CFD Trading guide

Forex CFD Trading

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Forex CFD Trading overview

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 day a week markets quite a compelling proposition.
As with anything in trading, understanding the product, risks and having a stringent risk and money management strategy are paramount when becoming more involved in the forex market.

Earning the basics

Firstly, currency trading is a relative game, whereby you are simply playing one currency against another. If you feel the AUD will appreciate against the USD for example (ie the exchange rate goes from 0.9100 to 0.9200) you simply buy the pair. Your directional bias is expressed through the first named currency, but your profit and loss (P&L) is made in the second named pair.

In our opinion, technical analysis must play a part in forex trading. We just don't see how you can trade currencies without looking at price action. There are so many players in the market; exporters (real money), leveraged funds, macro-focused accounts, retail players and reserves managers (who transact on behalf of central banks). This ultimately means that there are many opinions and varying thought processes so the only way to rationalise this human behaviour is through price action.

Whilst some will argue you can't look at a chart and make an argument that it will predict future moves; at the end of the day aren't all fundamental investors and traders forward looking? Therefore a chart is simply telling you what the so-called forward looking fundamental traders are doing, and thus tells you what the market feels about future policy moves by a central bank and the general underlying economy.

Using your gut feeling about an event or action from a central bank will often be wrong, so let price guide you, and as discussed in 'Trading Strategy' it's perfectly OK to be wrong, just as long as you 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.

Fundamentally the forex market takes time to fully comprehend and harness, and truth-be-told 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 bond yields, equity markets and volatility measurements to feed into their models.

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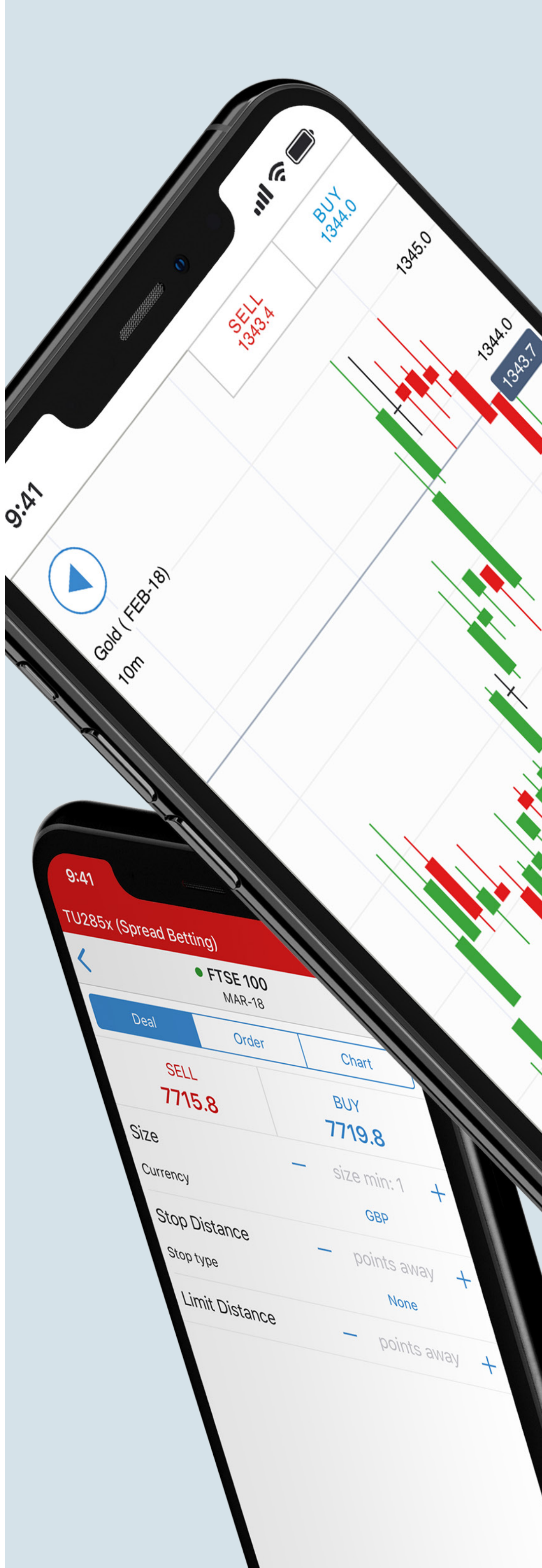

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Bonds and yields

The bond market plays a major part in valuing a currency and all good forex traders who incorporate fundamentals into their views will have a thorough understanding of the bond market. A write-up on the bond market is not something which can be fully justified in this short document, but 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 nations' 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 who had the bigger reaction. Using AUD/USD as an example, you would compare Australian government bonds with US treasuries. The concept of looking at the diverging yield levels in bond markets is what we call a 'yield spread' and is extremely influential in driving currencies.

The bond market plays a major part in valuing a currency

Market drivers

It is also very important to understand what the key drivers of currencies are. For example, countries which source a significant amount of revenue – and subsequent growth – from exporting raw materials such as the AUD, CAD and NZD, will usually underperform when commodities are sold. On the other hand, countries which run sizeable current account surpluses (ie 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 which standout here are Japan and Switzerland; both are bought as 'safe havens' when traders express concern. 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.

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currencies are driven by **international flows**

Summary

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

- **FX trading carries a high degree of leverage.** Use leverage wisely and always trade with stops and limits
- **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
- We like to use a mixture of technicals and fundamentals or 'technomentals' in the forex market. For us, if the technicals and fundamentals disagree, back the technicals. If they both paint the same story then that can be a powerful sign
- **Position sizing is vital when starting out and perfecting a strategy.** Start small and start simple. Look at currency pairs you understand and are familiar with
- **Currencies can trend really well.** Our preference is to buy strength and sell weakness. A currency in motion tends to stay in motion. You will greatly increase your chances of bring profitable 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 moves than AUD/NZD
- Traders generally start their FX journey by looking at EUR/USD
- **Don't fight a central bank when they are aggressively easing.** Generally what a central bank wants, they usually get. If the BoJ are aggressively easing policy, look to trade the JPY against a currency whose central bank policy is less accommodative – for example CAD
- **Don't restrict yourself to the majors; look at the crosses.** (ie anything not traded against the USD). Pairs like USD/JPY and EUR/AUD can trend extremely well