Wiley Trading

MAKING MONEY IN FOREX

Trade Like a Pro without Giving Up Your Day Job

RYAN O'KEEFE

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This work is dedicated to my beautiful wife, Christine. I am forever grateful for your love, friendship, strength, and commitment. I would not be the trader I am today without you. Thank you for your patience, encouragement, and assistance, making this book a reality. I couldn't have done it without you! I love you!

Contents

Preface

When I was introduced to trading, the Internet was young, charts connected directly to data providers via dial-up modem, and trades were placed over the telephone. I met a currency futures trader who introduced me to the market and taught me some basic technical analysis techniques, and I was hooked. I decided to focus on off-exchange spot currency trading versus futures for reasons I'll discuss in Chapter 1. In those days, $100,000 lots and account minimums created a problem for me. I was 17 years old, just graduating high school, and I was broke. I needed to raise trading capital, so I did what any technology-savvy high school graduate did during the Internet boom: I joined the revolution.

I began trading while I worked full-time and sought help from my local book store. I found a plethora of books focused on day trading but nothing that helped me navigate the 24-hour currency market around my day job. These books were written by people who claimed to trade full-time or Wall Street types who spent their entire day glued to a chart. Their methods depended on the volatility offered by active trading sessions and were completely useless to me. I lived in the Central Time Zone, so I was asleep while London traded and at work while New York traded. I tried staying up late and getting up early, and I even tried trading via a mobile device, but ultimately short-term trading wasn't a sustainable solution for me. Day trading may have sex appeal—promising Learjets, Lamborghinis, and limited work weeks—but day trading isn't an option for someone who is stuck in a staff meeting when the market is roaring.

WHY NOT TRADE FOR A LIVING?

Today I do not trade for a living. I am too risk-averse to rely solely on income from trading. Trading is a tough business, and there are no shortcuts to success. You've probably noticed that many of the appointed "gurus" in

the trading business work for currency dealers, or have other income interests. There is a reason for that: Trading is a fickle business. Investment gains are never linear, and some months are better than others. Even when a trader does everything correctly and according to his plan, he might have nothing to show for it at the end of the month. I say this because I want to be realistic and up front with you rather than implying that trading presents a rosy, get-rich-quick scenario.

The trading business is also exposed to government regulatory changes that can dramatically alter the way business is done. The spot market has traditionally been unregulated, but traders in the United States are beginning to feel the pinch of increased regulation. The CFTC Reauthorization Act enacted within the Food, Conservation and Energy Act of 2009, commonly known as the Farm Bill, sought to clarify and enhance the Commodity Futures Trading Commissions's jurisdiction over off-exchange currency trading. Since then, the CFTC has wasted no time enacting new regulations through the National Futures Association. The National Futures Association (NFA) recently enforced two new rules significantly altering the way some traders conduct business. First-in/first-out (FIFO) order execution forced some dealers to eliminate the availability of stop and limit orders on individual positions. I concede that those dealers have execution systems that exacerbated the problem, but it wasn't an issue until FIFO was handed down by the NFA. The NFA also eliminated the ability to hedge currencies in a single account. Many traders chose to move their trading accounts overseas, where the rules do not apply. As I write this, the CFTC is proposing new restrictions on margin requirements that will impact traders using leverage greater than 10:1. The proposed leverage restrictions have the potential to force many retail currency traders into overseas accounts, where margin restrictions are not as strict. The point here is how quickly this business can be altered by government regulators.

Regulation changes are not the only threat to the trading business. Taxation changes have the potential to severely impact profitability: H.R. 1068 is currently working its way through the House of Representatives. Conveniently titled "Let Wall Street Pay for Wall Street's Bailout Act of 2009," the legislation seeks to impose a 0.25 percent tax on any financial transaction "subject to the exclusive jurisdiction of the Commodity Futures Trading Commission." Retail currency transactions are now directly under the jurisdiction of the CFTC, therefore it isn't a stretch to imagine taxes imposed through currency dealers. Government changing the playing field while the game is being played remains a threat to the trading business and could get worse in the wake of the global financial crisis.

TRADING FOR RETURNS

I believe in diversification and prefer to diversify my income as I would my investment portfolio. Although I enjoy currency trading tremendously, it remains a cog within my investment strategy, which ranges from stocks to real estate.

I am not alone. There are many other traders who are not trading to pay their water bill each month. I've met many traders I would consider "professional grade" who are perfectly content at their day jobs. Many of these traders are managing their own retirement portfolios or supplementing an employer-sponsored retirement or pension plan. Still other traders speculate in the currency market to raise investment or discretionary cash. Learning to trade currency using the long-term methods in this book may offer an opportunity to supplement traditional investment vehicles. Whatever your motivation for trading, the methods in this book can help you achieve your trading goals.

I'm not trying to scare you away from trading for a living. If you are personally comfortable with the risks associated with trading for a living, then by all means go for it. Many people do indeed earn all their income from trading, and there is no reason you can't, too. My goal is to mentor you into becoming a professional-grade trader; what you do with this information is up to you.

WHY THIS BOOK?

I wrote this book to help people learn to trade around day jobs they can't quit cold turkey. It contains the experience and methods I've developed after nearly a decade of analyzing, trading, and writing about the spot currency market. The book's objective is to persuade you from chasing profit all over a five-minute chart and learn to trade using a steady, long-term approach.

You should understand up front that I am a trader, not an analyst. This book contains my experience and methodologies as a trader interested in two things: reducing risk and making money. I don't care about market correlations, the Big Mac Index, or speculating about whether a central banker is going to shave his mustache off. I do not spend my time analyzing the market to death; I'm a trader and making money is all I care about.

Do not expect a detailed analysis of each currency pair or the effect crude oil may have on the Canadian dollar. I will not discuss traditional

technical patterns, Elliot Wave theory, or Gartley patterns (whatever the heck they are). These topics have been discussed *ad nauseum* by other authors and I see no reason to cover them again. I don't use them in my trading, so why should I include them in this book? I am only interested in identifying support or resistance, where price is now, where is it headed, and how can I profit regardless of the cost of tea in China.

Throughout this book I refer to the theme of bargain hunting. Many traders tend to lose their shrewd business sense when it comes to trading. The same trader who wouldn't pay a penny too much for a car will pay full price for a trade. These traders chase breakouts, sell resistance, and buy support. I want to reset your thinking and remind you that trading is no different from any other market. Demanding the best deal out of every trade lowers your risk and increases your profits. No trade is worth taking unless you are able to dictate your terms to the market. Throughout the chapters on bargain hunting you'll learn the principles and methodologies I follow to be the cheapest trader I can possibly be. It's a badge I wear proudly.

Each chapter in this book ends with a section called "Closing Bell" that summarizes the key points I believe you should take away from reading that chapter. The simple methodologies in this book don't require constant attention. They are easy to implement, whether you are new to trading or you have some experience. Implementing longer-term strategies will free your day to work or pursue interests other than watching charts. Ultimately this book is designed to help you trade better today, without giving up your day job or making a drastic change to your lifestyle. This is the book I wish had been on the shelf when I visited the bookstore as a new trader nearly 10 years ago.

My hope is that this book returns your investment, inspires you to try new trading techniques, and helps you reach whatever trading goals you have set out to accomplish. If you need some help along the way, visit my blog at www.ryanokeefe.com and drop me an e-mail. I'd love to hear from you.

Author's Note

Trading foreign currency off-exchange on margin is one of the highest-risk investment products available in the financial markets. Risk exposure includes but is not limited to margin, limited regulator protection, liquidity, creditworthiness of trading partners, and market volatility that substantially affects the price of a currency. Foreign currency trading is not suitable for all investors, and you should carefully consider your investment objectives, experience level, and appetite for risk before trading. Leverage can work against you as well as for you, and the possibility exists that you could sustain a loss of some or all of your investment capital. Never trade foreign currency with money you cannot afford to lose. If you are unsure of the risks or have any doubts, you should seek the advice of an independent financial advisor before trading.

Many traders have an unrealistic expectation of profits related to trading foreign exchange. Currency trading is not a road to easy riches; if it were, everyone would have a private jet by now. Tremendous gains can be achieved only through taking a tremendous risks, which could be catastrophic to your investment capital. Regardless of your skill level, losses can and do occur. Prior to trading, you should thoroughly understand the damage you are capable of doing to your investment capital through the use of leverage.

Although some examples in this work are based on actual trades, many are hypothetical examples and benefit from hindsight. The opinions and information contained in this book do not constitute direct investment advice. This work is for informational purposes only and should not be understood as a direct recommendation to buy or sell any foreign exchange contract or other investment vehicle.

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I would like to thank the good people at John Wiley & Sons who made this book a reality. I'd like to acknowledge Kevin Commins, who listened and believed in my idea for a book focused on traders who also work full-time. Thank you for listening to my pitch, understanding my vision, and creating a book project from it. Meg Freeborn deserves an enormous thank-you for putting up with me over the course of this project. Meg patiently waited for material as I rewrote the book and changed the structure more times than I care to admit. She worked tirelessly toward the end, turning my drafts into a work deserving of the customer's time to read. Thank you, Meg! Thank you, too, to Jennifer MacDonald and the entire marketing team at John Wiley & Sons, who worked to share my book with retailers; your efforts are sincerely appreciated.

I'd like to thank my wife for supporting me through the late nights and long weekends and for giving up what turned out to be a beautiful Pacific Northwest summer to support this project. I can't thank you enough for helping me through this book!

Finally, I'd like to acknowledge my readers who have purchased this book. Your trust that my work deserves your hard-earned money is humbling, and I sincerely appreciate your interest in what I have to say.

CHAPTER 1

Exploring the Currency Market

Whether you trade stocks, commodities, currencies, or real estate on Mars, it is important to understand the marketplace in which you're working. If you have little market experience, if you're new to currencies, or if you want to brush up on market basics, this chapter is for you. This chapter does not contain an exhaustive history of the modern foreign exchange (forex) market. Instead, we look at the market from the perspective of an active trader. You will learn about the roots of the market, its structure and participants, how currency trades are executed, and the tools used to conduct business. If you have experience trading other markets, this chapter will brief you on the unique attributes of the currency market. If you have little or no experience in trading, the contents of this chapter are an essential part of learning the business of currency trading.

WHAT IS FOREX?

The currency market, or more specifically the forex market, derives its name from the generic term fo*reign* ex*change market*. The forex market is a decentralized global network of trading partners, including banks, public and private institutions, retail dealers, speculators, and central banks involved in the business of buying and selling money. The forex market is a *spot market*, which means that it trades at the current market price as determined by supply and demand within the marketplace. This differs from currency futures traded on the commodity exchange in the United States,

which trades a contract price for delivery in the future. In the spot market you are trading cash for cash at the current market price.

The forex market is the largest, fastest-growing financial marketplace in the world. Every trading day the forex market handles a transaction volume of nearly $3.2 trillion, according to a survey done by the Triennial Central Bank in 2007. To put that figure in perspective, the average daily volume on the forex market is nearly 20 times larger than on the New York Stock Exchange. The need for foreign exchange is driven by travelers, multinational corporations, and governments. Tourists from the United States need euros for their European vacations; corporations such as Microsoft exchange profits made overseas into U.S. dollars. Governments hold reserve currencies and manipulate the money supply while they implement their monetary policies. The forex market was created to facilitate the sale of currency to customers who intend to take delivery of the currency; however, the vast majority of trading is done by speculators seeking nothing more than profit.

FOREX ROOTS

The roots of our modern forex market are an interesting topic that has been covered *ad nauseum* by other trading books; however, I do believe it is important to have some knowledge of the market's history, so this section covers the key points. If you have never studied global monetary systems, consider this section an abridged history of the forex market. The modern forex market's roots began with over-the-counter currency trading desks established by banks throughout the 1970s and 1980s, following the collapse of a postwar-era monetary system known as the *Bretton Woods system*. Bretton Woods was established in June 1944, as World War II came to a close. The Allied nations sought to establish a new monetary system to promote global investment and capitalism and to eliminate the challenges of a gold standard system.

Under the Bretton Woods monetary system, member nations agreed to value their currency at parity to gold ±1 percent and then set their exchange rate against the U.S. dollar. In exchange, the United States agreed to peg the dollar against a gold standard of $35 per ounce and guarantee its exchange for gold. This promise by the U.S. government effectively made the dollar a global payment standard instead of using a gold standard. The phrase "good as gold" was frequently used to describe the U.S. dollar under the Bretton Woods monetary system. Although the system worked to foster investment and capitalism, it also encouraged a tremendous outflow of dollars into overseas currency reserves. The world needed dollars to support a global payment system based on the dollar, and the United States

was content printing more money. The United States assumed it could balance the deficit with trade. Unfortunately, the outflow of capital finally caught up to the Unites States in 1950 and the country began posting a negative balance of payments, despite the government's best efforts to increase trade.

As inflationary concerns loomed on the horizon, the United States found itself in a difficult position. Failing to supply the global demand for dollars would bring the monetary system to its knees, whereas continuing to print money would eventually threaten to devalue the dollar. Confidence in the U.S. government's ability to maintain a gold match standard for the dollar began to wane, and speculation grew that a serious devaluation in the world's primary reserve currency was inevitable.

In August 1971, President Richard Nixon finally intervened by suspending the peg dollar had against gold. The Bretton Woods era of a fixed exchange rate system was over. Policy steps were taken to implement a *floating exchange rate system*, which is the cornerstone of today's modern forex market. In the 1970s trading desks were established among major banking institutions to facilitate currency transactions for major clients. This private trading arrangement was known as the *interbank*, a term still used today to describe the electronic trading arrangements among major banks, institutions, and currency dealers. Today prices are determined by the forces of supply and demand within the forex market, allowing traders to capitalize on small swings between the exchange rates of two currencies.

FOREX PARTICIPANTS

Forex has a diverse population of participants, ranging from Japanese housewives to powerful central bankers. The objectives of the participants differ, and their individual actions may have dramatic affects on the market. It is important to remember that the forex market is an off-exchange marketplace; there is no central exchange where all orders are cleared, as on the New York Stock Exchange or the Chicago Mercantile Exchange. The bulk of trading is done between trading partners on the interbank; however, small retail traders are unable to trade directly with partners on the interbank. Therefore, some participants in the forex market exist to create a marketplace for others. Currency dealers create a market for smaller retail speculators and offset their risk by trading with their larger partners on the interbank. The hierarchy of forex participants is illustrated in Figure 1.1. There is a definite food chain among forex market participants, with interbank members on top and retail speculators on the bottom.

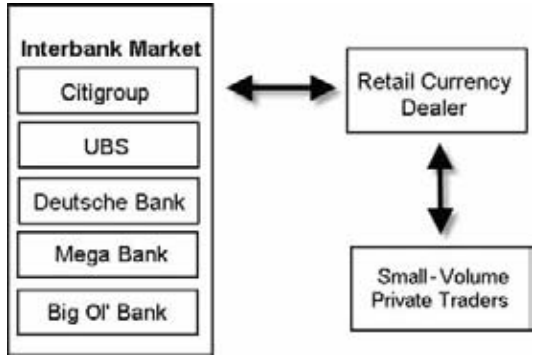

FIGURE 1.1 The Flow of Forex Market Participants

The Interbank

Interbank is a loose term held over from the early days when banks traded for clients and themselves over the telephone. Today trading is conducted electronically, with quotes from buyers and sellers matched up on the interbank market automatically. Many interbank members act as market makers for the currency pairs traded on the spot currency market and offer the quotes that ultimately drive the pricing you see in your trading software. Among the largest market makers on the interbank are banking giants such as Citigroup, UBS, Goldman Sachs, and Deutsche Bank. Lehman Brothers was a major interbank market maker prior to its demise in September 2008.

Participants on the interbank are big-dollar players, since the lowest accepted trade size is set at an even $1 million. It isn't uncommon for orders larger than $100 million to be executed on the spot forex market due to the global size and liquidity of the interbank market. Many banking participants on the interbank fill orders for customers who actually intend to take delivery of the currency being traded; however, most interbank members also trade the bank's money as speculators attempting to make a profit just like any other currency trader. The advantage interbank market makers have over a regular retail trader is access to order flow information. If you are the market maker and you see all the orders, you have insider information about the direction of the prices. Taking a trade against that information provides a significant source of revenue for many financial institutions.

Interbank members trade only with partners with which they have arranged credit agreements. This is an important point to understand because it affects the pricing you receive from your currency dealer. The quotes flowing from interbank trading partners ultimately drive the pricing you see through your currency dealer's trading software. The more trading partners a dealer has, the more quotes at which they can execute a

trade, resulting in more competitive pricing for you. You should look for a currency dealer with multiple liquidity feeds.

Institutional Traders

Institutional traders represent corporations or hedge funds trading directly on the interbank or through retail currency dealers. Hedge funds may participate as speculators while corporations participate to protect their interests against exchange risk. Corporations conducting business globally face a potential issue of fast-moving exchange rates, devaluing their profits made overseas. These corporations may participate in the currency market by hedging their risk directly in the currency market rather than waiting for a bank to exchange the currency for them. Most institutional traders representing corporations are involved in some kind of hedge to protect the value of their goods or services from exchange-related risks. Institutional traders may include professional money managers looking to diversify and hedge against the risk of loss in the equities market.

Central Banks

Central banks play an important role in guiding the forces of supply and demand for a country's currency on the forex market. Their monetary policy statements, interest rate decisions, and ability to intervene in the forex market should make every trader pay close attention to their actions. Central banks are also tasked with controlling the money supply of a nation's currency, which directly affects supply and demand. Low supply and high demand tend to increase the value of a nation's currency, whereas high supply and low demand will devalue it. Balancing growth with inflation is the typical goal of central bank policies. Central banks may also change their overnight lending rates as a tool against inflationary pressures. The interest rate set by a central bank can influence the value of a currency based on yield. The higher the central bank rate, the higher becomes the yield for holding that currency, influencing demand.

Table 1.1 lists the central banks and their Internet addresses for major currencies traded on the forex market.

Retail Currency Dealers

The average retail trader doesn't have the credit or capital required to participate directly with interbank trading partners. Retail currency dealers act as market makers for small-volume currency traders. Currency dealers manage their risk by balancing their portfolios of retail orders among the customers for which they are making a market. When they are overexposed to market risk due to an imbalance of short or long orders, they

TABLE 1.1 Central Banks around the World

Currency	Central Bank	Web site
United States dollar	The Federal Reserve Bank	www.federalreserve.gov
Great Britain pound	Bank of England	www.bankofengland.co.uk
Euro	The European Central Bank	www.ecb.int
Canadian dollar	Bank of Canada	www.bank-banque-canada.ca
Australian dollar	Reserve Bank of Australia	www.rba.gov.au
Japanese yen	Bank of Japan	www.boj.or.jp www.boj.or.jp/en
New Zealand dollar	Reserve Bank of New Zealand	www.rbnz.govt.nz

offset their risk by taking positions with their trading partners on the interbank. It is important to understand that currency dealers do not operate the same way stockbrokers do. The spot currency market does not have an exchange; therefore, the currency dealer often fills a customer's order by itself assuming the risk. This is commonly known as *taking the other side of the trade*. In other words, the currency dealer is betting against your ability to make money. If you lose, the dealer wins and collects the spread for doing the transaction. This is significantly different from a stockbroker, who is paid a commission for brokering your order to the exchange, where it is matched with an anonymous third-party order on the exchange.

There is an inherent conflict of interest when your dealer is profiting by taking the other side of your trade. Traders have historically complained about poor order execution, excessive quoting, or stops being "gunned," and there is probably some basis for these complaints. Forex after all is an unregulated market, and shady dealers do exist. Currency dealers are aware of these perceptions as well and are now marketing *no dealing desk execution* or *direct interbank trading* as an alternative order execution strategy to taking the other side of the trade. These trading platforms suggest the dealer is not involved with your trade, and passes the order directly to a trading partner. Whether every order is matched anonymously or not is a matter of trust, but it doesn't hurt to do business with a dealer who offers an alternative to taking the other side of every trade.

Retail Speculators

Retail speculators may be trading their own account or client funds through a managed account program. Some speculators at the retail level may be trading for clients looking to hedge risks; however, most are looking to generate profit. Retail speculators are too small to trade directly on the interbank and clear their trades through one of the many retail dealers available to make a small-volume market for them. For the most part,

retail speculators represent people like you and me, trading small-volume accounts purely for the sake of making a profit. The number of retail speculators involved in forex worldwide continues to grow as the popularity of currency trading grows.

FOREX VERSUS EXCHANGE MARKETS

The forex market is not structured like a traditional exchange market such as the New York Stock Exchange or the Chicago Mercantile Exchange. Forex is a decentralized global marketplace where trades are cleared one on one between trading partners. There is no central exchange, no pit full of yelling traders, no big board of quotes on a New York street, and no closing bell to ring. The pros and cons of an exchange-based market versus off-exchange currency trading are debatable, but there are obvious differences you should understand before trading in the forex market.

No Transparency

One clear advantage of an exchange-based market over off-exchange currency trading is the transparency the exchange offers traders about the market. Exchanges clear every trade through a central exchange, allowing them to provide traders with a wealth of information about the market activity. Common tools such as order flow and volume data are displayed on trader's charts, allowing them to gauge the strength or weakness of price moves throughout the trading day.

Because the forex market is decentralized, there is little data available on market activity. Market makers and retail dealers typically do not share their order flow data, and those that do only represent their trading desk activity and not the forex market at large. Volume is another popular indicator used by stock and commodity traders on exchange markets that is unavailable in the forex market because there is no central exchange on which to measure volume. Currency traders must learn on their own to read price action through their charts, without the aid of exchange-based indicators.

Little Regulation

The forex market has been known as the "Wild West" of financial markets due to the lack of regulatory oversight. The global nature of the forex market presents a problem for local government agencies to police trading activity around the world. Currently there are no regulatory requirements for an institution to establish itself as an interbank participant; however, any reputable retail currency dealer will register voluntarily with the

local regulatory agencies. We already pointed out the CFTC has new regulatory authority over the off-exchange retail currency market through the 2009 Farm Bill. As I write this, the CFTC is proposing new regulations that would require all dealers to register as members of the NFA.

In the United States, the National Futures Association (NFA) has begun implementing rules designed to protect currency traders, although some of its recent decisions have been met with skepticism. In 2009, the NFA banned a practice known as *hedging*, which allowed a currency trader to maintain opposite positions in the same currency pair, and implemented order execution rules, forcing changes in some dealers' trading platforms. Although the rules are designed to make trading operate closer to the futures and equity markets, some traders resent the presence of regulators making changes to a market that has been self-regulated since its creation.

No Trading Restrictions

Freedom to trade in whichever direction you see fit at any time you see fit is a key feature of the forex market. For years the Securities and Exchange Commission (SEC) enforced a rule against short-selling stocks known as the *uptick rule*. The uptick rule attempted to prevent speculators from intentionally driving down the value of a stock with relentless short selling. Under the uptick rule a trader could only sell a stock if the current price was above the sale price, or on an "uptick." Once a stock was falling, traders could not sell the stock again until the next uptick. Although the uptick rule was suspended in June 2007, there have been plenty of calls to reinstate it following the relentless stock market selling in 2008 and 2009. The forex market has no restrictions on trading. If you believe the euro will fall against the dollar, you can sell it without restrictions. Currency traders are able to move in and out of positions freely, without an uptick rule or other regulatory restrictions.

Having no restrictions on trading can also be a negative factor of the forex market. Since the market is unregulated and there are no restrictions on trading activity, the environment for manipulation exists. An extreme example of manipulation is the intervention by central banks. *Intervention* is a process of buying or selling tremendous amounts of currency to manipulate the exchange rate. The Bank of Japan has a history of intervening in the yen when its central bankers are displeased with the exchange rate. Manipulation can take many forms, from intervention to requoting a trader's order to favor the dealer's books. You should be aware of the risks involved with trading off-exchange in the spot market before you commit any live money to a trade. It's called the Wild West of trading for good reason.

Contract Flexibility

Trading on exchange-based markets and the forex market is conducted in standard contract or lot sizes. Unlike the exchange-based market, the forex market doesn't set restrictions on the size of a single contract. Theoretically you could place a single trade worth $1,384,284,927,944.01, assuming that you can find someone able and willing to take the other side of your trade—Dr. Evil, perhaps? Currency dealers on the retail market have carved up a standard $1 million interbank lot into three smaller lot sizes accessible to smaller retail traders, known as *standard lots*, *mini lots*, and *micro lots*.

Standard lots on the retail side of the currency market are equal to 100,000 units of the base currency. Mini lots are equal to 10,000 units of the base currency; micro lots are equal to 1,000 units of the base currency. Some currency dealers even offer trades in single units, allowing a trader to place an order for 13,428 units rather than a conventional lot size. This gives the trader very precise position sizing capability that's unavailable in traditional exchange-based markets. A unit might be a single dollar, euro, yen, or whatever the denomination of your account. For example, a trade of 10,000 units is synonymous with a $10,000 position if your account is denominated in U.S. dollars.

Micro accounts offer new traders the ability to trade real money without placing a tremendous amount of money at risk. Typically a micro account measures profit and loss in terms of a single dollar per pip or even less, depending on the margin requirement deployed. These small lots are a great place for a new trader to cut his teeth on live money trading once he has demonstrated he can trade profitably on a demo account. They are also useful accounts for testing theories with a live money account. I keep a micro account with less than $1,000 in it for testing strategies on live markets with live money. Overall, micro accounts are a great option to get started with, even if you have $100,000.

Transaction Costs

Currency dealers heavily advertise that there are no commissions for trading currency, but that doesn't mean the forex market is cheap to trade. Currency dealers earn their money through the *spread*, which is the difference between the price at which a dealer will sell a currency and the price at which the dealer is willing to buy it back. For most major currency pairs, the spread is very small, but the costs associated with that spread vary depending on the margin and leverage your account has used.

You'll learn more about currency pricing shortly, but for now understand that the transaction costs of trading currency on the forex market

TABLE 1.2 Transaction Costs Across Market Types

Trade Type	Commission or Spread	Contracts Traded	Total Transaction Cost
Common stocks	$9.95 per leg	10	$19.90
Options	$12.95 per leg	10	$25.90
Currency futures	$3.50 per contract	10	$35.00
Currency (forex)	Two-pip spread $10.00 per pip	10	$200.00

can be significant. For traders who trade frequently, transaction costs can be a significant amount of money to overcome to reach profitability. Fortunately the forex market is a fast-moving one, and once you clear the price of the spread there are no further transaction costs. The more interbank trading partners a currency dealer has, the better that dealer's pricing will be. Dealers with more than one or two interbank partners are able to take advantage of more quotes and pass them on to you.

Table 1.2 illustrates the difference in transaction costs for trading 10 different contracts across various market types. Although there is no commission, the forex market is certainly not a cheap market to trade. These prices were taken from the published commissions of a major broker's web site. The cost of the currency spread assumes a euro/U.S. dollar transaction using leverage of 100:1.

Trading Hours

The forex market is a global marketplace and trades 24 hours a day, five days a week. This around-the-clock trading environment is not unique to the forex market but certainly does make it easier to manage trades around a schedule that fits your lifestyle rather than certain market hours. In the United States the forex market begins trading Sunday evening as Asian markets open for business and continues to trade until the New York markets close on Friday afternoon. However, just because the market is open 24 hours a day doesn't necessarily mean anything interesting is happening.

There are three major trading sessions that account for the majority of volume seen throughout the trading day. The largest trading session by volume is the London session. London is uniquely positioned in a time zone that's open for business during work hours stretching from Dubai to New York. The London trading session accounts for the most price action and volume in the forex market by a long shot. New York follows London as the second largest trading session; Tokyo, or the Asian trading session, rounds out the top three.

TABLE 1.3 Trading Session Timetable

Trading Session	Open	Close
London	3:00 a.m.	12:00 p.m.
New York	8:00 a.m.	5:00 p.m.
Tokyo	7:00 p.m.	4:00 a.m.

Table 1.3 lists the three major trading sessions in the forex market and the times during which they are active. The times are listed in Eastern Standard Time.

Many trading strategies depend on the activity seen during the higher-volume trading sessions. For many traders who work at day jobs, it is impractical to trade during a trading session that happens while they sleep or are at work. This book focuses on placing trades around supply and demand levels during the quiet times of the market, around your schedule. It is better to plan and enter long-term trades during the quiet hours of the market and leave the trading sessions to day traders who enjoy staring at charts all day.

TRADE MECHANICS

Trading currency is a process of exchanging one currency for another, so each currency trade is actually two transactions happening at the same time. One currency is bought while the other is sold. The forex market quotes prices as currency pairs to facilitate the ease of trading one currency for another. The quote of a currency pair represents the number of units of one currency that are required to buy or sell the equivalent amount of the other, based on the given exchange rate. For example, if the exchange rate between the U.S. dollar and the Canadian dollar is $1.12, a trader may purchase 1.12 Canadian dollars for every one U.S. dollar, or she can buy one dollar for every 1.12 Canadian dollars. Your goal as a currency trader is to hold the currency you believe will gain value against the other currency quoted in the pair. It really is as simple as that.

Currency Pairs

Each currency pair is made up of two parts: the base currency and the quote currency. For example, the U.S. dollar/Canadian dollar example we just discussed is paired as USD/CAD. The base currency is always to the left of the slash (/) mark; the quoted currency is always to the right of

TABLE 1.4 Currency Pair Basics

Country	Currency	ISO Code	Nickname
United States	Dollar	USD	Buck or greenback
European Union	Euro	EUR	Fiber
Great Britain	Pound	GBP	Cable or sterling
Switzerland	Franc	CHF	Swissy
Australia	Dollar	AUD	Aussie
New Zealand	Dollar	NZD	Kiwi
Canada	Dollar	CAD	Loonie
South Africa	Rand	ZAR	
Singapore	Dollar	SGD	
Denmark	Krone	DKK	
Poland	Zloty	PLN	

the slash. It is the direction of the base currency you consider when deciding whether to buy a currency pair or sell it. If you believe the base currency will appreciate against the quoted currency, you will buy the currency pair. If you believe the base currency will depreciate against the quoted currency, you will sell the currency pair. This is an important distinction for new traders to remember because it is easy to buy by accident when you meant to sell. Currency pairs offered on the forex market are constructed using currency from both developed and emerging markets.

Table 1.4 lists the most common currencies, their countries, and their International Standards Organization (ISO) codes used in the forex market to construct currency pairs.

Major Pairs Major currency pairs are created by pairing currencies from countries with highly developed economies and financial systems. Major currency pairs are the most liquid and heavily traded currency pairs on the forex market. Currencies among the majors include the euro, U.S. dollar, British pound, Swiss franc, Japanese yen, Australian dollar, and Canadian dollar.

Cross-Pairs Some currencies are not directly quoted against each other; rather, they are synthetically traded by combining two different pairs. These pairs, known as *cross-pairs*, include currency pairs such as GBP/JPY, EUR/JPY, EUR/CHF, and GBP/CHF. When a trader executes a trade to buy GBP/JPY, the trade is really constructed by buying GBP/USD and selling USD/JPY. The dollar component of this trade is equaled out and the trader ends up long GBP and short JPY. Because these pairs are constructed with two different currency pairs, the spread or cost to trade a

cross-pair is significantly more than a typical major currency pair, such as EUR/USD.

Currency Lots

Currencies are traded in standard lot sizes to facilitate efficient trading on the forex market. The standard retail lot is 100,000 units of the base currency. Most currency dealers offer 10,000-unit mini lots and 1,000-unit micro lots. Some currency dealers offer a 100-unit nano lot. Positions can be sized larger by purchasing multiple lots. Fortunately, you don't actually need $100,000 in your trading account to buy a single standard currency lot. Currency dealers offer various levels of leverage, allowing you to control full-sized lots with significantly less capital in your account. We discuss margin and leverage later in this chapter.

How a Currency Trade Works

The way a currency is simultaneously bought and sold during a trade is confusing for many new traders, so an example will help clarify what happens under the hood of a currency trade. Assume for a minute that you are interested in buying the British pound against the U.S. dollar, which is listed as GBP/USD in your trading software. The base pair is the British pound; the quoted pair is the U.S. dollar. If the quoted exchange rate is $1.59 and you are trading one standard lot of currency, it will require 159,000 dollars to buy one British pound, or it will require selling 100,000 pounds to buy 159,000 dollars. Since we are interested in buying the pound, we want the exchange rate to increase, allowing us to sell our pounds at a higher rate for more dollars than we sold to buy the original 100,000 pounds. As an example, Table 1.5 illustrates how a currency trader realizes a profit or a loss using a single standard lot GBP/USD currency trade.

What Is a Pip? The term *pip* is an acronym for *percentage in points* and is used to measure the change in exchange rates on the forex market. A single pip represents the smallest possible decimal change a currency quote may move, and it is the standard on which profit and loss are calculated. Currencies are quoted in decimal format to 1/1,000th of a percent unless the currency pair contains the Japanese yen. Currencies quoted against the Japanese yen are in decimal format to 1/100th of a percent. Using a quote for GBP/USD as an example, a change in price from $1.5600 to $1.5650 represents a change of 50 pips.

Long versus Short The terms *long* and *short* simply refer to the position a trader has taken with a trade; the trader has either bought or sold it.

TABLE 1.5 Mechanics of a GBP/USD Currency Trade

Explanation	British Pound Position	U.S. Dollar Position
You believe that the British pound will appreciate against the U.S. dollar, so you purchase one standard GBP/USD lot at an exchange rate of $1.5900.	+100,000 (You've bought 100,000 pounds)	−159,000 (You've sold $159,000 to buy 100,000 pounds using an exchange rate of 1.59 × 100,000)
If the British pound does appreciate to a higher exchange rate, such as $1.6150, you can sell the pound and buy dollars, receiving a profit.	−100,000 (You sold 100,000 pounds)	+161,500 (Because the pound increased in value, you have earned a profit in dollars of $2,500)
If the pound depreciates in value to a lower exchange rate of $1.5650, you can sell the pound but you will receive fewer dollars, resulting in a loss.	−100,000 (You sold 100,000 pounds)	+156,500 (Because the pound decreased in value, you receive fewer dollars, resulting in a loss of $2,500)

The term *long* simply means that you have bought the currency; the term *short* means you have sold it. For example, if a trader decides to buy GBP/USD, it means she has gone long British pounds and short U.S. dollars because she has bought the GBP and sold the USD.

Understanding Currency Quotes

In the forex market, all price quotes are represented by two prices, known as the *bid price* and the *ask price*. Both the bid price and ask price represent the exchange rate of the base currency pair against the quoted pair, except they serve two different functions. The bid price indicates the price at which your currency dealer is willing to buy the base currency from you in exchange for the quoted currency. The ask price indicates the price at which your currency dealer is willing to sell you the base pair in exchange for the quoted currency. There is always a difference between the bid price and the ask price; this difference is known as the *spread*. The spread is

Symbol	Bid	Ask
EUR≠USD	1.4000	1.4002
USD≠JPY	94.80	94.83
GBP≠USD	1.5905	1.5909
USD≠CHF	1.0845	1.0849
USD≠CAD	1.1200	1.1205
AUD≠USD	0.7838	0.7843
NZD≠USD	0.6205	0.6210
EUR≠JPY	132.74	132.78

FIGURE 1.2 Understanding Price Spreads
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

usually less than five pips on major currency pairs. Cross-currency pairs such as GBP/JPY may have much higher spreads. The spread is the way a currency dealer earns money for executing a trade.

Figure 1.2 shows the difference between the bid and ask prices offered in the forex market. The difference between the two prices is known as the *spread*.

Using the prices quoted in Figure 1.2, if a trader wanted to buy EUR/USD, his currency dealer would sell it to him using the ask price of $1.4002. To sell the position at least at breakeven, the trader needs the bid price to move up two pips, to $1.4002. Alternatively, if a trader wanted to sell the EUR/USD, the currency dealer would sell it to him at the bid price of $1.4000 and the trader would need the market to fall by two pips before he could sell it at the ask price for a breakeven trade. The two-pip spread in this EUR/USD example is the cost of doing business with this currency dealer.

ORDER TYPES

At some point you will have to place an order with your dealer to make any money in the currency market. Opening, closing, and managing trades are accomplished through four different order types. Market orders, entry orders, stop orders, and limit orders all serve a specific role in trading on the forex market. The implementation of each order type is slightly different among currency brokers. Ensure that you have a firm grasp on how to use your dealer's software before you trade with real money.

Market Orders

When you need to get in or out of a position quickly, the *market order* is the right tool for the job. Market orders instruct your currency dealer to execute a trade at the current bid or ask price. Execution of market orders is nearly instant on most trading platforms, so a trader must be absolutely sure he wants to enter the market before submitting a market order. Market orders are not a guaranteed price, however, and your order may be filled at another price if the market is moving quickly. Receiving a price at which you did not intend to be filled is known as *slippage*, and though it is quite rare under normal market conditions, it does happen.

If the market is moving quickly, the broker may quote a new price to confirm whether the trader is still interested in filling the order at the new price. This process of submitting an order only to be quoted a new price over and over in a fast-moving market can be frustrating. Some currency dealers offer a *fill at best price* option, which allows the trader to choose a price range that's acceptable to fill the order. Assume that you would like to buy the EUR/USD at $1.4950, but the market price is changing quickly. If you do not want your dealer to quote you again when the price changes, you can specify a price range, allowing your dealer to fill the order at any price within that range. In this case, if you specified a range of 10 pips, your market order could be executed anywhere between $1.4945 and $1.4955.

Entry Orders

Entry orders instruct your currency dealer to buy or sell a currency automatically when the market reaches the price you have specified. The order should be filled at the price specified or better, as long as the new price favors your intended position. Entry orders are an important tool because they allow you to place trades on your own time schedule and have them execute automatically when you are not present. Figure 1.3 demonstrates the use of an entry order to sell the EUR/USD along a line of resistance using the hourly chart. Entry orders come in two flavors, depending on your currency dealer's technology.

Stop Orders

Limiting the amount of money lost when a trade goes bad is critical to your long-term success. *Stop orders* are placed to automatically close a trade that is not going your way. Stop orders are a form of entry order that is executed at the price specified or at the best possible price once the

FIGURE 1.3 Placing Entry Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

specified price has been reached. Stops can also be used to protect profit or reduce risk as a trade moves in your favor.

Figure 1.4 builds on the entry order example shown in Figure 1.3 by illustrating where a stop order could have been placed. Managing risk and using stop orders are discussed in detail in Chapter 4.

Limit Orders

Limit orders function in the opposite way of stop orders. Limit orders are used to close a position at a profit once a specified price has been reached. Limit orders are useful to preserve profit when a trader is unable to manage a position in real time. Figure 1.5 completes our EUR/USD example by taking profit with a limit order near the round number of $1.4700. Using a limit order ensures that this trade will be closed at a profit, even if the trader is unavailable when the market reaches her intended profit target. Many

FIGURE 1.4 Placing Stop Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

trading strategies rely on limit orders to manage profits, although some traders balk at the idea of cutting a winning trade short. The use of limit orders and managing profit are discussed thoroughly in Chapter 5.

MARGIN AND LEVERAGE

Currency is traded in lot sizes ranging from 100- to 100,000-unit lots on the retail spot market. Remember that a unit of currency could be a dollar, euro, pound, or whatever your account denomination. By trading multiple lots, a currency trader can hold a position of virtually any size, provided that she has the capital to match it unit for unit. Of course, investing in a single 100,000 lot is not practical for most retail traders, and even if you could, why would you? It would be an extremely inefficient use of capital to tie up 100,000 units in one standard currency lot.

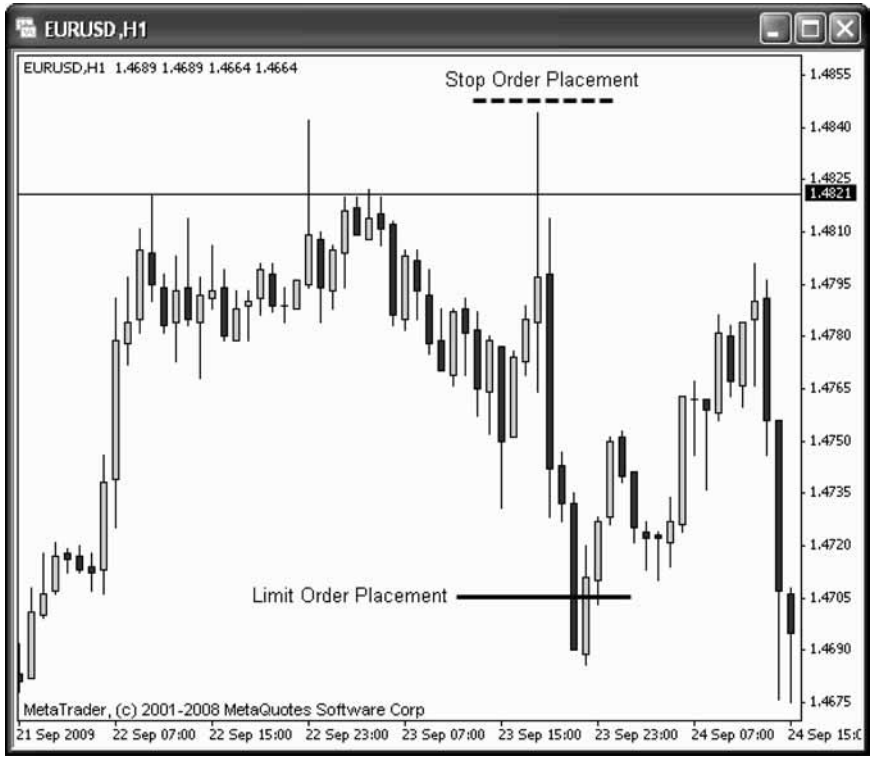

FIGURE 1.5 Placing Limit Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Currency is typically traded through a *margin account*, which allows you to control a position much larger than the capital you have in your account. Margin and leverage are important tools that are, unfortunately, misunderstood by many traders. In this section we discuss what margin is, how leverage works, and how leverage affects risk.

What Is Margin?

Margin is represented by the percentage of capital required to maintain an open currency position with your currency dealer. The margin amount represents a good-faith deposit to the dealer that you are creditworthy for the full amount of the position you are trading. Many traders believe margin is actually part of the currency you are trading, but it is not. Your currency dealer loans you the full position size in return for your good-faith deposit, represented by the margin amount. The percentage is usually fixed across

many currency pairs, although some illiquid or exotic currencies may have higher margin requirements. If your currency dealer requires a 1 percent margin and you open a 100,000-unit trade, your margin requirement to keep this position open is 1,000 units of currency in your account.

If your account balance falls below the required margin amount, your currency dealer will usually liquidate all open positions to avoid further losses. This process is known as a *margin call*. Although margin calls are painful, they actually protect you from owing the dealer money on a position that has gone bad. Without automatic margin calls, your account could fall into a negative balance and you would owe the dealer money to cover his losses. Talk about pouring salt in the wound! Maintaining an account balance large enough to manage normal market losses without approaching your margin requirements is a crucial step in money management. Most currency trading platforms will calculate your usable margin and used margin in real time to ensure that you always know where your account stands in relation to the margin requirements on open trades.

What Is Leverage?

Leverage is simply a function of the margin you are required to maintain for each trade. Leverage is measured in a ratio format such as 100:1 or 25:1. For example, if your margin requirement is 1 percent on a $10,000 trade, you must maintain at least $100 in your account to keep that position open. This represents 100:1 leverage because you control $100 for every $1 in your trading account. Some dealers advertise that they allow leverage as high as 700:1; however, using that amount of leverage on every trade might not be suitable for all traders.

Table 1.6 illustrates how leverage and margin work together. Assuming that a trader buys one standard currency lot worth $100,000, the leverage amount varies depending on the trader's margin requirement. As margin requirements are increased, leverage is decreased.

TABLE 1.6 The Relationship between Leverage and Margin Requirements

Margin	Margin Required	Leverage Ratio
0.5%	$500	200:1
1%	$1,000	100:1
5%	$5,000	20:1
10%	$10,000	10:1

TABLE 1.7 The Effect of Margin on Available Account Balances

Account Balance	Open Lots	Margin Required	Available Balance
$500	Four $10,000 lots	$400	$100
$500	Five $1,000 lots	$50	$450
$50,000	Ten $100,000 lots	$10,000	$40,000

The Effects of Margin and Leverage on Risk

Margin and leverage affect risk in different ways. Margin requirements climb as you accumulate open positions, which could leave your account at risk for a margin call, even when the individual positions are small. This is a death-by-1,000-cuts scenario because you have over leveraged your account with small trades to the point that there is no room between margin requirements and your account balance.

Table 1.7 illustrates how fast a trader with a small account can get herself into trouble by opening too many positions. The trader with $500 who opened four $10,000 positions left herself with only $100 to absorb any market losses that occur during the life of that trade. You must understand how much margin will be consumed by a trade before you open it or you could find yourself without sufficient usable capital to maintain it before a margin call occurs.

Smaller accounts should consider using no more than 100:1 leverage, whereas conservative trades may consider raising their margin requirements to bring leverage down to 25:1 or 10:1. Understanding how margin and leverage will affect your positions is crucial to surviving as a currency trader. Opening too many trades or using too much leverage with large trade sizes is sure to wipe out your trading account before winning trades can grow it.

EARNING INTEREST

The currency market is designed to facilitate the trade of money between two parties interested in actually delivering the currency being traded. The contracts traded on the spot market are designed to settle within two business days. Since most currency trades are speculative and traders do not want an armored car full of money to show up at their house, currency dealers automatically expire open positions and roll their settlement date

forward two more business days. This process, known as the *rollover*, takes place at the end of each trading day, around 5:00 P.M. Eastern Time.

Avoiding settlement is just one benefit; the rollover process also settles interest payments to your account, depending on your open positions. Earning interest for simply holding a position open is a benefit of trading money. Each currency pair has an associated *cost-of-carry premium*, which is either positive to your account or negative, depending on whether you are long or short. The premium is determined roughly from the central bank rates in the currency's home country. For example, if you are long AUD/USD while the central bank rate in Australia is 3.5 percent and the central bank rate in the United States is 0.25 percent, you should expect to be paid some of the difference between these two interest rates as calculated on the total size of your open trade. If you were short AUD/USD in this example, you should expect the difference to be debited to your account. There are some variables that affect the actual interest payment paid or charged to your account.

The actual interest rate used to calculate carry premiums is the *London Interbank Offered Rate* (*LIBOR*). This short-term interest rate is a benchmark rate maintained on 10 currencies by the British Bankers Association (BBA). The rates are determined through a survey process conducted by the BBA of 8 to 16 contributing banks per currency. The survey determines the lowest average rate at which banks are willing to borrow funds overnight and performs a calculation on that data to determine the LIBOR. The difference in LIBOR rates between two currencies determines the base cost of carry for your open position in the forex market. If you are interested in the specific details of how LIBOR is calculated, I recommend you visit the LIBOR web site at www.bbalibor.com.

Let's look at an example to understand how the carry premium is calculated using the LIBOR during the nightly rollover.

Assume that you have bought 100,000 units of GBP/USD. In this trade you are buying the British pound and selling the U.S. dollar. If the LIBOR for GBP is 2.4775 percent and the LIBOR for USD is 2.07 percent, the difference between the two currencies is 0.4075 percent. The difference is multiplied by your total position size, in this case, 100,000 × 0.004075, which equals 407.5 units of currency. LIBOR rates are annual yields; therefore, 407.5 represents the annual yield. Divide 407.5 by 360 days to determine the nightly interest premium, which is 1.13 units of currency. If the base currency in your trade is different than the currency your account is funded in, you must also multiply the interest payment by the currency exchange rate to convert the interest payment to your account's currency. The current GBP/USD exchange rate is $1.5928. The final calculation to convert 1.13 to dollars is 1.13 × 1.5928, which equals a final nightly premium of 1.79 units of currency.

The amount actually charged or credited to your position may vary by broker because many brokers derive income from the overnight swap payments before passing those rates on to you. Brokers routinely publish their swap rates for each currency and typically post them on their web sites. Traders should be aware of these rates and understand that holding a position against the carry could cause them to pay significant interest if they plan to hold the position open for a long period of time. Finally, traders should be aware that on Wednesdays the interest premium is triple the normal amount. This accounts for positions that are set to be settled on Saturdays or Sundays, when the market is essentially closed, by setting their valuation date to Mondays.

SELECTING A CURRENCY DEALER

The only partner a retail currency trader needs is a retail currency dealer. No two dealers are alike, so care should be taken to select the very best dealer as your trading partner. We discussed earlier that currency dealers are different from stockbrokers because they routinely assume the full risk of your trade and make the market for you rather than simply matching you with a counterparty on the exchange floor. Currency dealers will aggregate the positions they are holding for retail traders and offset their risk by trading with partners on the interbank. This arrangement requires great faith that the dealer is trustworthy and will not manipulate a retail trader's positions in the dealer's favor.

In this section we look at four key attributes you should evaluate before selecting a currency dealer. These attributes include a dealer's product offering, trading technology, regulatory status, and capitalization.

Product Offering

Currency dealers are a competitive bunch, and you will find that most have similar product offerings. Ensure that your broker offers multiple lot sizes, including standard, mini, micro, and even nano lots, but pay close attention to whether your broker allows flexible lot sizes in one single account. Some dealers lock micro accounts in their own group as a discount service and offer reduced customer service. Ensure that you understand which currency pairs are available and whether they are available for your account type. Many dealers do not offer the same currency pairs for a mini account as they do for a standard account.

In this same category, it's important to understand the dealer's policy on interest rate swaps. You may be able to get a better payment on interest

if you call the dealer and ask for it. Take the time to compare the dealer's spread on each pair you intend to trade. The difference of a single pip can mean a difference of several hundred dollars in transaction costs over the long term. Many dealers also advertise guaranteed stop orders without slippage, but you must check the fine print to understand the restrictions. Many of these guarantees are suspended during times of high market volatility. Make sure that you read the fine print and understand your trading agreement.

No matter how good a dealer looks on paper, you should test-drive his customer service prior to opening an account. Call the dealer's customer service desks, use his online chat capability, and make sure they are prompt and accurate with their answers before sending them a dime of your trading capital. After all, an extra pip on the spread may be worth the added customer service you get from some dealers.

Finally, we already discussed how margin requirements affect your ability to apply leverage to your trading account, potentially increasing profits or losses. Although high leverage and low margin rates may seem attractive, you should be prudent and use good judgment to ensure that your margin is set at a level that allows you to sustain losses without wiping out your entire account. A good currency dealer will allow multiple levels of margin and allow you to customize your account settings as required.

Trading Platform

The trading platform offered by currency dealers varies from custom-built to third-party packages such as Meta Trader. If you are a long-term trader, you might not need many fancy features; however, if you are a day trader, instant execution and information about volume could be useful. You should test drive each currency dealer's platform by trading on a demo account until you find a trading station you're comfortable with and that you enjoy using. Some brokers have technology that's so difficult to use you'll be glad you took the demo account for a spin. Additionally, only a handful of brokers offer mobile trading technology. If you need the capability to trade directly through a handheld device, your choices will be limited to a handful of brokers for now.

Regulation

It is important to remember that forex is an unregulated market. Fortunately, in the United States the National Futures Association is beginning to require that dealers meet certain capital requirements in order to conduct business in the United States. Traders should seek out currency dealers who have registered themselves with the regulatory agency for the

country in which they operate, ensuring they are trading with a currency dealer interested in regulatory oversight. Three of the major regulatory agencies are the National Futures Association (NFA) in the United States, the Financial Services Authority (FSA) in the United Kingdom, and the Australian Securities and Investments Commission (ASIC) in Australia. Any retail currency dealer worthy of your business will have registered with one of these regulatory agencies. If not, trader beware.

Capitalization

Currency dealers registered with a regulatory agency are required to maintain a minimum level of reserve capital to continue making a market for retail traders. The level of reserve capital maintained by a currency dealer has a direct impact on that dealer's ability to remain solvent. Having visibility to the reserve capital, a currency dealer allows traders to gauge the overall health of that dealer. In the United States the level of capital required was recently increased to $5 million, which helped clean out some undercapitalized and shady currency dealers from the marketplace. The CFTC is proposing these capital limits be increased to $20 million at the time of writing. Currency dealers registered with the NFA are required to report their net capital monthly, and the information is published on the NFA's web site at www.cftc.gov/marketreports/financialdataforfcms/index.htm.

I highly encourage you to visit this site monthly and monitor the health of your currency dealer as part of your plan to manage risk. In the United States, currency dealers are not required to segregate client funds from corporate funds, and many currency dealers have bankruptcy clauses in their trading agreements that will place you as a debtor to the currency dealer in the event of insolvency. Let me repeat that in case you are reading this before bed, because it is very important to understand: If your currency dealer goes bankrupt, your trading account may not be segregated from the general operating capital of the dealer. You will be treated as a creditor in bankruptcy court. You do not want to fight a bankruptcy court to get back your trading capital among a long line of unhappy creditors if your currency dealer goes bankrupt!

It is critical to trade only with well-capitalized dealers who are members of a regulatory agency that requires them to disclose their financial health so that you can gauge the solvency of your dealer. If you have a very large account, it might be in your best interest to trade with more than one broker or consider an account in the United Kingdom, where segregated accounts are required by law. Whatever you decide, read your trading agreement closely and always monitor the financial health of your currency dealer.

CLOSING BELL

This chapter provided a crash course on the business of trading currency on the spot forex market. You should understand a bit of the market's history, how it is structured, and who the major participants are. The important points of this chapter are ensuring that you understand order types, leverage, and how to select a currency dealer. These three topics form the core mechanics necessary to be a successful trader. Ensure that you understand how to use each order type without stumbling through the dealer's software; it is easy to make a mistake if you are not paying close attention when you're placing a trade. You should understand how leverage works and how it can affect your account before you trade live money. I recommend demo trading using various configurations of leverage to ensure that you truly understand the damage leverage can do to an unmanaged account. Finally, we covered some key attributes you should investigate when you're selecting a currency dealer. The currency dealer is an important partner in the business of trading; selecting a good one who is financially stable is an important part of mitigating risk that many traders gloss over.

CHAPTER 2

Principles of a Bargain Hunter

Nothing makes you feel like a sucker more than discovering you could have paid less for something you just bought. From garage sales to global finance, bargain hunters seek out the absolute best price, whether they are buying velvet Elvis or 1 million euros. Under all the fancy software, chart patterns, indicators, and analyst opinions, trading currency has only one goal: to buy currency when it is dirt cheap and to sell it to someone else for top dollar. Unfortunately, traders often get distracted from the primary goal of trading to search out new or exotic trading systems promising to have unlocked the secrets of trading currency. There is no secret to making a profit, whether you're running a pawn shop or trading pounds. Your job as a trader is to buy at a value, sell at a premium, and never pay full price.

Identifying a good deal in the currency market is a little more complicated than telling the local car dealer you won't pay sticker price. Traders become bargain hunters by learning to read price action and then anticipating the market's next move. It takes discretion and experience to develop a sixth sense about price action, and even an experienced bargain hunter can get suckered from time to time. Bargain hunting is a large component of the way I trade, because demanding the best price out of every trade ultimately reduces risk and increases profit.

I have created five principles of a bargain hunter to frame my style of discretionary support and resistance trading. The strategies described in this book have their own guidelines for locating trades, but all are grounded in the principles of bargain hunting. Each of the five principles is designed to guide you through a specific trading task. From maintaining a healthy

work and life balance to managing profit, the tenets of each principle in this chapter must be met before I will take a trade. Pay close attention to the material covered in this chapter; this is how I bargain hunt and I don't mind being called cheap. It's a badge I wear proudly.

LIVE YOUR LIFE

Why are you trading? Are you trying to fulfill a lifelong desire to wake up at 3:00 A.M. and stare at currency charts for 10 hours a day? I didn't think so. Unfortunately, I continue to meet traders who remain glued to their charts for more than 10 hours a day! Ironically, for many of these traders their effort doesn't translate into additional profits. I don't know your interest in trading, but whatever the reason you trade, never forget that there is more to life than trading!

Currency trading isn't like other businesses. You can't advertise your way to more sales or work your way to greater levels of success. The market doesn't care whether you spent 10 minutes or 10 hours planning a trade; it won't reward you for the extra time. Trading doesn't require 70 hours a week. If you want to work that hard, perhaps you should consider becoming a doctor, a lawyer, or a chief executive officer. The market will only offer a good trade when it is ready, you can't force a good trade with more time in front of the charts.

"Live your life" is the first principle of a bargain hunter because I want you to enjoy the road to becoming a professional trader. The longer you spend staring at a chart, the more likely you are to burn out or take a trade out of boredom. I've seen many traders struggle to maintain a healthy work/life balance when it comes to trading. Perhaps it is the global 24-hour nature of the market. Perhaps it is the emphasis on day trading that lures traders into thinking they must be engaged at all hours of the day. Whatever the reason, I'm here to tell you it doesn't take 10 hours a day to earn a healthy return trading.

Your mind needs time to recharge, and your desk chair needs time to reshape after you have sat in it for several hours. Additionally, your spouse or family and friends are going to grow tired of being abandoned in favor of the market. Take a break, go watch the sunset, fly a kite, or call your mom. Do something other than try to make another buck in the market. I understand the desire to become a successful trader is strong, but you can't create a trading opportunity simply because you want to trade, and you shouldn't abandon your life, loved ones, or hobbies in the meantime.

The majority of trading strategies in this book focus on trading with daily charts or longer time frames. These strategies can be executed in less than a couple of hours a night. I personally spend about an hour and

a half every night planning and managing my trades. If you're spending more than two hours a night with the market, I suggest you make a couple of changes. First, reduce the number of currency pairs you're monitoring. Second, trade longer timeframes using the price action strategies taught in this book. Quit chasing the market around on a 15-minute chart. Learn to trade on longer timeframes and you'll learn to let the market do the work for you. This might sound absurd to some of you, but this principle is first for a reason. I continue to see traders working themselves to death for no measurable gain. I suspect some of you reading this know exactly what I'm talking about. Slow down, trade longer timeframes, and live your life.

LEARN TO READ PRICE ACTION

Humor me for a moment and consider this riddle: What is the difference between a great bass guitarist and a great bass guitarist? It's an impossible riddle, right? Although both bass guitarists can play and entertain a crowd, only one truly understands how music works. The other has simply memorized notes and mastered a tempo. Without understanding how music is constructed through scales, chords, and timing, a musician has no idea why the notes he is playing sound good with other instruments. The same is true with currency traders who blindly follow technical indicators or oscillators. Technical indicators might appear to predict the next move price will make, but in reality they have no influence on price whatsoever. Indicators are helpful guides, but they are no substitute for learning how to read price action. Traders who rely on indicators to make all their trading decisions are playing an instrument without understanding why it sounds good.

Price action is defined by the movement of price on your chart. As the market moves higher or lower, your chart will depict areas where the market was unable to continue due to increased demand from buyers or an oversupply of sellers. You'll learn how to identify supply and demand boundaries, known as *support and resistance*, in Chapter 3. Learning to read price action is the most important skill a trader can develop, because it places the trader's point of view in synch with the supply and demand forces that drive the market. If you can read a chart without the aid of indicators, you'll have an advantage over relying heavily on them. Indicators and oscillators such as moving averages, Bollinger bands, or stochastics calculate their indications on past market data. They do not consider supply and demand and have no influence on what happens to price next.

Using support and resistance, a bargain hunter should identify opportunities to join price action at a bargain price. Your goal is to enter an existing trend when the market is offering a very good price, what I call a

bargain day. Learning to read price action will make it easier to find the lowest-risk, highest-probability trades when they are offered. When prices are moving higher in the context of a downtrend, bargain hunters should be looking for an opportunity to sell. When prices are moving lower in the context of an uptrend, bargain hunters should be looking to buy. It really is that simple. Reading price correctly does take some practice, which is why the methods in this book use some simple indicators to guide you along the way. They are there to help, but they are no substitute for learning to read price action.

Indicators Offer a False Sense of Security

I'm picking on indicators a bit here because I want you to forget about everything you've learned from traditional trading books, most of which promote the use of indicators. Indicators and oscillators are often taught as if they have predictive powers, and can tell when a market is overbought or oversold suggesting that is the price where a market will turn. This is total bunk. Every indicator simply represents a mathematical calculation on market data that happened in the past. There is no regard for supply and demand in the calculation of most indicators. Furthermore, indicators that use volume aren't helpful in the currency market because there is no central exchange to provide volume data.

Figure 2.1 demonstrates how an indicator can claim a market is *oversold* only to have the market fall further. There is no such thing as an "oversold" or "overbought" market. The currency market can and will move until a support or resistance level is reached. Without accounting for support and resistance, any trading system built on indicators is missing the point of why price moves to begin with. I believe relying on indicators to make every trade decision is a crutch that ultimately will hinder your ability to grow as a trader.

Figure 2.1 illustrates how indicators have no influence on price. In this example, the GBP/USD continued to fall after the Commodity Channel Index (CCI) gave an indication that the market was oversold. In fact, the market didn't reverse until a demand level was reached, marked by the parallel lines and the circle.

I'm not suggesting that indicators are the root of all evil, but I am telling you that price doesn't move because two moving averages have crossed or because the CCI leaves oversold territory. There is no such thing as an oversold or overbought market, as Figure 2.1 clearly demonstrates. Some people have suggested that indicators help move the market because so many traders follow them. I believe that notion is complete nonsense. If you give me 1,000 traders, I'll show you 1,000 different ways to use the exact same indicator.

FIGURE 2.1 GBP/USD Continues to Fall Despite Being Oversold
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Indicators are like a tape measure used by a carpenter. The measure guides a carpenter to the right cut, but ultimately it is up to the carpenter's skill to cut the wood correctly. Bargain hunters can use indicators to identify potential support and resistance opportunities, but ultimately it is up to the trader to make the right trade. In Chapters 6 through 8 we will look at using indicators to hunt for bargains. Combining indicators with what you'll learn about reading price is a solid methodology to find trading opportunities. Be careful not to let indicators become your core decision-making tool; it is important to learn how to read price action without the aid of indicators.

Is the Trend Really Your Friend?

Traders talk a lot about trends. Every trading book discusses the virtues of identifying and trading with the trend. You have probably heard the old trading adage, "The trend is your friend; trade with the trend until it bends" a million times, but what is a trend, and is it really your friend? Identifying trends is an extremely subjective process open to many different interpretations. One trader's uptrend may be another trader's downtrend. Figure 2.2 illustrates this subjective nature of trend analysis. One trader may

FIGURE 2.2 Looking at the EUR/USD Two Ways
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

believe the EUR/USD is about to continue in a downtrend while another believes it has established a new uptrend. The advice to identify and stick with a single trend until it "bends" sounds good but is rather shortsighted.

Within any trend, there are several countertrend moves that occur as the forces of supply and demand ebb and flow during the course of the major trend. For example, during an uptrend, eventually the number of buyers will dry up, allowing sellers to take over for a short period of time until the buyers emerge again. These cycles happen over and over again and offer traders who are keen on following price rather than trend an opportunity to profit, regardless of the predominant trend direction. After all, wouldn't it be acceptable to sell during a downtrend within the context of an uptrend? A trend is a trend, right? Bargain hunting traders should be aware of major trends, but they shouldn't allow traditional trend analysis to get in the way of a good trade. Following price is far more nimble than waiting for the market to favor a prevailing trend before trading. Figure 2.3 illustrates how a trader following price action could have taken advantage of various price action opportunities within the context of a USD/CHF downtrend. The USD/CHF could have been sold in three areas along resistance and bought along support as the currency moved sideways.

FIGURE 2.3 USD/CHF Downtrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

A lot of material in the field is dedicated to discussing whether trading with the trend is safer than trading against it. Since trend analysis is very subjective, I believe the argument is a moot point. Understanding the prevailing trend is useful to determine a general trading bias, but that shouldn't stop you from taking a countertrend trade when the opportunity is right. In Figure 2.3, clearly the bias was to sell USD/CHF in synch with the prevailing downtrend, but an opportunity to buy the pair emerged as support built in near $1.06. This is why the second principle of a bargain hunter is to learn how to read price action. Traders who follow price looking for a good deal rather than following a trend will be nimbler and able to profit, even when conditions begin to change against the prevailing trend.

NEVER PAY FULL PRICE

In real estate it is said the real profit is made when you purchase the property, not when you sell it. This adage means that when you purchase a home or investment property, you should try to get the absolute best price for the property. Paying as little as possible for a home will help you make

the most profit when you decide to sell it at a later time. Buyers who pay market or get into bidding wars for a home are paying full price and will have a much harder time making a profit than those smart enough to wait for the best price.

Trading is no different than negotiating to buy a home. The basic goal of trading is to buy something you believe will appreciate at a good price and sell it later for a profit. Even when you sell a currency, you are buying the currency it is paired with, so, as they say in real estate, the real profit is made when you open a trade, not when you close it. Never paying full price for a trade is the third principle of a bargain hunter.

You might wonder how a trader can negotiate with the market for a better price when trading currency is nothing like buying or selling real estate. The answer is rather simple: Learn to read price action. Through the study of price action and support or resistance, the market will tell you when a currency is potentially *on sale* and offering a bargain price. Traders who can learn to identify these opportunities will make more profit than traders who chase the market and pay full price. Figure 2.4 illustrates how a trader can use *pullback* or bargain days within a trend to join the market at a much better price than traders who simply jump on every breakout.

FIGURE 2.4 AUD/USD Bargain Days
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Traders who join trends on pullback days are effectively entering the market at a discounted price. Traders who do not wait for a pullback day are paying full price and assuming more risk in their trades.

Getting the best deal on a trade is simple if you're patient enough to wait for the market to pull back and offer you a bargain. When the market is trending higher, as shown in Figure 2.4, a bargain day is represented by price action that moves against the trend or doesn't close with a new high price. These bargain days allow you to enter the market, with the trend, at a price better than that obtained by those who bought at the top of the rally. This reduces the amount of risk you must take on, because a protective stop can be placed below the low of the bargain day candle. The opposite is true for a downtrend. When price is trending lower, bargain days are represented by price action that moves higher, against the downtrend, or closes without making a new low. When you enter trades based on a bargain day price and are stopped out two or more days in a row, it should be a signal to you that the price action you are following may be coming to an end. Look for signs that the market is starting to move sideways or is perhaps even reversing the trend direction before you continue to trade the existing price action trend.

Bargain days or bargain prices occur due to the structure of what drives prices in the first place: supply and demand. When there are not enough buyers to support sellers, the oversupply of sellers will drive the market lower until new buyers are found. When there are not enough sellers to support demand, the market will drive price higher until more traders are willing to sell. While price is trending, there will be pauses during the trend when buyers or sellers are reluctant to join the trend at such lofty prices. This pause creates a temporary imbalance in supply or demand against the trend and moves the price in a countertrend fashion for a short time until buyers or sellers reemerge and continue driving the trend in its original direction.

These small countertrend moves represent bargain days and allow us to join the trend at a discounted price. The effects of supply and demand as represented by bargain prices are illustrated in Figures 2.5 and 2.6. Figure 2.5 demonstrates supply and demand creating a bargain price opportunity to sell the USD/JPY on a four-hour chart. In this example the market was unable to find new buyers at the round number of $99, causing a selloff. When the market returned to test that supply level, buyers dried up again, causing an even larger selloff. This process happened a third time, causing a selloff of nearly 500 pips.

Figure 2.6 demonstrates the concept of supply and demand creating a bargain price related to breakout trading. In this example the weekly chart of USD/CAD clearly shows a breakout following months of consolidation. Traders who bought the USD/CAD immediately after the breakout paid full

FIGURE 2.5 USD/JPY Breakout Returns to Test Failed Support as Resistance
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 2.6 USD/CAD Breakout Returns to Test Failed Resistance as Support
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

price; traders who waited for the pullback or bargain price entered the market at a much more favorable rate. Whenever breakouts occur, the impulse to jump on a fast-moving market is hard to resist, but you must keep your emotions under control and avoid paying full price for a trade. Pullbacks occur because the market is reloading with new interest from the buyers or sellers who created the breakout. Wait for the bargain price created by a pullback before you enter a trade and it will ensure that you never pay full price for a trade ever again.

MANAGE YOUR RISK

The only factor a trader has under her control when a trade is opened is risk. Managing the amount of money you lose when a trade goes bad is critical to your longevity as a trader. The reality is that there is no safe way to trade, and losses are a part of trading. If you do not learn to manage your losses, you will either blow your account out on one spectacularly bad trade or grind it down to nothing over time. Bargain hunting by definition is about managing risk. Seeking out the best entry price for a trade may lower the risk necessary to take it, but you still must manage risk appropriately when things go bad. This is why managing risk through stop orders is the fourth principle of a bargain hunter. The tactics used by a bargain hunter to manage risk are discussed in Chapter 4.

If you do not manage risk appropriately, your losses will add up quickly. Unfortunately, losses are not on an equal playing field with gains. With each loss your account suffers, it requires a larger return to recoup the loss and return your account to breakeven. Table 2.1 clearly illustrates how losing just 25 percent of your account will require a significant effort to return your capital to breakeven. Considering that the best money managers on Wall Street would be thrilled to post a 33 percent return annually,

TABLE 2.1 Runaway Losses Can Keep a Trader from Breaking Even

Account Balance	Loss	% to Return to $1,000
$1,000	10%	11%
$900	25%	33%
$675	50%	100%
$338	75%	300%
$84	90%	900%

the average retail trader would be hard-pressed to post a 100 percent gain after suffering a 50 percent loss. You must manage your risk and avoid a draw down so significant that you are unlikely to recover through trading profits alone. Whether you risk 2 percent or 5 percent per trade, always know what that limit is and aggressively cut off bad trades early, before they wreak havoc on your trading capital.

MANAGE YOUR PROFIT

Taking profit is often more difficult than taking a loss for many traders. Unlike risk, reward is not a fixed variable. The market may move 10 pips or 1,000 pips in your favor, and though you know how much you'll lose if the trade goes bad, you have no idea how much potential profit a trade could bring. Traders often torture themselves when a trade is closed, only to realize that they could have made more profit if only the trade had been left open another hour, day, or week. However, in the real world of trading, a trader has no idea what will happen if the trade is left open; the trader makes each decision with the information he has at the time the trade was closed. He could have made more money, but he could easily have lost money or a significant portion of his profit as well. Hindsight is always profitable, so playing the "what if?" game will only encourage you to make a poor profit management decision on the next trade.

When to take profit is a variable that should be planned before you place money at risk. Once the trade is open, emotions tend to run high, and it can be difficult for some traders to objectively consider when to take a profit. Taking a profit should be as automatic as taking a loss, which will remove any emotion attached to what profit you might have made in hindsight. This is why the final principle of a bargain hunter is to know when to sell and how to actively manage profit. The tactics used by a bargain hunter to manage profit are discussed in Chapter 5.

Generally speaking, your profit targets should give you ample opportunity to make money over a series of trades, assuming that your success ratio is above 25 percent. Look for trades with risk-to-reward ratios greater than 1:3. This means that for each pip you place at risk, you expect to earn at least three pips in profit. Do not be fooled into thinking risk-to-reward is a magic ratio that will lead you to profitability. You still need to select good trades and combine that practice with a healthy risk-to-reward ratio to achieve a profit in the long run. The larger your average risk-to-reward ratio, the better the chances that you will achieve profit over a series of trades. How you select profit targets may vary from trade to trade, but you should always have a target planned ahead of opening the trade and, once in the trade, stick to that plan.

CLOSING BELL

Every discretionary trader should have a set of guiding principles that define the type of trader he or she strives to be. The five principles of a bargain hunter create a framework for discretionary trading methodologies to follow by detailing the components necessary in each trading strategy. Every trading method taught in this book is built under the guidance of these principles. To meet the needs of a bargain hunter, a trading methodology should provide a good balance between trading time and personal time. It should base trade selection on price action and support and resistance rather than an indicator, although it is acceptable to use indicators as a guide. It should seek out the best possible price and avoid paying full price for a trade by chasing the market with orders. Finally, the methodology should provide systematic guidance for managing risk and profit.

This is a small chapter, but its content is very important. Every trading methodology in this book has been built on the principles described in this chapter. In the coming chapters you will see each principle executed tactically in the form of entry orders, stop orders, and limit orders. Through reading about various example trades, you'll begin to understand how I approach each trading opportunity with the eye of a bargain hunter. The real point of this chapter is to get you thinking the same way I do about trading, before you learn the tactics I use. Following the principles of a bargain hunter will ensure that you buy at a value, sell at a premium, and never pay full price for a trade.

CHAPTER 3

Reading Price Action

Traders constantly search for an edge over other market participants that will lead them to greater profits. Many traders have placed their faith in technical indicators or oscillators to help them predict the next move in price without regard to price itself. Unfortunately, indicators and oscillators have no influence on the market, as we discussed in Chapter 2. Despite this fact, I still know traders who cover their charts with so many indicators and oscillators they can't even see the price bars, which is unfortunate because the best indicator to predict the next move in price is price itself.

In this chapter you will learn to read price action without the aid of technical indicators or oscillators. This is a very important chapter for you to consider, because reading price action through the study of support and resistance is at the center of every trading methodology in this book.

UNDERSTANDING SUPPLY AND DEMAND

If technical indicators or oscillators do not drive price, then what does? Viewing a currency chart, price seems to oscillate in a completely random fashion, but under the hood what drives price is actually quite orderly. The spot currency market is a competitive marketplace driven by the economic model of supply and demand. Many factors influence the equilibrium between supply and demand, causing shifts in the market price. When more traders are willing to buy a currency than sell it, the price will move higher,

seeking new sellers. The opposite effect occurs when more sellers exist than buyers: prices fall.

Imbalances in supply and demand may last a few minutes or several years, depending on the factors that created the imbalance. It is often said that the currency market is a strong trending market, making it a playground for long-term trend traders. This can be partially attributed to some very long-term imbalances in supply and demand created by policymakers, such as a country's central bank. Traders who understand how to measure supply and demand bias are fundamentally better prepared to take trades that align them with the reason the market is moving price.

In this section we review three measuring tools you can use to gauge the sentiment of supply and demand.

Measuring Fundamental Strength

Supply and demand for a currency can be affected by the fundamental strength or weakness of the country it represents. Economic and political factors combine to encourage participants to buy or sell a given currency, which affects overall supply and demand. Since currencies are paired together, it is ideal to determine which country in the currency pair is stronger than the other and buy that currency while selling the other. Knowing which currencies are stronger than others requires a systematic method for measuring the fundamental health of each country involved. In this section we look at a simple way to measure fundamental strength on a weekly basis.

Measuring fundamental strength begins by monitoring the health of a nation's economy through economic reports. Using the fundamental data reported on each country, I create a ratio for each country that represents its overall fundamental strength or weakness. I call this the Currency Strength or Weakness Ratio, or *CSOWR*, which I pronounce "sour." The CSOWR determines how sour or sweet a nation's economy is by using data from economic reports such as the gross domestic product and retail sales report. If you're a fan of Chinese food, feel free to call it the sweet-and-sour ratio. Whatever you call it, the ratio is used to determine which currency within a currency pair may have the upper hand in fundamental strength. The weaker a country, the more likely its currency will get beaten up by a stronger currency in the spot market.

Collecting Fundamental Data The first step in calculating a country's sour ratio is collecting the key fundamental data for that country. This is not intended as a way to *trade the news*, so it doesn't need to be done in real time. The data is released by several government and private institutions, so visiting each web site would be a time-consuming process.

I recommend using any one of the good fundamental calendars available on the Internet to consolidate the data and speed up the process. A list of fundamental calendars I use to collect data on a weekly basis follows. To keep the sour ratio uniform across all countries, I collect data using only fundamental reports available from each country represented by a major currency. For example, the German Ifo Business Climate data is not used in the CSOWR because it affects only the euro and no other currency. The goal of the CSOWR is to compare strength and weakness, apples to apples. The sour ratio uses data from the following sources:

- Central bank interest rate
- Gross domestic product (GDP)
- Consumer Price Index (inflation)
- Retail sales
- Employment
- Trade balance

These six fundamental reports were also chosen because they reflect positive and negative measures of the nation's economy. When any of these indicators are rising, that is generally thought to be good for the nation's currency compared to when they are falling. This ensures that the sour ratio is truly measuring strength versus weakness and is not skewed by a report that works against it. An example would be unemployment data, because a drop in those numbers would be positive for the country but could reflect weakness in the CSOWR. You could argue that trade balance data should fall into this category as well, since a falling trade balance indicates a lower deficit, but that doesn't necessarily indicate strength in a consumer-driven economy, because retail sales may fall along with imports. The choice is up to you. I prefer to calculate the trade balance as part of the CSOWR.

Simply load the raw number into a spreadsheet for each fundamental source. You should load each value individually and keep historical data if you're interested in doing any kind of trend analysis on a fundamental value. (We look at calculating the sour ratio and comparing currencies in the next section.) Finally, if you prefer to use my CSOWRs, I post them freely on my web site at www.ryanokeefe.com.

Fundamental Calendars Provider	**Web site**
FX Street	www.fxstreet.com/fundamental/
Bloomberg	www.bloomberg.com/markets/ecalendar/index.html
Yahoo!	http://biz.yahoo.com/c/e.html

Calculating the CSOWR The CSOWR is a super-secret, complicated formula that took me nearly 10 years and thousands of hours to perfect. I'm not really sure why I'm even sharing it with you. Actually, it's just an average calculated on the fundamental data that is collected weekly. Keep in mind that the CSOWR is not meant to be perfect science. It is a cheap, easy way to measure the fundamental strength versus weakness in a given currency pair.

To calculate a CSOWR, simply average the values collected from the fundamental data. Table 3.1 illustrates the data and the CSOWR I calculated for the Australian economy from January 2009 to September 2009. Table 3.2 contains the CSOWRs for the United States during the same time period. You'll notice a few nuances about the numbers in the spreadsheet. First, large numbers such as trade balance or employment change results are recorded in short form. For example, numbers such as 1.45 billion are recorded as 1.45, and –1,200 is recorded as –1.2. This is done to keep the spreadsheet easy to read and the CSOWR from being extremely large. Second, some fundamental reports such as the GDP are not available monthly. When a report isn't released in a given month, simply carry forward the number from the previous release. Third, to predict a CSOWR before data is released, use the *forecast* number available on any economic calendar and then update your spreadsheet once the actual number is released.

Using the data in Tables 3.1 and 3.2, we can clearly see that the CSOWR favored the Australian dollar over the U.S. dollar through most of 2009. Traders can use the CSOWR when contemplating an AUD/USD trade to determine whether they are positioning themselves on the site of fundamental strength or weakness. Figure 3.1 illustrates the AUD/USD weekly chart while the CSOWR favored AUD over USD. Clearly, the fundamental strength was on the side of the Australian dollar, whereas the United States slashed its central bank rate, shed jobs and retail sales fell. The CSOWR is not an indication to trade on its own; you should always consider support and resistance along with price action before taking any trade. The CSOWR does provide a quick and easy way to measure fundamental strength between two currency pairs.

Measuring Institutional Interest

Institutional participants drive massive sums of money into and out of the spot forex market. Their bias toward a currency should be of interest to any retail trader because their influence on supply and demand can change a currency's value over time. Wouldn't it be nice to know whether the big dollars were generally bullish or bearish on a currency before you pulled the trigger on a trade? Unfortunately, the forex market does not offer

TABLE 3.1 CSOWRs Calculated for Australia, January–September 2009

	Jan	Feb	March	April	May	June	July	Aug	Sep
Interest rate	4.25	3.25	3.25	3	3	3	3	3	3
GDP	0.01	0.01	-0.05	-0.05	-0.05	.04	0.4	0.4	0.6
CPI	-0.3	-0.3	-0.3	0.1	0.1	0.1	0.5	0.5	0.5
Retail sales	0.4	3.8	0.2	-2	2.2	0.3	1	v1.4	-1
Employment	-1.2	1.2	1.8	-34.7	27.3	-1.7	-21.4	32.2	-27.1
Trade balance	1.45	0.59	0.97	2.11	2.5	-0.09	-0.56	-0.44	-1.56
CSOWR	0.77	1.43	0.98	-5.26	5.84	0.34	-2.84	5.71	-4.26

TABLE 3.2 CSOWRs Calculated for the United States, January–September 2009

	Jan	Feb	March	April	May	June	July	Aug	Sep
Interest rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
GDP	-3.8	-3.8	-3.8	-3.8	-5.7	-5.7	-1	-1	-1.2
CPI	0	0.2	0.2	0.2	0.3	0.1	0.2	0.1	0.1
Retail sales	-3.1	-2.7	1	-0.9	-0.5	0.5	0.6	-0.1	2.7
Employment	-524	-598	-651	-663	-593	-345	-467	-247	-216
Trade balance	-40.4	-39.9	-36	-26	-27.6	-29.2	-26	-27	-32
CSOWR	-95.18	-107.33	-114.89	-115.54	-104.38	-63.18	-82.16	-45.79	-41.03

FIGURE 3.1 Australian Dollar Rally
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

position information on its participants and their positions because there is no exchange to capture and report the data. The futures market, however, does offer position information, and there are currency futures traded on the commodity markets in the United States that can provide useful information to forex traders.

Every Friday the Commodity Futures Trading Commission publishes the Commitments of Traders, or COT, report online at www.cftc.gov/marketreports/commitmentsoftraders/index.htm. The report contains information on currency futures traded through the exchange, which includes the euro, Canadian dollar, Swiss franc, New Zealand dollar, and Australian dollar. Figure 3.2 depicts the COT data for New Zealand dollar futures from the week of September 22, 2009.

The data on the COT report is captured from the exchange on Tuesday and published on Friday, rendering it stale the moment it is published. Although it isn't real time, the data on the COT report is still useful for measuring institutional interest in a specific currency. There are many different strategies developed around the data contained in the COT report, but I use it only to determine the net positioning of noncommercial traders.

NEW ZEALAND DOLLAR - CHICAGO MERCANTILE EXCHANGE Code-112741
Commitments of Traders - Futures Only, September 22, 2009

	Total	Reportable Positions							Nonreportable Positions	
	Open	Non-Commercial			Commercial		Total			
	Interest	Long	Short	Spreading:	Long	Short	Long	Short	Long	Short
		(CONTRACTS OF NZD 100,000)								
All	23,603:	19,874	1,229	0	442	21,007	20,316	22,236:	3,287	1,367
Old	23,603:	19,874	1,229	0	442	21,007	20,316	22,236:	3,287	1,367
Other:	0:	0	0	0	0	0	0	0:	0	0
		Changes in Commitments from: September 15, 2009								
	232:	-332	18	0	311	-185	-21	-167:	253	395
		Percent of Open Interest Represented by Each Category of Trader								
All	100.0:	84.2	5.2	0.0	1.9	89.0	86.1	94.2:	13.9	5.8
Old	100.0:	84.2	5.2	0.0	1.9	89.0	86.1	94.2:	13.9	5.8
Other:	100.0:	0.0	0.0	0.0	0.0	0.0	0.0	0.0:	0.0	0.0
	# Traders	Number of Traders in Each Category								
All	36:	15	5	0	3	14	18	19:		
Old	36:	15	5	0	3	14	18	19:		
Other:	0:	0	0	0	0	0	0	0:		

	Percent of Open Interest Held by the Indicated Number of the Largest Traders							
	By Gross Position				By Net Position			
	4 or Less Traders		8 or Less Traders		4 or Less Traders		8 or Less Traders	
	Long:	Short	Long	Short:	Long	Short	Long	Short
All	60.6	71.1	74.6	84.5	60.6	71.1	74.6	84.5
Old	60.6	71.1	74.6	84.5	60.6	71.1	74.6	84.5
Other:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

FIGURE 3.2 Commitments of Traders Report, September 22, 2009

Noncommercial traders represent speculators in the futures market. These are traders who do not intend to take delivery of the futures contracts they are trading; they are in it for the profit. These are the institutional traders I'm interested in monitoring because their big dollars help drive supply and demand forces in the forex market. Without volume and position information on the spot market, the COT report is the closest thing a forex trader has to finding out what the big dollars actually think about a given currency pair. To determine the net position of institutional speculators, compare the noncommercial short contracts with the noncommercial long contracts. In Figure 3.2 the noncommercial traders were net long, the New Zealand dollar futures contracts giving this pair a long bias.

The COT Flip Monitoring the Commitments of Traders data weekly allows you to determine the direction institutional traders are headed with their contracts. For example, if you knew every week that noncommercial traders were reducing the number of long contracts and increasing the number of short contracts, it could be a signal that interest is shifting to the short side. You will also know the precise moment when institutional investors have switched from being net long to being net short. For trend traders, the information is especially useful to determine whether the trend they are trying to trade is with or against the institutional bias for a currency. Figure 3.3 demonstrates this point using the NZD/USD weekly chart between April and September 2009. In April 2009 noncommercial traders moved from net short to net long, which corresponded with a strong

FIGURE 3.3 Noncommercial Traders Are Net Long NZD during This Rally in NZD/USD
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

uptrend beginning in the spot market. At the time of this writing, noncommercial traders are still net long New Zealand dollar in the futures market.

Just as with the CSOWR, I do not use the COT data as a stand-alone trading strategy. I use this information to measure institutional sentiment only. If you are interested in using the COT report to build more advanced trading strategies, I would recommend reading *Sentiment in the Forex Market: Indicators and Strategies to Profit from Crowd Behavior and Market Extremes*, by Jamie Saettele, part of the John Wiley & Sons Trading series.

The Influence of Central Banks

Central banks are active participants in the currency market, and their actions have a direct impact on supply and demand within the marketplace. It is the role of a central bank to monitor the money supply and make policy decisions affecting a country's monetary system. If a central bank is

sending an unclear message to the market through its committee statements or if the market is unhappy with the decisions being made, demand for the country's currency can suffer in the marketplace.

Managing the money supply is an active part of a central bank's role. Having too much money in the marketplace can lead to higher levels of inflation and can stagnate growth. Central banks attempt to promote growth and fight inflation through a host of economic tools, the most familiar being interest rates. Using the U.S. Federal Reserve Bank as an example, the central bank sets two interest rates, known as the *discount rate* and the *federal funds rate*. The discount rate is the interest rate banks are charged to borrow money directly from the Federal Reserve through a facility known as the *discount window*. The federal funds rate is a target interest rate for banks to charge each other interest for reserve money borrowed on an overnight basis. When banks have a shortage or oversupply of reserve cash, they can lend it to each other to cover the reserve requirements at other banks while making money on the overnight loan. The interest charged on those loans is set by the federal funds rate. If the Federal Reserve wants to increase the amount of money in supply, it can lower either the discount rate or the federal funds rate to encourage lending. Conversely, if the Fed wants to decrease the money supply, it can increase rates.

You learned in Chapter 1 that open currency positions are paid or charged an interest premium, depending on their position in the currency—either long or short. The nightly rollover premium is derived from the LIBOR, but the overnight rate set by the central bank is the source for overnight lending, which is ultimately reported to the British Bankers Association to calculate the LIBOR. The higher the interest rate set by a central bank is, the higher the LIBOR yield will end up being. The higher yield creates demand for that currency, and traders often buy higher-yielding currencies and sell lower-yielding currencies specifically to collect the interest payments; this is known as a *carry trade*.

Supply and demand are affected by the demand from carry traders as more and more traders accumulate large positions over time, ultimately bidding up the currency. Figure 3.4 illustrates how a high yield from the Bank of England and a low yield from the Bank of Japan fueled demand for GBP/JPY for nearly eight years as carry traders continued to hold the higher-yielding currency. The rally was finally unwound by the global credit crises of 2008.

The Effect of Fundamental Shocks on Supply and Demand

Severe imbalances in supply and demand can be created by major world events or the release of heavily anticipated fundamental data. If the event

FIGURE 3.4 GBP/JPY Demand Fueled by High Central Bank Interest
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

is a complete surprise, traders often favor a safe path of liquidating their positions and moving to cash until the panic subsides. This reaction to shocking news or events causes aggressive pressure on supply and demand as money flows out of one currency and into another. Though dramatic, these events are often a knee-jerk reaction; the market often returns to its previous state once traders realize that the sky isn't actually falling. Bargain hunters can use these events to their advantage to join existing trends at a steep discount.

An extreme example happened during the terrorist attacks of September 11, 2001. In the year leading up to the attacks, the dollar had appreciated nearly $13 against the Japanese yen, rallying from $107 to $120. The week before September 11, 2001, the USD/JPY was moving lower to test a support level clearly established on the weekly chart in Figure 3.5. The shock of the attack is seen as the market fell nearly 400 pips by the end of trading on September 14, 2001. Even in the face of tremendous global uncertainty, the principles of supply and demand held up. Two weeks later, the USD/JPY continued its uptrend as traders decided the U.S. dollar was the currency to hold.

FIGURE 3.5 Even Terrorists Can't Overcome Supply and Demand
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Fundamental price shocks do not have to be global terror events to affect supply and demand. Every week the market digests economic data concerning the health of each nation's economy, as we discussed earlier in this section. Occasionally the data the market expects to hear is not the data it receives. The market often responds with a knee-jerk reaction to news that doesn't meet expectations, regardless of whether the data is positive or negative for the country. These reactions offer an opportunity to astute bargain hunters.

Figure 3.6 demonstrates an opportunity to trade the AUD/USD after a price shock has subsided. The Royal Bank of Australia kept its rates unchanged on July 7, 2009, which is exactly what the market expected. The initial reaction was a quick rally as short-term traders believed the news would benefit the Australian dollar. Unfortunately for the bulls, this rally was only a temporary price shock. The central bank hinted in its rate statement that interest rates would not begin to rise until obvious signs of inflation appeared. Following the initial rally, the market continued to sell the AUD/USD as it was doing prior to the central bank's statement.

Regardless of the reason for fundamental price shocks, traders should keep a cool head in the face of vicious, illogical price action. Stay on the sidelines until it is clear that support and resistance will win out

FIGURE 3.6 Brief AUD/USD Rally Caused by a Fundamental Event
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

over panic, then take the trade against those who are still in panic mode. The fundamental calendar is full of events that could produce trading opportunities every week. You'll learn how to trade fundamental shocks in Chapter 9.

Trading Supply and Demand

Supply and demand may drive price under the hood, but you might wonder how a trader can take advantage of changes in supply and demand to make a profit. The battle lines between supply and demand are drawn visually on our charts as barriers called support and resistance. The terms *support* and *resistance* are synonymous with *demand* and *supply*. Support is seen as buyers increasing demand and pushing prices higher; resistance is seen as sellers flooding the market with supply and pushing prices lower. Learning to identify support and resistance by reading price is one of the most important skills a trader can develop. When you trade along the battle lines between supply and demand, you have aligned yourself with the real driving force behind changes in price.

IDENTIFYING SUPPORT AND RESISTANCE

The trading methodologies in this book are built on the assumption that you will build your skills as a support and resistance trader. Identifying support and resistance isn't difficult with a little practice. This section will teach you the techniques I use to identify support and resistance. By the end of this section you will be able to identify support and resistance levels on any currency pair and any chart timeframe. You will learn to identify key support and resistance levels that offer a higher probability of success. You'll learn how to identify a good deal using a technique I call the *bargain day*, which is a major component in every trading methodology this book teaches. Finally, you will learn how to time your trades to take advantage of the market's natural rhythm within a 24-hour trading day.

Using Trend Lines

Trend lines are diagonal lines used to visually depict the direction of price on a chart. Traders often use trend lines to enter trades whenever the market touches them or breaks through them. I prefer to use trend lines as a guide to determine trends due to their subjective nature. Traders draw trend lines many different ways, making questionable their usefulness to support and resistance trading. Just because you draw a trend line on a chart doesn't meant there is evidence through support and resistance that price will respect your trend line. Trend lines are useful as a guide to determine whether you should consider buying or selling a currency pair based on trends.

The generally accepted practice to draw trend lines is by connecting three or more consecutive price points without the trend line being broken by price. In an uptrend, the trend line should connect consecutive lows that are increasing in price. In a downtrend, the trend line should connect consecutive highs that are decreasing in price. Figure 3.7 illustrates trend lines in use during a downtrend and an uptrend. Notice how the EUR/USD downtrend slows and consolidates prior to breaking through the downtrend line and establishing a new uptrend.

Using Horizontal Lines

Horizontal support and resistance are drawn using lines that connect consecutive highs or consecutive lows. Horizontal support and resistance lines represent a distinct boundary in the battle between buyers and sellers because supply and demand temporarily balanced and price was unable to

FIGURE 3.7 Drawing Trend Lines Using EUR/USD MetaTrader, © 2001–2008 MetaQuotes Software Corp.

continue through them. These support and resistance areas are the primary technique used to enter trades and manage risk by every trading methodology in this book.

Drawing Support Support is drawn across consecutive lows, indicating a price area where buyers have balanced sellers and price was unable to move lower. It is important to understand recent price action before you consider buying a currency pair along support. During an uptrend, support acts as a jumping-off point for demand to push prices higher, making it a good area to consider buying. You do not want to buy into support during a downtrend, because the market is likely to break through support to achieve new lows. Figure 3.8 demonstrates how to draw support during an uptrend.

Drawing Resistance Resistance is drawn across consecutive highs, indicating a price area where sellers have balanced with buyers and price was unable to move higher. During a downtrend, resistance offers traders

FIGURE 3.8 Drawing Support during an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

a low-risk, high-probability area to sell a currency pair and join the existing downtrend. Knowledge of recent price action or trends is important to correctly selecting resistance. It is not advisable to sell at resistance during an uptrend, because the market is likely to push through resistance and make a higher high. Figure 3.9 demonstrates drawing resistance levels during a downtrend.

You might have noticed by now that support and resistance often change roles. When support is broken, the market often tests it again as resistance before the market falls further. Conversely, when resistance is broken, it is often tested as support before the market moves higher. These principles are important for support and resistance traders because they offer high probability, low risk, and predictable areas on the chart to enter trades. Figure 3.10 demonstrates this principle in action using a EUR/USD four-hour chart. Earlier in the chart the EUR/USD broke out of consolidation and fell several hundred pips. This breakout created a resistance zone, as shown by the parallel lines in Figure 3.10. When the market revisited the resistance zone, it sold off again. Support and resistance traders who identified this resistance opportunity were able to capitalize on a fantastic trade with very little risk.

FIGURE 3.9 Drawing Resistance during a Downtrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 3.10 Support and Resistance Often Reverse Roles
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Using Key Zones

The challenge many traders face is determining which horizontal support and resistance levels have the highest probability of holding price versus which will fail. Although trend and price action have a lot of influence on selecting the right support or resistance level, there are some shortcuts you can use to quicken the process. Key support and resistance zones can be used to increase the probability price will respect the price level and offer you a good trade. Key zones are created by identifying psychological round numbers, range extremes, strong rejections, and turnabouts. These techniques offer the highest probability of success, in my opinion, and I use them on a regular basis.

Using Round Numbers Using round numbers to identify support and resistance is an excellent strategy because it takes advantage of the psychology behind supply and demand. Traders are people, and people like to think in terms of round numbers, allowing you to exploit this trait in the forex market. Entry and stop orders are routinely clustered around round numbers because it is easier to calculate the profit or loss mentally when you're considering a trade. For example, would you rather calculate profit or loss on a trade placed at $1.20 or $1.19836? The more zeros a price has in it, the stronger a barrier it tends to be.

Round numbers are particularly effective to use near the open of a major trading session. When the market is hovering above or below a round number ahead of the London or New York open, it is likely that the market will test that round number as trading gets under way. The reason this happens is grounded in supply and demand. If market makers are looking to move price lower, they may move the market higher initially to generate selling pressure by triggering stops above a nearby round number. The opposite effect is seen when the market makers are looking to move price higher. Traders often refer to this as *stop gunning*, and though most market markers would never admit to doing it, you can see it play out on charts time and time again.

Bargain hunters can use this market behavior to their advantage by anticipating when it will happen and placing their orders to take advantage of it. If the market is trading near a round number and you believe it may be gunned at the open, place your orders 10 pips above or below the round number. In my experience, when a round number holds after it is gunned, the market rarely moves more than 30 pips higher than the round number before continuing in the opposite direction. When this technique works, it offers a high-probability entry with extremely low risk.

Figure 3.11 demonstrates this technique in action. During an uptrend the GBP/USD moved into a small consolidation phase. On the morning of

FIGURE 3.11 Using a Round Number for Support
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

September 10, 2009, GBP/USD was trading just above the round-number price of $1.6500 before the London open. Shortly after the open, GBP/USD traded down to test the round number and reached a low of $1.6479 before continuing to rally higher.

Using Daily Ranges The daily high and low of each trading day represents a key support and resistance level. These are two areas where supply and demand balanced momentarily and formed support and resistance. It is not uncommon for the market to test a daily high or low during subsequent trading days, which gives support and resistance traders another high-probability, low-risk area to enter the market. Understanding the currency price action is important to using a daily range successfully. Regardless of the long-term trend, if the recent trading days were very bullish, you might want to consider buying near the daily low. If the recent daily price action is bearish, consider selling the daily high. The usefulness of a daily high or low range degrades over time, so I recommend using only the last

FIGURE 3.12 Buying a Daily Low within an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

two or three trading days with this technique. Figure 3.12 illustrates the GBP/JPY within the context of an uptrend represented by the long arrow. The daily low from Friday, July 17, offered trend traders an opportunity to join the trend with very little risk.

Using Weekly Ranges The high and low prices of a full trading week offer key support and resistance levels for traders, just as daily ranges do. Weekly ranges have greater longevity than daily ranges do and may be respected by the market for several days, weeks, or even months. Identifying the high or low on a weekly chart is simple but doesn't offer much detail to plan a support or resistance trade. Using a lower timeframe will give you a clearer picture of support and resistance along the weekly range. Figure 3.13 illustrates an example of selling the GBP/JPY at the weekly high. Using a four-hour chart to plan this trade, you can determine whether the weekly high is holding as resistance before you sell the currency pair. The long wicks on each four-hour candle illustrate strong selling pressure in that area as price rallies higher, only to be sold back down again. These candle wicks are strong clues that a resistance or support level will hold

FIGURE 3.13 Selling GBP/JPY at the Weekly High
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and a trade opportunity exists. Traders who sold near $159.70 were offered a low-risk, high-reward trading opportunity along the weekly high.

Long-Term Support and Resistance Traders using price action to plan support and resistance trades should start with very long-term charts and then move to lower timeframes. The longer the timeframe you are looking at, the more likely it is that the support and resistance level will be respected by price. I developed my working theory on this concept not because there is something magic about longer timeframes; rather, more traders are able to identify long-term support and resistance. This is one scenario where the idea of a self-fulfilling prophecy in the market may actually have some merit. Weekly and monthly charts do not change as frequently as daily or hourly charts. The support and resistance levels on long-term charts may be respected for many years before finally being broken. These levels of support and resistance should be known to any support and resistance trader looking for a bargain. They are traded as any other support and resistance level would be traded using the tactics outlined in the next section.

TRADING PRICE ACTION

Identifying support and resistance is only half the battle; to make money, you have to be able to trade them. There are a couple of tactics I prefer to trade price action along support and resistance levels, and you will learn those tactics in this section. You will see these tactics in action when we discuss actual trading methodologies in Chapters 6 through 9. To trade price action successfully, you need to be clear on one critical concept about support and resistance: It isn't a perfect line in the sand. Occasionally, a price will be struck that causes an instant and obvious market reaction, but support and resistance barriers are normally established in a range between a high and a low price. This range represents the support or resistance zone where buyers and sellers are momentarily in balance. The relative balance between buyers and sellers may last a few minutes or a few years, depending on what timeframe you are trading, but the range should be clear. This range is where traders should look to enter a low-risk, high-probability trade along support and resistance.

Identifying Support and Resistance Zones

Locating a support or resistance zone is done by finding the price range immediately preceding a turn that takes price in a new direction. The range could be near a round number, at a daily or weekly range, or preceding a major breakout in price. Once located, the zone becomes the focus point for a bargain-hunting support and resistance trader to place orders. Figure 3.14 illustrates support and resistance zones using a GBP/USD hourly chart. In this example, the market is approaching a support zone identified between a high price of $1.6025 and a low price of $1.5975. It is worth noting that the psychological round number of $1.6000 sits in the middle of this support zone, making it attractive for traders to consider taking a long position if the zone holds support.

Lower timeframes are often used to identify support and resistance zones. Most of the trading strategies taught in this book use lower timeframes to plan support- and resistance-based entries after identifying a trade opportunity on the daily chart. Spend some time identifying support and resistance zones using historical data and get a feel for the way that price moves in and out of these zones; it will be worth your time.

Identifying Strong Rejections

Occasionally the market will touch a price that generates a tremendous amount of interest. When this occurs, the market is often rejected strongly

FIGURE 3.14 Support and Resistance Zones
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

from that price, creating a pattern, which I so creatively refer to as a *strong rejection*. There are a number of names associated with single bar or candle patterns that are well known, such as *pin bars* or *hammers*, but don't confuse strong rejections with traditional candle patterns. Candle patterns and pin bars have restrictions that qualify their patterns as trading signals. Strong rejections are focused on analyzing the strength of a support or resistance zone and are not trading signals on their own.

Strong rejections are often seen as a single bar or candlestick; however, a series of strong rejections only adds further evidence that the support or resistance level you are looking at is genuine. Candlesticks display strong rejections with a very long wick or tail. The size of the body doesn't matter; this is about observing order flow, not spotting a candle pattern. Bar charts display a strong rejection with a long bar whose open and close ticks are close together. Figure 3.15 illustrates what a strong rejection looks like in both candlestick and bar chart format.

Strong rejections occur when the market hits a price that triggers a massive amount of selling or buying interest and serves as a warning to traders that a demand level may be forming. This example shows a strong objection with a bias to sell because the wicks are higher than the body.

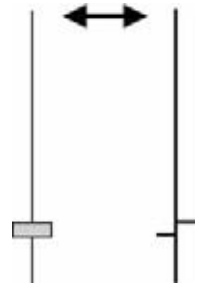

FIGURE 3.15 Strong Rejection Examples

Reversing this pattern would indicate a strong objection with a bias to buy. Seeing a strong rejection should serve as a warning shot to traders that a good support and resistance trade may occur near the source of the strong rejection.

Strong rejections are visual tools to support the idea that a strong support or resistance level may have formed near the price that was the source of the rejection. You should always analyze the surrounding landscape to ensure that any strong objection has some teeth; otherwise, you will enter a trade without merit. Strong rejections that occur near round numbers are usually very good signs that the round number has developed support or resistance and will hold. Strong rejections are also potent clues that support or resistance is strong when they appear near the open of a major trading session or following the release of major fundamental data, such as the nonfarm payroll report.

Strong rejections occur on every currency pair and any timeframe. The longer the timeframe, the more attention a strong rejection should receive. It takes a tremendous amount of activity to push a daily or weekly candle around, so when price is rejected on a longer timeframe, take note. Figure 3.16 illustrates how a cluster of strong rejections combined with a round number created a buying opportunity on USD/JPY in July 2009. USD/JPY had tested support at $92.00 twice and was strongly rejected; on the third test the market reversed and moved higher. Using an entry order to buy the USD/JPY below the round number at $91.90, a bargain hunter could have taken advantage of this low-risk, high-probability support trade.

Identifying Turnabouts

Turnabouts are a very conservative technique to identify support and resistance trades. Using a turnabout, the trader essentially waits for confirmation that a suspected support or resistance level will hold price before

FIGURE 3.16 USD/JPY Strong Rejection Trade
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

taking action with a trade. When you make a mistake trading, there are no money-back guarantees, but waiting for a turnabout is probably the closest thing you'll find to a guarantee in the world of support and resistance trading. The market must turn in order to trade—hence the name *turnabout*. The downside to a turnabout trade is missing out on other valid support and resistance opportunities.

When traders aggressively enter on support and resistance, they will get into a trade well before a turnabout trader does. In some cases the market will move away from the support or resistance level with such force that waiting for the turn may keep a turnabout trader sidelined while the aggressive trader is in the money. Although waiting for the turn will reduce the number of trades taken, the trades that are taken may offer a higher probability of success. Turnabout traders are not guessing whether support and resistance will hold because they waited for the turn. Turnabouts also take the guesswork out of placing protective stop orders. During the turnabout, the market will make a high or low price, depending on whether you are trading support or resistance. This high price mark gives traders an excellent place to put a protective stop order on their position, should the trade turn out to be a loser.

FIGURE 3.17 Trading Support Using a Turnabout Technique
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Figure 3.17 illustrates an example of waiting for the market to turn before assuming that the resistance level will hold. In this example, the USD/CAD rallied to test a resistance level at $1.2670 and was rejected again. Traders who waited for the market to close below the resistance level used the turnabout effectively to short sell this resistance level. The small line above the high price during the turnabout represents a potential stop order level to protect a short position.

Identifying a Bargain Day

Bargain days are a recurring theme you will see in almost every trading methodology I use. Traders often jump into trends at a price that doesn't represent the best possible value for their trade. This is usually referred to as *chasing a breakout* or entering at the top of a rally or selloff. Bargain days represent an opportunity to join an existing trend at a much cheaper price. They are often referred to as *pullbacks* and are formed when the market has moved against the prevailing price action or trend.

The idea is simple and is rooted in the theory of how supply and demand drive prices higher or lower. Within the context of any trend there

comes a point where the traders who are driving the trend lose interest and the trend slows. This pause allows the other side to gain control and push the market in the opposite direction of the prevailing trend. Eventually the participants in the original trend notice the cheaper prices and begin to enter the market again. When the prevailing trend has paused and the market is on sale, a bargain day is usually close by.

Selecting the Best Bargain Days Each methodology taught in this book will explain how to identify a bargain day for that specific trading strategy, because the rules do vary. Regardless of a strategy's nuances, all bargain days are represented by a pullback against the prevailing price action or trend. Figure 3.18 illustrates several bargain days in uptrends and downtrends using a USD/CAD daily chart from 2009. Bargain days fit with the bargain-hunting principle, *never pay full price*. Looking for a bargain day will help reduce the risk you must take to join an existing trend and

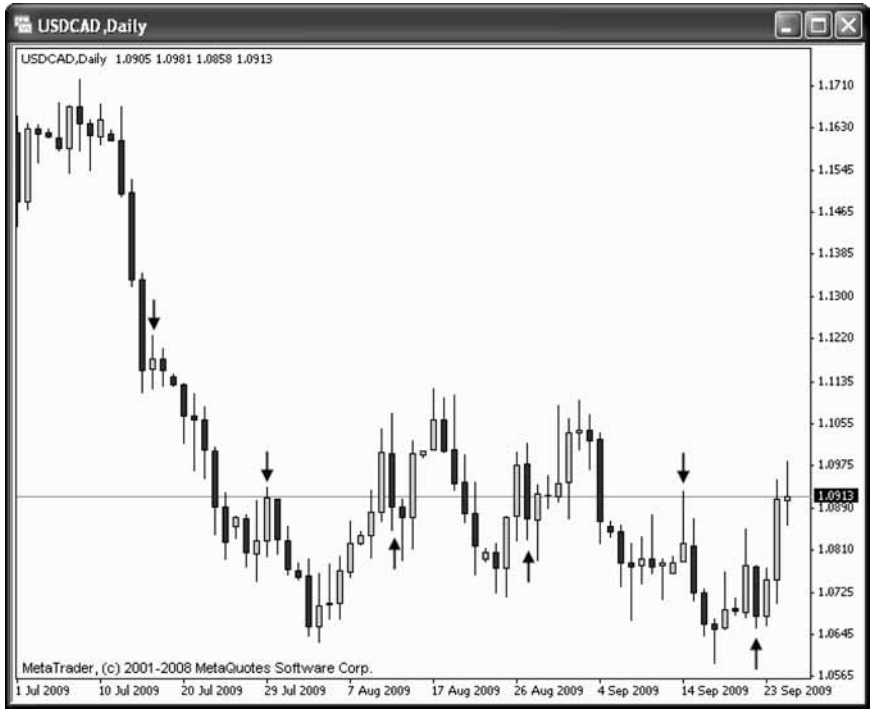

FIGURE 3.18 Bargain Days during Various Trends
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

increase profits by avoiding entries at the top of a selloff or rally. You will see bargain days in action in Chapters 6 though 9.

Wicks and Tails Are Important A good bargain day will have either a wick or a tail, depending on which way the trend is expected to continue. The length of the wick or tail is not as important as simply having one, although the longer it is, the more support or resistance may be present. The importance of a wick or a tail lies in the level of support or resistance provided as the bargain day came to a close. Without it there is little evidence through price action analysis that the market actually found traders willing to stop the direction of the bargain day, and the market may move further on the next trading day. If you are looking to sell a currency pair, the bargain day should have closed above the indicator and have a visible wick on the candle. If you are looking to buy the currency, the daily or weekly candle should have closed below the indicator and have a visible tail.

Always Consider Support and Resistance When you consider a potential bargain day, do not do it in vacuum. Even if the bargain day has a decent-sized wick or tail, that doesn't mean that the market isn't done moving against the trend. You can see that clearly demonstrated in Figure 3.18, which shows that not every bargain day is one you should trade. The bargain day alone is not a signal to trade; it is a signal that there may be a support-and-resistance opportunity coming soon. When you see a bargain day, you should look for a support-and-resistance opportunity to join the existing trend at a bargain price. Use everything you have learned about support and resistance to determine whether there is an opportunity to trade. If you don't see obvious opportunities, move on, because not every bargain day will yield a trading opportunity.

Wait for the New York Close Daily candles tend to be slightly different from chart to chart, depending on your data feed and the time at which your software considers the end of a trading day. I prefer charts that close daily candles at 5:00 P.M. Eastern Time. This ensures that the daily candle on your chart accounts for the full range of trading that occurred during the London and the New York trading sessions that day. For most traders this won't be an issue, but if your daily candles close at another time, you might consider changing your settings or switching software.

Learning to Place Effective Entry Orders

Trading long-term support and resistance opportunities allows you to manage how you enter trades using entry orders. You do not need to be present when the support or resistance opportunity is executed. Learning to place

entry orders so that you receive the best possible price, even when you are not present to execute the trade, takes some practice, but it is not difficult to master. Placing an entry order depends on the kind of opportunity you are trying to take advantage of. Round numbers should have entry orders placed at least 10 pips above or below the round number, depending on your desire to be long or short. Support and resistance trades should take advantage of a defined support or resistance zone near the desired entry price. Support trades should place an entry order along the top of a support zone. Resistance trades should place an entry order along the bottom of the resistance zone. This practice ensures that your entry order will be executed as the market enters the outer boundaries of the support or resistance zone being traded. These techniques are demonstrated in Chapters 6 through 9.

CLOSING BELL

This chapter taught you the key concepts behind learning to read price. You learned how supply and demand are influenced, how support and resistance are identified, and how to trade on price action without the aid of indicators. Remember that support and resistance are useless without the context of price action or trend. When you select a support or resistance level, ensure that it agrees with recent price action before you take a trade. Buy support during an uptrend and sell resistance during a downtrend. If you are unsure which trend is in control, move to a higher timeframe to identify the prevailing trend and follow price.

You learned the concept of a bargain day and learned to look for opportunities that offer you the highest probability and lowest risk to trade. Use key support and resistance zones found along the high and low of daily or weekly candles, round numbers, and near strong rejections. Finally, if you are more conservative, use a turnabout strategy and allow the market to enter and exit an area you believe is a support or resistance zone before taking a trade.

This was a very important chapter because it lays the framework for executing trades along support and resistance, which is critical to implementing the methods taught in Chapters 6 through 9.

CHAPTER 4

Managing Risk

Losing is part of trading, and sooner or later you will lose money on a trade. How you handle risk is the single most important concept a trader must understand to survive long term. Unfortunately, managing risk is a confusing topic for many traders. Through my blog I've spoken with traders from around the world who have made the same mistakes I did as an inexperienced trader; the discussions in this chapter are a response to those conversations.

In this chapter you will learn how to use stop orders, avoid overtrading, size your positions correctly, and manage trailing stops appropriately. Managing risk is a key principle of bargain hunting because you can't trade if you end up losing all your money. Arm yourself with the information in this chapter and you'll be prepared to protect your account capital from the risks of trading currency.

ALWAYS USE A STOP ORDER

I get at least one e-mail each month from a trader who has let a bad trade get away from him. Usually the trader did not place a stop order on his trade and the market moved against him, creating a significant loss. Closing a trade at a loss can be very difficult for traders, especially new traders who haven't built a callus against the sting of losing real money. Automating the exit of a bad trade is important because some traders will continue to hold a bad trade, hoping and praying that the market will at some point return

in their favor. I've seen some traders stick with a position even as their accounts are drawn down 10 to 40 percent or more. Nobody likes losing money, but you must cut a loss quickly or you will not have any money left to trade again. Stop orders help remove the emotions involved with closing a bad trade by taking the decision out of your hands and authorizing your currency dealer to close it for you.

Stops are only effective if you leave them alone. Some traders move their stop further and further from the entry point, to give the trade more room. This is no different than trading without a stop, in my opinion. Once you have determined the best price at which to put a stop order, leave it alone! Moving a stop order is a horrible habit to get into and will lead you to take on more risk per trade and may lead your account to ruin. When the trade goes bad, let the stop loss do its job and take you out of the market. It is far better to be out of the market and looking for another good trade than married to a bad one.

Placing Stop Orders

Stop orders are effective only if you know how to place them correctly. Traders often complain when their stops are triggered only moments before the market moves in their favor. These traders likely do not know how to place stops correctly and will continue to get stopped out prematurely. You should ask yourself two questions when you're looking for a place to put a stop order:

1. Where has price already proven it hasn't traded at recently?
2. At what price will I know my trade is invalid?

Your stop should be placed at a price you know the market hasn't been able to trade at in recent price history. Support and resistance zones offer areas above or below the zones at which price has proven it is unable to trade during recent price action. These areas offer excellent places to place your stop order. You will also know a support and resistance trade is no longer valid in those areas above or below support and resistance zones because the zone should not fall to price if your trade theory is correct. Once a zone is violated by price, it is no longer valid support or resistance and the trade is invalid.

Figure 4.1 demonstrates the proper place to put your stop order using a support zone entry. In Figure 4.1 the EUR/USD has set up support between the round number of $1.4000 and $1.4100. Traders who went long EUR/USD near the top of this support zone should have placed their stop below the bottom of the support zone. This ensures that their stop is

FIGURE 4.1 Placing a Stop Order below Support
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

located where price hasn't been able to trade in recent history and is a logical exit point if the support zone fails to hold EUR/USD from going lower.

Figure 4.2 demonstrates the proper place to put your stop order using a resistance zone entry. In Figure 4.2 the USD/CAD has established a resistance zone between $1.050 and $1.1150. Traders who sold USD/CAD near $1.050 should have placed stop orders above the resistance zone, as shown by the dashed line. This placement ensures that the stop is located where USD/CAD hasn't been able to trade in recent price history. If the USD/CAD violates this resistance zone and moves higher, the trade is invalid and the stop placement is a logical exit point.

This process can be repeated on any currency pair and any timeframe. Placing stops takes some practice, and even by following these guidelines some trades will be stopped out by spikes in price. Avoid placing your stops within 15 pips of a round number, because we have already discussed the attraction round numbers have to price. If you place your stops near a round number, you are more likely to get stopped out during a spike that probes the round number looking for stops. Make sure that you are at least

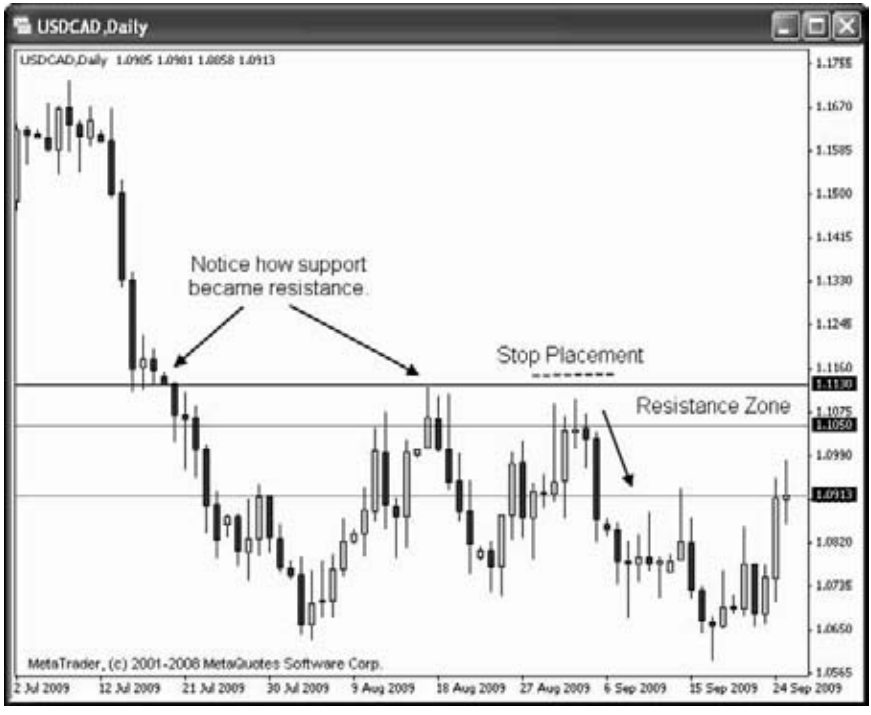

FIGURE 4.2 Placing a Stop above Resistance
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

20 pips above or below a round number to avoid being "stop gunned" during a round-number test. Overall, stops are an excellent tool to manage risk precisely and take the emotion out of a losing trade through automatic execution.

BEWARE OF OVERTRADING

Without capital in your account, you're dead as a trader; therefore, protecting your trading capital should be your top priority. Anytime you open a trade you are placing capital at risk, so it is important to select only the best trades and have a good reason to risk capital. Unfortunately, many traders are eager to earn money and assume that the more they trade, the more potential they have to make a few more pips, but it doesn't work that way in the real world of trading. You can't force the market to give you a decent trade simply because you want to trade; if you are, you're

overtrading. Traders overtrade due to a lack of discipline to stick to a solid trading methodology, boredom, or greed and are failing to manage risk to their trading capital. Here are some common warning signs that you could be overtrading:

- Unable to explain why you took some recent trades
- Making a profit but giving it all back by the end of the month
- Studying charts and looking for trades more than eight hours a day
- Taking trades because you "believe" price will go a certain way

Correcting overtrading is the responsibility of the individual trader, but I do have a suggestion: Stop trading on short timeframes. Most of the traders I see prone to overtrading are trying to trade 5- or 15-minute charts during the London or New York trading sessions. These traders are bombarded with price action because the market is very active at those times, and they end up chasing price all over the chart trying to make another pip. I advocate trading a longer timeframe. You do not need to earn 1,000 pips a month to make a good return on your capital, so why threaten your account with multiple trades when you don't need to? The daily or weekly charts might only offer one or two trades a week versus several a day, but less trading means less risk and more focus. Long-term trading can also reduce the cost of trading, as you will see in the next section.

REDUCING YOUR TRANSACTION COSTS

In terms of risk, another reason I promote long-term trading is to reduce transaction costs. Currency dealers are very good at marketing the notion that somehow the currency market is cheaper to trade because there are no commissions. The reality, however, is that trading currency can be very expensive due to the spread charged on each trade. Using typical leverage, a standard lot account may pay $20 to 50 per lot to open a position. If you trade 10 lots, the total transaction costs are $200 to $500 per trade! The bottom line is that the more often you trade, the higher are your transaction costs. Short-term traders must work much harder to turn the same profit as a long-term trader. Consider the transaction costs in Table 4.1 for earning 500 pips in profit.

Table 4.1 illustrates how transaction costs become a significant percentage of a trader's profit the more frequently that trader trades. This example assumes standard lots with 100:1 leverage trading the euro/U.S. dollar currency pair with a two-pip spread. The trader who made 50 trades had to earn $980 more than the trader who made one trade to gain 500 pips

TABLE 4.1 Transaction Costs Can Really Add Up

Number of Trades	Total Profit	Transaction Costs	Profit
1	$5,000	$20	0.4%
10	$5,000	$200	4%
25	$5,000	$500	10%
50	$5,000	$1,000	20%

overall. Additionally, traders who are constantly jumping in and out of the active marketplace are more likely to encounter slippage. Whenever a currency dealer is unable to complete a trade at the price requested by the trader, it is known as *slippage*. Traders who focus on trading the news or other times of high market volatility might not get the price they want and spreads can widen, adding to their transaction costs. Clearly there is a significant advantage in transaction costs for traders who focus on long-term trading.

STOP THINKING ABOUT LOSSES IN PIPS

Whenever I do a presentation about trading long-term charts, I'm always asked how many pips I risk on each trade. Many traders assume that trading a daily or weekly chart requires risking a tremendous number of pips on each trade, and they can't afford that risk. This is a logical assumption because many traders are conditioned by lessons on day trading to risk a small number of pips when trading a smaller timeframe. The notion is also suggested by books and articles. I read one book that actually suggested that in order to "swing trade," you need to risk between 100 and 250 pips per trade. These assumptions are completely absurd because managing risk correctly has nothing to do with how many pips you risk. Managing risk is about managing the size of each position relative to your account. How many lots you trade and what kind of leverage you use will determine how many pips you can risk on a single trade.

Of course, the number of pips actually risked on any trade will be determined by the placement of a stop loss, but the overall risk to the account will depend on the position size. By adjusting the position size, a trader can increase or decrease the number of pips available for a trade to risk, as illustrated in Table 4.2. The example in Table 4.2 illustrates how a trader can risk $1,000 three different ways by adjusting her position size. Notice how the number of pips available changes with the change in position size.

TABLE 4.2 How $1,000 Can Be Risked Three Different Ways

Amount Risked	Pips Risked	Position Size
$1,000	50	Two standard lots
$1,000	100	One standard lot
$1,000	500	Twenty micro lots

The example assumes a trade on the EUR/USD using 100:1 leverage. You might be able to risk over 100 pips and still only risk a small percentage of your account using the proper position size. You should always determine the proper place to put your stop loss and then work a position into the number of pips being risked. Never arbitrarily place a stop loss based on position size. The stop should be correct for the trade at all times. If you can't afford the stop, don't take the trade. For the record, you can trade using a daily chart and risk as little as 30 pips. You'll learn how to do that in Chapters 6 through 9. The key lesson of this section is to stop limiting yourself by thinking about losses only in terms of pips and use the lessons in the next section to size positions properly.

MANAGING RISK THROUGH POSITION SIZE

Managing risk is all about controlling the amount of money you lose when a trade doesn't go your way. Many traders make the mistake of sizing their positions too large and losing more money than they should on a single trade. To determine position size, you first need to decide how much money as a percentage of your account you are willing to lose on a single trade. The amount varies for every trader, depending on the amount of risk the trader is willing to take on, but generally speaking, 2 to 5 percent is a typical number. The more money you risk on each trade, the faster your account will be damaged if you lose more than one trade consecutively, as demonstrated in Table 4.3.

Table 4.3 illustrates how dramatically a $10,000 account can be damaged after 10 consecutive losing trades. The trader who sized his losses at 2 percent lost 18 percent; the trader risking 10 percent per trade lost 65 percent! Sizing positions to ensure that you do not lose a tremendous amount of your account during a streak of bad trades is essential to your survival.

TABLE 4.3 The Effect of Increased Risk on Losses

	Trade	2% Risk	4% Risk	6% Risk	8% Risk	10% Risk
Starting balance		$10,000	$10,000	$10,000	$10,000	$10,000
	1	$9,800	$9,600	$9,400	$9,200	$9,000
	2	$9,604	$9,216	$8,836	$8,464	$8,100
	3	$9,412	$8,847	$8,306	$7,787	$7,290
	4	$9,224	$8,493	$7,807	$7,164	$6,561
	5	$9,039	$8,154	$7,339	$6,591	$5,905
	6	$8,858	$7,828	$6,899	$6,064	$5,314
	7	$8,681	$7,514	$6,485	$5,578	$4,783
	8	$8,508	$7,214	$6,096	$5,132	$4,305
	9	$8,337	$6,925	$5,730	$4,722	$3,874
	10	$8,171	$6,648	$5,386	$4,344	$3,487
Total loss		18%	34%	46%	57%	65%

To calculate position size, you must know how much of your account you are willing to risk per trade and the total cost of the protective stop order, as shown in the following calculation:

$$(\text{Account balance} \times \text{Acceptable risk \%})/(\text{Stop loss} * \text{Value of a pip}) = \text{Number of lots}$$

For example, assume that you have a $20,000 account and you are willing to risk 3 percent of the account, giving you $600 to risk on a single trade. The trade you are considering requires a stop loss of 75 pips on the EUR/USD, and you are trading mini lots. Assuming that your leverage is set at 100:1, the value of a EUR/USD mini lot pip is $1. To size this position, use the calculation as shown here:

$$(\$20{,}000 \times 3\%)/(75 * 1) = 8$$

Using this calculation, we have determined the proper position size for this trade to be eight mini lots.

Supercharging a Small Account

Position sizing to keep risk around 2 percent per trade may work well with a $20,000 account, but what if you only have $500? If you consider that 2 percent of $500 is only $10, it doesn't leave you much risk capital to work with. Micro accounts are a great place to start if you have only $500. With micro accounts, a $10 risk will usually fit your position into a 100-pip

stop loss, which is sufficient for almost any trade. The problem with micro accounts is that your gains will be less than exciting. Let's face it: When you trade micro lots, even if you averaged 100 pips a week, you have only earned a profit of $10 per lot. Those 10 bucks represent a great percentage return on your money, but when you're trying to grow $500 into $20,000, it is going to take a while.

I suggest supercharging your account growth by determining a monthly budget you are able to spend on trading and adding it to your micro account on the first of every month. The amount doesn't have to be a lot—perhaps $100 to $500 a month, whatever your budget can afford. The point is to supercharge your gains while smoothing out any losses you sustain, to accelerate your small account's growth into a bigger account.

Think of it like compounding interest. If you average 5 percent a month but are adding $100 to your account every month, you'll have gained more than you would have only booking the 5 percent each month. This is because each month that you add money to your account, the option of trading more lots is available. While you're supercharging your small account, I recommend adjusting your trade size every couple of months, too. This is a very simple but very effective method for growing a small account quickly, as long as you have already demonstrated the ability to trade profitably on a demo account. The effects of supercharging a $500 account can be seen in Table 4.4. The effect of depositing an extra $100 a month into your account can be dramatic. In a year's time the supercharged account grew

TABLE 4.4 Compounding Gains by Supercharging a Small Account

	Month	Gain/Loss	Regular Micro	Supercharged Micro
Starting balance			$500.00	$500.00
	1	2%	$510.00	$610.00
	2	4%	$530.40	$734.40
	3	−3%	$514.49	$812.37
	4	8%	$555.65	$977.36
	5	2%	$566.76	$1,096.90
	6	−2%	$555.42	$1,174.97
	7	5%	$583.20	$1,333.71
	8	−10%	$524.88	$1,300.34
	9	4%	$545.87	$1,452.36
	10	15%	$627.75	$1,770.21
	11	−6%	$590.09	$1,764.00
	12	1%	$595.99	$1,881.64
Total gain			19%	276%

276 percent, whereas the nonsupercharged account grew only 19 percent. The extra monthly deposit helped smooth losses and increase gains each month to grow the account 14 times faster than trading alone. This sample used a randomized rate of return for each month for example purposes.

MANAGE RISK CONSISTENTLY

Since we are on the topic of position sizing and risk percentages, traders often make the mistake of risking inconsistent amounts. Either they believe in one trade more than another or they are just terrible at calculating their position size. Either way inconsistent risk per trade will kill your account over the long run. How much you decide to risk on each trade is a personal tolerance, but whatever you risk, ensure that you are consistent trade to trade, month to month. If you are not consistent with risk, one single trade could wipe out all your gains, or as Table 4.5 points out, your winners might not overcome your losers. Risking inconsistent amounts could actually lead you to a positive gain in pips but a loss in capital.

Table 4.5 illustrates the effect that inconsistent risk can have on your trading capital over a series of 10 trades. In the first example, the trader risked between 2 percent and 8 percent and ended up losing $46.54 of his trading capital. In the second example, the trader consistently risked 2 percent of her account and gained $115.06 to her trading capital. Both traders

TABLE 4.5 Managing Risk Inconsistently Can Affect Returns

Example Account One		Example Account Two	
Gain/Loss	Account Balance ($)	Gain/Loss	Account Balance ($)
	1,000.00		1,000.00
−2%	980	−2%	980
4%	1,019.20	4%	1,019.20
−8%	937.66	−2%	998.82
3%	961.11	3%	1,023.79
7%	1,028.38	7%	1,095.45
−5%	976.96	−2%	1,073.54
5%	1,025.81	5%	1,127.22
−4%	984.78	−2%	1,104.68
−6%	925.69	−2%	1,082.58
3%	953.46	3%	1,115.06
	−46.54		115.06

made the same winning trades, but only the trader who applied risk consistently ended up making money.

BE CONSERVATIVE WITH TRAILING STOPS

To move or not to move my stop order—that is the question. Emotions are a powerful thing to overcome when you are watching the market move against a profitable trade. Many traders live by the advice "Never let a winner turn into a loser," and use trailing stop losses to protect profit or at least remove risk by moving their stop order to a breakeven price. But many traders struggle with when to move the stop order, how far to move it, and whether they should use a trailing stop loss at all. Using trailing stops is a balancing act between potential risk and potential reward. Although you might cut the risk out of your trade by moving a stop order to break even, you could also cut out the profit. Many traders are too aggressive with trailing stops and end up making nothing on a breakeven trade that would have made a healthy profit if they had given themselves more room.

Whether you are going to use a trailing stop should be decided before you open a trade. The risk management section of your trading plan should detail whether trailing stops are acceptable, how to determine new stop levels, and when you should move the stop. Without a written plan you'll be left to decide what to do while the trade is open and your emotions are active, which is never a good place to be. This section provides guidelines for using trailing stops to ensure that you're not following too close.

Enter and Manage on the Same Timeframe

When you are using a trailing stop, use the same timeframe you entered the trade with to determine when and where to move your trailing stop. Traders commonly use a lower timeframe to manage their trailing stop, but this practice doesn't put your trailing stop in tune with the timeframe you are trading. If you use a lower time chart to manage the trailing stop, you might not be giving the trade enough room to maneuver. Assume for a moment that you planned a trade using the daily chart and then use an hourly chart to trail the stop order. If you place stop orders on the hourly chart, you might be stopped out during the several fluctuations that price goes through in order to create one daily chart candle. Trailing stops should be managed on the same timeframe with which you planned the trade.

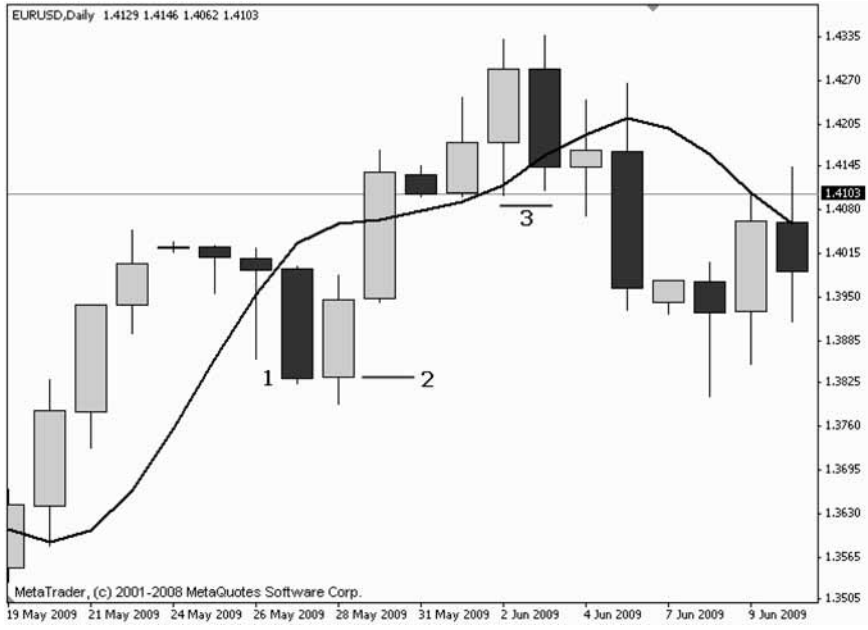

FIGURE 4.3 Trailing Stops Using Price Action
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Trailing Price Action

Using price action on the timeframe with which you planned the trade is an excellent strategy for trailing your stop loss. As each candle closes on your chart, you have all the information you need to move the stop. Using price action, a trader will move her stop every couple of candles once her trade has been profitable for at least one candle. This strategy allows the trade room to become profitable without being stopped out at breakeven too soon and gives the trader an opportunity to profit from each trade by trailing just below or just above price action. Occasionally the market will reverse and the trader might be stopped out at breakeven or at a smaller loss than initially planned, but that is just the nature of this trading game when you use a trailing stop. This technique is demonstrated in Figure 4.3.

Figure 4.3 demonstrates a trailing stop using price action. At point 1, the trader bought EUR/USD on a dip during an uptrend. At point 2, the trade was profitable after two candles had closed, so the trader moved his stop loss to breakeven. At point 3, the trader moved his stop order up as the market moved in favor of his position. Every two candles the stop was moved to protect profits until the market reversed and the trader was stopped out. Chapter 5 expands on this topic as a technique for managing profit.

Personally I am not a huge fan of trailing stops. I think every trade should have a set amount of risk and an ideal profit target, which is significantly greater than the amount you have risked. If you continually use trailing stops, it is likely that you will end up with trades that should have reached their profit targets but were stopped out at breakeven or less than their intended profit target. These trades are worse than a loss, in my opinion. Breakeven trades that would have reached their profit targets lull a trader into believing he has managed risk properly when in reality he might be hurting his overall profitability. What would happen if you just set the trades in motion and forgot about them? You'd probably lose more trades, but you would also make more money per trade, just as you originally planned when you opened the trade.

IS LOSING 70 PERCENT OF YOUR TRADES BAD?

What would you think if I told you I lost money on 70 percent of my trades? Would you scoff at my trading performance? Would you think I'm a bad trader? Or would you be interested in knowing how much I made on the 30 percent of trades on which I made money? Traders tend to focus on winning and taking profits because nobody likes to lose money and everybody likes to talk about wins. Winning isn't everything in trading, as you'll soon find out. Your winning percentage is not as important as your average win versus your average loss. If you continue to take profits early, you could hurt the ratio between average win and average loss and ultimately affect your profitability. The tool used to help increase your average win versus your average loss is a ratio known as the *risk-to-reward ratio*, and its proper use along with position sizing will go a long way to raising your overall success as a trader. The mistake many traders make is not sticking to their plan once they have planned a trade with a proper risk-to-reward ratio.

Traders are traditionally taught that they should strive for a risk-to-reward ratio of at least 2:1 on every trade. In other words, each trade should earn two pips for every one pip risked. In a perfect world the 2:1 risk-to-reward ratio allows a trader to lose 50 percent of her trades and still be profitable. The problem, of course, is that trading is rarely a perfect world. Trades can be cut short of their profit targets when using a trailing stop, the market could miss a profit target by only a few pips before suddenly moving against you, and traders often lack the discipline necessary to remain steadfast until their profit target is hit and they close their trades prematurely. This is why I like to refer to the risk-to-reward ratio as a *risk-to-potential ratio* instead. If you head into every trade knowing that

the potential is there to mathematically cover your losses, hopefully you will learn to stick to each trade and stop meddling with them. Overall, striving for a large risk-to-reward ratio can help you improve your trading results and should be a part of your risk management plan.

Go Big or Don't Bother

Since risk-to-reward ratios are not a perfect science, my advice to you when you're planning a trade using risk-to-reward as a guide is to go big or don't trade at all. Planning a trade with anything less than a 1:4 risk-to-reward ratio doesn't make any sense to me. Trades do not always reach their profit targets, and if you are unable to make a profit on every trade, using a lower ratio won't help cover your losses if your winning percentage is less than 50 percent. Waiting for trades that offer you the largest potential reward for the least amount of risk will help ensure a profitable result, even if the trade doesn't reach its profit target. It is better to get a risk-to-reward ratio of 1:2 on a trade you tried to get 1:5 on than it is to get a breakeven result on a trade you tried to get 1:2. Do you understand the difference? Over the long run, traders who wait for the big trades and stick to their stops and profit targets will do better than traders taking any little trade that comes their way.

Figure 4.4 illustrates a trade planned using good risk-to-reward. In this example, a trader bought USD/CAD during a pullback within an uptrend on support and used Fibonacci to identify a profit target. This trade ultimately offered a risk-to-reward ratio of 1:5. The example trade in Figure 4.4 also illustrates how a trailing stop loss isn't necessarily the best thing to use. If the trader did not use a limit order on his profit target but trailed it with a two-day low stop loss, the trade would have been cut short three days prior to the market rallying through the intended profit target. Shooting for a risk-to-reward ratio of at least 1:4 on each trade will allow you to lose more than 50 percent of the time and still be a profitable trader.

The Numbers Don't Lie

At the end of the trading day, the only thing that matters is whether you have made money or lost money. Even if you plan each trade with a high risk-to-reward ratio, it doesn't mean that you will automatically be a profitable trader. You must have the courage to hold each trade through to the end and realize each profit target. This means that you may have to watch a profitable trade give back its gains before the market reaches your profit target. You might even have to sweat a little while a trade that was once profitable dips into negative territory before moving on to your profit

FIGURE 4.4 Planning Risk-to-Reward with Profit Targets
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

target. This is where many traders fail to hold ranks with the disciplined traders and start using breakeven stops or trailing stops. They can't stand the idea of losing on a trade that was once profitable, but you have to look at the big picture to understand why that could in fact be good money management.

If you start cutting your trades short, you won't realize the profit target you planned, and that changes your trading performance's average risk-to-reward ratio. Each time you cut a trade short, you must increase your winning percentage to compensate for the loss in profit. The higher your required winning percentage, the harder it will be to maintain a profitable trading record, as illustrated in Table 4.6.

The example data in Table 4.6 demonstrates how trader number 3 had to be 60 percent more accurate than trader number 1 to make the same amount in profit. If the third trader's winning percentage drops to 50 percent, he will break even over 10 trades; anything less than 50 percent will result in a loss. Unfortunately, maintaining a 90 percent success ratio month after month can be extremely difficult to do, but trader number 3 has

TABLE 4.6 How Risk-to-Reward Changes the Necessary Winning Percentage

Trader #	Win %	Average Win	Average Loss	Average Risk-to-Reward	Net Return After 10 Trades
1	30	$1,250	$250	1 to 5	$2,000
2	60	$750	$250	1 to 3	$3,500
3	90	$250	$250	1 to 1	$2,000

left himself with no other choice but to be right, because he is not making more per trade than he is risking. Cutting your trades short, either through trailing stops or a lack of discipline to stick it through to your profit target, has a dramatic effect on your profitability.

KNOW WHEN TO TAKE A BREAK

Finally, the last mistake I see traders make on a regular basis is refusing to take a break when their trading is really suffering. I think this applies to discretionary traders more often than system traders. If you are a system trader, you probably understand your trading system's average drawdown and might not feel personally attached to each trading decision. Discretionary traders, on the other hand, often select trades without the aid of system-based rules and might feel personally invested in each trading decision they make, whether they should or not.

Regardless of your trading style, every trader will go through a period of time when his trading really suffers. Losing multiple trades in a row is a tough blow to overcome and can shake the confidence of many traders. Sometimes all that is needed is a short break from trading to clear your mind; take a walk and come back in a better mood. Trading when you are angry can lead to taking trades simply because you want to get back at the market. You might feel cheated, and you might be looking for revenge. This is a bad mental state to be in when you are planning a trade, because the market doesn't care about you or whether you win or lose. Trading when you are stressed, angry, or looking for revenge against the market will only cloud your judgment and lead to more bad decisions. I've even seen traders become so angry with losing money that they mentally give up and open positions for no reason other than gambling and continue to trade until their account is margin called.

Include some guidelines in the risk management section of your trading plan to remind yourself to take a break from trading when things are not going well. Perhaps it is a limit of 10 losing trades in a row; perhaps it

is a certain percentage loss of your capital. Some managed funds use a rule stating that if the client account loses more than 20 percent, trading must halt and the client must be consulted before trading continues; 20 percent seems like a decent number to me. Know when to take a break, and never try to trade when you feel like the market owes you a win. It doesn't.

CLOSING BELL

Managing risk through stop placement and position sizing is a critical skill every trader should master. If you are unable to consistently manage risk, you will not last long as a trader. Successful traders know that when risk is managed appropriately, profits will appear over the long run; no single losing trade matters to them. This chapter walked you through the components of risk management techniques and pointed out common mistakes traders make managing risk. The following list summarizes the key points from this chapter:

- Always use a stop loss.
- Avoid overtrading.
- Think of risk in terms of percent loss, not pips.
- Control risk through position sizing.
- Keep risk consistent for every trade.
- Do not trail stops too closely.
- Focus on trades with a good risk-to-reward ratio.
- Know when to take a break.

The final point to remember is that risk management is no good unless you are able to select good trades. Plenty of traders have blown out their accounts by practicing good risk management but selecting horrible trades. If you can't consistently pick a good trade, risking 10 percent or 0.01 percent of your account won't matter; ultimately you will blow out your account. Before you put your faith in risk-to-reward ratios and limited risk with live money, ensure that you have developed a consistent and profitable track record using a demo account. Finally, when things get ugly and you have taken a few losses, know when to take a break. The worst thing a trader can do is try to take revenge on the market after a series of losing trades.

CHAPTER 5

Managing Profit

Complete trade management should include guidelines to enter a trade, manage risk, and manage when to take profit. Many traders focus on entering and managing risk but leave managing profit open to subjective decision making, which is a mistake. Knowing when to take a profit is important enough to include managing profit as a core trading principle for bargain hunters. In this chapter you will learn to manage profit systematically and make the process as automatic as managing risk. You will learn how common techniques, including a breakeven stop loss, can actually hurt profitability. Finally, you will learn three techniques to manage profit based on market principles, including support or resistance and Fibonacci ratios.

Profit is a fickle thing to manage. Unlike risk, profit is never a guaranteed part of every trade. Floating profits are often vaporized in less time than it took to earn them, leaving traders to wonder why they didn't simply take the profit when they had the chance. Traders also want to earn as much profit as they possibly can out of every trade; after all, we are in this for the money, right? Often traders leave profit management open ended, assuming that it will allow them to be flexible and capture as many pips as possible out of every trade; unfortunately, it doesn't always work in their favor. The problems in managing profit are exacerbated by common trading adages such as "Cut your losers short and let your winners run." I've worked with traders who believed taking their profit should be delayed as long as possible, trying to "let their profits run." Unfortunately these traders often leave their trades open longer than they should and earn little to no profit after the market conditions radically change against them.

Taking profit also carries a heavier psychological burden than managing risk. Traders seem to accept that losing money is a part of being in the business of trading, but missing out on profit drives them to frustration. The market regularly taunts traders with profits they could have earned if only they had left the trade open a little longer. Participating in the "if only" game is a complete waste of time, but that doesn't stop traders from noting the profits they could have made on each trade. The "if only" game becomes dangerous when a trader allows his regrets from a previous trade to influence his decisions on the next trade. Each trade is a new trade, and what happened on a previous trade has no influence on what happens on the new trade. Each trade should be treated individually with a plan to manage profit. If you fail to create a systematic way to manage profit, you'll make decisions on a whim after the trade is opened, which is never a good position.

COMMON PROFIT MANAGEMENT TECHNIQUES THAT INCREASE VOLATILITY

Regardless of how careful a trader is in planning a trade, there is no guarantee that the market will reach the intended profit target. Occasionally the market will come close to a profit target only to reverse direction and move quickly against a trade. There is nothing more frustrating than setting a trade in motion only to find out later that you could have taken a profit but ended up with a loss.

To combat this problem, traders deploy a number of techniques to capture some profits quickly and remain in the trade, hoping to capture more. These techniques are great when a trade fails to reach its intended profit target, because the trader at least captured some profit along the way. Unfortunately the devil is in the mathematical details, and what appears to be a good idea on the surface often causes unintended consequences. Moving stop orders to breakeven or scaling out of a winning trade by reducing the position size as profits are accumulated can actually increase volatility in your trading returns. These techniques assume that a trader has a high percentage of successful trades because each trade takes on more risk in its initial phases than it takes in profits, even when the intended profit target is reached.

In this section we look at two common techniques often used for managing profit that can actually do more harm than good in many cases.

Moving Your Stop to Breakeven

Arguably the most common technique traders deploy to protect both their profits and their exposure to risk is the breakeven stop loss. Once a position is "in the money" or showing a meaningful floating profit, traders often move their protective stops to breakeven, assuming that they are protecting their capital by mitigating any risk the trade may bring. The breakeven stop is also seen as a way to manage profits by protecting any gains the trader has made on previous trades by, again, mitigating the risk of any trades still open. In fact, many trading systems encourage getting a trade to breakeven as quickly as possible to reduce the risk proposed by the trade. Since booking a profit is never a guaranteed event for any trade, moving your stop to breakeven might seem like a good idea, but in my opinion it is rather misleading advice. Each trade must assume a certain calculated amount of risk to potentially enjoy taking in a profit. Reaching that profit target is rarely a straight move from entry to exit. The market oscillates back and forth as it moves higher or lower, and often a trade is taken in and out of a profit as the market moves toward the intended profit target. Traders who move their stops to breakeven often get in the way of a good trade, as illustrated in Figure 5.1. In this AUD/USD example trade, the trader was taken out at breakeven. If the trade had been left alone, the market eventually reached the traders' intended profit target. This oscillation in price happens frequently as the battle between buyers and sellers is worked out on the way to a profit target.

Trading involves risk, and if you calculate your risk appropriately before you enter a trade, you should be comfortable maintaining that level of risk throughout the life of the trade. To reach your intended profit target, you might have to endure some time in negative territory, even after being at a profit. Remember, no trade is done until either the profit or the loss is booked, so being afraid of "letting a loser turn into a winner" is actually counterproductive to the health of your account if you maintain a disciplined risk-to-reward ratio on every trade. Patience to see a trade through to the end or as close to it as possible is a skill any professional trader needs to develop. Let's consider some example trades to illustrate this point.

Assume that two traders use an identical trading system. They both risk 40 pips per trade and they both use a profit target of 120 pips, which works out to be a 1:3 risk-to-reward ratio. In other words, they are risking one pip for every three pips they expect to earn in profit on each trade. The only difference between these two traders is that one moves her stop to breakeven once she has made 80 pips in profit, and the other doesn't. Table 5.1 demonstrates how the practice of moving protective stops to breakeven actually increases volatility in your trading results versus simply letting your trade run over a series of 10 example trades.

FIGURE 5.1 Breakeven Stops Often Hurt More Than They Help
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

TABLE 5.1 Breakeven Stop Orders Increase Account Volatility

	Net Pips Using Breakeven Stops	Net Pips Without Breakeven Stops
Trade #1	120	120
Trade #2	**0**	**120**
Trade #3	−40	−40
Trade #4	−40	−40
Trade #5	0	−40
Trade #6	−40	−40
Trade #7	0	−40
Trade #8	120	120
Trade #9	−40	−40
Trade #10	−40	−40
Net pips	40	80
Winning %	20%	30%

The trader who used a breakeven stop did not suffer as many losses, however, trade number two was taken out at breakeven when it should have made a profit. In this case, the market touched the breakeven stop order before ultimately reaching the profit target. This single trade made a tremendous impact on the overall profitability of the trader using breakeven stop orders. The results over 10 trades clearly demonstrate that using a breakeven stop added 10 percent more volatility to the trader's account and earned her 40 fewer pips versus the trader who left his trades alone.

With the results in Table 5.1 fresh in your mind, do not get the impression that breakeven or trailing stops should never be used. Moving your stop can be useful to protect profits when a trade is within a few pips of reaching its profit target. Consider the scenario where a trade is 150 pips in the money with only 40 pips left to the target. Is it really worth risking 150 pips to gain another 40? That is up to the trader's personal appetite for risk, I suppose. I personally prefer to set a trade and forget about it, allowing my trade plan to execute.

The issue with breakeven stops is usually the way a trader executes them versus how they should be executed. Many traders are simply too aggressive with breakeven or trailing stops and do not allow the market room to maneuver. Support and resistance can be used to improve the chances that a breakeven or trailing stop will not be taken out prematurely, but there is no guarantee. If you are comfortable with the additional volatility that breakeven and trailing stops bring to your account, pay close attention to the section in this chapter titled "Using Trailing Stops."

Scaling Out

Another popular but flawed profit management technique is known as *scaling out*. Traders scale out by closing a portion of their overall trade size as the trade becomes profitable and continues to their profit target. This technique allows traders to capture smaller profits faster while leaving the position open as the market moves farther in their favor. There are many different flavors for scaling out of a winning position. Some traders take 2/3 of their position early in order to use that profit as a cover for the risk on the remaining 1/3 of the position that is still open. Other traders use two profit targets, taking half of their position at the first profit target and the other half at the second profit target. Regardless of how scaling out is done, all traders who scale out of profitable positions share a common problem: an imbalance in risk versus reward. When a trader scales out, the amount of profit taken is rarely equal to the amount of risk assumed when the trade is opened.

Consider a trader who trades 10 currency lots at a time and a 40-pip stop loss. His total initial risk on the position is 400 pips. If the trader scales half of his position out with a 50-pip profit, he will have covered 250 pips of the initial 400 pips. The remaining position must be closed out at a profit greater than 50 pips to maintain a risk-to-reward ratio of 1:1. Traders usually exacerbate the problem by moving their stop loss to breakeven after scaling out with some profit. If their remaining position is closed out at breakeven, they have effectively risked 400 pips to gain 250. If their next trade is stopped out for the full 400 pips, they have a deficit of 150 pips to overcome on their next trade, assuming they are still trading 10 lots per trade. The imbalance in risk-to-reward requires a trader who scales out to maintain a much higher success ratio than traders who do not, because just one losing trade can erase the profits from multiple winners.

IDENTIFYING PROFIT TARGETS

Knowing when to take profit on a trade is often a subjective and frustrating process for many discretionary traders. Often a trade will be closed too early or open too long while a trader tries to squeeze every last pip out of it. Without a systemic, repeatable procedure to determine when to take profits, a trader will never feel truly comfortable with his decision to take profit, and volatility will continue to be an issue in his returns.

In this section you will learn two of my favorite tactics to identify profit targets. First, you will learn how to use support and resistance to identify simple profit targets based on price action. Second, you will learn an advanced method of identifying profit targets using Fibonacci retracement and extension ratios.

Identifying Profit Targets with Support and Resistance

Chapter 3 taught you how to read price using support and resistance. This section builds on that knowledge by using support and resistance to identify profit targets. Support and resistance levels are often revisited as the market oscillates higher or lower, making them ideal profit targets. The difficulty with using support and resistance barriers as profit targets is the process of selecting which support or resistance level to target. Traders have no idea which support or resistance levels will be respected by price and which will not be reached until the market actually tests them. Additionally, support and resistance levels can create severe market reactions so that the profit target may be reached, if only for very brief moment in time.

If you decide to use support and resistance to identify profit targets, I have a couple of recommendations. First, look to use the first major support or resistance barrier as the profit target. If the market is unable to break through that barrier, at least you'll be taken out with a profit before it reverses direction. Second, always look for a risk-to-reward ratio of 1:3 or greater, just as we would when using Fibonacci. Finally, take profit a few pips ahead of actually reaching the support- or resistance-based profit target. Price action tends to slow down as it approaches a major support or resistance zone, and occasionally the zone is never reached before the market reverses direction. Taking profit slightly ahead of the profit target ensures that your trade will be taken out for a profit if the market turns around early. Typically 10 to 20 pips before the profit target will give you enough room.

Figure 5.2 demonstrates how a trader who bought near the bottom of a ranging market could use the top of the range as a potential profit target. Placing her limit order just below the top of the range ensures that she is taken out with a profit in case the market fails to rally through the

FIGURE 5.2 Support and Resistance Profit Targets in a Ranging Market
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 5.3 Support and Resistance Profit Targets in a Trending Market
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

resistance level. In the case of Figure 5.2, the EUR/JPY easily rallied through resistance, but there was no guarantee that it would, and it's better to be safe than sorry you didn't take profit when you had the chance.

Figure 5.3 demonstrates how a trader may identify a support and resistance profit target within the context of a trend. In the case of an uptrend, the long trade may target the most recent price high. In the case of a downtrend, a short trade may target the most recent price low. Either way, you are looking for a trade opportunity where the potential profit is at least three times greater than the amount risked to maintain a good risk-to-reward ratio. If the market is unable to offer that, you might consider skipping the trade and looking for a better opportunity.

Figure 5.3 clearly illustrates the psychological game profit plays with a trader's mind. The USD/CAD continued to rally well beyond the intended profit target, leading some traders to begin scaling out, moving their stop to breakeven, or doing a magic pip dance to capture as much profit as they can out of every trade. Don't fall into this trap. You never know what will happen in the next minute, hour, day, or week in the currency market. Plan

a trade based on sound risk-to-reward ratios and stick to that plan. Don't let greed get in the way of taking a good profit today.

IDENTIFYING PROFIT TARGETS WITH FIBONACCI RATIOS

As a discretionary trader, using Fibonacci retracement ratios is my favorite technique for identifying profit targets. Many books discuss using Fibonacci as a trade entry technique, but I prefer to use them to identify profit targets. Fibonacci ratios provide a simple and consistent profit management technique that regularly provides sound risk-to-reward ratios.

Fibonacci refers to a mathematical sequencing of numbers known as a *Fibonacci sequence*. The formula was introduced to the European world in 1202 in a book titled *Liber Abaci*, written by Leonardo of Pisa. Leonardo went by the nickname Fibonacci. In his book Fibonacci used the rapid population growth of rabbits to explain the principles of the Fibonacci sequence. In the sequence the first two numbers are 0 and 1, and each subsequent number is the sum of the previous two. The sequence is calculated using recurrence relation, creating a sequence of numbers as follows:

0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, 610, 987...

I am a trader and not a mathematician, so I won't pretend to understand the formulas and theories behind the Fibonacci sequence. If you are truly interested, there are many good books written on the subject and how it relates to the financial markets. What I do know is that the Fibonacci sequence can be calculated as ratios and adapted to the financial markets. There are many ratios a trader could choose from to identify a profit target, but one in particular stands out among the crowd: 61.8 percent. This ratio is important because it equals a mathematical constant that can be found throughout nature and manmade environments that is known as the *golden ratio*. This ratio represents an irrational mathematical constant that can be found throughout geometry and calculates to 1.618 percent. The ratio is found naturally in the arts, architecture, nature, music, geology, and even the structure of the human body. Having read earlier chapters in this book, you know I'm a believer in supply- and demand-based influences related to price, but it is hard to deny the theory of Fibonacci's golden ratio of 61.8 percent. I don't believe in voodoo, but when it comes to pulling profit targets out of thin air in a systemic, mathematically based way, I'll take all the help I can get.

Fibonacci ratios come in two flavors: retracement ratios and extension ratios. Whether you use a retracement ratio or extension ratio to identify a profit target depends on the style of trade you are planning. When the market is ranging or you expect the market to move against the preceding price action, you should use retracement ratios to identify a profit target. When the market is trending, extension ratios allow you to project a profit target into the future to capture the most profit from a trend trade. In this section we review how to draw and use both retracement and extension ratios.

Using Fibonacci Retracement Ratios to Identify Profit Targets

Virtually any charting software will draw Fibonacci ratios for you. In this case we are interested in drawing Fibonacci retracement ratios. Retracement ratios are useful to identify profit targets when you believe the market will reverse direction. This can happen when a trend is coming to an end or when the market is stuck in a range. Fibonacci retracement ratios are drawn by connecting two price points. Usually an extreme low, known as a *swing low*, and an extreme high, known as a *swing high*, are connected using the Fibonacci ratio tool offered by your charting software. Fibonacci retracement ratios are automatically calculated between the swing high and swing low prices, once they have been selected.

Figure 5.4 demonstrates a swing low and swing high price with Fibonacci retracement ratios drawn. Fibonacci ratio tools will typically draw three standard retracement ratios, which are 38.2 percent, 50 percent, and 61.8 percent. You can change them or add other ratios if you prefer. For the purposes of this book we are only interested in the 61.8 percent retracement ratio for use as a profit target. Traders are traditionally taught to draw Fibonacci retracement ratios by connecting a swing low and a swing high, as shown in Figure 5.4. However, I'm not interested in how everybody else uses Fibonacci.

When I draw Fibonacci retracement ratios, I connect a swing high or low to the entry price of my trade. This technique allows me to identify a profit target based on my entry point and not necessarily the swing high and low. In many cases it also increases the distance between my entry point and the 61.8 percent retracement ratio because I've shaved a few pips off the top or bottom of the Fibonacci grid. Fibonacci purists will suffer a heart attack over what I just said, but remember, I'm not trying to be academic. I use Fibonacci simply to identify potential profit targets.

Figure 5.5 illustrates how a trader can use Fibonacci to establish a profit target when selling the USD/CAD. Figure 5.5 is the same chart as

FIGURE 5.4 Traditional Fibonacci Retracement Ratios
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Figure 5.4, but the Fibonacci ratios have been adjusted to reflect the entry point of a resistance-based trade versus the traditional price high.

One subtle but important advantage gained by using Fibonacci retracement ratios as profit targets is grounded in supply-and-demand theory. Since Fibonacci retracement ratios are created inside a swing high and swing low, you know the market is able to potentially reach your profit targets because it has traded at those price points in the recent past. You are not asking the market to go outside a range it hasn't already been able to trade at for you to make a profit on the trade. Additionally, by using the 61.8 percent retracement ratio, you are not asking the market to retrace the entire length of the range between the swing high and the swing low price. From a supply and demand perspective, Fibonacci retracement ratios make a lot of sense to use as profit targets.

Unfortunately Fibonacci retracement ratios are limited to predicting profit targets within the range of a swing high and swing low price. When the market is trending and making new highs or lows, retracement ratios lose their effectiveness as tools to identify profit targets. In the next

FIGURE 5.5 Using Fibonacci Retracement Ratios to Identify Profit Targets
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

section you will learn how to use Fibonacci extension ratios to identify profit targets during a trending market.

Identifying Profit Targets with Fibonacci Extension Ratios

When a trending market is expected to continue making a new high or new low price, Fibonacci extension ratios are a powerful tool to identify profit targets. Using extension ratios, traders are able to project where a trending market may be headed and establish a profit target at a price at which the market hasn't traded yet. Fibonacci extension ratios are drawn using the same tool as retracement ratios in most charting software. Extension ratios project Fibonacci ratios beyond the high or low price used to calculate retracement ratios. As you might expect, extension ratios are correlated with retracement ratios that share the same percentages. Common Fibonacci extension ratios include 138.2 percent, 150 percent, and 161.8 percent, which correlate with their retracement counterparts,

38.2 percent, 50 percent, and 61.8 percent. Although these ratios are the most common, you may create custom ratios with most charting packages if you desire. In this section you learn how to use Fibonacci extension ratios to manage profit within the context of a trend.

Using Fibonacci Extension Ratios The advantage of Fibonacci extension ratios is their correlation to retracement ratios. During a trend, the market often retraces its steps after making a new high or new low. This retracement often stops along well-known retracement ratios such as 38.2 percent or 61.8 percent, as shown in Figure 5.6. During the USD/JPY downtrend, the market retraced its steps three times before making a new low all three times. When a trade entry using any method in this book happens to correspond with a Fibonacci retracement ratio, an opportunity exists to use extension ratios as a profit target. To identify the

FIGURE 5.6 Retracement Cycles in a Downtrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 5.7 Using Fibonacci Extensions to Identify Profit Targets
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

profit target, use the extension ratio that correlates with the retracement ratio at which you have entered a trade. This idea is demonstrated in Figure 5.7.

For example, assume that you have entered a trade along support after the market has retraced to a 61.8 percent retracement ratio. Assuming that the trend will continue higher, you can use the 161.8 percent extension ratio to identify a profit target for this trade. If the trade had been entered near the 32.8 percent or 50 percent retracement ratio, you should use the 132.8 percent and 150 percent extensions ratios for profit targets. Figure 5.7 demonstrates a GBP/JPY trend-based trade using Fibonacci extensions to identify a profit target.

Finally, Fibonacci is an easy tool to use and provides a systematic, repeatable process for identifying a potential profit target for each trade you plan. When a trader combines Fibonacci ratios with a risk-to-reward ratio of at least 1:3, he has a mechanical process with built-in positive expectancy. This profit management technique should produce a winning

result, provided that the trader's winning percentage is greater than 30 percent.

USING TRAILING STOPS

Earlier in this chapter we discussed how breakeven stops and scaling out can actually add volatility to your trading performance, but what about trailing stops? Many traders attempt to lock in profits as the market moves in their favor by trailing the market with their stop order. I rarely use trailing stops in my personal trading, but I do recognize the value they provide when they are used properly. When trailing stops are not used properly, you will end up adding volatility to your results, just as with a break even stop.

There are many techniques to managing a trailing stop. Traders often start moving their stop when the position has earned twice the amount risked. Another popular technique is to trail the market with a stop placed near the high or low price over the last three to five candles. Both of these techniques are effective for short-term results, but they follow arbitrary rules that are not in tune with the market. Traders using a trailing stop should take into consideration the relationship between supply and demand as drawn in support and resistance lines on the chart before moving a trailing stop. Using support and resistance analysis, a trader will know exactly when and exactly where she should move a trailing stop.

The key to using support and resistance with trailing stops is to wait for the market to establish a turn. The turn is marked by a pullback followed by a continuance in the original direction of the market. Depending on the timeframe you are trading, the turn may take one candle or several in the case of a daily chart, but waiting for the turn to complete is critical to successfully moving a trailing stop. Illustrated in Figure 5.8 by waiting for a turn to complete, the trader has placed his trailing stop in an area the market has already respected through the principles of support and resistance. The trader can have confidence knowing the market has tested that level and continued in his favor. By placing a trailing stop below the turn, you know it is in a position not likely to be visited by price unless the market conditions dramatically change. It should be noted that this technique is valid for use on any timeframe and with any currency pair.

There is one significant difference between using a trailing stop and using other profit management techniques such as Fibonacci ratios: There are no set profit targets. Although there is nothing stopping you from having a profit target in mind, generally speaking, using a trailing stop is about capturing the most profit you possibly can out of every trade taken. The

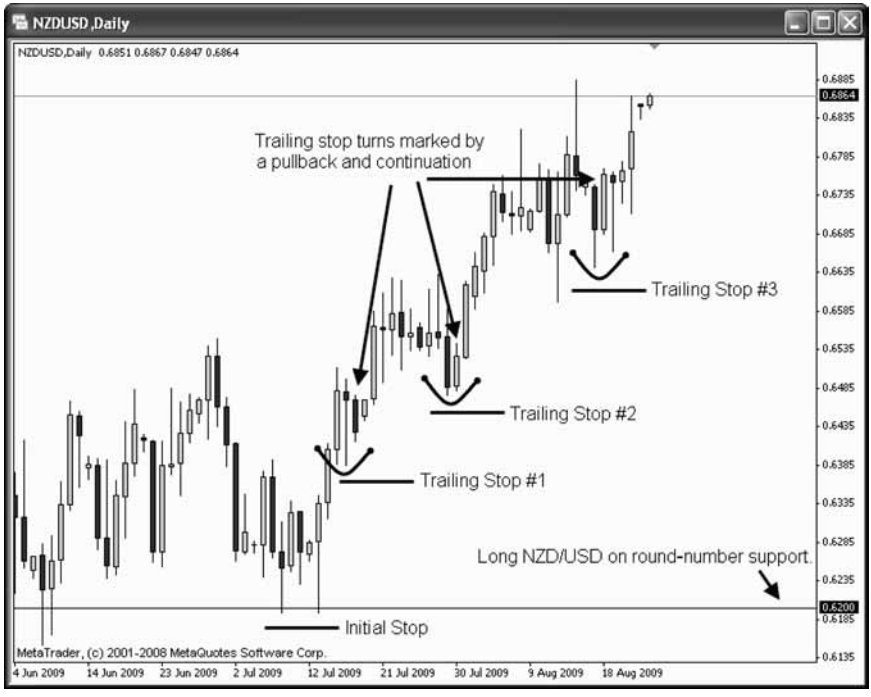

FIGURE 5.8 Using Support to Manage a Trailing Stop in an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

trailing stop itself is the only tool used to decide when the trade is over. When you follow the market using the turns described in this section, your trade should remain open until a dramatic change occurs, signaling the end of the trend you are following. Figure 5.8 demonstrates this principal clearly. Traders who were long USD/CAD and using a trailing stop were taken out at a profit after selling pressure near $1.17 overcame the bulls. The opposite occurred to the bears as demand appeared again near the $1.08 demand level. Using a trailing stop means you should always let the stop take you out of the market. This should keep you in the trend, following safely behind the turns for as long as possible.

AUTOMATING PROFIT WITH LIMIT ORDERS

Automating profit management through the use of limit orders is just as important as managing risk through the use of stop orders. It might seem

FIGURE 5.9 Using Turns to Manage a Trailing Stop
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

counterintuitive to actually limit the amount of money a trade can make, but as you'll see from the examples in this book, taking profit according to your plan is never a bad call to make. Unfortunately, many traders do not automate the process. Instead they allow their emotions to dictate when a trade should be closed. This is a poor practice to get into, because once a trade is opened there is money on the line and emotions may run higher than before the trade was opened. Greed often keeps a trader in a trade too long, while fear often compels a trader to close a trade too early. Automating risk management through the use of limit orders removes the decision-making process from the trader and shifts it to the dealer. This allows a trader to go about her business knowing that she has planned the trade properly and will be taken out with a profit or a loss automatically, according to her trading plan.

There are other reasons to automate the process of taking profit other than emotional reasons. The market is a 24-hour environment and you might not be available to close the trade when the market reaches your profit target. Often profit targets are reached during the London

trading session, when many traders in the United States are asleep. If you work a day job, it is unlikely that you have access to monitor the market from work, which makes automating the process even more critical. Finally, the market can be a fast-paced environment that can change dramatically in just a few minutes. Even though your profit target may be reached, the market might not remain there long enough for you to close the order if you are out and about. You could rely on mobile trading technology, but do you really want to carry the market around in your pocket?

Let's look at an example that occurred on August 19, 2009. In this example, the trader shorted the GBP/USD during the Asian session near the round number of $1.66. A limit order was placed near the profit target shown in Figure 5.10. Since the trader lived in the United States, he went to bed. Overnight the market sold off, hit the trader's profit target briefly, and then rallied again. If the trader had not automated his plan to take profit by using a limit order, he would not have gotten the chance to take his profit as planned, because he was asleep.

FIGURE 5.10 Automating Profit Management with Limit Orders
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CLOSING BELL

In this chapter you learned the concept and tactics of managing profit. Learning to manage profit is just as important as managing risk, which is why managing profit is one of the key principles of a bargain hunter. Without a plan to manage profit ahead of entering a trade, you are vulnerable to making a decision on a whim or emotion instead, which is rarely good for your account.

You also learned how common techniques such as moving your stop to breakeven or scaling out of a profitable position can actually hurt your trading performance over the long run. This chapter taught you three systematic techniques for identifying profit targets and managing profit. Fibonacci retracement ratios provide effective profit targets during a ranging market. Fibonacci extensions are effective profit targets in a trending market. You also learned how to use support and resistance to identify profit targets. Finally, you learned a support- and resistance-based approach to using trailing stops that will keep you in a trade based on market conditions rather than arbitrary decisions.

Whatever method you choose to manage profit, it is important to look for trades with a risk-to-reward ratio greater than 1:3 and stick to the plan as much as possible. This will allow you to statistically lose up to 70 percent of the trades you take and still earn a profit. That is a worst-case scenario; ideally your success ratio will be greater than 50 percent as you gain experience trading. If you have trouble taking profits at the right time, make it automatic by using limit orders. At the end of the day, all that matters is that you've made money, and learning to manage profit is a critical step to getting there.

CHAPTER 6

Bargain Hunting Along the Edge

This chapter contains the first of three trading methodologies that will put the support and resistance tactics you learned in Chapter 3 to good use. In this chapter you will learn a trading methodology I affectionately refer to as the *Sitcom System* because it allowed me to trade on my own schedule, often while I watched a favorite television sitcom. The system combines what you have learned about support and resistance with simple price action analysis. The Sitcom System focuses on daily charts, and for the purposes of this discussion I define the end of the trading day as 5:00 P.M. Eastern Time. This ensures that both the London and New York trading days have closed before we begin to plan a trade, allowing us to see the full range or price action for that trading day.

After each trading day there are two distinct boundaries formed by support and resistance. The daily high is a boundary that buyers could not overcome; the daily low is a boundary that sellers could not overcome. The extreme edges of price action for a trading day mark the front lines in the battle between buyers and sellers. Traders can use these clearly identified support and resistance zones to their advantage with the help of simple price action analysis.

To trade the Sitcom System, you need a trend, a bargain day, a support or resistance zone, and a profit target. If you're one of those traders who believes that a daily chart requires 100 pip stops, you're about to learn a much better way to trade long-term charts.

DETERMINING TRENDS

Every trading day has a high and a low edge that you could potentially trade along, but it isn't efficient to do so. To increase your chances of selecting a successful trade, the Sitcom System begins by determining a directional trend bias through the use of a simple moving average indicator. The rules for determining a trend are simple: When the market is trading above a 13-period smoothed moving average, the trend bias is to buy the currency pair. When the market is trading below a 13-period smoothed moving average, the trend bias is to sell the currency pair. I selected a 13-period smoothed moving average because it responds to changes in price action efficiently, and 13 is a number in the Fibonacci sequence. As I've said before, I don't believe in voodoo, but I'll take all the help I can get. I suppose if you are really superstitious, you could use 12 or 14 instead.

The period you select for your moving average is flexible. If you prefer to use a 20- or 50-period simple moving average to determine a trend, that is fine. The goal is to keep your trend analysis simple and focused on where the market is currently trading rather than a lengthy trend analysis that might not be in tune with price action over the next few days. Determining trends in this manner is not an exact science; it's simply a quick and easy way to determine a bias to buy or sell based on where the market is currently trading.

Figure 6.1 depicts a bias for both long and short trades determined for the AUD/USD daily chart. In this example, the bias should be for long trades; however, a short bias existed for a brief period of time while the market traded below the moving average.

You can enhance the definition of a trend by drawing trend lines to supplement the moving average. In Figure 6.1 the brief spike below the moving average could have been ignored if the trader was sure he was on the positive side of an uptrend. In other words, a trend line can act as a filter on the trend bias created by the moving average, if you prefer. Trend lines are discussed in Chapter 3.

IDENTIFYING A BARGAIN DAY

After determining a trend bias the next step is to identify a bargain day. Chapter 3 introduced you to the concept of finding bargain days, and the Sitcom System uses them to locate days that potentially offer the best deal on a trade. Traders often jump into trends at a price that doesn't represent the best possible value for their trade. This is usually referred to as

FIGURE 6.1 Determining a Trend with a Moving Average
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chasing a breakout or *entering at the top of a rally or selloff*. Bargain days represent an opportunity to join an existing trend at a much cheaper price. Often these days are referred to as *pullback days* and are formed when the market moves against the prevailing trend. The Sitcom System defines a bargain day as any day that has closed against the prevailing trend.

Figure 6.2 points out several potential bargain days during a downtrend on the GBP/USD daily chart. Figure 6.3 illustrates a series of bargain days that occurred during a EUR/USD uptrend in May 2009.

Clearly, bargain days do not guarantee that the trend will continue. In many cases the pullback continues for two or three days before the trend continues. You must be judicious in selecting which bargain days you choose as trading opportunities. Some helpful guidelines are:

- Select bargain days that pull back closer to the moving average.
- Look for corresponding support or resistance that may stop the pullback.
- Wait for a "double bargain" day, when the market has pulled back two days in a row, before entering.
- Look for a 00 price slightly above the high or low of a bargain day.

FIGURE 6.2 Bargain Days in a Downtrend
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FIGURE 6.3 Bargain Days in an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

These are general guidelines to help you gauge the validity of a bargain day before you enter a trade. Your ability to select the best bargain days for a Sitcom System trade will come with experience. The more time you spend with a specific currency pair, the more familiar you will become with its nuances.

LOCATING A SUPPORT AND RESISTANCE ZONE

After you determine a trend and wait for a bargain day, the Sitcom System enters a trade along a support or resistance zone created by the daily high or daily low price from the bargain day. Support and resistance zones are discussed in Chapter 3, if you need a refresher. In the case of the Sitcom System, we are going to use the extreme edge of price as a predetermined zone to enter our trades using entry orders. This allows you to plan a trade on your schedule and let the entry order do the work for you while you watch television or visit your favorite web site, www.ryanokeefe.com. (I know that was a cheap plug, but I couldn't help it!)

To determine the support and resistance zone, you will mark the high and low price with a horizontal line and mark the high or low of the "turn" candle, as shown in Figure 6.4. The "turn" candle is the candle immediately

FIGURE 6.4 Location Support or Resistance Zones at the Daily High and Low MetaTrader, © 2001–2008 MetaQuotes Software Corp.

preceding the candle that breaks out of a support or resistance zone. It represents the last full candle before that support or resistance level gave up and the market turned the other way; therefore, it is significant for marking a support or resistance zone.

Using Figure 6.4 as an example, if our bias was to buy the USD/CAD, we would be interested in placing an entry order near the top of the buy zone. Conversely, if our bias was to sell the USD/CAD, our entry orders to sell would be placed at the bottom of the sell zone. Figure 6.4 uses a USD/CAD hourly chart, but you can use a 15-minute chart if you prefer a more granular view of supply and demand lines near the daily high or low price. The lower the timeframe, the more precise you can be with entry orders. If the high or low of a bargain day doesn't represent the best support or resistance level in your judgment, use the high or low over the last few trading days as an alternate.

MANAGING RISK

Every system should have a strategy for managing risk; fortunately the Sitcom System makes the process easy. Managing risk is done by placing a stop order below the buy zone or above the sell zone. Typically you'll want to give your trade a few extra pips in case the market tests the support or resistance zone with some strength; usually 10 to 15 pips will give your trade enough room. Figure 6.5 builds on the example of Figure 6.4 by demonstrating where stop orders should be placed for each buy and sell zone. Figure 6.5 illustrates with dashed lines where protective stop orders should be placed.

MANAGING PROFIT

Managing profit with the Sitcom System is just as simple as managing risk. In this case, we are going to use the high or low price of the trend to determine the profit target for the trade. Bargain days occur by pulling away from the ultimate high or low price set by a trend. They represent a significant pause in the trend, long enough to encourage more traders to rejoin it. Targeting the high or low price of the prevailing trend ensures that the market is capable of trading at the profit target. Anything beyond the high or low mark of the trend is new territory and offers no assurance that the market can trade at that level.

There is only one qualifying factor for the high or low price within a trend before it can be used as a profit target: It must offer a profit at least

FIGURE 6.5 Setting Stop Orders for Buy and Sell Zones
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three times larger than the risk required by the stop loss. If a profit target doesn't create at least a 1:3 risk-to-reward ratio, *the trade should not be taken*. This requirement will keep you from taking a trade on a bargain day that doesn't reflect the absolute best value for the available profit. The higher the ratio between risk and reward, the better your trading performance should be. Figure 6.6 illustrates an example profit target using the trend high following a bargain day. In this USD/JPY example, the market formed a bargain day along support and our basic "trend-marking" moving average. The bias to go long offered a nice trading opportunity, risking 50 pips to gain at least 240 pips. The risk-to-reward on this trade was nearly 1:5!

What about Fibonacci?

Since this is a trend-based trade, you might wonder why Fibonacci extension ratios are not being used. Fibonacci extensions are valid only when the market has pulled back to a correlating Fibonacci retracement ratio. The Sitcom System often takes trades along support and resistance that doesn't correlate with a Fibonacci retracement ratio, which is the reason

FIGURE 6.6 Setting Profit Targets Using the Trend High
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I suggest using support and resistance profit targets instead. If you happen to locate a Sitcom System bargain day that is resting on a Fibonacci retracement ratio, you are free to use Fibonacci extension ratios with this system.

EXAMPLE TRADES

In this section we review four example trades using the Sitcom System. These examples should solidify your understanding of how to apply the rules of this system to live market conditions. To review, the process for creating and managing a sitcom trade along the edge of price action are:

- Determine the trend using a 13-period smoothed moving average on a daily chart.
  - When price is trading above the moving average, the bias is to buy.
  - When price is trading below the moving average, the bias is to sell.

- Identify a bargain day.
- Locate a support or resistance zone on which to enter the trade.
- Place a protective stop just beyond the support or resistance zone.
- Place a limit order at the trend high or low to take a profit.

USD/CAD Long Example Trade

On June 18, 2009, the USD/CAD currency pair was trading above the trend-defining moving average after snapping out of a long downtrend on the daily chart. Figure 6.7 illustrates USD/CAD and the bias to buy the pair based on its new position above the moving average. At the close of trading on June 17, 2009, USD/CAD closed lower and was near the moving average. This signaled a potential bargain day for the Sitcom System.

With the trend and bargain day identified, the next step is to locate a support zone along the daily low to enter the trade. In this example the best support zone is located a couple of days earlier than the actual bargain day low. Figure 6.8 illustrates the support zone drawn using a USD/CAD one-hour chart. Notice that the support zone is between $1.1270 and $1.1220. Precise bargain hunters who are interested in getting the absolute best deal

FIGURE 6.7 USD/CAD Bargain Day in an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 6.8 USD/CAD Support Zone at the Daily Low
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can use 00 and 50 numbers for their entry orders, which take advantage of market psychology, as we discussed in Chapter 3. Looking at the chart in Figure 6.8, placing an order at $1.1250 to buy USD/CAD would be a great strategy.

Risk and profit targets are also illustrated in Figure 6.8. In this example, risk was limited to no more than 50 pips, although an order at $1.1250 could have lowered the risk to 35 pips. The potential profit target offered a gain of 160 pips. This trade offered a worse-case risk-to-reward ratio of 1:3, which is an acceptable trade to take using the Sitcom System risk management rules. Five days later, the USD/CAD continued to rally, reaching the profit target set for this trade, as shown in Figure 6.9. In this case the trade had to be maintained over a weekend, which some traders might be uncomfortable with, but that's life as a long-term trader.

USD/JPY Short Example Trade

The next example occurred on May 18, 2009. The dollar was losing value against the yen for several days, as shown in Figure 6.10. USD/JPY was trading well below the trend-defining moving average, giving Sitcom traders

FIGURE 6.9 USD/CAD Sitcom System Trade Reaches Profit Target
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FIGURE 6.10 USD/JPY Bargain Day in a Downtrend
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a strong bias to sell USD/JPY when a bargain day opportunity appeared. After the weekend, USD/JPY rallied to create an attractive bargain day on May 18, 2009. This was a signal to Sitcom traders that a resistance trade might be available.

With a bias to sell and a bargain day identified, the next step in trading the Sitcom System is to locate a resistance zone along which to sell USD/JPY. In this example, the daily high price set by the bargain day was near $96.50. This price should be interesting to bargain hunters because it qualifies as a 00 or 50 price, which often provides a good support or resistance level for price. Figure 6.11 illustrates how a trader could set up a USD/JPY short trade using entry and stop orders on the one-hour chart. Using the high of the bargain day, clear resistance from the previous trading week on May 12, 2009, and the round number $97.00, a resistance zone is identified.

Using the trend low for a profit target, the trade offers a risk-to-reward ratio of almost 1:4. Two days later, the USD/JPY completes a quick selloff and reaches the profit target. Figure 6.12 illustrates the final result of this trade. Aggressive traders could have added to their position after the first day printed a bearish candle. The fact that $97.00 and the resistance zone

FIGURE 6.11 USD/JPY Bargain Day Resistance Zone
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 6.12 USD/JPY Sitcom Trade Reaches Profit Target
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

had been respected with a lower close on the daily chart was an excellent signal that the market was headed lower.

AUD/JPY Long Example Trade

The next example trade occurred on May 21, 2009, trading the AUD/JPY currency pair. In this example the Australian dollar had established a strong uptrend and was trading above the moving average. Figure 6.13 illustrates the AUD/USD closing lower but above the moving average after trading ended on May 20, 2009. The lower price action created a bargain day and offered traders an opportunity to buy AUD/USD in accordance with the Sitcom System trading rules. Notice the horizontal line marking a minor support level on the daily chart in Figure 6.13. This support, combined with the round number of $73.00, makes the bargain day opportunity even more attractive. Round numbers often provide psychological barriers for price, especially when they are combined with demonstrated support or resistance.

Using the low price of the bargain day and a recent support level near the round number $73.00, a support zone can be identified, as illustrated in Figure 6.14. Round numbers are excellent areas in which to look for

FIGURE 6.13 AUD/USD Bargain Day during an Uptrend
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 6.14 AUD/JPY Support Zone
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

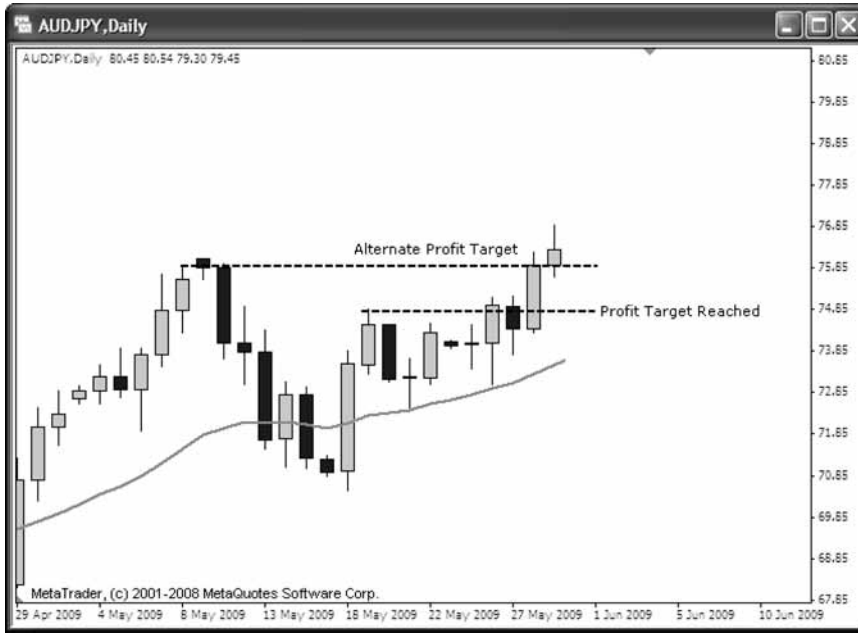

FIGURE 6.15 AUD/JPY Profit Targets Are Reached
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support and resistance to hold in the context of a trend as bargain-minded traders try to rejoin the trend and traders already in the trend are taking profit near the round-number levels with trailing stops. The profit target is set at the high price prior to the bargain day. Alternatively, this trade could have used the daily chart trend high, as shown in Figure 6.15, for a longer-term profit target. Either way, both profit targets were reached after only a few trading days. The risk-to-reward ratio on the shorter-term profit target equaled 1:3.

AUD/USD Short Example Trade

No trading strategy is immune to losses; the Sitcom System is no exception. The final example trade occurred on November 23, 2008, trading AUD/USD. In this example, the Australian dollar had been losing value against the U.S. dollar for several weeks in an established downtrend. Figure 6.16 illustrates a potential bargain-day opportunity to sell AUD/USD when trading ended on November 21, 2008. Using the hourly chart, a clear resistance level was established by the high price of trading on November 20, 2008,

FIGURE 6.16 AUD/USD Bargain Day during a Downtrend
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near the round number $0.6400, at $0.6415, as shown in Figure 6.17. The stop loss was set at about 60 pips above the top of the resistance zone. The profit target was set at the trend low of $0.6080. Overall this trade risked 60 pips to gain 480 pips, which is a risk-to-reward ratio of 1:8! Unfortunately the market rallied further and this trade was stopped out for a loss, as shown in Figure 6.18.

This trade does offer a lesson about selecting the right bargain day for a trade. In this example, the bargain day rallied out of a support zone created a few weeks earlier. The supply zone is drawn on Figure 6.18. Remember to survey support and resistance to ensure that the market will actually have somewhere to go before you enter a trade. The trend high or low is an excellent target, but if the market is already moving away from a major high or low, it is unlikely that the trend will continue. Pay attention to the daily chart and understand where support and resistance zones are in longer timeframes. Discretion is required to trade support and resistance properly, and good judgment will come with time.

FIGURE 6.17 AUD/USD Resistance Zone Entry and Profit Target
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FIGURE 6.18 AUD/USD Sitcom System Trade Stopped Out
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CLOSING BELL

This chapter introduced you to the Sitcom System, a trading methodology that takes advantage of trend and support or resistance levels using the daily chart. The Sitcom System is one of three support and resistance methodologies you'll learn in this book that use the concept of a bargain day to locate trades at the best possible price. All my trading methodologies that use the bargain-day concept start with an indicator as a cheap, easy way to identify potential support and resistance trades. In this case, we use a smoothed, 13-period moving average to define a trend.

When the market is trending higher, traders should look for an opportunity to buy after a bargain day. When the market is trending lower, traders should look for an opportunity to sell after bargain days. Hopefully the example trades in this chapter have given you some insight into identifying a good deal within a trend and placing orders to take advantage of them. Selecting the right bargain day is a matter of experience and discretion. Bargain days that correspond with logical support and resistance or round numbers should be given precedence. If the daily high or daily low of a bargain day doesn't offer a logical support or resistance zone to enter a trade, look back over the past few trading days and see what you can find. You can sum up this strategy in one saying: Buy the dips in an uptrend and sell the rallies in a downtrend.

If only it were that simple.

CHAPTER 7

Bargain Hunting with Price Action

Chapter 6 introduced you to bargain hunting along the edge of price by using the daily high or low as an entry point within a trend defined by a moving average. This strategy works well when the high or low entry zone is near the moving average, but it often breaks down as the market begins to swing from one trend into another. In this chapter you will learn a bargain-hunting method that takes advantage of short-term price swings, regardless of trend. This methodology builds on what you already know about identifying bargain days and introduces an approach to trading them that is more responsive to the most recent price action.

This chapter introduces you to an indicator called a *Hull moving average*. You'll learn to use this indicator as a guide to identify bargain days based on price action. You'll learn how to manage risk and identify profit targets using this strategy. Finally, we will walk through several example trades to solidify your understanding.

I have taught this strategy to traders around the world and I still trade it myself whenever I see a good bargain opportunity. If I had to pick, bargain hunting with price action and a Hull moving average is probably my favorite method to trade the spot currency market.

IDENTIFYING A BARGAIN DAY WITH PRICE ACTION

Identifying a bargain day using price action is slightly different than was defined in Chapter 6. This methodology is more aggressive and attempts

to find a bargain regardless of the primary trend. In this section you will learn how to identify a bargain day using price action and a trend indicator called a *Hull moving average*, or HMA. The HMA is a trend indicator, but we do not use it to define a trend as we did in Chapter 6 with a moving average. Instead, the HMA is used to visually determine the direction of price and alert us to any trading days that have moved significantly against that direction. The days that move against the primary direction of price as defined by the HMA are considered *countertrend days*. Countertrend days are by definition bargain days because they offer bargain hunters a chance to buy into the dominant direction of price at a much better price.

What Is a Hull Moving Average?

The Hull moving average, or HMA, was created by Alan Hull, author of *Active Investing* (Wrightbooks, 2004). The HMA is an accelerated moving average that attempts to solve the issue of lag in normal moving average indicators. The HMA is actually several weighted moving averages calculated with the square root of whatever period you set the HMA to. The result is a moving average that responds much faster to price and gives bargain hunters an excellent visual indicator of when the market is on sale in the midst of price action.

If you're interested in the calculations used by the HMA, you can read Hull's explanation of the indicator by visiting www.justdata.com.au/Journals/AlanHull/hull_ma.htm. Hull's web site includes formulas to create an HMA in MetaStock and SuperCharts; additionally there are HMAs available at the MetaQuotes Language Community web site at www.mql4.com. If you want the HMA I use for MetaTrader, visit my web site at www.ryanokeefe.com.

Configuring a Hull Moving Average To begin, you need to configure an HMA on the currency chart you intend to trade. You should place the HMA over a daily or weekly chart and set the indicator to a period of 12, 16, or 20. The period you choose has to do with the number of trades you are willing to take. The lower the period you choose, the more trades you will be presented with. Of course, the more trades you take, the more exposed you are to taking a loss, so a balance must be struck. I prefer to set my HMA to a period of 16. Some HMA indicators allow you to configure the price the HMA should use for its calculation. I prefer to set my HMA to use the open price of each daily candle versus the close price. This keeps the HMA static throughout the trading day because the open price doesn't change, whereas the close price does change until the end of the trading day. If you

FIGURE 7.1 Configuring a Hull Moving Average
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don't mind the HMA jumping around on you, then it doesn't matter. When you are finished you should have a line on the chart that looks very similar to Figure 7.1.

Simulating a Hull Moving Average If you are unable to use MetaTrader or can't locate an HMA for your chart software, you can come very close to an HMA by using a weighted moving average. The HMA is built on several weighted moving averages, and the square root of the period entered for the HMA, so a faster weighted moving average can closely simulate an HMA. You will not receive the same smoothing that an HMA is able to attain, but that isn't important for the purposes of identifying a bargain day with the indicator. Try using a standard weighted moving average set to calculate from the open price using a period of 5.

Figure 7.2 illustrates the differences between an HMA set to a period of 16 and a WMA set to a period of 5. You'll notice that the differences are slight; both indicators follow price quickly, which is all you need to identify a bargain day.

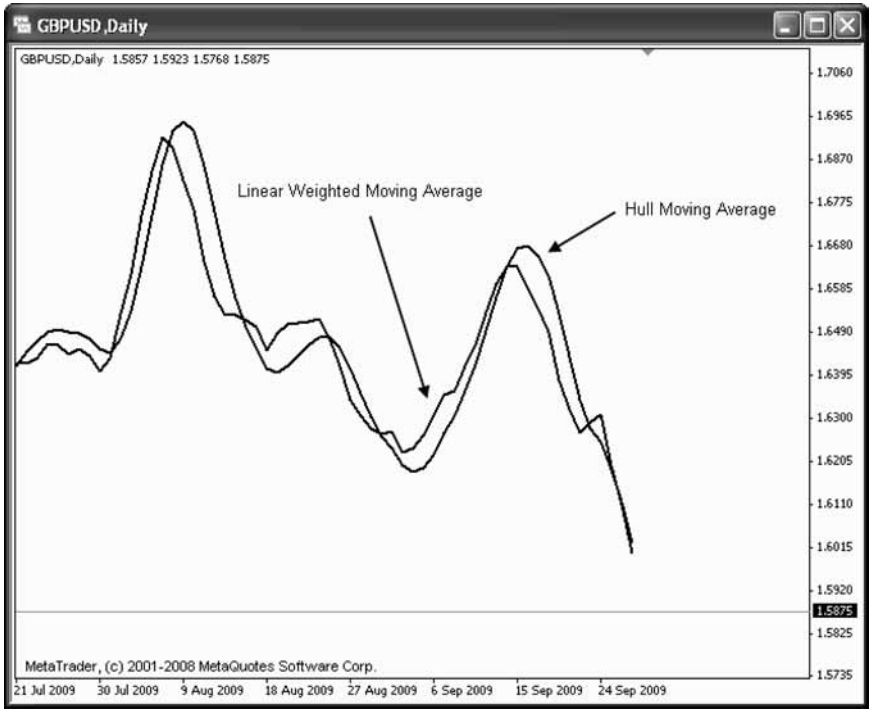

FIGURE 7.2 Comparing a Hull Moving Average to a Weighted Moving Average MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Defining a Bargain Day

When you have decided on using either an HMA or a WMA, defining a bargain day begins on either a daily or a weekly chart, depending on the timeframe you prefer to trade. The examples in this chapter are done using an HMA, so from this point on I will only make references to using an HMA for clarity. Bargain days are defined as any daily or weekly candle that has closed against the direction of recent price action as depicted by the indicator and has closed beyond the indicator itself. For example, when the market is trending higher, any daily or weekly candle that closes below the HMA is a potential bargain day. Conversely, when the market is trending lower, any daily or weekly candle that closes above the HMA is considered a potential bargain day.

Figure 7.3 demonstrates two trading days that qualify as bargain days using an HMA and price action. In Figure 7.3, both example bargain days are represented by a day that closed above the HMA during a USD/CAD downtrend. These bargain days offer bargain hunters an

FIGURE 7.3 USD/CAD Bargain Days
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

excellent opportunity to potentially join an established move in price at a discount.

Figure 7.4 demonstrates several bargain-day opportunities to buy and sell the AUD/USD currency pair. The first bargain day occurs while the market is trending higher and temporarily sells off to close below the HMA. The second bargain day occurs later in the uptrend but likely would have produced a losing trade. AUD/USD then reverses trend and offers a bargain-day opportunity to sell near the recent high by closing above the HMA. This bargain day is followed by another that would have resulted in a loss because the market was changing trend direction again. The final bargain-day opportunity to buy AUD/USD occurred when the market closed below the HMA on its way higher to challenge the most recent high.

Figure 7.4 illustrates why identifying a bargain day is not an adequate reason to take a trade. Identifying a bargain day simply puts you in the ballpark to find a potential trade. You must do some more investigative work to decide whether the trade is truly an opportunity. Support and resistance are always the determining factors in deciding whether to trade a bargain

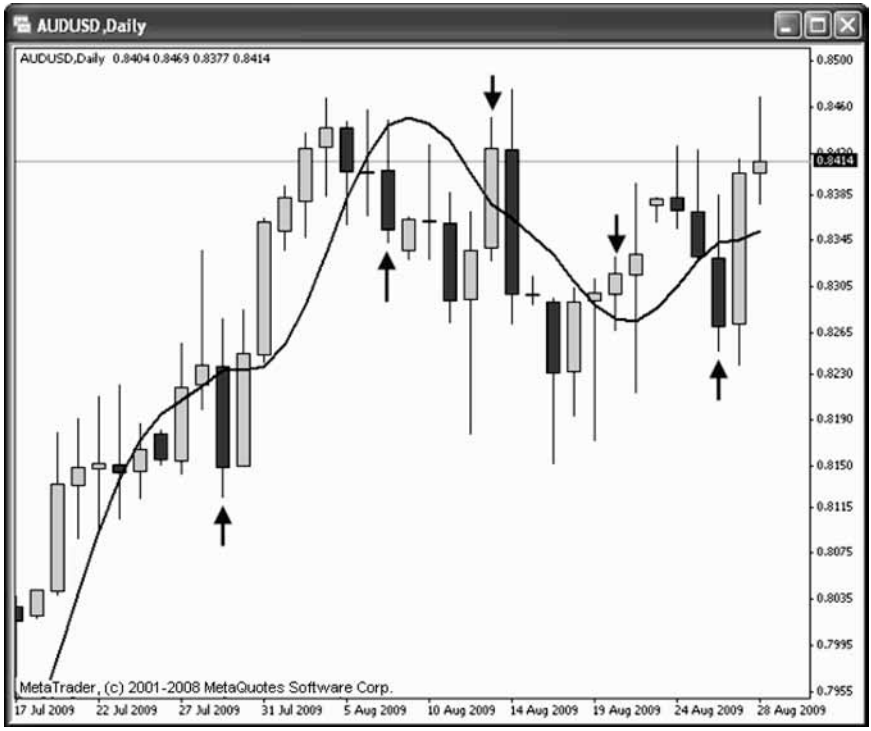

FIGURE 7.4 AUD/USD Bargain-Day Opportunities
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day. Figure 7.4 clearly shows that some bargain days are actually a change in trend.

Using Support and Resistance with Bargain Days The best bargain days correspond with an obvious level of support or resistance. Figure 7.5 demonstrates how support and resistance analysis can be used to select the best bargain day out of many choices. In Figure 7.5, the first bargain day was not an ideal bargain day to trade. Although it had closed above the HMA during a downtrend, it has not tested the major support level that was broken earlier by the downtrend. Understanding that support often becomes resistance when it is broken, an astute trader should have waited for the second bargain day before selling USD/CHF.

The second bargain day had tested the former support level and failed to close above it, making it a much higher probability that the downtrend would continue. The same scenario is seen with bargain days three and four. The third bargain day failed to test any major resistance levels;

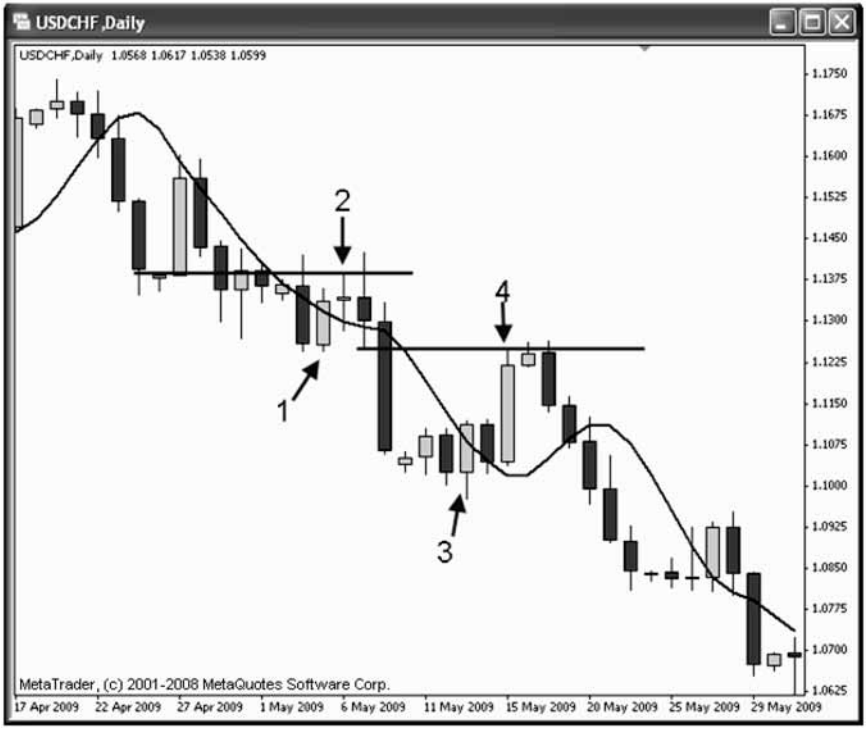

FIGURE 7.5 Using Support and Resistance to Choose Bargain Days
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the fourth bargain day tested former support that was now expected to become resistance. You should always consider the support and resistance landscape surrounding a bargain day before entering a trade to separate the good bargain days from the bad ones.

Where Are the Round Numbers? Finally, the proximity to round numbers could help determine a good bargain day from a bad one. Chapter 3 taught you the significance of round numbers, which we put to use in this section. When a bargain day's high or low price stops just shy of a round number, it is usually a higher-probability opportunity. Round numbers are often tested in the opening hours of the London or New York trading session, making them excellent places for a bargain hunter to join the existing trend after a bargain day has appeared. Figure 7.6 demonstrates a USD/CAD bargain day that stopped just short of $1.1000. This price is a significant round number because it is a 000 round number instead of a more common 00 round number. Placing an entry order to sell just above

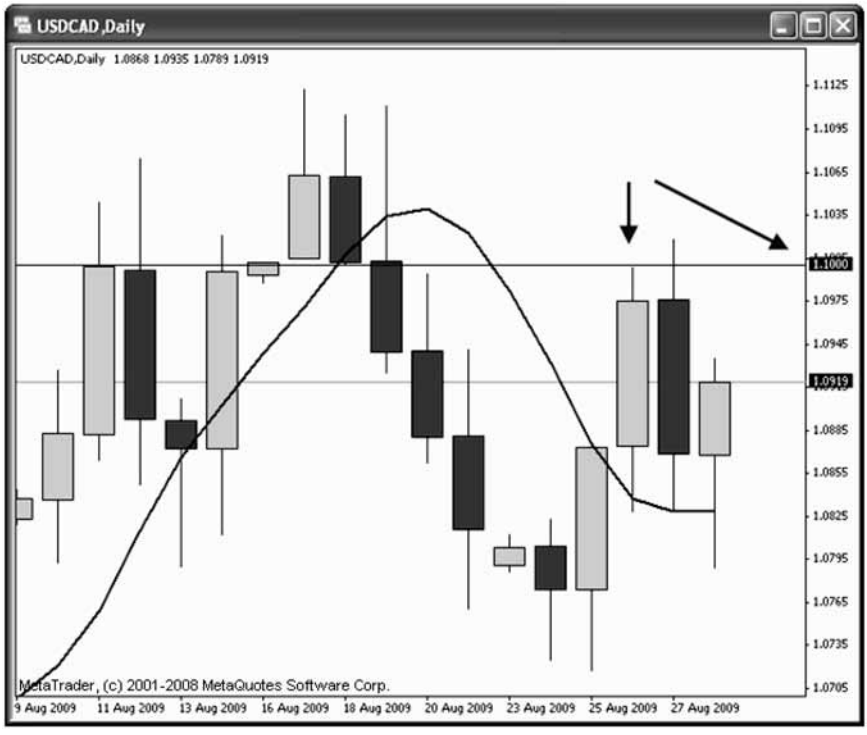

FIGURE 7.6 Spotting Bargain Days with Round Numbers
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$1.1000 would have been an excellent strategy for bargain hunters. In my experience, the ideal place to set an entry order would be $1.010 because the market rarely goes past 30 pips in testing a round number. It is not a perfect science, but it is something to watch for in relation to a bargain-day trade.

MANAGING RISK

Managing risk when you are bargain hunting with price action is no different than a traditional support and resistance trade. Your stop order should be placed beyond the support or resistance zone you have decided to use as an entry point for your trade. This ensures that your stop is placed in a position at which the market hasn't been able to trade and if it did the trade would be invalid. Chapter 3 taught you to identify support and resistance

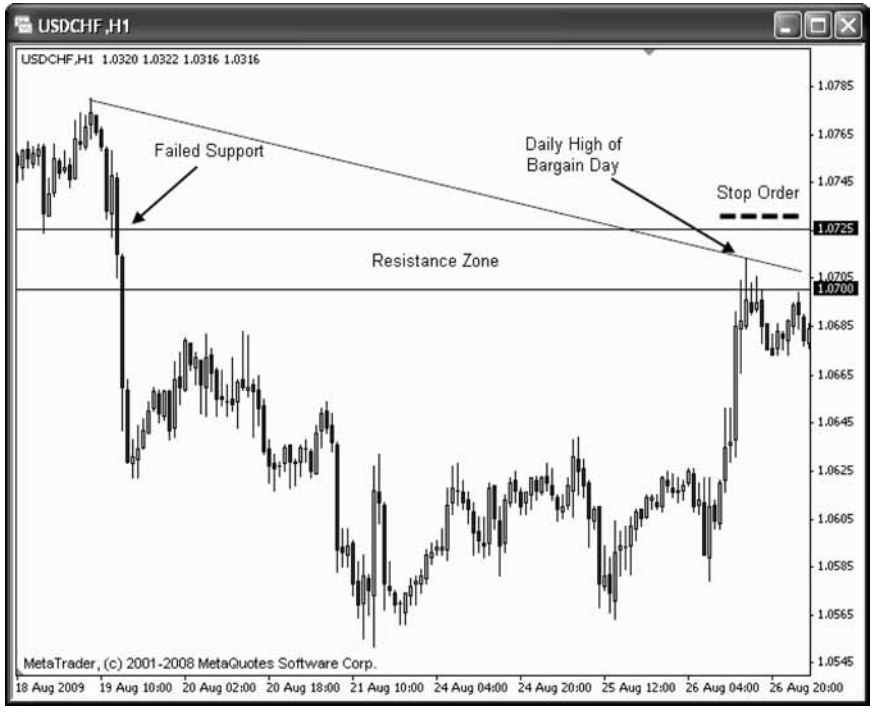

FIGURE 7.7 Placing Bargain-Day Stop Orders
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zones along the daily high and low, round numbers, and strong rejections, so it is time to put that knowledge to use. Once you have identified a bargain day, decide on a support or resistance zone at which to enter and place your stop order beyond that zone.

Figure 7.7 demonstrates an example bargain-day trade using a 60-minute USD/CHF chart. In this example the bargain day was identified using the daily chart on August 26, 2009. The lower timeframe is used to inspect support and resistance granularly and identify precise locations for the entry and stop order. This example sells USD/CHF following a bargain day along the round number $1.0700 with a protective stop just above failed support from a previous trading day.

MANAGING PROFIT

There are three options available to bargain hunters to manage profit with bargain days based on price action. First, if you believe the trend is strong

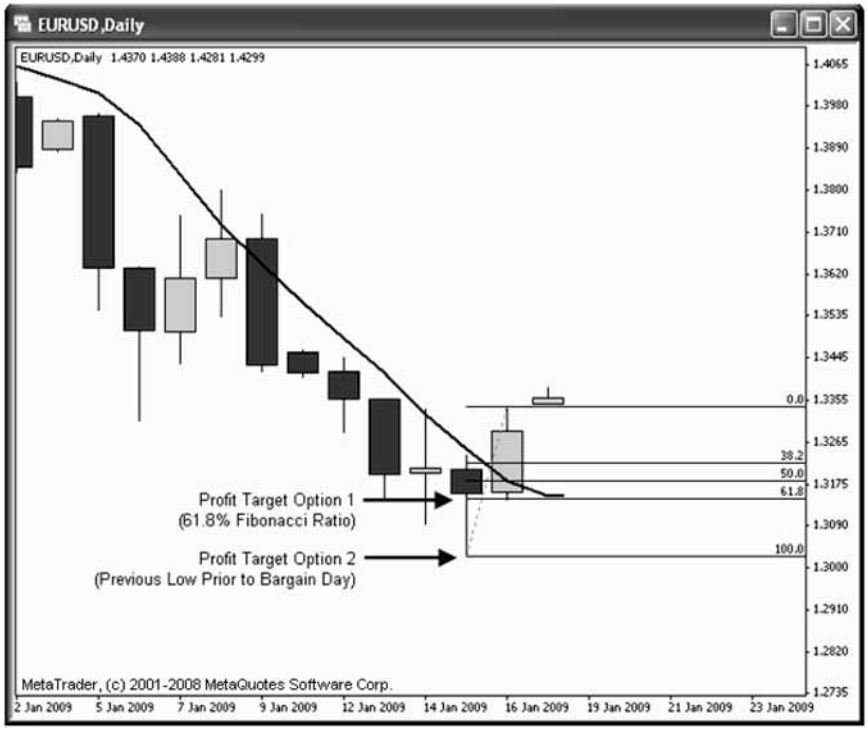

FIGURE 7.8 Establishing Profit Targets for Bargain-Day Trades
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and will continue beyond the low or high set prior to the bargain day, you can simply let the trade run and manage it with a trailing stop. The proper technique for moving a trailing stop is explained in Chapter 5. Second, if you can, use the high or low price set immediately prior to the bargain day as a profit target. Third, you can measure Fibonacci retracement ratios using the low or high set immediately prior to the bargain day to the entry point of your trade. Traders who use Fibonacci should target the 61.8 percent ratio as their profit target. Figure 7.8 illustrates how to establish profit targets using the swing low price and Fibonacci.

EXAMPLE TRADES

This section reviews four example trades located by bargain hunting with price action and an HMA. This method works well in trending markets, but

it can struggle during a ranging market. Additionally, the HMA, like any indicator, is prone to lag behind the market when the trend is changing rapidly. You must be aware of the support and resistance levels surrounding the bargain day you're interested in trading and do your best not to get caught by a trend change. The key steps to bargain hunting with price action are:

- Identify a bargain day using an HMA or WMA and price action.
- Identify a support and resistance zone at which to enter the trade.
- Identify a profit target.
- Place your stop and entry orders.
- Allow the trade to run.

Bargain hunting with price action is a little like firefighting: You're running in when everybody else is running out. Selling when everybody is buying or buying when everybody else is selling takes some time to get used to. When it is done correctly, you should have the immediate trend at your back, but there is always a stop order to protect you when you get it wrong.

NZD/USD Example Trade

The first example trade occurred following a NZD/USD bargain-day opportunity on June 23, 2009. In this example, the New Zealand dollar had established an uptrend against the U.S. dollar and was testing support near $0.6260. The bargain day created a buying opportunity for bargain hunters to join the existing trend at a very good price. In Figure 7.9, the bargain day is clearly illustrated, having closed below the HMA. There is was also a rising trend line being tested on the same day, as shown in Figure 7.9. You can use trend lines or horizontal support and resistance lines to help further your case when you're investigating any bargain-day opportunity.

Using the daily low prices from June 16 and June 17, a support zone was established between $0.6260 and $0.6238. Figure 7.10 illustrates the support zone and potential stop order placement for this trade. Bargain hunters should use the top of any support zone to place their entry order, as you learned in Chapters 3 and 6. This trade risked about 45 pips to gain approximately 140 pips by targeting the 61.8 percent retracement ratio, as shown in Figure 7.10. The risk-to-reward ratio for this trade works out to be slightly over 1:3. NZD/USD continued to probe support at $0.6260 through the Asian trading session and then rallied to the profit target during the next trading day. Figure 7.11 illustrates the final result for this trade.

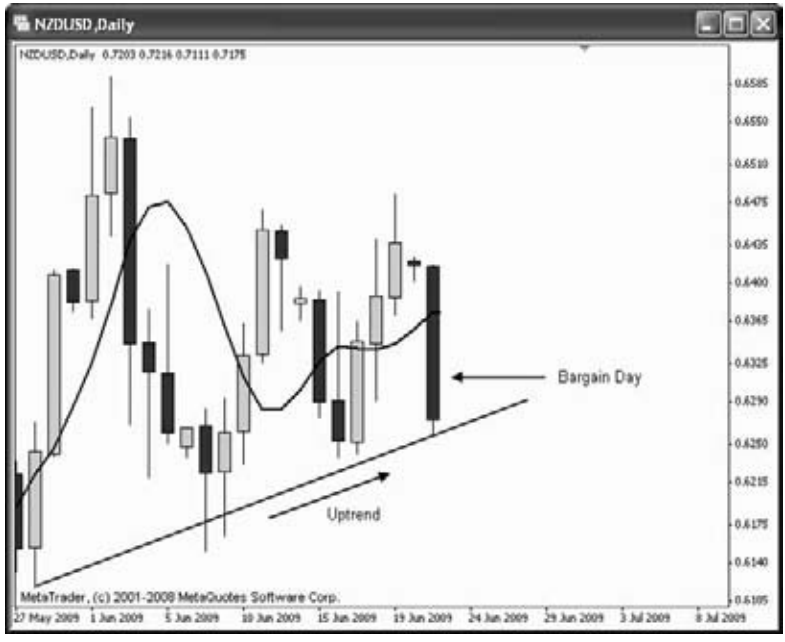

FIGURE 7.9 NZD/USD Bargain-Day Opportunity
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FIGURE 7.10 NZD/USD Bargain-Day Entry, Stop, and Profit Targets
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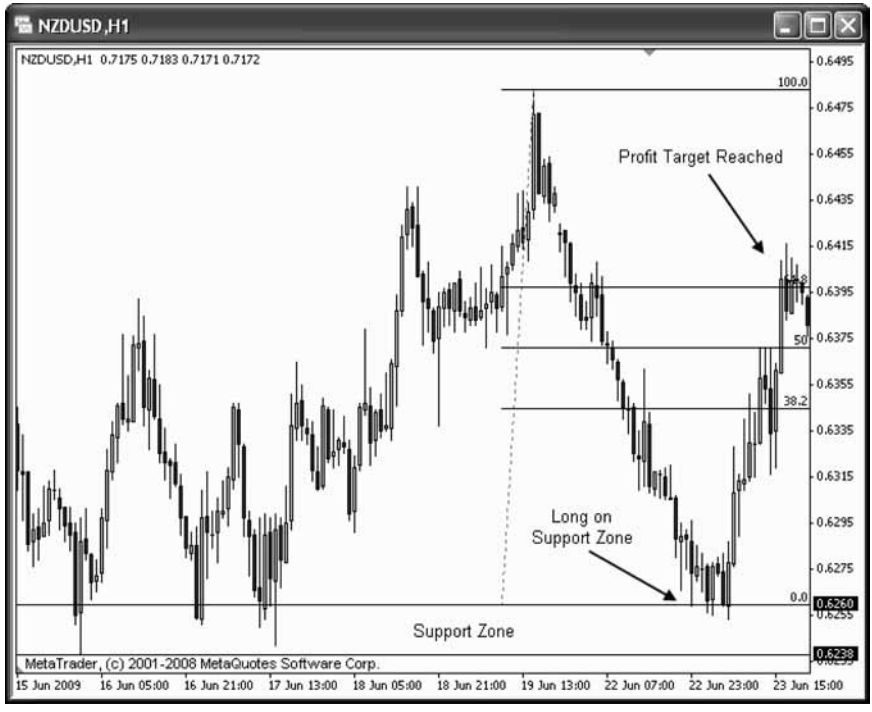

FIGURE 7.11 Completed NZD/USD Bargain-Day Trade
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USD/JPY Example Trade

The second example trade occurred following a USD/JPY bargain-day opportunity on July 21, 2009. In this example, the U.S. dollar had established an uptrend against the Japanese yen and was testing support near $93.27. The bargain day created a buying opportunity for bargain hunters to join the existing trend at a very good price. Figure 7.12 depicts an interesting support and resistance landscape on the USD/JPY daily chart. The currency had broken through support at $95.00 during a downtrend but was now moving higher. The USD/JPY looked ready to test $95.00 as resistance, which gave USD/JPY some room to move price higher. The support level near $93.20 was created by a small breakout on July 14, 2009, and provided a support zone to take advantage of this trading opportunity.

Placing the stop on this trade isn't as clean as our first example. Using the low of the bargain day and the support level shown in Figure 7.13, a trader could have placed entry orders at $93.20 and risked 30 points,

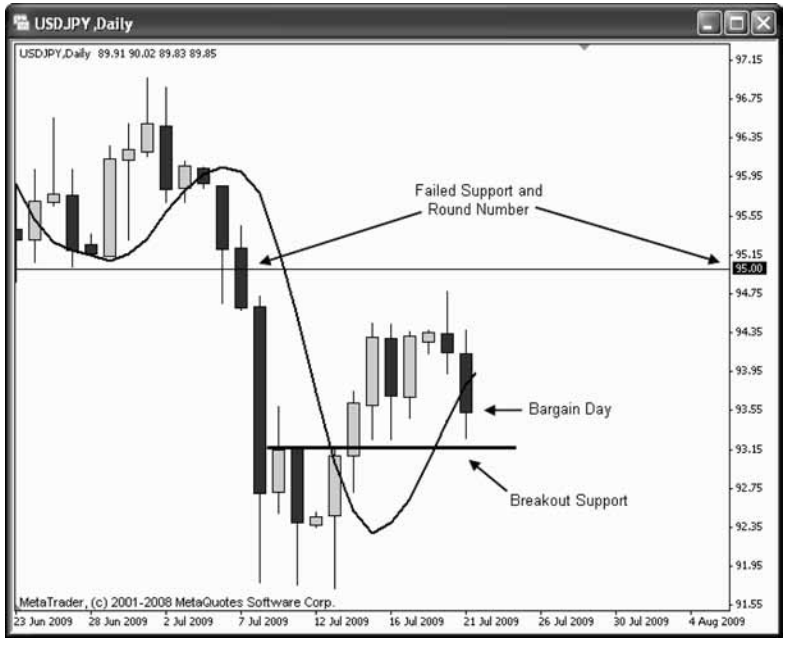

FIGURE 7.12 USD/JPY Bargain-Day Opportunity
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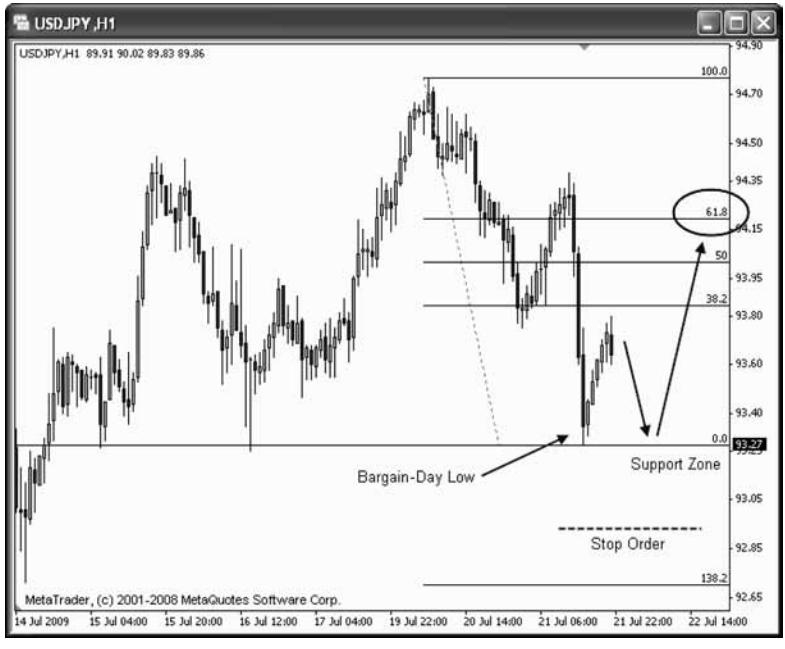

FIGURE 7.13 USD/JPY Bargain-Day Entry, Stop, and Profit Targets
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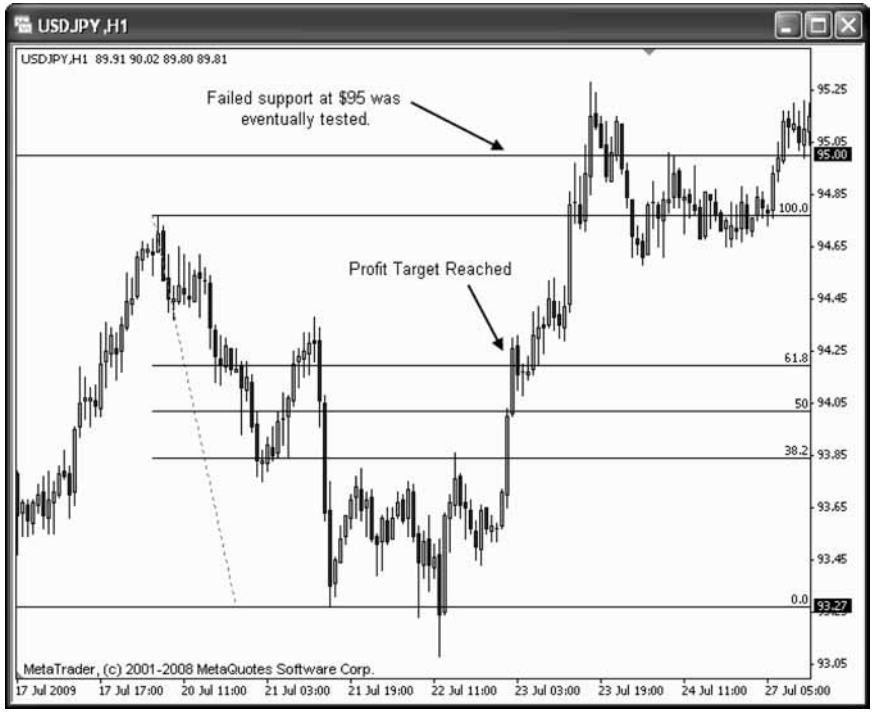

FIGURE 7.14 Completed USD/JPY Bargain-Day Trade
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placing her stop order below support and the round number $93. If the bargain hunter anticipated that $93 will be probed at the London open, she could lower her entry to $93.10 or perhaps $92.90. Using Fibonacci retracement ratios, a profit target is identified at the 61.8 percent retracement ratio, giving this trade a potential profit of 90 pips. The risk-to-reward ratio is right at 1:3.

The completed trade is illustrated in Figure 7.14. The trade took two days to reach the profit target, which is not unusual. Typically a bargain-day trade identified with price action will take one to four trading days to reach its profit target. Alternatively, the failed support level at $95 could have been used as a profit target in this trade. If the thesis is that failed support will reverse roles and become resistance, the argument could have been made that USD/JPY was on its way to test $95. Bargain hunters should be creative with their profit targets and read the support and resistance landscape. The guidelines in this chapter for managing profit are only guidelines. That is the advantage of discretionary trading.

EUR/USD Example Trade

The next example occurred on April 13, 2009, during a EUR/USD downtrend. In this example, EUR/USD had rallied and closed above the HMA, creating a potential bargain day. The currency had also stopped below the round number of $1.34, making this bargain-day opportunity more enticing. Figure 7.15 illustrates the EUR/USD bargain-day opportunity on the daily chart. The downtrend is clear, and a trending has been started from the high established in March. Normally a bargain hunter would be interested in selling around the round number shown in Figure 7.15; however, the Asian trading session held a surprise for bargain hunters, shown in Figure 7.14.

At the open of the Asian session, EUR/USD broke out of consolidation it had established at the high of the bargain day to create a new resistance zone. The resistance zone is marked in Figure 7.16 between the breakout point and the high price set during the bargain day. The Asian

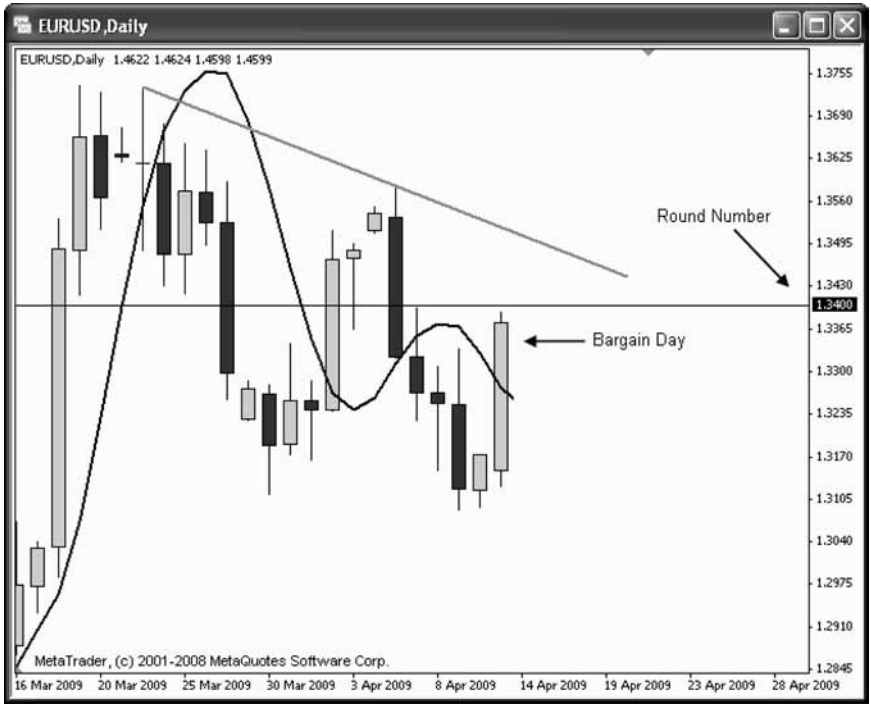

FIGURE 7.15 EUR/USD Bargain-Day Opportunity
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FIGURE 7.16 EUR/USD Bargain-Day Entry, Stop and Profit Targets
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session breakout offered bargain hunters a well-defined resistance zone to sell EUR/USD. Profit targets are identified using Fibonacci ratios, measured from the low on April 9, 2009, to the planned entry point near the bottom of the resistance zone at $1.3360. This setup risked approximately 50 pips to gain 150 pips for a risk-to-reward of 1:3.

EUR/USD ended up testing $1.3350 early in the London trading session on April 14, 2009, triggering any entry order to sell along the resistance zone. The profit target was reached near the London open two trading days later. Figure 7.17 illustrates the completed EUR/USD bargain-day trade. This trade provided a good lesson in reading support and resistance clues ahead of the London session to ensure that you get in a trade. Bargain hunters that ignored the Asian session breakout and placed orders to sell near the round number of $1.34 were left behind, since the market never tested $1.34. Using this methodology, at times your orders will be placed in the wrong place and will not be picked up by the market. I guess there is such as a thing as being too cheap! If you read support and resistance

FIGURE 7.17 Completed EUR/USD Bargain-Day Trade
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correctly, as in the case of this Asian session breakout, hopefully you will reduce the number of times you are left behind.

EUR/JPY Example Trade

The final example trade occurred on March 27, 2009, during a EUR/JPY uptrend. In this example, EUR/JPY sold off after making a new high and closed below the HMA, creating a potential bargain-day trade. Figure 7.18 illustrates the sharp selloff that occurred to create the bargain day. The market stopped short of the round number $129.00, which happened to correspond with some minor resistance that was broken earlier in the uptrend. The expectation that a round number plus a support level could turn this bargain day into a trading opportunity was reasonable.

A support zone was determined using the round number $129.00 and a small breakout level shown in Figure 7.19. The profit target is determined by measuring Fibonacci retracement ratios from the recent swing high to the entry point near $129.00. The stop order is placed below the support

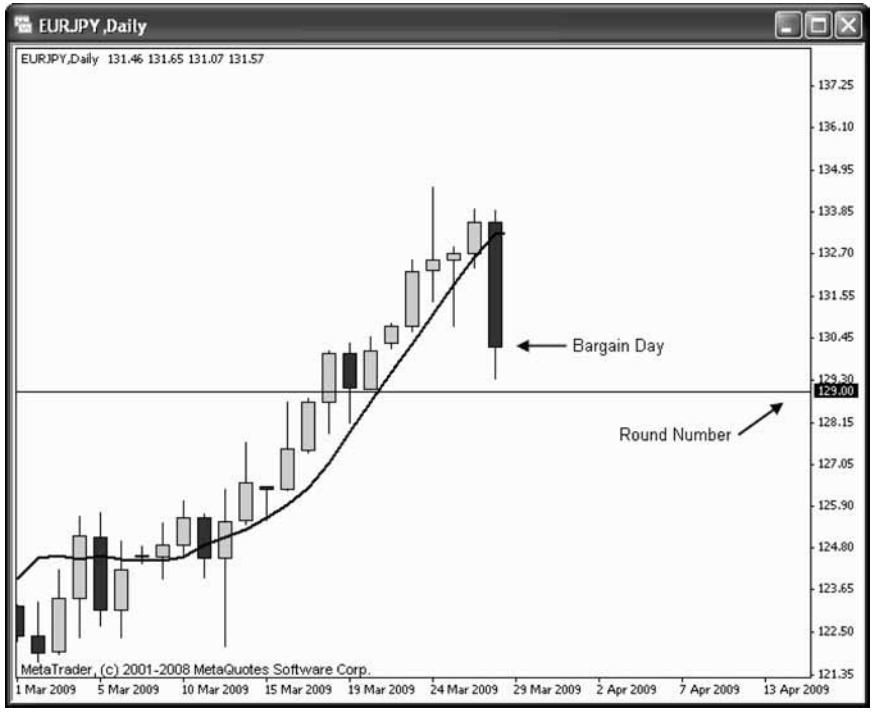

FIGURE 7.18 EUR/JPY Bargain-Day Opportunity
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zone as usual. This trade risked approximately 60 pips to gain 340 pips. The risk-to-reward ratio offered by this trade was just under 1:6.

Unfortunately, not every trade will work out as planned, and this trade was stopped out. There are two lessons to learn from this losing trade. First, the support zone was not well defined. The breakout marked on Figure 7.19 was minor support and not a defined horizontal support zone. Second, the bargain day occurred on a Friday, which is questionable because the market's sentiment may change dramatically over the weekend and change the immediate trend. Figure 7.20 illustrates that Monday's price action drove EUR/JPY lower, but ultimately the thesis for a long trade was correct. When a bargain day occurs on a Friday, consider letting the market trade through Monday's close before making any decision to trade. Remember, forex may be a 24-hour marketplace, but Monday morning is the first chance London and New York have to react *en masse* to the news of the weekend. You'll have a better picture of what price has in mind after the Sunday and Monday jitters are shaken out.

FIGURE 7.19 EUR/JPY Bargain-Day Entry, Stop, and Profit Targets
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FIGURE 7.20 EUR/JPY Bargain-Day Trade Is Stopped Out
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CLOSING BELL

Bargain hunting with an HMA or WMA indicator is probably my favorite tool for spotting trades based on price action. The indicator is only a guide; you must use traditional support and resistance techniques to decide whether you are actually going to trade after a bargain day has formed.

In this chapter you learned how to identify a bargain day using the HMA or WMA indicators. Remember that when price is moving higher, a bargain day closes below the indicator; when price is moving lower, a bargain day closes above the indicator. Profit and risk are managed very similarly to what you learned in Chapter 6. Place your stops just beyond the support or resistance zone in which you enter the trade. Identify profit targets using Fibonacci retracement ratios as usual. Happy bargain hunting!

CHAPTER 8

Bargain Hunting with the Commodities Channel Index

Chapter 7 introduced you to bargain hunting with price action and a trend indicator, a technique that performs well during a trending market but is less effective in a ranging market. In this chapter we build on what you have learned by introducing an indicator that is effective in both trending and ranging markets. The *Commodities Channel Index* (CCI) is an oscillator that measures the relative strength of recent price action. The CCI indicator attempts to predict when the current trend is coming to an end. CCI was originally developed by Donald Lambert in 1980. CCI has become a popular indicator and is available in nearly every charting program on the market today. Plenty has already been written on how CCI is calculated, its original intent, and how it was adapted to the financial markets, so I will spare you those details here.

What you need to know about CCI is how traders are taught to use it traditionally versus how a bargain hunter should use it. In this chapter you learn how to identify a traditional CCI breakout signal and then trade it the bargain hunter's way. You will learn to combine CCI with support and resistance to demand the best possible price, and you will learn where to place a stop order and how to identify profit targets. Finally, one thing you'll notice about this strategy is the lack of a visible bargain day. This trading methodology doesn't wait for a bargain day to appear; it anticipates where a pullback will occur and positions ahead of the forming bargain day.

THE TRADITIONAL CCI TRADE

Knowing how CCI is traditionally taught to traders is useful for understanding why the bargain-hunting methodology is more effective. CCI is an oscillator that measures cycles between a market high and low price range and plots its calculation along a horizontal scale, illustrated in Figure 8.1. The CCI indicator attempts to measure the strength of the current market cycle and attempts to predict when it will end. The default measurements on a CCI indicator are 100 and –100. When the indicator is above 100, the market is considered "overbought." When CCI is below –100, the market is considered oversold. Obviously the market can continue to move higher or lower regardless of what a CCI indicator says. Traders usually wait for the CCI indicator to leave overbought or oversold conditions as a confirmation that the current trend has actually ended. When this occurs, it is known as a *CCI breakout*.

CCI breakouts occur when a CCI indicator falls out of overbought territory or rises above oversold territory. Traders are taught to buy when a breakout from oversold territory occurs or to sell when a breakout from overbought territory occurs. Traditional CCI trades are illustrated in Figure 8.2 using a USD/JPY weekly chart. Long and short orders are typically initiated when the CCI indicator breaks from overbought or oversold territory, as indicated by the arrows in Figure 8.2.

The issue with traditional CCI trades is a complete dismissal of support and resistance. During a strong trending market, the CCI indicator may remain in overbought or oversold territory for many cycles. Often the indicator will break above –100 or below 100 briefly before moving into overbought or oversold territory again. If you study Figure 8.2 closely, you will see many false signals that could result in losses if the trader

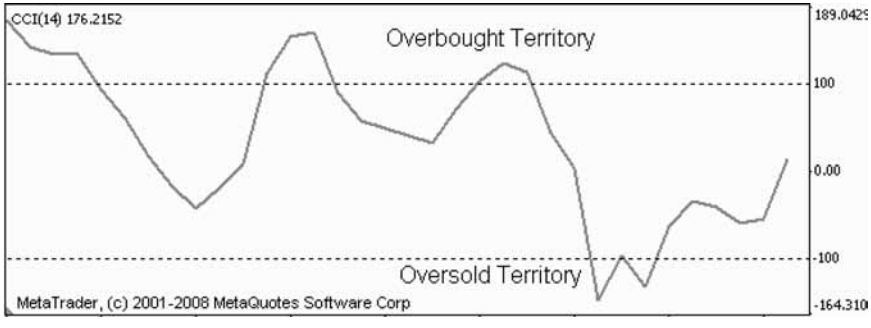

FIGURE 8.1 Commodities Channel Index Indicator
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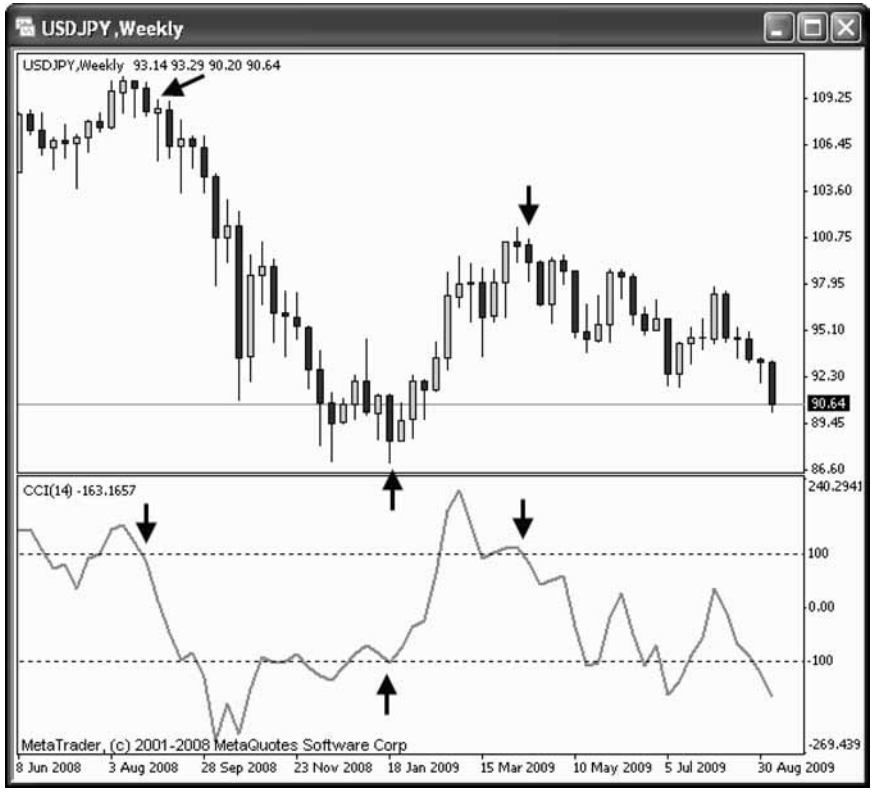

FIGURE 8.2 Traditional CCI Breakout Trades
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followed the traditional CCI trade guidelines. The signals generated by a CCI indicator should be compared to surrounding support and resistance levels to determine whether the breakout is valid or simply another false signal. During an uptrend it is smart to favor breakouts from oversold territory and buy into the uptrend. During a downtrend it is smart to favor breakouts from overbought territory and sell into the downtrend.

The traditional CCI breakout trade places traders in a poor position relative to price. Traders are taught to enter following a CCI breakout, but doing so places them at the very top or bottom of a major move in price. When the CCI indicator breaks from oversold or overbought conditions, it often does so after a major rally or selloff, as demonstrated by Figure 8.3. Traders who enter at the very top or bottom of a breakout are not getting a good price for the trade. They are paying full price for a breakout and assuming more risk than necessary. In Figure 8.3 both CCI breakouts were

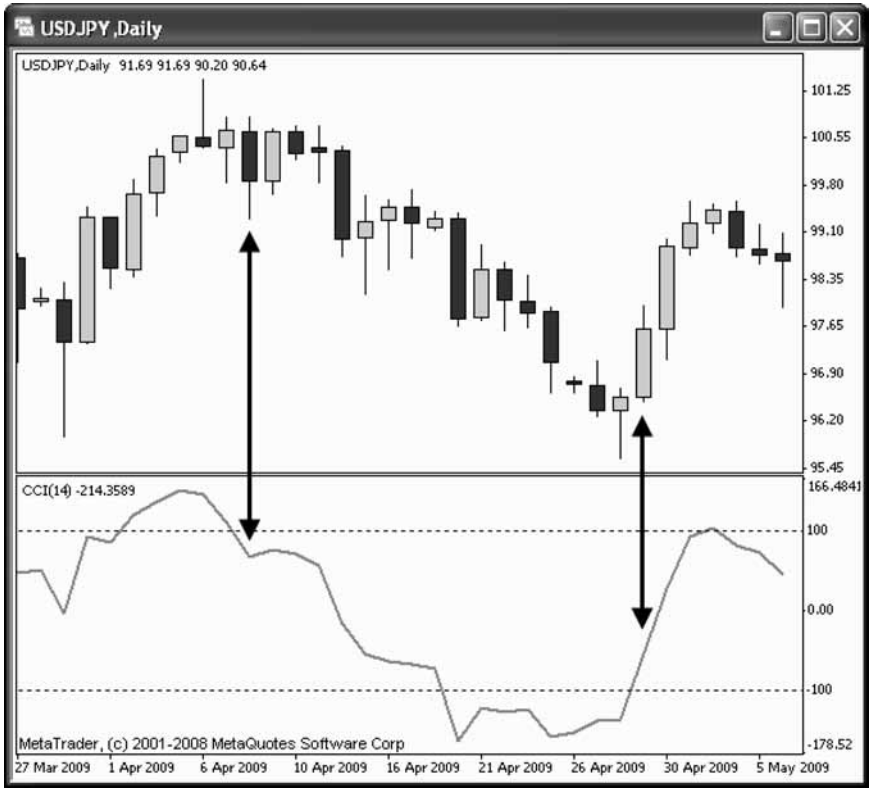

FIGURE 8.3 CCI Breakouts Caused by Strong Price Action
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followed by a pullback in price before the move continued. Bargain hunters should avoid the temptation of chasing a CCI breakout. Trading the CCI breakout as every other trader does will not give you an edge.

In the next section you will learn how to trade CCI breakouts the bargain hunter's way.

THE BARGAIN HUNTER'S CCI TRADE

Bargain hunters should combine a CCI breakout with support and resistance to enter trades at a good price. There are two methods a bargain hunter can use to enter a CCI breakout trade. Both methods offer a better

entry price and allow the trader more flexibility to enter and plan trades on his own schedule rather than entering on the breakout itself.

The first method is simply an entry order at the open price of the daily candle that caused the breakout. When a CCI breakout occurs, the market often retraces, or *pulls back*, to find enough interest from buyers or sellers to continue the breakout. Often the retracement reaches the open price of the daily candle that caused the CCI breakout, giving bargain hunters an opportunity to enter the market at a much better price. Usually this retracement occurs on the day following a CCI breakout; however, sometimes momentum will carry a breakout further without pulling back to the open price of the breakout candle for several days. If your order hasn't been filled within seven trading days or if CCI reaches an oversold or overbought indication opposite to your order, you should remove your order and look for the next trade opportunity.

The second method is based on any support or resistance levels broken by the daily candle that caused the CCI breakout. Occasionally the breakout candle is large enough to break nearby support and resistance levels that offer excellent entry order opportunities. Read the daily candles to identify nearby support and resistance that make sense for the market to test following the breakout. Daily candle high or low prices and round numbers make excellent candidates. I personally prefer using the open price of the breakout candle as my entry price, but support and resistance can work when the open price of the breakout candle is left in the dust by the breakout.

Figure 8.4 illustrates both entry options using a USD/CHF daily chart. In Figure 8.4 the open price of the daily candle that caused a CCI breakout was used to trigger a long trade; however, the open price was never visited on the short trade. In the short trade example, a round number and support level broken by the breakout day were used to short USD/CHF.

The goal of bargain hunting is to identify a potential trading opportunity, demand the best price, and let the market come to your order rather than chasing the market. Using either of these entry techniques allows a trader to reduce risk and enter at a much better price than those of traditional CCI breakout traders. Before you pull the trigger on a CCI breakout trade, you should always be aware of major support or resistance levels around your trade. Remember, the CCI indicator has no power over price; it is simply a guess measurement related to the strength of price. Only support and resistance will actually turn price, so avoid falling into the trap of "following the indicator." CCI is simply a guide in this methodology; support and resistance still rule the roost. When a CCI breakout occurs along support and resistance or along the *edge of price*, as you learned in Chapter 3, the probability is higher that CCI has led you to a good trade. It's up to you to demand the best price.

FIGURE 8.4 Two Entry Methods for CCI Bargain Hunting
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MANAGING RISK

Placing a stop order for CCI breakout trades is no different than doing so for a traditional support and resistance trade. Your stop order should be placed beyond the immediate low or high prior to the CCI breakout. This ensures that your stop is in a location price was unable to reach, and unless a significant shift in price action occurs, it shouldn't reach your stop. If the market does move beyond the immediate high or low set prior to the CCI breakout, you know market conditions haven't reversed as expected and the trade is broken. Figure 8.5 uses the USD/CHF example trades from Figure 8.3 to demonstrate where protective stop orders should have been placed.

FIGURE 8.5 Placing Stops for CCI Breakout Trades
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Traders should always consider the risk-to-reward ratio for each trade before a trade is entered. Stops should always be placed beyond the immediate high or low set prior to the CCI breakout. If the stop is too large or there isn't enough potential profit to offset the risk required, there are two options. First, you can move the entry order until the stop is pushed beyond the immediate low or high set prior to the CCI breakout. If you take this approach, you should locate a logical support or resistance level or a round number to place an entry. Use a lower timeframe if necessary to view support and resistance at a granular level. Your second option is to skip the trade. If you can't fit a stop into your risk tolerance percentages and place the stops in the correct place, the trade is not worth taking. Just skip the trade, because there will be others.

MANAGING PROFIT

Bargain hunting with the CCI indicator can identify trend, countertrend, or range trades. Profit targets are identified using Fibonacci in all cases. The type of trade determines the type of Fibonacci ratio to use. Countertrend or range trades should use Fibonacci retracement ratios. Trend trades should use Fibonacci extension ratios. (If you need a review, managing profit with Fibonacci is discussed in Chapter 5.) Bargain hunting with the CCI indicator requires tremendous patience. It is not unusual for a trade to last several weeks or longer to reach its profit target. You must be disciplined enough to set these trades in motion and let them run, or you could cut the trade short with a breakeven or trailing stop. Occasionally these trades will move from positive to negative floating profits as they work their way to the intended profit target. Ensure that you plan a solid risk-to-reward ratio for every trade, allowing you to plan the trade and stick to that plan.

EXAMPLE TRADES

This section reviews five example trades found by bargain hunting with the Commodities Channel Index indicator. This methodology can be applied to trending markets and ranging markets using Fibonacci ratios or extensions as profit targets. The following list summarizes the rules necessary to identify, enter, and manage a trade:

- Identify a CCI breakout trade.
- Identify the type of trade opportunity.
- Identify profit targets using Fibonacci.
- Place an entry order on the open price of the breakout day.
- Substitute logical support and resistance for entry, if necessary.
- Place a stop order above the high or low prior to the breakout day.
- Allow the trade to run.

AUD/USD Example Trade

The first example trade occurred during an AUD/USD uptrend in April 2009. Fueled by a high interest rate, confidence that global economies were improving, and a steady rise in commodity prices such as gold, the Australian dollar steadily gained value against the U.S. dollar. At the time, the Australian dollar had the highest-yielding interest rate among major

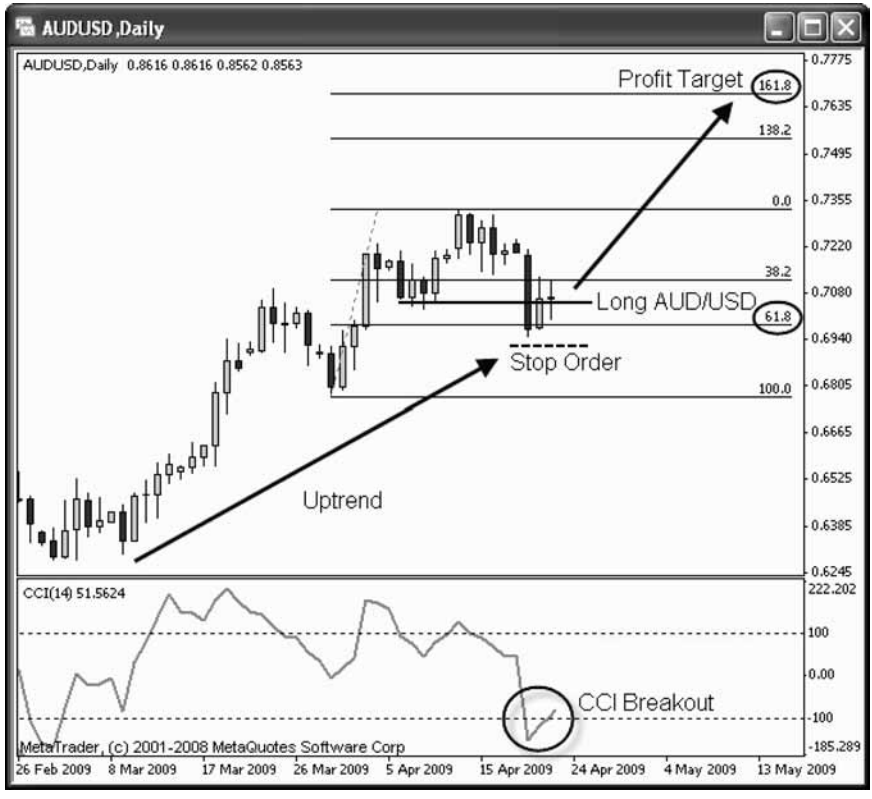

FIGURE 8.6 AUD/USD CCI Breakout Trade Opportunity
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currencies, giving traders who were long AUD the benefit of higher interest payments during the nightly swap.

Figure 8.6 illustrates a pullback in price, causing a CCI breakout from oversold conditions near support along the round number price of $0.7000. This area also matched the 61.8 percent Fibonacci retracement measured from the recent swing low and high. The breakout day occurred on April 22, 2009. The entry day offered two options for buying AUD/USD. The open price of the breakout day was $.0765; however, an even greater bargain could have been made buying at the round number of $0.7. Round numbers that contain triple zeros are usually more powerful barriers for support and resistance versus more common double-zero round numbers.

The stop order on this example trade should have been placed directly below the low price established prior to the entry day. If the low is breached by price, the breakout opportunity was not valid and the trade is

over. The profit target in this example can take advantage of CCI extension ratios because AUD/USD appears to be holding support along a Fibonacci retracement ratio within the context of a trend. The 161.8 percent extension ratio should be used since the market is turning along the 61.8 percent retracement ratio, as shown in Figure 8.6. This profit target offers a potential gain of 600 pips with a risk of approximately 150 pips. This is a risk-to-reward ratio of 1:4, which is better than the minimum bargain hunters look for of 1:3. Notice how using the round number $0.7000 as an entry point shaved 65 pips of risk from the trade and increased the risk-to-reward ratio to 1:6. Demanding the best price does make a difference.

AUD/USD took 12 trading days to reach the profit target, as shown in Figure 8.7. There are two lessons to learn from this trade example. First, after two days many traders might be tempted to move their stop to breakeven because the trade was nearly 150 pips in the money, which

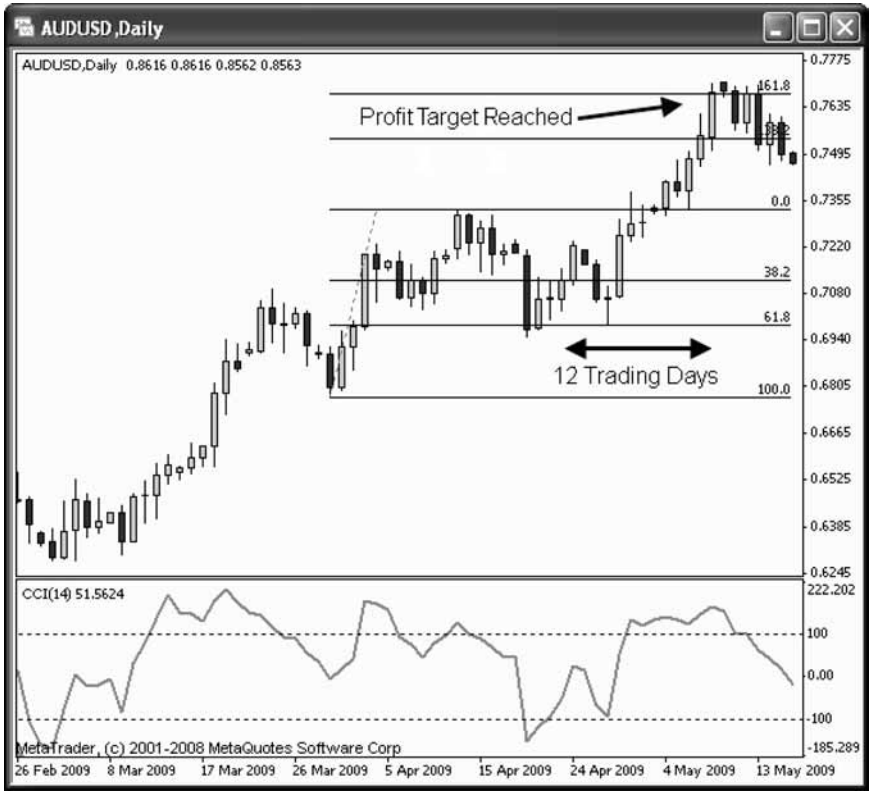

FIGURE 8.7 Completed AUD/USD CCI Breakout Trade
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would have been a mistake. AUD/USD cycled lower once before it moved on to the profit target, which could have stopped a breakeven or trailing stop from earning the trade's true potential. Second, the trade lasted nearly two weeks. Patience is important when trend trading CCI breakout trades.

USD/CHF Example Trade

The second example trade occurred during a USD/CHF uptrend in late September 2008. The U.S. dollar had fallen from a recently established high price and settled along support marked by the round number $1.070. By the close of trading on September 25, 2009, the market had found new support above $1.080 and a CCI breakout day had occurred. Figure 8.8 illustrates the opportunity to buy USD/CHF at the open price of the breakout day,

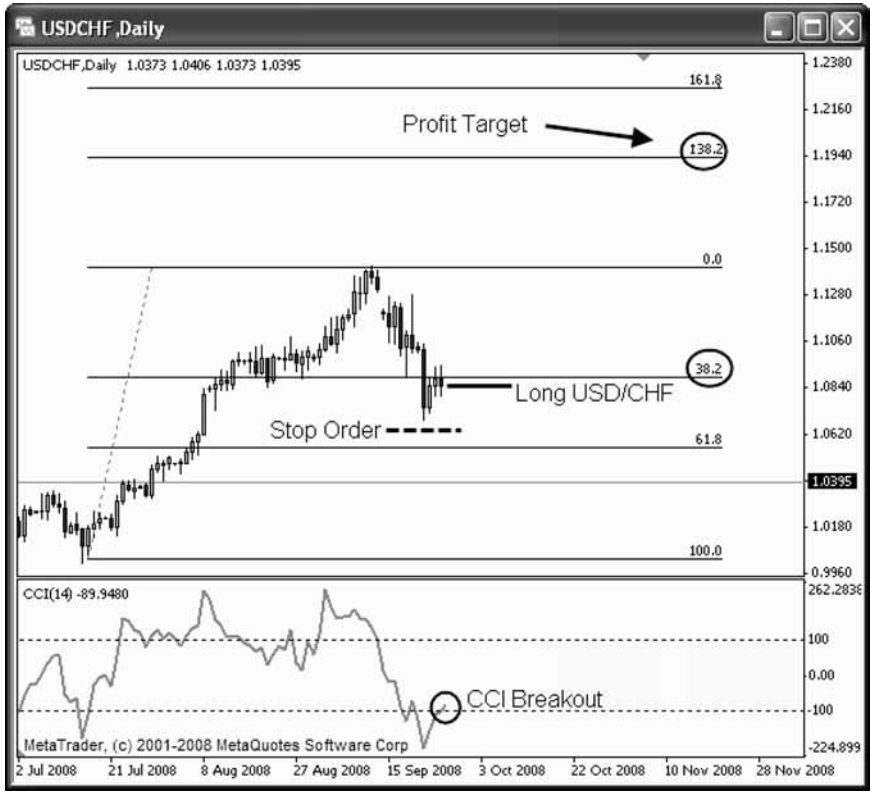

FIGURE 8.8 USD/CHF CCI Breakout Trade Opportunity
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near $1.0880. Bargain hunters could shave 30 pips of risk by selecting the 50 price near the open and buying at $1.0850 instead.

Assuming that the trade was entered at $1.0850, the stop order would risk approximately 100 pips. To identify a profit target, Fibonacci retracement ratios were measured from swing low on July 15, 2008, to the swing high on September 11, 2008. The market was holding support along the 38.2 percent Fibonacci retracement ratio, which correlates with the 138.2 percent extension ratio identified as the profit target. This trade offered a total risk-to-reward ratio of 1:10. The trade risks 100 pips to potentially earn 1079 pips.

USD/CHF required 35 trading days to reach the intended profit target illustrated in Figure 8.9. This trade was open for nearly a month, highlighting the requirement for patience with trend trades. While the trade was open, it experienced two drawdowns against the floating profit, but again, moving

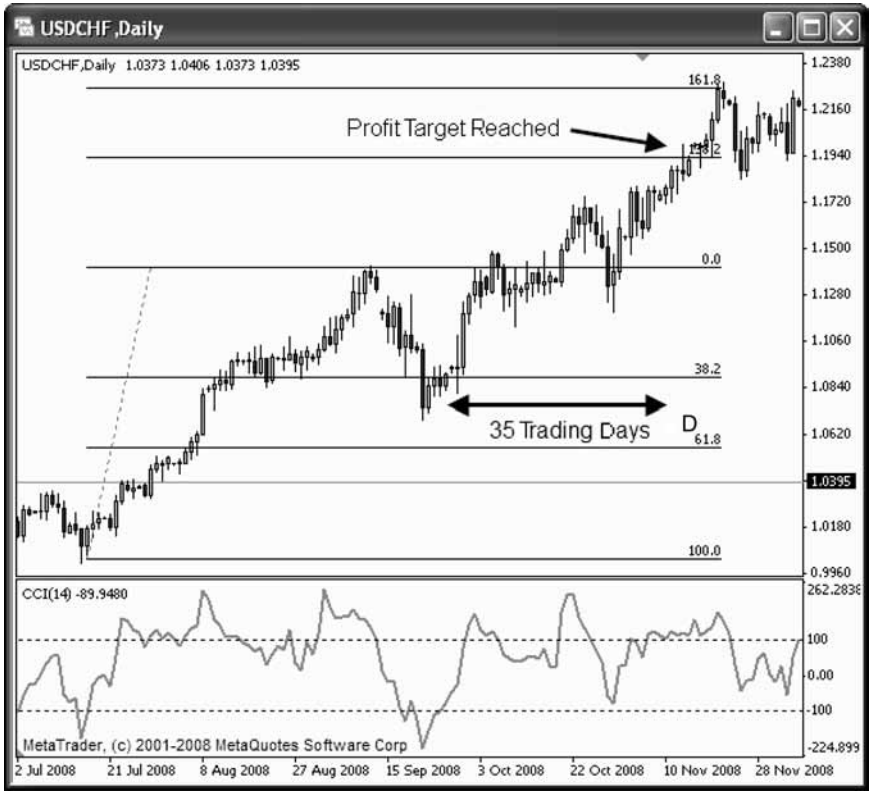

FIGURE 8.9 Completed USD/CHF CCI Breakout Trade
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the stop would have been a mistake. You must let these trend trades run; they take time but they will do their job if you just leave them alone. If they don't work out, that is what the stop order is for.

USD/JPY Example Trade

The third example trade is perhaps the longest trend trade in this section. This example trade began on August 2, 2004, and remained open nearly 18 weeks before reaching its profit target. Figure 8.10 illustrates USD/JPY finding resistance along a 61.8 percent retracement ratio measured from the most recent swing high and low. The entry price on the CCI breakout day was well below the high price marked before the breakout, which raises the risk required to trade this opportunity. Bargain hunters could

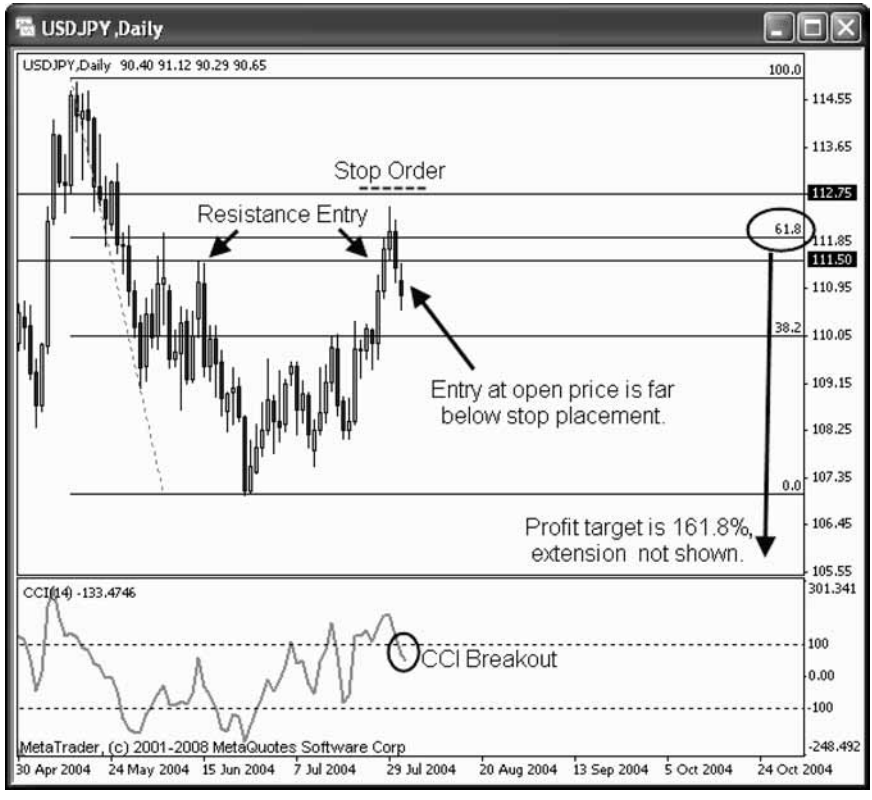

FIGURE 8.10 USD/JPY CCI Breakout Opportunity
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have selected a higher price near the resistance level of $111.50 to reduce their risk and demand a better price from the market.

Assuming that the trader sold short USD/JPY at $111.50, a stop placed above the high prior to the breakout required a risk of 130 pips. USD/JPY is also turning along the 61.8 percent retracement ratio; therefore, using the 161.8 percent extension ratio for a profit target makes sense for this trend trade. The risk-to-reward ratio calculates to 1:7 since the trade risks 130 pips to potentially earn 930 pips.

USD/JPY took 18 weeks to finally reach the intended profit target illustrated in Figure 8.11. There were four occasions when the market returned to test resistance at $111.50 before ultimately falling to reach the profit target. This is another excellent example of setting a trade in motion and letting it run. Any trader who moved his stop to breakeven during the early stages of this trade would have been stopped out just prior to the large selloff.

FIGURE 8.11 Completed USD/JPY CCI Breakout Trade
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USD/CAD Example Trade

The fourth example trade is a range trade opportunity rather than a trend trade opportunity. In this example, USD/CAD had found support along the bottom of a range and near the round-number price of $0.9800, as illustrated in Figure 8.12. A CCI breakout opportunity appeared at the close of trading on March 3, 2008. In this example the open price on the breakout day did not offer a favorable entry price because it was rather far from the potential stop order placement. Bargain hunters are always looking to reduce risk and trade along support and resistance; therefore, lowering the entry price in this example to the round number of $0.9800 makes sense. Don't forget that the rules in these trading strategies are only guidelines. Discretionary traders ultimately make the final call on when and where to enter the market.

FIGURE 8.12 USD/CAD CCI Breakout Range Trade Opportunity
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The profit target is identified for a range trade using Fibonacci retracement ratios. In this example, the retracement ratios are measured using the recent swing high and swing low, as shown in Figure 8.12. With a range trade you are interested in targeting the 61.8 percent retracement ratio to give your trade the maximum risk-to-reward offered by standard retracement ratios. This trade risked 100 pips to gain approximately 320 pips, establishing a risk-to-reward ratio of 1:3.

It took about two trading weeks for USD/CAD to reach the intended profit target in this example. Figure 8.13 illustrates the competed trade and price action after the profit target was achieved. Notice how targeting the 61.8 percent Fibonacci retracement ratio was a better strategy than targeting the swing high price. The retracement ratio does not require the market to reach the opposite end of a range in order for your trade to reach its intended profit target. Also notice how USD/CAD did move lower to test

FIGURE 8.13 Completed USD/CAD CCI Breakout Range Trade
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support at $0.98 before moving higher. Bargain hunting by demanding the best price following a CCI breakout will put you in a much better risk position than traders who jump on the breakout near the top of the market.

GBP/JPY Example Trade

The final example trade is a trend trade using the GBP/JPY on August 18, 2009. In this example, GBP/JPY appears to find support along the 50 percent Fibonacci retracement ratio measured from the low on July 8, 2009, and the high on August 7, 2009, as illustrated in Figure 8.14. The daily trading range of GBP/JPY is much wider than most currency pairs, so demanding the absolute best price from this currency pair is essential or you could be stopped out frequently. In this example, the open price from the

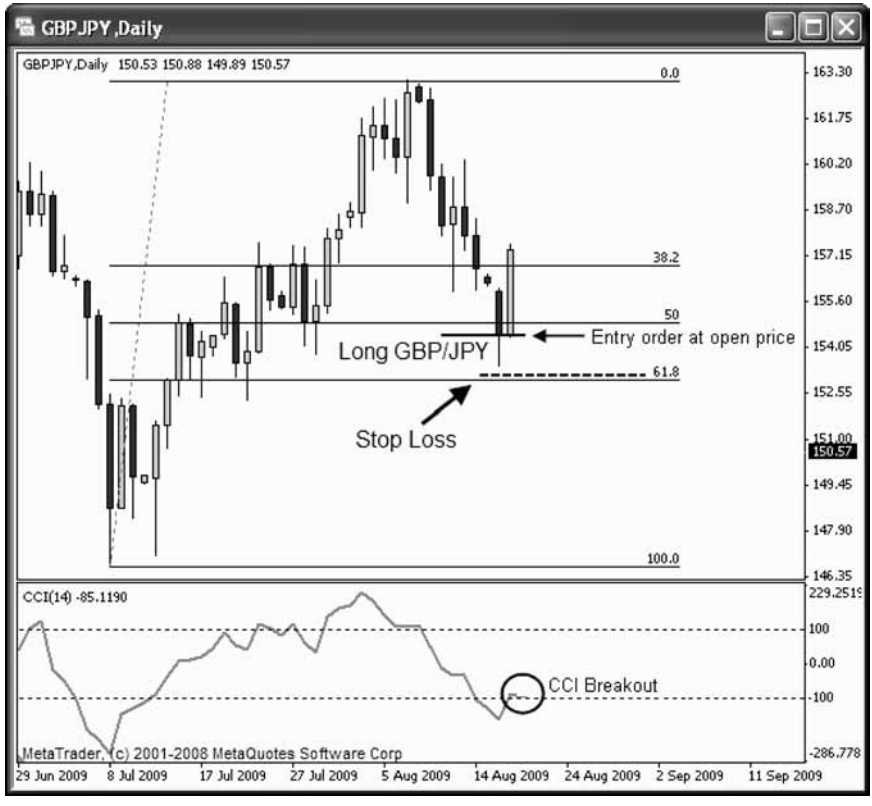

FIGURE 8.14 GBP/JPY CCI Breakout Trend Trade Opportunity
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breakout candle is approximately $154.50, which is a good entry price. Bargain hunters could have bought lower along the round number of $154.00 if they chose; either is fine. Since the market is turning near the 50 percent retracement ratio, this trade should target the 150 percent extension ratio as a profit target.

Using a 200-pip stop, this trade offered a potential profit of 1,664 pips, since the 150 percent extension was marked at $171.14. That might sound like a lot of pips for one trade, but the GBP/JPY is a volatile pair and can easily move 1,000 pips in only a few trading days. Even though the numbers are big, the risk-to-reward calculates to a ratio of 1:8. Unfortunately, not every trade can turn out well. This trade was stopped out after a few days of consolidation between the 38.2 percent retracement ratio and our entry price. Figure 8.15 illustrates the end result of this trade as the market continued to sell GBP/JPY down to the $150 level.

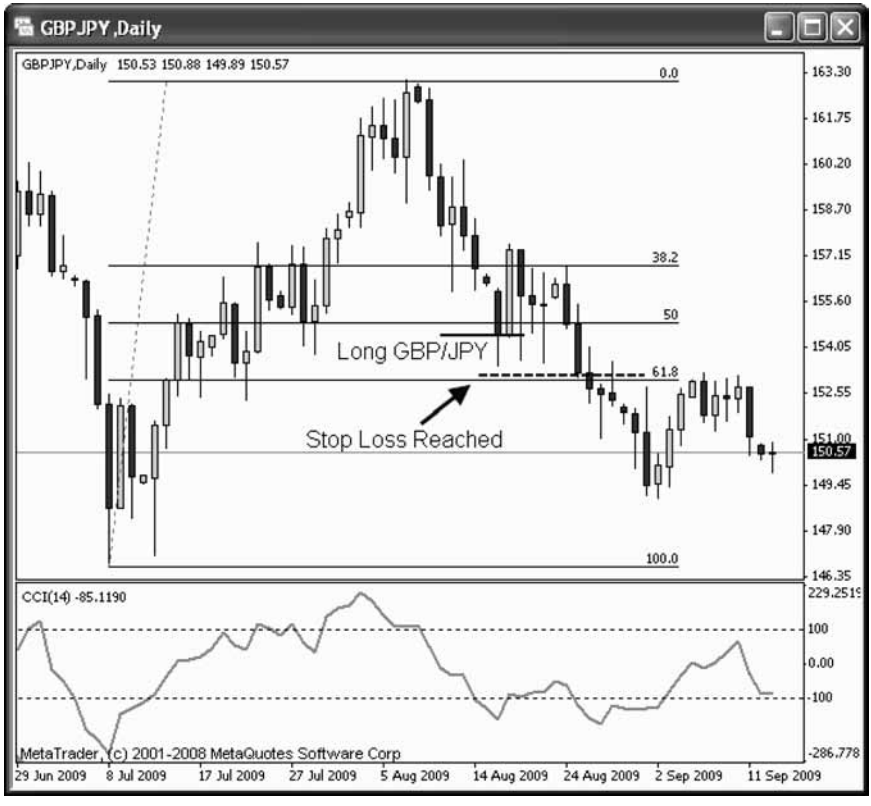

FIGURE 8.15 GBP/JPY CCI Breakout Trend Trade Stopped Out
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CLOSING BELL

Bargain hunting with the CCI indicator is an effective strategy for range trading, countertrend trading, and trend trading. Using a traditional CCI breakout signal, a bargain hunter can look for opportunities to enter at a better price than the crowd gets using Fibonacci retracement ratios or support and resistance. This strategy should be traded using the daily chart timeframe, which makes it ideal for traders who work full-time or who do not want to watch charts all day. The caveat of the flexible schedule is the time between and during trades. Patience is a critical component of making this strategy work.

You should avoid moving stops to breakeven or attempt to protect profit with these trades because the market often oscillates against the trade before the profit target is achieved. The most important component in this strategy is risk control. Keep risk limited to less than 3 percent of your account balance, demand the best price out of the market for each trade, and ensure that each trade offers at least a 1:3 risk-to-reward ratio.

CHAPTER 9

Bargain Hunting with Fundamental Data

Inexperienced traders are drawn to news trading like moths to a flame for one reason: implied simplicity. What could be more attractive than the promise of making 40, 50, or 100 pips in mere minutes? Inexperienced traders view news trading as an opportunity to book large profits without requiring them to sharpen their trading skills. In theory, trading the release of fundamental data such as the Non-Farm Payroll report is simply a matter of deciding whether the news is good or bad, then trading accordingly. In reality, news trading is far more boorish than buying on good news and selling on bad news. In fact, nothing will test the skills of a trader more than trying to capitalize on the volatility following the release of major fundamental data.

Unfortunately, news trading is promoted to inexperienced traders by authors who pitch asinine straddling strategies. These strategies look great on historical charts but fail miserably in a live market. In the minutes following a major economic event, the market often becomes illiquid as traders and market makers rapidly adjust price in reaction to the data. The lack of liquidity can cause large price gaps or severe slippage on entry and stop orders. Currency dealers often will not guarantee your stop or entry order price during the moments immediately following a major news event. These factors can make it dangerous to straddle the market with entry and stop orders ahead of a news release.

Even when the news is positive for a currency, the market may aggressively sell it. Traders who continue to buy on good news and sell on bad news are often washed out of the market and left confused by the market's reaction to news. Successful news trading blends everything you've

learned about supply and demand trading with the sentiment created by news itself. In this chapter you learn what news is tradable, which currency pairs to trade during a news event, and how to trade news from a support and resistance perspective.

WHY TRADE NEWS?

Traders often have a negative reaction to trading the news due to the assumption that it is risky and unpredictable at best. I believe that most of this sentiment comes from traders who use news-trading strategies that do not take advantage of support and resistance, or they chase breakouts caused by the news release, which leaves them paying full price for a bad trade. Fundamental events can be very powerful trading tools for those who understand the bigger picture of support and resistance just prior to the news being released. Many of the erratic price moves that confuse traders are clear and obvious to a trader viewing the market through the lens of support and resistance, as you'll see in this chapter.

So, why trade the news? Fundamental events can act as catalysts for much larger and orderly moves in price. Most traders focus on trying to capture a few pips during the volatility that follows a major release, but that is rarely the best opportunity offered by trading the news. Fundamental events often jab into support and resistance zones during the short period of volatility following a release, and this offers the observant trader a low-risk way to enter the market based on support and resistance. Trading the news is no different than any other support- and resistance-based trade except for one significant advantage: You know exactly when and what currencies may offer trading opportunities. Fundamental events are scheduled and released on a regular basis, giving you the advantage of knowing when a decent trade may form. Traders who work a day job or have limited time to trade can use fundamental events as a catalyst for standard support and resistance trades by scheduling the events into their existing routines. With news being released around the globe almost on a daily basis, it is hard to imagine someone not being able to find at least a couple of events that fit into their schedule. It is important to remember that not all fundamental events are worth trading.

WHAT NEWS IS WORTH TRADING?

Selecting which economic events to trade versus which to ignore has to do with understanding the prevailing market sentiment rather than a

particular report's importance to the country's economic health. As economic conditions change, traders may lose interest in some reports while other reports are deemed more important. For example, the New Home Building Permits report in the United States tells us how many applications were made for new home construction permits in the previous month. The market couldn't have cared less about this report until the housing market started to collapse in the third quarter of 2007. When traders began to realize that the housing bubble had burst, this boring little report became a market mover. Traders understood how the fall in new home construction permits reflected the negative economic pressure developing in the broader economy.

As the economy begins to stabilize in the United States, the sentiment will change to place importance on different economic data. After billions in government stimulus spending, I suspect that the reports that will hold more impact in the near term will include the Consumer Price Index, trade balance, and Treasury inflow capital. Traders will want to know how the increased money supply will affect inflation and whether the government is raising enough capital through treasury auctions in order to finance their spending. All these factors will affect the value of the dollar. Evaluating which reports are catching the attention of the market is not difficult. Traders should simply monitor the financial press, their favorite trading blogs, or currency-related web sites such as www.fxstreet.com.

Key Fundamental Reports

Market sentiment may drive the importance of smaller reports, but there is always a group of key fundamental reports that are worth trading. These reports gauge the primary factors of a country's economic health. Table 9.1 lists key economic reports I monitor for trading opportunities, along with the countries to which they apply. I will not provide an exhaustive explanation of each report because frankly, other authors have covered this material. I'm a trader, not an analyst, and so I don't focus on the nuts and bolts of how data is calculated. If you're interested in the nuts and bolts behind each country's fundamental factors, I recommend reading Kathy Lien's book, *Day Trading and Swing Trading the Currency Market, Second Edition* (Wiley, 2008). Kathy is a brilliant analyst and excellent trader; her book will teach you all the gory details of each economic report.

Finding out when a report will be released to the public is very easy via the Internet. You can either visit the web site of the agency releasing the data or use one of the many economic calendars available online. The economic calendars I use on a regular basis are located in Chapter 3. Since fundamental data is released at various times throughout the day,

TABLE 9.1 Major Fundamental Events and the Currencies They Affect

Fundamental Report	USD	EUR	GBP	JPY	AUD	NZD	CHF	CAD
ADP Employment Survey	X							
Balance of Goods and Services (Trade Balance)	X	X	X	X	X	X	X	X
Central Bank Rate Statements	X	X	X	X	X	X	X	X
Consumer Confidence	X		X				X	
Consumer Consumption	X						X	
Consumer Price Index (CPI)	X	X	X			X	X	X
Durable Goods Orders	X			X				
Employment Change	X				X	X		X
Gross Domestic Product (GDP)	X	X	X	X	X	X	X	X
IFO Business Climate Survey		X						
Industrial Production								
ISM Manufacturing	X							
KOF Economic Barometer							X	
M3 Money Supply		X						
Producer Price Index (PPI)	X	X	X		X	X		
Retail Sales	X	X	X	X	X	X	X	X
Treasury Inflow Capital	X							X
Tankan Survey				X				
U.K. Housing Starts			X					
Unemployment Rates	X		X		X	X	X	X
ZEW Economic Sentiment		X					X	

I recommend planning your trading week on Sunday. This will give you plenty of time to consider each report and arrange your schedule.

U.S. Data Reigns Supreme

The United States is still the largest national economy in the world despite recent economic troubles that continued into 2010. The U.S. gross domestic product dwarfs all others, and the United States remains the largest consumer of exports for most countries around the world. This position of economic power places the importance of U.S. economic data higher than that of any other country. Many believe the United States will be the first to recover from the recent economic troubles and pay close attention to the health of its economic data, looking for signs the worst may be over. All this accumulates to make fundamental data from the United States reign supreme when the market is expecting data from more than one country at the same time. Whenever the United States has economic data on the docket, plan to trade around that report over any other country's data.

For example, on August 14, 2009, the Canadian manufacturing sales data completely surprised the market by posting a gain of 1.9 percent when no growth was expected at all. On any other day this data could have been very bullish for the Canadian dollar, except that the United States was releasing CPI, Industrial Production, and the University of Michigan's Consumer Sentiment reports. The market initially sold USD/CAD on the back of good news from the Canadian manufacturing data, but as the trading day continued, the U.S. data took over. The USD/CAD had sold off into a support level that sparked more interest in buying USD/CAD. Additionally, the consumer sentiment data was worse than expected, adding fuel to the rally as risk aversion took hold of the market, as illustrated in Figure 9.1.

Whenever the United States has a fundamental event scheduled, its importance is typically higher than other countries' data as it relates to USD-paired currencies due to the sheer importance of the U.S. economic strength. Estimating the importance U.S. data will have over other reports scheduled for a USD-paired currency is not a perfect science, but the U.S. data will likely be held in greater importance. Traders should always

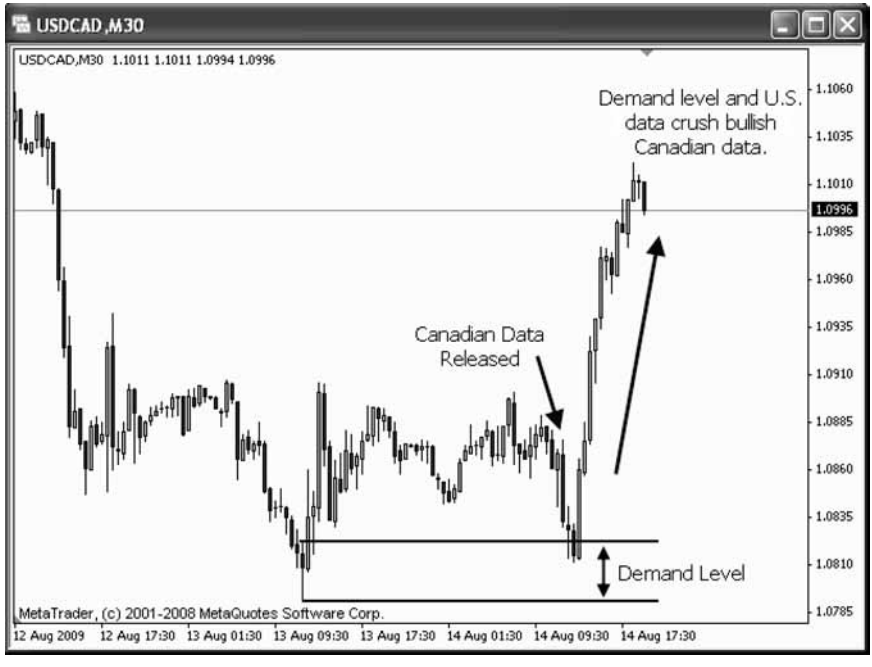

FIGURE 9.1 A Support Level and U.S. Fundamental Data Overpower Bullish Canadian Manufacturing Sales Data
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be aware of potential conflicts with fundamental data being released by the United States before they consider a "news trade" on any USD-paired currency.

WHICH CURRENCY PAIR SHOULD YOU TRADE?

Trading fundamental data properly is a matter of selecting the right currency pair for the data being released. Currency pairs are constructed with two currencies, each with its own fundamental influences. When a fundamental report is released, you should try to eliminate any influence another currency may have on the market's reaction. In other words, if you're trading the retail sales data for Australia, you don't want an outside fundamental influence from the United States to mess up the trade. Fundamental bargain hunters should select a currency pair that emphasizes the currency affected by the fundamental event. Traders can achieve this by eliminating the influence of the U.S. dollar or by pairing strength with weakness.

Eliminating the Influence of the U.S. Dollar

If you are not trading on fundamental data from the United States, you should select a currency pair that eliminates any influence the U.S. dollar may have on the currency you are trading. This gives you the ability to trade the fundamental data purely for the currency that belongs to that country. Cross-currency pairs give you the ability to eliminate the U.S. dollar as a factor in your trade by effectively hedging its risk on both sides of the trade. For example, if you want to trade the Australian Retail Sales data, you should look for opportunities with AUD/JPY instead of AUD/USD. Assuming that you bought AUD/JPY, the trade is constructed synthetically by buying AUD/USD and selling USD/JPY. The position effectively hedges your exposure to the U.S. dollar and creates a fundamental play of the Australian dollar against the yen. Since the yen is typically a risk-averse and weaker currency against the major currencies, you have effectively created a purely Australian fundamental trade. Whether you buy AUD/JPY or sell AUD/JPY depends on supply and demand barriers along with the fundamental data's actual result. Figure 9.2 illustrates how the U.S. dollar is removed from a fundamental play by trading a JPY cross-pair.

FIGURE 9.2 Cross-Pairs Hedge the U.S. Dollar

AUD/JPY is a synthetic currency pair constructed by two trades using AUD/USD and USD/JPY. When you're buying AUD/JPY, the position gets long AUD/USD and short USD/JPY, hedging your exposure to the U.S. dollar. Fundamental traders can use JPY cross-pairs to eliminate any influence the U.S. dollar may have on the currency they are interested in trading.

Pairing Strength with Weakness

An alternative to trading fundamental data with cross-currencies is to pair severe strength with severe weakness. This technique takes advantage of the fact that each currency trade is constructed with two separate trades. The trick is finding a fundamental trade within the context of a strong trend. When a currency is trending strongly against another, you can use fundamental events as an excuse to attach yourself to the prevailing trend. The process is simply a matter of analyzing price on a weekly, daily, or four-hour chart and determining the prevailing trend. Whether you use trend lines, a Hull moving average, or voodoo doesn't matter. However you define a trend is acceptable; just make sure that the trend is strong. The stronger the trend, the more likely a fundamental event that agrees with the trend will kick the market into overdrive.

Figure 9.3 illustrates how a simple trend line and moving average combination can identify strength versus weakness opportunity. Traders should look to pair the strongest currency with the weakest to create the highest-probability trade. When the fundamental data agrees with the trend, it can add fuel to an already strong move in price.

UNDERSTANDING MARKET REACTIONS

Why the market rallies or sells off following the release of economic data is difficult for many traders to understand. Often the market will move in a rather counterintuitive fashion, leaving traders scratching their heads in disbelief. Assuming that good news will always be positive for a currency and bad news will always be negative leads inexperienced traders into a trap, which results in many bad trades. Many traders believe that the market's reaction to a fundamental event depends on whether the data met expectations, exceeded exceptions, or fell short of expectations. I believe this is an oversimplified point of view. The currency market doesn't simply wait around for a fundamental report to be released before it makes an adjustment. It moves price ahead of fundamental data, anticipating what the data will be when it is released. Often the market is wrong and a quick adjustment in price occurs. This, what I call a *valuation error*, happens quite often.

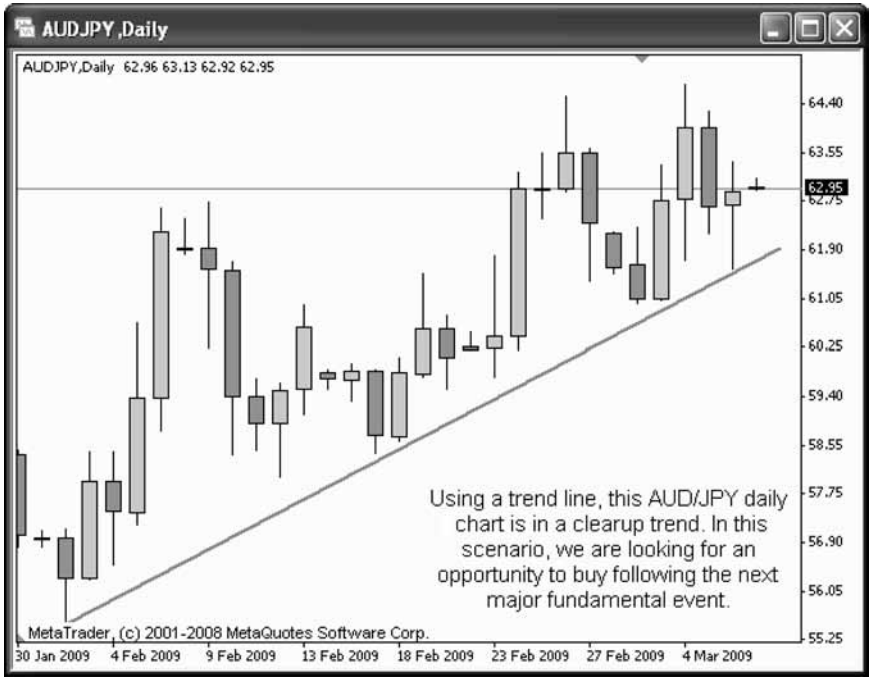

FIGURE 9.3 Identifying Strength vs. Weakness in an AUD/JPY Currency Pair
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Valuation Errors

In the few days leading up to a major fundamental event, the market often moves price to a level that reflects the expectations of the coming data. This process is often referred to as *pricing in* or having a report *priced into* the market. The theory is, if the market has valued a currency correctly and the data meets expectations, the price shouldn't change dramatically when the data is released because it has been "priced in" already. Fortunately for traders, pricing in a fundamental report isn't an exact science. The market is often surprised by data that misses its mark, sparking a flurry of activity as traders quickly adjust their positions to compensate for the new data. Even if the data meets expectations, the market may move dramatically, having priced in an expected higher or lower number for the report. Fundamental traders should pay attention to the financial press and understand the sentiment surrounding a particular report before it is released.

Figure 9.4 illustrates how valuation errors can cause unexpected results. Even though the United States lost 651,000 jobs for the month of

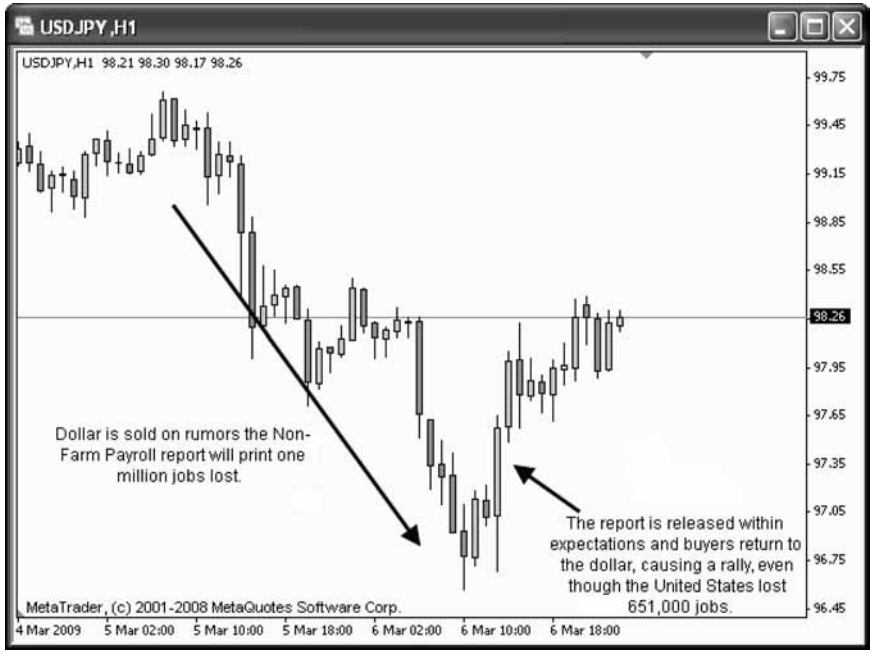

FIGURE 9.4 An Example of a Valuation Error
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February 2009, the market feared a number higher than 1 million and had aggressively sold USD/JPY ahead of the report. Though the number was horrible, it wasn't as bad as the market feared, resulting in a USD/JPY rally that confused many traders.

What If Fundamental Data Meets Expectations?

Many traders believe that the market must be surprised by data that is worse or better than expectations, to spark a move in price, but that is not always the case. Often the market will start a move in price, anticipating that the fundamental event will meet expectations; when it does, the move simply continues. Consider Figure 9.5 as an example. The market began to sell EUR/JPY, expecting the European Central Bank to cut rates by 0.50 basis points. Anticipating the rate cut and factoring in surprises, it seemed that traders didn't want to be holding euros ahead of the fundamental event. The European Central Bank (ECB) did cut rates 0.50 basis points as expected, but nothing in the statement released by the central bank enticed traders to begin buying euros, and the selloff continued.

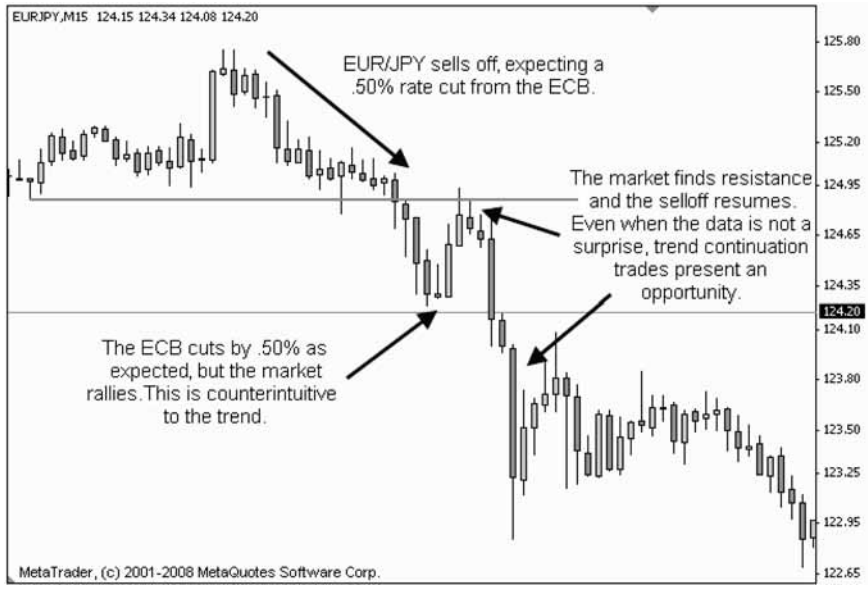

FIGURE 9.5 News That Meets Expectations Can Still Produce Dramatic Price Changes
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What is interesting about Figure 9.5 is the initial rally that lasted 30 minutes after the ECB's rate statement was released. The rally was a total fake-out, simply to revisit the resistance layer EUR/JPY broke earlier in the morning. Unfortunately, I'm sure the rally led some inexperienced news traders to their slaughter by enticing them to get long EUR/JPY. Conventional news trading often chases the move immediately following a fundamental event. In this case traders may assume that the market's reaction to a lack of surprises in the ECB's statement was bullish. In reality, the post-news rally was simply a test of broken support that offered sellers an opportunity to join the existing selloff and push EUR/JPY lower. The irony is that many news traders who got long probably put their stops just below the low set prior to the ECB's statement. Once the market moved below that level, their stops were triggered, adding more fuel to the selloff.

Understand that regardless of actual data on the report, support and resistance are often strong enough forces to control price after the news is released. When planning a news trade, the support and resistance barriers you see on an hourly chart or larger are usually significant enough to use as potential entry zones. When a support or resistance zone falls near a round number, it can be particularly useful as an entry opportunity.

Occasionally the fundamental event is so shocking to the market that support and resistance are overtaken, which is why news traders shouldn't place orders ahead of the news release. Take your time to evaluate the news and confirm its effect on support and resistance prior to taking a trade.

TRADING A FUNDAMENTAL EVENT

In this section we walk through example trades that combine fundamental data with support and resistance. The process of planning a trade should be very familiar to you by now. The only difference between a fundamental trade and a bargain day or Sitcom trade is the fundamental event itself. First, you should survey the support and resistance landscape using a four-hour or one-hour chart about 30 minutes prior to the scheduled release. You're looking for support and resistance levels or round numbers that might be tested immediately following the news release. Second, you'll use Fibonacci to plan potential profit targets as usual. Third, you'll plan risk to accommodate at least a 1:3 risk-to-reward ratio, which gives you a 70 percent margin of error while maintaining profitability.

We walk through four examples in this section. The first example trade uses the USD/CAD currency pair to trade the Canadian GDP data. The second trade example uses the AUD/JPY to trade Australian Retail Sales data. The third example uses GBP/USD to trade a U.K. housing report, and the final example trades EUR/USD during the non-farm payroll report.

USD/CAD Example Trade

Our first example trade is from June 30, 2009. The market was digesting the results of the Canadian GDP data, which met expectations at a small loss of –0.1 percent. Although GDP data was in negative territory, it was showing improvement over the previous months' –0.3 percent loss. Initially the market's reaction was very positive for the Canadian dollar and very negative for the U.S. dollar, as illustrated in Figure 9.6. The USD/CAD began to approach a decent support level near $1.1450 while the market awaited consumer confidence data from the United States. We pointed out earlier how fundamental data from the United States usually trumps any other data on the docket, so the observant support and resistance trader could have looked for a long opportunity near the upcoming support level as consumer confidence data was released.

An hour and a half after the Canadian GDP data was released, the market saw consumer confidence data for the United States, and the data

FIGURE 9.6 A USD/CAD Fundamental Trade Opportunity
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wasn't good. Consumer confidence was expected to rise slightly; however, the report surprised the market with a sharp drop in consumer confidence. The news renewed sentiment averse to risk, the equity market began to sell off, and the U.S. dollar was bought. USD/CAD tested the support level at $1.1450 for several hours, offering traders an opportunity to buy the currency pair at support. Figure 9.7 illustrates the USD/CAD immediately after the release of consumer confidence data. The market is clearly beginning to consolidate above the support level identified in Figure 9.6.

Traders may choose to wait for confirmation that a support or resistance level will hold price before entering the market, since fundamental events can cause swift reactions in the market. Furthermore, aggressive traders may place an entry order at the top of a support level or the bottom of a resistance level to ensure that they get into the trade during a quick spike. Either way, ensure that you limit risk on every trade with a stop order placed just beyond the support or resistance level set up by the fundamental event, as shown in Figure 9.8. It doesn't hurt to be a little more

FIGURE 9.7 $1.1450 Provides Support after the Release of U.S. Consumer Confidence Data
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aggressive with risk control when you use a fundamental event to trigger a trade.

Planning a profit target using a fundamental trigger is no different than any other support- and resistance-based trade. You can target either the high or the low set before the trade entry or, as I prefer, the 61.8 percent Fibonacci retracement ratio. The Fibonacci ratios are measured using the high or low preceding the entry price and the entry price itself. In Figure 9.8 the Fibonacci ratios are drawn using the high of $1.1655 and the entry price of $1.1450.

AUD/JPY Example Trade

The second example trade is from March 2, 2009. In this example, the Australian dollar had been trending higher against the Japanese yen and had just completed a pullback and new breakout above minor resistance.

FIGURE 9.8 Entry, Stop, and Profit Targets for USD/CAD Fundamental Trade MetaTrader, © 2001–2008 MetaQuotes Software Corp.

The market expected data on Australian retail sales, which offered an opportunity to trade fundamental data using the AUD/JPY cross-pair. Australia's retail sales were expected to post a –0.5 percent loss, but the data indicated a 0.2 percent gain. The Australian Current Account data showed a narrowing trade deficit, and three hours later the Royal Central Bank of Australia surprised the market by increasing its rates 0.25 basis points. The fundamentals were very positive for the Australian dollar against the weaker Japanese yen. Illustrated in Figure 9.9 is the AUD/JPY hourly chart prior to the fundamental announcements. The currency pair had rallied through minor resistance earlier in the trading day and looked set to test it from above as support. This trade opportunity combined strength with weakness, trend, and round-number support, all in one single trade!

The initial market reaction to the positive news is to aggressively sell AUD/JPY, which is counterintuitive to the positive news and a source of confusion for many traders. However, support and resistance traders understand that the market is likely moving lower to test support and

FIGURE 9.9 Support and Resistance Pivot Combined with a Round Number to Create a Potential Support Level
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locate potential buyers before it can move higher; this is supply and demand in action.

There are two options for entering a trade during a fundamental event. You can use either a market order or a limit order, depending on your aversion to risk. Figure 9.10 illustrates where protective stops could have been placed for either entry technique. If you waited for a turnabout and bought the AUD/JPY after the market closed above the demand level, a protective stop could be placed immediately below the turnabout. If you used an entry order at the round number of $62.00, an alternative location for your stop is below the most recent low during the previous day's rally. The goal is to keep risk limited, because fundamental events tend to be volatile.

Planning a profit target for this example trade requires a different approach. Typically I'd use the 61.8 percent Fibonacci retracement ratio measured from the high or low preceding the entry; however, in this case, the risk-to-reward ratio isn't sound enough. This activates plan B, which is to

FIGURE 9.10 Alternate Fundamental Trade Entry Techniques
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target the high or low preceding the entry instead. Figure 9.11 illustrates where the appropriate profit target would be based on maintaining a risk-to-reward ratio of at least 1:3.

GBP/USD Example Trade

The next example demonstrates that no trading methodology is immune to taking a loss. Support and resistance are powerful forces, but they can be overpowered by the forces of trend and fundamentals. On Sunday, August 16, 2009, the GBP/USD opened lower and appeared interested in challenging the round-number support set on Friday at $1.64. The fundamental data on tap that afternoon included housing price index data out of the United Kingdom, which could have added fuel to the support-driven rally. Normally, fundamental data on Sunday is not of interest, but housing data of any kind in the economic climate that existed during the summer of 2009 was worth watching.

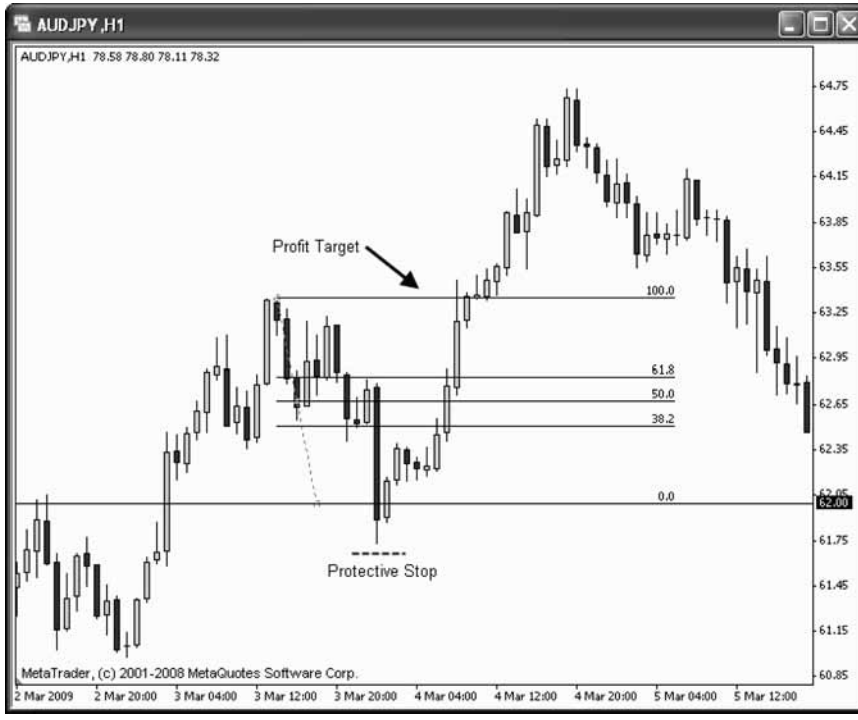

FIGURE 9.11 Profit Target Using the High Price Prior to Entry Price
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Figure 9.12 illustrates how I set the trade up using support and Fibonacci for the entry and profit targets. I planned to enter just below the round number at $1.6390 and target the 61.8 percent retracement ratio near $1.6563. This gave me a risk-to-reward ratio just over 1:3, with a 50-pip stop. Unfortunately, the U.K. housing data missed expectations completely and GBP/USD continued to sell off, triggering the entry order and stop order on this setup, as shown in Figure 9.13.

EUR/USD Example Trade

The final example trade demonstrates that even when a fundamental report is considered dangerous to trade due to volatility, it can be tamed by support and resistance. The non-farm payroll report is considered one of the most influential and volatile fundamental events of the month. It is released by the U.S. Bureau of Labor Statistics on the first Friday of every month and contains statistics on the health of the U.S. labor market.

FIGURE 9.12 Fundamental Trade Setup GBP/USD on August 16, 2009 MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 9.13 Fundamental Trade Triggers Protective Stop Order MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Traders place tremendous importance on the health of the labor market because strength in the labor market affects every sector of the economy as people earn and spend more money. The first few minutes following the release of non-farm payroll data are notorious for large price spikes in the currency market as traders frantically adjust their positions in reaction to the numbers. Often these reactions run straight into a support or resistance zone, which is exactly what a fundamental bargain hunter is looking for.

On September 4, 2009, traders awaited the release of the non-farm payroll report. Figure 9.14 illustrates the EUR/USD 60-minute chart approximately 30 minutes prior to the report's release. The EUR/USD was trading within a range between a high price of $1.44 and a low price of $1.42, giving bargain hunters two potential trading opportunities. If EUR/USD tested $1.42, they could get long and place a stop order below $1.4180; if EUR/USD tested $1.44, they could get short and place a stop order above $1.4415. Either trade wouldn't risk more than 40 pips.

If the trader bought near $1.42, she could target the 61.8 percent retracement ratio shown in Figure 9.14 for a gain of approximately 130 pips.

FIGURE 9.14 EUR/USD Fundamental Trade Opportunity
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

FIGURE 9.15 EUR/USD Fundamental Trade Result
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

If the trader sold near $1.44, she could target the 38.2 percent ratio illustrated in Figure 9.14, also for a gain of 130 pips. Note that in Figure 9.14, the 38.2 percent retracement ratio is placed exactly where the 61.8 percent ratio would be had I drawn the Fibonacci ratios to favor a short trade.

In Figure 9.15 you can see that the EUR/USD tested $1.42 and was held above the support level following the release of non-farm payroll data. Traders could have entered this trade with entry orders at $1.42, or they could have waited for the turnabout before going long EUR/USD. Either entry option produced a successful trade.

CLOSING BELL

This chapter taught you to view trading the news through the lens of a support and resistance trader. Rather than chasing the volatility that often occurs following a major news announcement, you learned to take a step back, analyze support and resistance that could be tested by news, and place clear trades with concise profit targets. News trading may attract many traders with the lure of

quick profits in minutes, but chasing volatility doesn't often favor the average retail trader. Slippage, gaps, and trading software that lags are all potential realities of trading in the first few minutes of a major news release. Use the news as a catalyst for good support and resistance trades and you'll have a much calmer approach to trading the news.

Fundamental bargain hunting is no different than any other support- and resistance-based trade. The only advantage to trading a fundamental event is the benefit of knowing exactly when and on what currency a trade may appear. Use Fibonacci ratios for profit targets, limit your risk, and stick to the trading plan.

CHAPTER 10

Achieving Consistency: Simple Steps Every Trader Can Take

Achieving consistent results is the largest challenge any trader faces on the road to becoming professional grade. Consistency in this context is not measured by profits, because even when a trader does everything according to plan, he might still lose money. Consistency is measured by how traders conduct their business, control their emotions, and manage their accounts. Is your trading organized and efficiently executed, or do you change strategies every week, hoping you have found a better mouse trap? Having nearly finished this book, you now understand how I trade the currency market, but whether you'll be able to do anything with this knowledge is up to you.

Even if I published the Holy Grail of trading strategies in every major newspaper across the United States, there would be plenty of traders who would still go broke. Every trader goes through a personal journey to achieve consistency; this journey has less to do with skill and everything to with the trader's personality and state of mind. In this chapter you will read about several common problems I see among traders who e-mail me for help. You will learn how to organize your trading by writing a trading plan and keeping a trade journal. I'll share some advice that has worked well in my own trading, and finally, you will learn how to demo trade correctly.

STOP SEARCHING FOR THE HOLY GRAIL

Traders waste a tremendous amount of time searching for the one system that will turn them into a confident and successful trader. The pursuit for

the Holy Grail of trading is not only futile, it damages a trader's confidence in her ability to trade her own style. When you are constantly searching for a better, easier trading system, you are not spending time with the live market and you'll eventually lose confidence in your own ability to select a good trade. The less time you spend on Internet forums, chat rooms, or getting trading tips off Twitter, the better. Stop looking for the Holy Grail; it doesn't exist, and no number of indicators, gurus, or web sites is going to make you a better trader. You have everything you need in this book, and now it is time to do it on your own. If you spend another week searching for another trading system, you're using it as an excuse to avoid doing what you already know works. It's like buying yet another diet book to lose weight when you already know you should eat less and exercise.

These traders are not alone. I struggled with trading strategies for several years. I finally had to accept that trading was a game of probabilities, and no matter how hard I worked, losses were going to happen. The notion that I couldn't eliminate all the inefficiencies in my trading strategies was very alien to me. I had come to trading from a lengthy career in e-commerce and software engineering, so coding out bugs was a part of my nature. I wasted a lot of time trying to perfect various trading systems until I ditched them all and simply focused on support and resistance. You do not need a perfect trading system to make a decent return in the trading business.

If you find yourself frustrated over losses and you're ready to try a new trading system, consider this quote from Tom "Terrific" Seaver:

> *In baseball, my theory is to strive for consistency, not to worry about the numbers. If you dwell on statistics you get short sighted, if you aim for consistency, the numbers will be there at the end.*

Seaver retired from Major League Baseball in 1987 after a 20-year career in which he pitched an ERA of 2.86. Seaver was inducted into the Baseball Hall of Fame in 1992 and received more votes than even the great Nolan Ryan. What is interesting about Seaver's record is not how often he won but how often he lost. Tom "Terrific" Seaver won 311 games and lost 205 games, achieving a winning percentage of only 60.3 percent! Even though he lost nearly half the games he pitched, Seaver is considered one of the greatest starting pitchers ever to play the game of baseball.

Traders can learn a lot about consistency from a guy like Seaver. Your trading system doesn't have to be perfect. What matters is how you approach the game of trading. Following the same methodology day in and day out is the mark of a consistent professional, whether you are trading currency or pitching baseballs.

FIX YOURSELF FIRST

Achieving a consistent result has more to do with a lack of discipline in a trader's life than anything else. Trading is such an individual journey that it has a keen ability to lay bare any emotional or discipline problems a trader has in his personal life. I believe that learning to trade is closer to learning how to lose weight or play an instrument. Each is well documented, and anyone can learn to lose weight or play an instrument, but the ability to do so lies in the individual's resolve to commit to the process. There are no quick and easy roads to losing weight or playing a bass guitar, and there are no quick and easy roads to becoming a successful trader. Is it any wonder, then, why weight loss ads and currency trading infomercials offer quick rewards with little effort?

Assuming that two traders use the same trading system, the only variable between a trader who wins and a trader who loses is the trader herself. I've seen many traders suffer by allowing influences from their personal lives to creep into their ability to make good trading decisions. Traders who lack discipline in their personal lives are under financial or family pressure, or continually make excuses for their trading decisions are doomed to ultimately lose their entire account. You must fix yourself first before trading or your results will suffer.

You don't have to take my word for it. Richard Dennis proved it during a famous trading experiment known as the Turtle Traders. Through trading, Dennis had built a personal fortune worth several hundred million dollars through the 1980s; if anyone could teach someone to trade, it was Dennis. Through an application process, 23 original Turtle Traders, as they were known, were accepted into an apprentice program with Dennis. Each was given a trading system known to produce profitable results and a live money trading account with $1 million. Trusting that the system worked and trading it religiously should have been a no-brainer for the Turtle Traders, yet many lost money, and some were even fired for their inability to follow the system. Think about that for a moment. Even when given a profitable trading system from a guy who made millions in the market, 23 traders produced 23 different results, with some failing to achieve consistency at all.

Fixing yourself first is a critical first step to achieving a consistent result as a trader. The topics in this section may be uncomfortable for some of you to read because you'll realize you are in this situation, but do not worry; you can overcome these issues and become a great trader. Finally, don't skip this section because you think you have it all figured out. You might identify trouble spots you didn't even realize you had, and your results could show it.

Be Financially Stable

Regardless of how well you protect your account the money in your trading account is called *risk* capital for a reason. Trading currency off exchange, on margin, is probably the riskiest trading environment in which a trader can participate. Traders can and have lost their entire accounts through stupid trades, poor risk management, or both. It should be obvious to point out that a trader should be financially stable before he begins trading, but I continue to meet traders who are literally down to their last $500 and are trying to trade their way out of a jam. This kind of desperate trading is typically not sustainable, and many of them I meet ultimately fail under the pressure. I suspect a number of traders in this situation are drawn to trading in part due to the low barrier of entry offered by micro accounts and the constant marketing of get-rich-quick trading schemes.

Trading is not a road to easy wealth, and you shouldn't be trading if you are struggling to keep the lights on or food in your house. I'm not suggesting you can't trade if you only have $1,000, but trading is a serious business that requires financial stability going into the venture. If you lose that $1,000, it shouldn't bankrupt you. Stress can lead to poor decision making, and there is already enough pressure to achieve consistency without worrying about having to pay your bills with the next trade. If you are not where you need to be financially, I suggest you seriously demo trade until you are on better financial ground. You'll be much better prepared to trade with live money after a few months of practice and much calmer about taking trades, knowing that your risk capital doesn't represent what's left of your life savings.

Personality Traits and Trading

I've found trading to be the most rewarding, exciting, personally demanding, and emotionally draining profession I've ever pursued. When I came to trading I had already established myself as a leader in the highly technical field of e-commerce and information technology management. What I did for a living was hard, complex, and demanding, so I figured trading would be a breeze to master. I was wrong. What many traders do not realize about trading is how demanding it will be on their personal emotions. I liken learning to trade to learning to lose weight. Just like a dieter, each trader has a unique set of emotions, personal barriers, fears, and insecurities he must identify and move beyond in order to achieve success. Just like losing weight, trading is a personal journey, and each trader will achieve success only when he is ready to cut loose his personal anchors. You should be prepared for a journey in personal development when you begin to trade.

In this section I discuss some common personality struggles I see in many new traders to make sure that you are aware of them before they cause you grief.

Analytical Thinkers If you are an analytical thinker, someone who likes structure, logic, and predictable outcomes, you may have a personality that will become easily frustrated with trading. I'm an analytical thinker; I was a programmer for years and have flown airplanes since I was 13. I've always believed that with hard work and logical thinking any problem could be solved, which is not the case in trading. I found myself trying to optimize every trading system I developed to the point where I determined the trading system to be flawed and proceeded to look for a better one. I grew increasingly frustrated that I couldn't apply logic and remove all the faults from each trading system. It actually hindered my trading for a long time because I spent more time trying to build a system rather than actually trading. I finally had to accept the fact that trading is an abstract world, void of clean, logical assumptions and to simply start trading with an imperfect system. For a binary guy like me, that was very hard to do. The market is an abstract beast, and you can't develop the perfect system. If you're an analytical personality type, be aware of the desire to over optimize a system because it might an issue for you. You should be ready to accept that the market isn't perfect and no trading system will be, either. You can't optimize every loss out of a trading system, and that is okay. Just start trading!

Workaholics and "Type-A" Personalities Most people in this world are content with coming to work and doing their 40 hours a week in exchange for a stable paycheck. These are not the kind of people I meet who are interested in trading. People who are driven, who want to better their lives and achieve true financial and personal freedom, are the types I see every day through my blog and online webinars. Most of these people are already successful corporate warriors and now they are looking to ditch a day job they hate, and supplement their investments. Others are approaching retirement and realize they need to do something to maintain their current lifestyle into retirement. These people are driven, success oriented, and willing to put in the effort necessary to become successful traders. The problem is, trading doesn't necessarily reward constant effort, and that can be a problem for driven folks.

Workaholics and "Type-A" personalities need to have something to do every day or else they do not feel they are doing enough to reach their goals. Perhaps this is why such people are attracted to day trading. Unfortunately, just because you want to trade today doesn't mean the market is offering any opportunities. The currency market will move when it is ready, and people who can't contain their desire to trade in order to "be a

trader" will place their capital needlessly at risk. Driven personality types are at risk of developing a habit known as *over trading*. Over trading occurs whenever a trader takes a trade simply because she is bored or feels the need to be trading to justify her existence as a trader. Listen, the market doesn't care if you spend one hour or 10 hours a day looking at charts. I've met traders who spend 12 hours a day trading and still haven't made a profit. You must learn to let go, allow the market do the work for you, and trade only when it is necessary. You can't force success just by putting in more hours watching the charts. Think about the old saying, "A watched pot never boils," and learn to relax a bit.

Discipline

The science behind losing weight isn't hard to understand; it's simply a matter of reducing your calorie intake, eating the right foods, and exercising. There is no magic pill or secret exercise routine needed to lose weight, yet billions of dollars are spent on coaches, diets, and exercise programs because people simply are not disciplined enough to do it on their own.

If struggling traders were trying to lose weight, the outcome would be very similar. There is no secret formula to achieve success at trading. It takes good money management and the discipline to do the same thing every day. Is it any surprise that diet pills and currency trading systems are advertised the same way? People respond to promises that a pill or a black-box trading system will fix all their problems. If you have problems with discipline in your life, this will probably be the largest struggle ahead of you on the road to becoming a successful trader. Discipline issues are subtle, and even people who seem to have it together could be a mess under closer examination.

I fell into this category myself. Even though I was driven and detail oriented, I had a lot of discipline issues in my life. I was horrible at keeping my calendar straight, which was an issue for trading because I kept changing my routine for planning trades, or I would simply forget when a big fundamental report was going to be released. Since I was constantly trying to improve my trading system, I failed to maintain the discipline to stick with one trading system through the good times and the bad. Fortunately, discipline is not a talent but a habit that can be developed by making a few changes in your life. In this chapter you'll learn simple techniques for organizing your trading activity, including how to write a trading plan and what should be in a trading journal.

Character

Discussing one's character is a sensitive topic, but you can be assured that trading will expose any flaws in your character. Trading is very binary;

each trade either wins or loses, and the results are there in no uncertain terms. You can't reason with the market or negotiate your way out of a loss, and for many people used to politics or smooth talking, it can be a difficult reality. The two character flaws I see routinely in traders are bragging and lying.

Traders who embellish the truth serve only to create a false sense of security about their trading performance. These people tend to tell you about the winning trades but never discuss their losing trades. They can't be honest about their actual trading performance and therefore they will never grow beyond being just another trading braggart. If you tend to embellish stories or tell half-truths, you should be on alert. You have a serious character flaw, and trading will expose it faster than you care to admit. This isn't a game for bragging rights. Everybody wants to see you succeed, especially me; however, if you want to grow as a trader, you must be able to honestly discuss your trading record, including both the big wins and the big losses.

At the other end of the spectrum are traders who lie about their performance. These traders are unable to face reality. They can't accept the fact that they are losing money and they lie to cover up the reality of their trading performance. I even see traders lie to their spouses about how much money they are losing. Perhaps traders who lie have a pride issue at stake. These people may be used to achieving success in business or the corporate world, but they have yet to achieve it in the trading world and it is driving them insane. They have a pride issue and they can't be honest about the fact that trading isn't coming as easy to them as they thought it would. Or perhaps they are just dishonest people in general, used to maneuvering to success on their charm and ability to sway people's opinion. Whatever the reason, lying won't hide the truth forever, and you won't grow as a trader until you're able to honestly inspect your trading record and accept it for what it is.

If this is you, it is time to clean up your act and accept the truth for once. It's okay to have a bad trading record; everybody goes through a learning phase, and yours might be longer than others. Rather than lying I suggest that you simply enjoy the apprentice phase of trading. Try sharing your trading record with someone you trust on a regular schedule, and be honest about your skills. Only then will you improve both your character and your trading record.

Quit Making Excuses

If you can't be honest with yourself, you will have a hard time becoming a consistent trader. Traders who make excuses for their performance avoid taking personal responsibility for their trading decisions and shift the blame to reasons usually thought of as beyond their control. I've heard

excuses from traders all over the world, and frankly they are usually the same regardless of the trader's skill level. If you find yourself explaining why a trade went bad or why you haven't made a profit, the problem is likely that you and the symptom are the excuses you are spewing forth and not the other way around. This might sound like tough love, but you must understand that although you stand on the crutch of justification, your performance will never improve and your trading will never achieve consistency. Ask yourself honestly whether you're using some of the excuses in this section, and if you are, ask yourself what it will take to accept responsibility and ditch the crutch.

"My Trading System Doesn't Work" Trading systems are a dime a dozen. I could spend five minutes on the Internet and find more trading systems than I could possibly know what to do with. The irony of most struggling traders I meet is that their trading systems are usually sound. Their problem is usually in poor risk management or poor discipline related to over- or under-trading. Many traders are unable to accept the truth that the problem is them. These traders blame their mistakes on a bad trading system and constantly seek out the next Holy Grail to trade. What I'm trying to tell you is, if a trading system is back-tested and known to be profitable but you continue to lose money with it, the problem might not be your system. You need to look at everything related to trading to determine where the problem lies. Are you taking trades against your trading plan? Are you risking too much money? Are you risking inconsistent amounts of money on each trade? Are you afraid to take trades, even when your system tells you to? Usually fear is driven by risking too much money on each trade; you can overcome that fear by reducing your trade size. The point is not to allow a bad system to become an excuse for inconsistent trading results.

"I'm Asleep When the Market Moves" I've actually used this excuse myself. When I began trading I felt that the only serious way a trader could be successful was to trade during either the London or the New York session. The forex market might be open 24 hours a day, six days a week, but everybody knows that London and New York see the most action. This attitude was reinforced by nearly every book, web site, and mentor who promoted day trading as the only serious way to trade forex. My perception at the time was that successful traders were session traders and that is what I should pursue as well.

Unfortunately, I lived in the Central Time Zone and worked a day job. I couldn't trade New York due to my commute, so I did my best to get up early and trade with London. It was a disaster. I was fatigued and unfocused while I traded, and it was a recipe for as many losses as I could rack up. I told myself I just couldn't be around when the market was active, and

I used this excuse to justify why I couldn't maintain success. I actually rationalized that since the majority of trading strategies seemed to work only during active market hours, I was out of luck because I couldn't trade during the active sessions. Of course, all of that was bunk, but it took me some time to get over the block I had built as an excuse.

If you're using this excuse you should understand that successful trading is not limited to the session traders. With a little practice you can apply the support and resistance methodologies in this book on any timeframe around your day job and you'll do just fine.

"I Can't Afford Big Stop Losses" Contrary to popular belief, using a daily or weekly chart to trade doesn't necessarily mean you must use a large stop loss. There are a several options available to a trader who needs to trade long term but can't afford large stop losses. First, you can always skip a trade if the required risk is too expensive for your preferences; just wait for the next one. Second, you can simply reduce the size of your position so that you are not risking more than your preferences. This book has taught you several methods of trading on a daily chart with as little as 40 pips risked. I've traded daily charts with as little as a 25 pips stop loss, so what's the problem?

"My Stop Orders Are Gunned" I hear this excuse constantly from traders who routinely pick horrible places for their stops. I won't claim that stop gunning doesn't happen in the forex market, but to use it as an excuse is foolish. If you're constantly getting stopped out prior to the market moving in your favor, you need to examine your stops and quit using this as an excuse. Analyze the number of pips the market moves beyond your stop placement, on average, and adjust your stops or entries accordingly. Avoid placing stops near a round number; if you're 10 pips above or below a 00 level, you're asking to get tagged. Finally, reduce your position size to fit into a wider stop if necessary.

"I Can't Trade Because . . ." The number of excuses I've heard and used myself could fill a book. The bottom line is, if you're making excuses for why you haven't achieved consistent trading, you're really masking a personal issue, in my opinion. Whatever the excuse, examine it and figure out why you're making that excuse. If you don't believe that your strategy works, back-test it and convince yourself it works before you ditch it. If you don't believe you have the time to trade, try carving out only one hour every day to plan trades and forget about the market until that hour arrives again. Do this every day for at least two months and you'll find a rhythm that works for you.

Perhaps you're afraid of losses. Try reducing your position size or returning to demo trading until your confidence returns. Losses are part of the business; don't blame yourself or your system when you take one. Whatever you think is holding you back, it isn't. You are the only obstacle between you and consistent trading. Quit making excuses; create a plan and stick to it.

Family Support

Many people do not understand trading as a business; rather, it is perceived as a reckless and risky venture that should be avoided. Everybody seems to have a story about an Uncle Jimbo who went bankrupt after something called a "margin call" happened on the corn futures he bought. Within my own family I had relatives who constantly told me that trading is too risky and that I should quit before I lost my shorts. Your family means well and has your best interests at heart, but their fear is based on uninformed perceptions of how a professional trader conducts business. Unless you're single and can call your own shots, having the support of at least your immediate family is critical to your success as a trader. If your family doesn't believe that trading can be viable, how do you expect to keep their support when things are bad?

If you think this is a bunch of fluff, I want you to consider a true story that illustrates how critical having the support of your family is to a trader. I spoke with a trader who was struggling to make a consistent profit, and by the time he e-mailed me he had reached his wits' end. I learned that he was out of work, had suffered great losses in his account, and couldn't bring himself to share the bad news with his wife. He told me that his wife didn't understand trading and he felt alone. He might not have realized it at the time, but his despair had caused him to turn on himself, and told me he felt too stupid to be a successful trader. Rather than give him a trading system or trading advice, I told him that his first priority was to come clean with his wife. This trader needed to honestly share his struggles, because his isolation and financial pressure were driving him to take reckless trades. I don't believe he ever did, and the last e-mail I received from him told a story of how his trading had been reduced to taking gambles until ultimately his account was margin called.

Take the time to educate your family about the market before you begin trading. Show them your trading plan and explain to them how risk is managed. Update them regularly on your performance, and do not hide anything. Honesty is the best policy, and your family will hopefully support you once any of their perceived fears about trading have been addressed. They must understand the risks and know where your account stands at all times. If you come to them after blowing out the account

with little or no warning, you might never gain their support for another account.

ARE YOU *REALLY* GOING TO EARN 100 PERCENT A MONTH?

Usually about once a month I get an e-mail from an aspiring trader who is convinced he will be able to trade for a living within two or three months. These wannabe traders typically have an elaborate plan detailing how many pips they will earn per month, how much money they will make, and how soon they will be trading for a living. For a moment ignoring the fact that they have no experience trading actual money, the problem with these traders is that they typically have less than $5,000 in trading capital. They all have an idea of what they need to earn in order to trade for a living and have done the math based on pips to determine how long it will take them to get there. The problem is that market gains are never linear.

For example, let's assume for a moment that you live in Washington State and you want to trade for a living. Ideally you would like to earn at least the state's median household income. According to the U.S. Census Bureau, Washington's three-year average median household income from 2005 through 2007 was $56,049. This divides out to $4,670.75 per month. Let's round up to $5,000 per month for a little fun money, shall we? So, assuming that the trader is trading one standard EUR/USD lot per trade, he needs to *average* 500 pips a month. Do you see the problem here?

These traders are only thinking about gains in terms of pips per month and leverage. They are not thinking about gains as a return on their account versus the risk taken. If you have a $5,000 account, you really have no business trading a standard lot with standard 100:1 leverage due to the risk each trade will pose to your account. In this case a 10-pip loss would represent 2 percent of the account! The trader should consider trading a mini account, which means he now must average 5,000 pips a month trading one lot. If you increased the lots to 10, you are effectively trading one standard lot again, and the risk is unacceptable.

These traders are making the assumption that they will be able to return nearly 100 percent on their money month after month with only three months of experience. I think the likelihood of that happening is nil. Even the best money managers on Wall Street are returning only 30 percent to 50 percent *annually* on their clients' money! If you really could return 100 percent a month consistently, you wouldn't have to worry about trading for a living because you'd have every hedge fund participant in the world begging you to trade their money. Keep your expectations in

perspective with your available capital and you won't be let down when you only return 10 percent in a month—and yes, that was sarcastic, because 10 percent a month is a great return by any standard.

Promoters of trading systems and seminars focus their efforts on the gains made by their respective styles of trading, but as with everything in life, great reward comes only with great risk. I've seen a number of systems and seminars promoting gains higher than 300 percent per year, which sounds amazing, but the devil is in the details. To gain these tremendous returns, many of these systems use a significant amount of leverage or their risk-to-reward ratios are very dangerous. Some even admit to being so risky that they blow out accounts every once in a while.

There is nothing wrong with super-aggressive trading with tremendous levels of risk if you are willing to deal with the consequences of your actions. You may lose all your investment capital regardless of whether you're trying to play it safe or you are trading super-aggressively, so the choice of how much risk to take is up to you. The point I'm trying to make in this reality check is this: You should understand that great gain is achieved through being willing to take on great risk. If you are unable to swallow that pill, you might want to rethink your expectations and focus on smaller, consistent gains.

CONSIDER LONG-TERM TRADING

Most trading books, Internet articles, and gurus are focused on teaching traders how to trade during an active market session. Even if they use long-term charts to plan a trade, many are still using short-term charts to enter the trade in real time. I assume that the idea of day trading and making tons of money in a few hours sells well and appeals to a wide audience, but the reality is, most of the retail traders I speak with work other jobs for a living and can't participate during an active trading session. I don't deny that an experienced day trader can achieve impressive results; I would submit to you that an experienced long-term trader can do the same. This book is about trading *around* a day job, regardless of whether your end goal is to quit that day job. Therefore, the methods I teach in this book are focused on long-term trading due to the number of advantages it offers over day trading.

First, despite the constant marketing hype that the currency market is a 24-hour-a-day market, there are really only a handful of hours during each trading day during which the market is worth watching. If you're not trading during the London or New York trading sessions, there isn't much going on and you best not be trying to day trade. Even if you did try to

day trade around your day job, the schedule you'd have to keep is nuts. Depending on your time zone, these trading sessions will happen when you sleep, during your morning commute, or during your workday. In my time zone, if I wanted to trade with London and New York I'd have to be awake from midnight to eight o'clock in the morning, and that simply isn't going to happen. My family would like to see me throughout the day and I like to sleep when the moon is out, not the sun. I didn't become a trader to work nights, and I suspect you don't want to, either. Short-term trading can be highly stressful as well. Constantly looking at charts for hours and selecting trades in real time can burn a trader out quickly and lead to over trading and possibly more losses.

SPECIALIZE

Specialists are good at what they do because they are highly trained and focused on a single trade. There is a reason that commercial pilots earn type ratings in specific aircraft or doctors will refer you to a podiatrist when you smash your pinky toe. Trading is no different. Traders who are laser focused on a particular specialty will likely outperform traders trying to master many trading techniques at the same time.

There are two specialties a trader should consider focusing on. First is the currency pair; second is the trading strategy.

Begin with One Currency

Most currency dealers offer over 50 currency pairs to trade, but if you aren't profitable trading one currency pair, what makes you think that trading 10 or 20 will make you a better trader? When you are struggling to achieve consistency or are new to trading currency, I recommend selecting one base currency pair to trade and becoming a specialist in that currency. You should learn its fundamental drivers and spend time observing its personality. Each currency has different habits that you will gain an understanding of by focusing on one currency at a time. For example, the GBP/USD and EUR/USD both tend to test key areas near the London open, only to reverse direction based on supply and demand. The EUR/USD and GBP/USD tend to test breakouts that happened during the London session again during the New York session. The USD/JPY tends to be sensitive to the action happening in the U.S. equity markets, while USD/CAD and AUD/USD tend to move on risk appetites; bad news for the United States tends to drive the dollar higher against these pairs.

The point is to learn one currency until you can trade it in your sleep. Only then should a trader consider adding another currency to her watch list. Besides, who wants to spend all night analyzing currency pairs? Think about it this way: If you traded 20 currency pairs and spent 10 minutes analyzing them daily, it would require three hours every night! I'm going to go out on a limb and assume that between a day job and other commitments, you don't have an extra three hours every night.

How Is Your Elevator Pitch?

An *elevator pitch* is used by entrepreneurs, marketers, and salespeople to quickly explain why their ideas, products, or companies are worthy of the recipient's further attention. The pitch is typically associated with entrepreneurs pitching their idea to a venture capitalist to receive funding for their start-ups. The investor is able to quickly judge how focused an idea is based on the quality of the pitch. When an entrepreneur can't pitch his idea succinctly and clearly, it becomes obvious that they don't know exactly what they are doing and their idea is not worthy of further investment.

Let's assume for a minute that we both go to a trading conference and run into each other in an elevator. If I asked about your trading system, could you answer me accurately in the 30 seconds it takes the elevator to reach my floor? The trader who is laser focused and can confidently explain how his system is far more likely to achieve consistent results than the trader who either can't explain how he trades or changes his trading strategy every time you speak with him. It doesn't matter if you focus on trading the news, support and resistance, breakouts, or flipping a coin; what matters is how focused you are and how well you stick to that methodology, come hell or high water. If you can't explain how you trade in the time it takes to ride an elevator, how do you expect to make a trading decision in real time? Focus on one trading system and you'll be liberated from the burden of chasing the next great trading system.

DEVELOP A WRITTEN TRADING PLAN

Every well-run business has a plan, and trading is no different. Consistent traders use a written trading plan as their playbook for executing trades throughout the trading week. Actually writing down your trading methodology is a great exercise to ensure that you can clearly articulate the strategy. Remember the elevator pitch? Having a written plan will strengthen your commitment to a particular trading methodology, which keeps you focused and specialized. I've seen trading plans of all types, from note cards

to multipage documents, but my personal preference is to simplify a trading methodology down to a single printed page. I've found that trading plans greater than a single page are either too vague and document many variables to entering and managing a trade or they are simply too complicated and many traders won't have the discipline required to follow it correctly. In my opinion a trading plan should contain each of the following:

- When to trade
- What to trade
- Entry rules
- Risk management rules
- Profit management rules
- Position sizing rules

Whether the trading plan is focused on short-term or long-term trading, the principles of a written trading plan are the same.

When to Trade

Defining when to trade sounds obvious, but it actually is quite important to carefully consider when you are going to trade. Many trading systems only work well during a specific window of time; others are more flexible, allowing a trader to place orders around the clock. Either way you should clearly define when you are expected to trade for a specific trading plan. When to trade can be determined through back-testing a system. If you have tested a strategy, try conducting an analysis of when the majority of profitable trades happened. Why trade a system during a timeframe you know puts your trade at a statistical disadvantage? If you know the majority of profitable trades happen in the morning, consider limiting the hours you can take trades, to avoid unnecessary losses. It's a simple rule to include, but it's very effective at limiting losses. Finally, establishing a time to trade allows you to build in a daily routine to conduct your trading business. Discipline to do the same thing every day is the mark of a true professional trader, and setting a time to trade will help you build that discipline as part of your trading plan.

What to Trade

Successful traders eliminate distractions that could affect their ability to make a good trade. If you're watching too many currency pairs or trying to trade a currency pair you haven't tested your trading system on, you might take unnecessary losses. Listing what currencies you will trade in your trading plan is an effective tool to keep you focused and avoid

distractions from other currency pairs throughout the trading day. Remember, you don't need to make a gazillion pips a month to earn a healthy return. Your trading plan should keep you focused on only the currencies that have back-tested well against your strategy and ignore anything else. Following a written plan is about maintaining discipline, and knowing what currencies you should focus on is a key component. If you can't find a trade following the system of a currency you specified, there is no trade to take and you should remain patiently sidelined.

Entry Rules

The heavy lifting of any trading system is done by rules dictating when to enter and when to exit the market. Stating clear rules is crucial to the success of a written trading plan because they provide confidence in the actions a trader must take to execute a trade on the plan. If your rules to enter a trade ramble on for two pages with many logic decisions such as "If indicator ABC crosses the voodoo moving average only when the magic eight ball says it's certain, get long," how do you expect to ever be confident you're taking the right trade?

You should be able to read your entry rules to anyone and have them clearly understand the steps you are going to take. After all, if another trader doesn't understand your rules, how do you expect to execute them in real time? I've seen enough traders who use ambiguous entry rules miss trade after trade only to wonder why they didn't take a good trade in hindsight. In my opinion, rules should be bullet points making clear what action you will take. Take the following rules as an example:

- Long entry rules
- Hull moving average turns bullish
- After price completes the first pullback, enter at market on the first bullish candle
- Do not enter when the signal candle is greater than the stop loss
- Do not enter on a signal that follows a successful trade; wait for the next one
- Reverse for short trades

These are some concise rules that are easy to follow and could be applied to virtually any timeframe you want to trade. Keeping rules short and simple helps me follow them accurately without hesitation.

Risk Management Rules

Risk management is really the heart of any trading system. Regardless of how good the entry or exit, a system known to be profitable can still return

a loss if the trader does not practice good risk management. Risk management rules should be as clear as entry rules. Single bullet-point instructions are clear and easy to comprehend when you are considering a potential trade. Here are some example rules for a system built around bargain hunting:

- Do not place more than 2 percent of the account's capital at risk on a single trade.
- Reduce risk by looking for 00 levels that may offer a better entry price.
- Look for trades requiring 60 pips in risk or less. More is okay, but consider reducing position size to 1 percent.

You should specify the maximum amount of risk to which any one trade should expose the account. In this example the system is very specific about managing position size. When more risk is required, the system reduces the position size to protect the account from a larger loss. Be as specific as necessary with risk management, and once these rules are established, do not violate them for any reason. Risk management is discussed in Chapter 4 if you need a review.

Profit Management Rules

Profit management should include guidelines for identifying profit targets, closing a trade when it is making money, and adding to a trade as it earns more profit. You should specify which Fibonacci ratios you are interested in using if that is your profit management tool of choice. Profit management is discussed in Chapter 5 if you need a review.

Position Sizing Rules

The final section of every trading plan should contain rules for increasing your position size as the equity in your account grows. Managing the growth of your position sizes is associated with risk management and profit management at the same time. (Calculating position size is discussed in Chapter 5.) For the purposes of writing a trading plan, all we really need are some guidelines for when position size should be evaluated and how much it will be increased.

Assume that you have a $1,000 mini account with 400:1 leverage and you are risking 2 percent per trade. Your acceptable loss per trade would be $20. As your account grows, the amount of money that is acceptable to lose grows as well. Eventually you will want to increase the standard amount of money you're willing to lose based on the new account balance.

My standard method is to evaluate position size standards at the beginning of each month.

For example, if I have a $1,000 micro account and I'm willing to risk $20 per trade (2 percent risk), I will trade a position size that risks $20 for the entire month, even if my gains allow me to trade a larger position. When the first of the month arrives, I will recalculate my standard position size according to my current account balance and trade the new position size for the duration of the month.

Whether you do this weekly, monthly, quarterly, or yearly doesn't matter; the point is to ensure that your gains are consistent and you don't take on too much risk too fast for your account balance. Just because you made a huge $1,000 profit on your last trade doesn't mean you're free to increase your position size for the next trade, unless losing more than you gained on the last trade is okay with you.

KEEP A TRADING JOURNAL

When I started learning how to play a bass guitar, my mentor asked me to bring a journal with me to each session. Following each lesson he would write in my journal instructions for me to study between lessons and then sent me on my way. I started using the journal to record my daily practice sessions. I would write down how I practiced major scale intervals in different keys, tuning harmonically, or simply that I did some improvisation using a specific scale in the key of G. Keeping a journal helped build the discipline to select something to practice every day, and over time my playing improved, to the relief of my wife's ears.

It doesn't matter if you're trying to learn an instrument, lose weight, learn a language, or trade consistently; when you're trying to install a new discipline in your life, keeping a journal can help accelerate the process. Keeping a trading journal is arguably the most effective tool a struggling trader can employ to achieve consistency. Over time the trading journal will become a wealth of information to help identify weaknesses you should correct to improve your performance. Trading journals do not have to be fancy; a simple spreadsheet will suffice, but every trading journal should include the following:

- Specifics about each trade, including open, close, dates, and times
- The position size in lots
- The stop loss and overall risk percentage to the account
- The net gain or loss in pips and money
- The risk-to-reward ratio achieved on each trade

You should also roll the individual trades up by month and year to monitor how you are doing on a longer-term basis. You should have statistics for each month, including the net profit or loss in pips and money, the average risk-to-reward ratio for the month, the largest gain for the month, the largest loss for the month, and the average loss for the year. These statistics will give you insight as to how stable your trading is throughout the month and where you need to make improvements.

I also include screen shots of my charts before I enter the trade and after I have exited the trade, cataloging them by date along with my trading journal. The images give me a visual teaching tool when I review my journal at a future date. As they say, a picture is worth a thousand words. I use a great screen capture program called Snagit for all my journal and blog screen shots. Snagit is inexpensive and allows you to write comments or draw on any screen shot you take. Snagit is available online at www.techsmith.com.

DEMO TRADE PROPERLY

Would you attempt to fly a Boeing 747 without years of proper training and experience? Even if you had the proper experience, would you shut down three of the four engines in flight to practice emergency procedures? Of course not. Commercial pilots spend hours in simulators practicing procedures and situations that are too dangerous to practice in an actual airplane. From wind shear to engine fires, many seasoned pilots will break a sweat wrestling a crippled, and fake, airplane safely back to the ground. The point of a realistic simulator is to build real-world experience without placing people and machines in jeopardy. For traders, demo accounts are a valuable simulator for building your skills or trying new strategies in live market conditions. Unfortunately, the use of demo accounts has been cheapened by the notion that they are some kind of game or useful only to learn dealer's software, but nothing could be further from the truth. You get what you put into the use of a demo account, and in this section I have some suggestions for getting the most out of trading fake money.

Start with an account that matches the amount of risk capital you plan to trade. Many dealers allow you to fund the demo account with a variable level of capital. If you only plan to trade with $10,000, trade a demo account with $10,000 in it. If you don't take this seriously, you won't get a realistic view of what may happen to your risk capital when you begin trading live money. If you open a demo account with $10,0000 and open a number of impulsive or risky trades you know wouldn't be taken in a smaller live account, you might as well be flying loops in a 747 simulator. It might be fun,

but it serves no useful purpose toward training you to be a professional trader.

Trade the demo account as though your bills depended on it making a profit. You should follow your trading plan and meticulously record each trade in a trading journal. Remember, the point of using a demo account long term is to build you into a professional trader before you put live money at risk, so run a demo account the same way you would run a live money account. Your demo account is an apprentice phase on the road to becoming a professional trader. It's a safe training zone where you won't do any real damage, but you will influence your trading skills, so learn as much as you can and take each trade seriously. As an illustration of this point, I mentored one student who demo-traded successfully for four months before he opened a live account. His first month with live money netted over 250 pips, trading part time around his day job. Because he took demo trading and the apprentice phase seriously, he was able to transition to live money without a single hiccup.

Configure the account's leverage and margin requirements similarly to what you intend to trade with live money. Margin and leverage have a big impact on how many trades you can maintain at once, position sizes, and profit and loss. Margin and leverage also affect rollover interest and the spread, since pip value will change with higher or lower leverage. The closer you can get a demo account to represent your live account, the more comfortable you'll be trading live money.

Finally, if you are completely new to trading, I recommend demo trading for at least six months. The market goes through various cycles between ranging and trending markets, and you should gain enough experience in those six months to understand how to trade any potential market condition. Additionally, you should show a profit over those six months. If you don't, continue to demo trade until you can consistently show a profit. There is no reason to think you'll make money with a live account if you can't with a demo.

CLOSING BELL

This chapter is probably easy for a lot of readers to dismiss. However, I encourage you to read this chapter every couple of months to remind yourself of the emotional and organizational pitfalls that can keep you from achieving consistency. I wanted you to see with this chapter what I see through my web site. I regularly speak to traders who are struggling to achieve a consistent result, and frankly, it isn't because they are greedy or scared. Most of them simply lack the discipline to do the same thing every day, and they risk too much money on the trades they do take.

If you are struggling, I know the advice in this chapter can help you get organized and build some discipline into your trading routine. It is time to reflect on why you haven't achieved consistency. Look inward and identify what you could change about yourself before you start using the methods in this book. If you don't change your bad habits, nothing in this book or any other will help you become a professional trader. I encourage you to become a specialist, write down your trading plan, and start keeping a trading journal. Try it for at least six months and see how your trading improves. I think you'll be pleasantly surprised.

AFTERWORD

The Final Closing Bell

I thought it would be appropriate to end this book with one final closing bell. On October 21, 2007, I published my first blog about trading on my personal web site, I decided to share my experience as a long-term trader because I was sick and tired of reading material dedicated to day trading. I wanted to show people that they could trade currency and still have a life that didn't involve staring at a chart for 10 hours a day. Apparently the idea has caught on. Two years later my blog is read by over 1,300 traders a month. I've met many interesting people trading currency in nearly every corner of the globe, and now I've written this book.

Though the content and structure of this book have changed throughout the writing process, the message I want to get across hasn't: You can learn to trade currency, even if you work full-time or are unable to day trade for whatever reason. Each chapter in this book was dedicated to explaining details behind a principle of bargain hunting or it shared a price action-based trading method. The book focuses on support and resistance because price action is one indicator you can always rely on. Price always knows where it is going, and your job is to read it correctly. Trading on price action can be applied to any currency pair and any chart time. Frankly, you could take the same lessons about support and resistance in this book and apply them to trading stocks or futures. Supply and demand are universal across the financial markets.

Finally, I wanted to write a book to help traders I couldn't reach through my web site, I hope the discipline and strategies in this book help you. Take what you believe is useful and craft it into your own trading style. At the end of the day the only right way to trade is one that

earns a profit. If you need some help along the way, visit my web site at www.ryanokeefe.com. I have posted numerous sample trades from my own account as well as several educational lessons that are completely free. Finally, you can reach me by e-mail at ryan@ryanokeefe.com. I might be slow to respond, but I will respond; I get a lot of e-mail these days.

I wish you the best of luck and continued success trading the spot currency market!

About the Author

Ryan O'Keefe is a private spot currency trader who has studied, traded, and written about the currency market since his introduction to currency futures at age 17. Although he has been around the currency markets his entire adult life, Ryan is not your typical Wall Street type. He has never worked in the financial industry and doesn't hold a degree in economics or finance. Originally an Internet developer and e-commerce manager, Ryan learned to trade the spot currency market around the demands of his career and family. His long-term trading style resonates with retail currency traders who are trying to trade around their day jobs and offers them an alternative to short-term or "day trading" styles so prevalent in trading today.

Through his blog at www.ryanokeefe.com he is visited by over 1,300 traders every month. Ryan is committed to helping traders who work full-time learn to trade the spot currency market through trade examples, videos, and webinars. He regularly presents an educational webinar, "Trading Currency around Your Day Job," which is focused on long-term trading strategies. Ryan has mentored traders one-on-one and currently writes a blog for one of the largest independent currency web sites FXStreet.com. Ryan trades from a quiet lake house around various interests in writing, aviation, technology, and real estate. He is a hack golfer, bass guitarist, and private pilot. He lives in the Pacific Northwest with his wife Christine and their toy poodle, Daisy.

Index

Praise for

MAKING MONEY IN FOREX

"This book is truly superior and brimming with new strategies on supply and demand trading. If you have a 9-to-5 and are interested in trading forex, this book is a must-read. Ryan takes what for most is a complicated and hard-to-learn subject and breaks it down to its simplest form. Supply and demand is what moves prices, and anyone serious about making it in forex trading should read this undeniably compelling and terrifically rewarding book. It is an easy read with excellent explanations and plenty of chart examples."

—Kulu Moyo, Actuarial Associate, part-time trader

"Having traded the forex around a day job for the last two years, I cannot think of a time during my growth as a trader that I would not have been able to use what Ryan has put in this book. It contains direct and to-the-point information that WILL make you a better trader. He helps you think through your trading and the market. This book is packed with information about forex to get you where you want to be as a trader."

—Doug Hayward, Logistics Planner, part-time trader

"Finally! A trader and book that TEACHES how to trade the forex market that works around MY schedule and time frame and not their own. Ryan arms the trader of all seasons with the tools and skills to trade in any market condition. *Making Money in Forex* is a must-have in any trader's arsenal if they are serious about trading!"

—Sung Choi, Software Engineer, part-time trader

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