Forex Is Your Friend

Foreign Exchange As The Trader's Alternative

Trading opportunities in the forex market deserve serious consideration as a diversification strategy for your portfolio.

While online equities and futures trading have enjoyed exponential growth and widespread notoriety over the past few years, online foreign exchange trading is only now gaining popularity among seasoned active traders, commodity trading advisors (CTAs), and other professional money managers.

Until recently, large international banks dominated the foreign exchange (FX or forex for short) market, only allowing access via telephone trading to a select few such as *Fortune* 1000 companies, large funds, high–net worth individuals, and so on. But now, the tide has turned and finally there are established online trading firms that provide individual investors with direct access to the largest, most liquid financial market in the world.

Diversify your diversification strategy

In addition to the market's trading opportunities, foreign exchange can be a solid diversification component in your financial portfolio. Most diversification strategies involve a combination of sector allocation, foreign and domestic equities, and fixed income. Some participants have branched out into precious metals and/or energy products; however, few traders consider expanding into forex. Why?

The reason may be in the simple fact that in the US, investors tend to be underexposed to foreign exchange. Unfamiliarity typically breeds misconceptions, and foreign exchange in the US is no exception.

Risky business?

Is forex as risky as everyone thinks? One way to measure risk is to compare a financial product's risk relative to its return. If you take the time to compare an investment in forex to common investments such as equities and fixed income, you will find that from a risk/reward standpoint, forex investments provide respectable returns and should be considered viable portfolio diversification tools.

For example, 2001 annual volatilities for the Dow Jones Industrial Average (DJIA), 30-year bond futures, and US dollar/yen (USD/JPY) were roughly 21.5%, 10%, and 10.5%, respectively. An investment in a basket of major currencies (or USD/JPY) last year was comparable to 30-year bond futures (which was one of the best returns for the fixed income markets in years), and clearly outpaced the negative returns generated by the DJIA.

Although forex trading can lead to very profitable results, there are risks involved. When it comes to trading forex, you'll need to worry about exchange rate risks, interest rate risks, credit risks, and country risks—things you may not consider when trading stocks.

The trend is your friend in forex

Approximately 80% of all currency transactions last a period of seven days or less, while more than 40% last fewer than two days. Given the extremely short lifespan of the typical trade, technical indicators heavily influence entry, exit, and order placement decisions.

by Mark Galant

Further, approximately 85% of all daily forex transactions involve "the majors," which include the US dollar, yen, euro, British pound, Swiss franc, Canadian dollar, and Australian dollar. The depth and concentration of the market in just seven currencies provides a statistically significant dataset for trend analysis.

Technical indicators work the same way on the currency markets as they do on the equity markets. On the hourly chart of the British pound/US dollar in Figure 1, see how the market followed the trend from point A to point B. This rising trendline — a relatively steep one that indicates the trend will sustain — acts as a significant support level. At point B, price closed below this trendline for at least two consecutive days, suggesting a trend reversal. This support level acts as a barrier that prices are, generally speaking, reluctant to break.

When they do break through support, consider it an alert to open a position. Once the support level is broken, it'll begin to act as a resistance level. Note how after prices fell to about 1.4530 they started moving up, forming another uptrend. In this example, prices never did reach the first trendline, although there were times it seemed as though market participants were attempting to do so. The second upsloping trendline was also broken to the downside. Both breakdown points were good areas to enter a short position.

Another example of how trend-following indicators can be applied to intraday price movement is displayed in the hourly chart of the euro/US dollar in Figure 2. During prominent trends, the moving average crossover method worked well. This example used 10- and 40-period moving averages; if you had entered a trade when the 10-period moving average crossed above the 40-period moving average at point 1 and exited the trade at point 2 when the 40-period MA crossed below the 10-period MA, you would have made a very nice profit.

These examples show the use of one indicator or technical analysis tool to make trading decisions. Often, you may have to use more than one. The chart of the euro in Figure 3 displays the use of multiple technical indicators as confirming signals. There, you see a divergence between price movement and the movement of the relative

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FIGURE 1: SIMPLE TRENDLINE. This hourly GDP chart shows an excellent opportunity to enter a short position on a trendline break of a previously strong upward trend.

FIGURE 2: MOVING AVERAGE CROSSOVER SYSTEM. When the shorter-period moving average crosses above the longer-period moving average, consider it a signal to enter a long position. When the short-period MA crosses below the longer one, consider it to be an exit point.

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strength index (RSI) and moving average convergence/divergence (MACD). While prices are moving up, the RSI and MACD are moving down. This suggests that prices will move down, and this is confirmed with the trendline break at point 3.

SHORT-TERM NATURE

The foreign exchange market is unique in that central banks intervene from time to time to affect the price movements of their respective currencies (one example would be the recent intervention by the Bank of Japan to push down the value of the yen). On the surface, this may disturb those who use fundamentals to make investment decisions, trusting that the "invisible hand" guiding free-market behavior is not being manipulated. However, it has been proven time and again that central banks can only influence currency values for short periods; over time, the markets adjust to the changes. This leads to the formation of trends, which your trend-following strategies will help you trade.

Since most currency trading is short-term in nature, speculators can cause erratic fluctuations in the exchange rates. You can see this in the 15-minute chart of the June 2002 Canadian dollar contract displayed in Figure 4. On June 3, 2002, due to the dismissal of the Canadian finance minister Paul Martin, short-term traders brought the value of the Canadian dollar down away from its long-run equilibrium point. But the value cannot move away from this point forever, and this can be seen by the quick revival of the exchange rate.

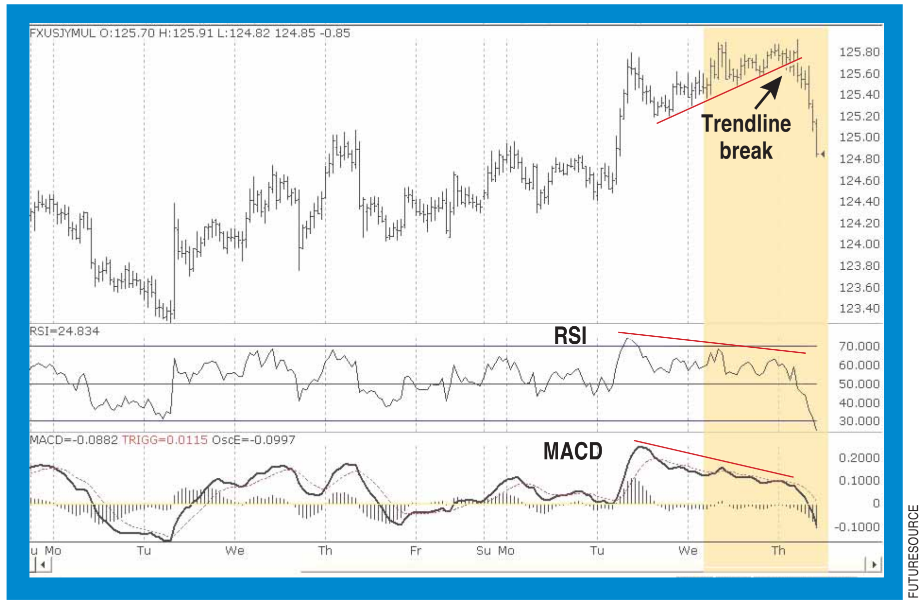

FIGURE 3: USING MULTIPLE INDICATORS FOR REVERSALS. When you see the diverging action of the RSI and MACD indicators, wait for the confirmation with the trendline break to enter a short position.

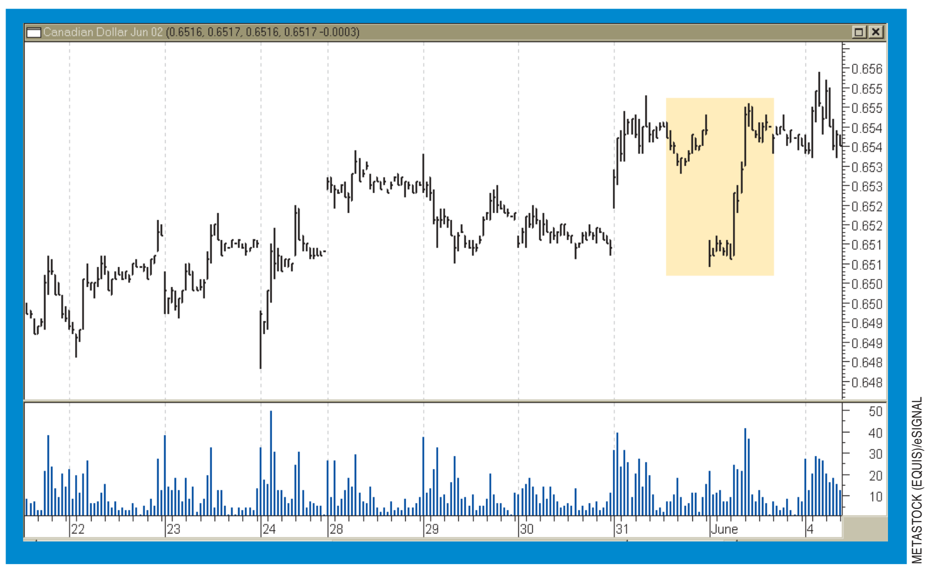

FIGURE 4: SOUND FUNDAMENTALS. Changes in certain fundamentals can cause short-term traders to create fluctuations in price, although prices will usually resume their original moves.

WHY FOREX?

- **24-hour trading:** Traders benefit from the ability to respond to breaking news immediately, day and night.
- **Superior market liquidity:** More than one trillion dollars are traded every day in the FX market. The sheer volume of this market helps ensure price stability, as well as less gapping and price slippage.
- **Narrower dealing spreads:** Normal bid/ask spreads are five pips or less, much tighter than a typical stock transaction.
- **No uptick rule:** It's easy to establish both short and long positions.
- **Increased leverage:** Firms offer traders a 2% margin, compared to a 50% margin for equity markets.
- **No commissions or fees:** Overall, FX has much lower transaction costs than equities or futures — an important point for active traders.

When considering trading currencies, you cannot ignore fundamental factors. These include:

- Relative interest rates
- Relative economic stability
- Relative political stability, *and*
- Relative trade deficit/surplus.

These fundamentals or market forces should be strong enough to initiate the formation of discernible trends in order for you to apply profitable technical trading strategies. Further, the length of the trends needs to be sufficient for you to recognize them and be able to take advantage of market swings.

CONCLUSION

Of the more than one trillion dollars a day transacted in the foreign exchange markets, an estimated 95% comes from speculative trading. While large international banks are responsible for the majority of this volume, there are retail investors all over the globe trading forex on a daily basis. Without a doubt, investors in the US are behind the curve with regard to learning about and participating in this market.

Active equity and futures traders who appreciate liquidity, strong technical indicators, and a multitude of short-term trading opportunities will find the forex market especially appealing. But at the very least, trading the foreign exchange market deserves serious consideration as a diversification strategy in anyone's portfolio.

COMMON MISCONCEPTIONS OF FOREX

- Forex has a higher risk component than other investment alternatives. (It doesn't.)
- Technical analysis does not translate well into forex. (It does.)
- Fundamental analysis is ineffective due to central bank intervention. (Fundamental analysis is very effective.)

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‡Charts and data courtesy of GAIN Capital, FutureSource, MetaStock (Equis International), and eSignal

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