

# The Beginner's guide to Forex trading

- **What is Forex trading?**
- **Who are the "majors" and the "exotics"?**
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- **Currency speculation; How do I calculate my gains and losses?**
- **What makes currencies move?**

## What is "Forex trading"?

"Forex" (foreign exchange) is the buying or selling of overseas currencies.

"Forex trading" can be an extremely lucrative business. Famously wealthy currency speculators include Joe Lewis and George Soros. These guys have made fortunes identifying currency trends and anticipating market movements!

When we buy overseas goods in local shops, or buy petrol or go abroad, we are part of a currency exchange. The retailer has acquired goods from a wholesaler, who has acquired the goods from a local or EU distributor. Somewhere in this process of goods changing hands, currency trading has been employed as the tool of international trade.

The management of currencies is the task of the country's central bank and/or the Government. There are many forex market participants, including banks, brokers, multi-national companies and investment institutions. Since the relaxation of UK exchange controls in 1979 individuals have been active in the forex market.

Currency dealing or "forex" dealing/ trading takes place in every major city in the world. Major forex centres are London, New York, Tokyo and Sydney. London is the world's biggest centre for foreign exchange trading worth \$3,000bn per day.

Forex dealing is popular because it is a highly liquid, transparent market open 24 hours and uses standard terms that are easily understandable. These days forex dealing is so easy you can trade from your own home computer! You can use leverage to increase your exposure to market movements. Forex dealing offers flexibility in that the investor is able to take a more intuitive approach.

## The “majors” and the “exotics”

In forex trading “parlance” there are 6 “major” trades, they comprise over 70% of trading:-

€ / US\$; 28.2%

US\$/ JPY; 16.7%

£ / US\$; 13.8%

A\$ / US\$; 5.1%

US\$/ C\$: 4.4%

US\$/ SwF; 4.0%

Other trades involving the US\$ account for 16.5% of trading.

“Minor” currencies are usually those of developing countries including Russia, Brazil, South Korea, Malaysia, Mexico. The annual traded volumes of these currencies are around 6-10x annual the respective GNP.

“Exotic” currencies are currencies that are thinly traded outside their own countries. The Thai baht is a good example of a currency traded mainly between neighbouring countries reflecting physical trade in goods. The Thai baht considered exotic because it trades only low volumes in international markets.

The difference between trading the majors and the exotics is largely in the “spread”. For the very liquid majors, the spread ie the difference between the buying and selling price is very small. However for the exotics, the difference between buying and selling price can be quite large.

The size of the spread is a key factor. For an investor to profit, the position has to “get though the spread” ie move in the investors favour by an amount larger than the spread. Hence it is easier to profit from engaging in major trades than in the exotics.

## CSS can help you with your forex trading strategies:-

Hedging against market movements or against an existing portfolio.

Markets are volatile. Forex dealing enables clients to hedge against an existing position or risk exposure or future cash flows.

Assume you own a property in Japan that is rented for a year. You would receive periodic rent payments into your Japanese bank account. You could decide to remit money every month to your UK account or to receive one payment at the end of the year. You could hedge against adverse movements in the exchange rate by selling the Yen against sterling using a forward rate.

Speculation occurs when the buyer buys a currency in the belief that it is likely to rise against other currencies.

Speculation essentially means that you are creating an asset/ liability mix. When you buy an overseas currency then that becomes your “asset” currency whilst the currency that is sold is the “liability” currency. The speculator makes money when his asset currency exceeds his liability currency.

One form of speculation involves the “carry trade”. The objective of a carry trade is to benefit from interest rate differentials ie the fact that some currencies pay higher rates of interest than others.

One example is GBP/ Yen; GBP interest rates are currently around 5.0% against Japanese interest rates of 0.5% hence 10x more interest can be earned in GBP than in Yen.

During periods when the market is quiet the “carry trade” can be left in place ie you would be receiving sterling interest income, paying interest in Yen and therefore likely to benefit from this income “profit”. Essentially the trading system would adjust your position daily in your favour, to reflect the net income earned from the difference in interest income. “Carry trades” are often used by other market participants helping your odds of success.

Our foreign exchange platform allows our clients' access to the forex markets ie the ability to trade in any currency and at anytime. It combines competitive exchange rates, leading back office systems and an online payments platform alongside specialist advice. We aim to ensure your business is conducted at opportune times and at good prices.

We strongly suggest acquiring a good understanding of forex trading basics prior to pressing buttons and trading. We are here to help you do this.

The best advice on how to trade profitably is to learn trading techniques from the experts. Our experts provide in-house advice that will explain market movements and provide mentoring enabling you to acquire an in depth understanding of the trade. Our charting techniques will provide an insight into how the market is behaving helping you to trade profitably.

## Understanding the forex quotation

Currencies are always traded in "pairs" ie one currency's value is expressed in terms of an overseas currency.

There is a BASE CURRENCY against a VARIABLE CURRENCY.

When we obtain a quote it is expressed in terms of its buying and selling price in the overseas currency.

Let's use "cable" as an example; that's sterling vs US Dollar. The quote as it appears looks like this:-

<b>1.7450</b> <b>"BID" ie SELL</b>
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<b>1.7453</b> <b>"ASK" ie BUY</b>
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This simply means that the sell price is US\$1.745 whilst the buy price is \$1.7453.

If I went "Long" I would be buying GBP at US\$1.7453.

If I went "Short" I would be selling GBP at US\$1.7450.

USEFUL TIP: The "ask" or the "asking price"; it is a bit like when you instruct the estate agent to get offers on or as near as possible to the asking price.

In the above quotation the last digit is known as the "pip" short for the price interest point. In this case the spread is worth 3 "pips".

In normal and especially in fast moving markets the movement in the "pip" is highly sensitive and moves quickly. Currency traders and specialists watch these small movements like hawks especially when central banks are making announcements.

## Currency Speculation; How do I calculate my gains/ losses?

Assume for the purposes that I had £100k for forex trading. How would I make money from forex speculation?

Let's say I was convinced the US dollar would rise. I am willing to leverage up my position by 10x. Hence my £100k on deposit in my account would allow me to control a forex position worth £1m.

Using the above example GBP/USD is 1.7450 (Bid) / 1.7453 (Ask); I would SELL £1m GBP at US\$1.7450.

The GBP/USD would fall as I expected:-

The quotation is now GBP/ USD 1.7215 (Bid) / 1.7218 (Ask).

I would then buy back GBP/USD at the ask price ie 1.7218.

My profit would be:  $1.7450 - 1.7218 * 1,000,000 = \text{USD}23,200$

Note that my profit or loss is always expressed in terms of the overseas currency.

Then let's assume I wanted to continue trading but limiting my trading to movements of 50 pips and my leverage to 5x ie control a position of £500k with my £100k deposit.

I would then use the CSS platform to limit my exposure.

The CSS platform will let me know my net exposure at any time and should I close my position it would be described as "square". A squared position typically clears on a T2 basis ie 2 business days after the transaction.

## What makes currencies move? What should you be mindful of?

With currency trading, the investor needs to be mindful that there are a multitude of possible factors that can influence exchange rates. Some factors such as economic data occur at set times, other factors such as shocks or political changes occur randomly.

Primarily the strength of a currency is based on the strength of that nation's economy.

The reason that currency values fall, sometimes precipitously, resulting in hyperinflation, (Zimbabwe dollar / the German mark during the 1920s) is due to the perception and performance of the economy.

Often when investors decide 'en masse' that an economy is weakening "capital flight" takes place. Capital flight involves the moving of cash deposits from one centre to another. Large investors, central banks will move deposits from London to New York or to Tokyo or Geneva if they perceive economic weakness may result in lower local interest rates.

If an earthquake hit the Tokyo Bay area, the Yen would decline against major currencies and investors would expect the Japanese stock market to fall. This is what happened after the Kobe earthquake in 1995. Due to the decline in Japanese asset values and the weakening in the Japanese economy, investors withdrew money from Japan.

If more money leaves the country than comes in; then the currency will depreciate. If more money comes into the country than leaves then the currency will appreciate.

Economic data therefore is vital for currency trading. Examples of important data published monthly include:-

- **UK unemployment**
- **UK retail sales**
- **UK retail price inflation (RPI)**
- **UK M4 money supply**
- **UK public sector borrowing requirement**

Other countries publish monthly economic data that is very important in determining currency values.

Interest rates are also very important because currency values can move very sharply due to changing interest rate "differentials". This means that countries with high interest rates will attract speculative "hot money" flows.

This works as follows. Let us assume that LIBOR interest rates in the UK are 5% whilst LIBOR interest rates in the US are 2%.

A US investor or anyone with US dollars could buy sterling and deposit the cash in London earning 5%. He could then enter into a forward agreement to sell US dollars. Let us assume the current spot rate is US\$1.80 and I have £50,000.

I enter into a spot transaction: £50,000\* (US\$1.80 \*1.02) = \$91,800.

I am quoted a one year forward rate of US\$1.7485 ie \$91,800 / £52,500

Due to the workings of currency arbitrage (ie the risk free buying/ selling of currencies) even small discrepancies in forward rates are eliminated. If forward exchange rates did not behave in this way it would be possible to make risk free profits and everyone would be doing it!

Currency dealing is also about watching what other investors are doing. This is not an exact science in itself as it is essentially reliant on old information and on other investors who may have different motives and risk/return requirements and reach different conclusions. However it is possible to discern trends from looking at charts that identify currency changes. The value of charting is that it helps identify entry and exit points and support and resistance levels enabling the investor to extrapolate trends.



The chart above shows GBP vs Swiss Franc from January 2004 to October 2008. This demonstrates that four individual trends have been apparent since 2004, three of which have been significant downtrend periods.

Other charts are easier in terms of trend spotting!



This chart shows the US dollar v Euro

## SUMMARY

Our beginner's guide is intended to give you a flavour but "you can only learn by trying"!

Feel free to sign up on our website at [www.css-investments.com](http://www.css-investments.com)

We hope this guide has been informative and clarified some of the more technical points to forex dealing. Please send us any questions you might have.

## General Risk Warning

The market information relating to the past performance of an investment is not necessarily a guide to its performance in the future. The value of investments or income from them may go down as well as up. As stocks and shares are valued from second to second, their bid and offer value fluctuates sometimes widely. The value of investments may rise or fall due to the volatility of world markets, interest rates and capital values or, for investments held in overseas markets, changes in the rate of exchange in the currency in which the investments are denominated. You may not necessarily get back the amount you invested.

You should carefully consider in the light of your financial resources whether investing in stocks and shares is suitable for you.

## Foreign Exchange Risk Warning

Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to trade foreign exchange you should carefully consider your investment objectives, level of experience, and risk appetite. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose. You should be aware of all the risks associated with foreign exchange trading, and seek advice from an independent financial advisor if you have any doubts.