex futures:

**One central market** – Instead of having just one source providing bid/ask quotes as in cash Forex trading – a source that incidentally knows your position – you have literally hundreds of traders including major banks and financial institutions making bids and offers all of the time in futures. The bids and offers are channeled into one place, establishing one price that is widely distributed the instant a trade takes place.

**Tight bid/ask spreads** – With so many traders and so many 'bids' and 'asks' coming into one location at one time, futures provide substantial liquidity and a smooth flow of trading from one price to another. The spread between 'bid' and 'ask' is small in Forex futures, frequently only a pip or two, in a very competitive environment. You cannot count on that when you deal with only one firm facing no competition when it comes time to close out your position.

**Transparent pricing** – The current price arrived at by these multiple sources is available to all traders of all sizes at the same time. Electronic futures trading does not play favorites but puts the small trader on equal footing with the large trader on a level playing field. You are not limited to one set of bid/ask quotes offered by one firm and do not have to worry that prices may favor a dealer that may be factoring hidden spread costs into its quotes. All prices and all costs associated with Forex futures trading are out in the open.

**No counter-party risk** – You are not trading with one firm and do not have to worry about the creditworthiness of the party that may be on the other side of your trade. In futures trading, the exchange's clearing organization is actually the counter-party to every trade, setting the rules and policies to preserve the integrity of its futures markets and provide a verified record of all trading activity that can be audited, if necessary. To date, no trader has ever lost money in futures due to counter-party default.

*Darrell Jobman is Editor-in-Chief of [www.TradingEducation.com](http://www.TradingEducation.com), a web site providing free information and education to traders. He is an acknowledged authority on the financial markets and has been writing about them for more than 35 years.*