

*An Insider's Perspective*

# Trading In The Forex Trenches

Foreign exchange markets offer great liquidity, are less prone to being pushed around by major market players, and adhere to technical trading rules more closely than equity markets. So why aren't they more popular with traders? A seasoned forex trader provides us with a view from the inside, including some of his favorite trading strategies.



Experienced traders often remark that the foreign exchange markets are a technician's delight, as they adhere more closely to the technical indicators than other securities. There is less random noise (that is, volatility) in the forex markets, and trends there are generally of the long-term nature.

When currency guru George Soros was asked about the weakness in the US dollar in June 2002, he predicted that the greenback could drop as much as 30% before the move was over, since trends tend to be prolonged. The currency had dropped from 1.14 euros to the dollar in December 2001 to 1.08 by June 2002. A year later, the value of the dollar had fallen to 0.83 euros, a drop of more than 28%, and there were no indications that the move was over. In total, the dollar had dropped (and the euro gained) more

than 40% from its high (a euro low) in October 2000, when \$1 = 1.21 euros. Since then, the US dollar has experienced a retracement of nearly 100% of its earlier move from late 1998 (see Figure 1).

Soros has played the game long enough to know currency technicals and was clearly expecting the retracement. Traders who listened to him in 2002 have profited handsomely. (Soros said that he was again "short the dollar" after comments made by US Treasury Secretary John Snow on May 19, 2003. In response, the greenback lost more than 2% by month's end.)

According to forex trader Michael Kouznetsoff, trading currencies is not rocket science. Currencies tend to follow fairly strict rules, and are therefore more predictable than other markets. In a recent presentation to the Canadian Society of Technical Analysts in Vancouver, British Columbia, he touted



**FIGURE 1: EURO/US\$.** Euro-FX weekly chart (Euro/US\$) from launch to June 2003 with five-, 10-, 20-, and 80-week moving averages. It is interesting to note that the euro paused near each of the significant Fibonacci resistance levels on the way down and on the way back up again.

by **Matt Blackman**

the merits of currency trading, not the least of which are the slow deliberate trends.

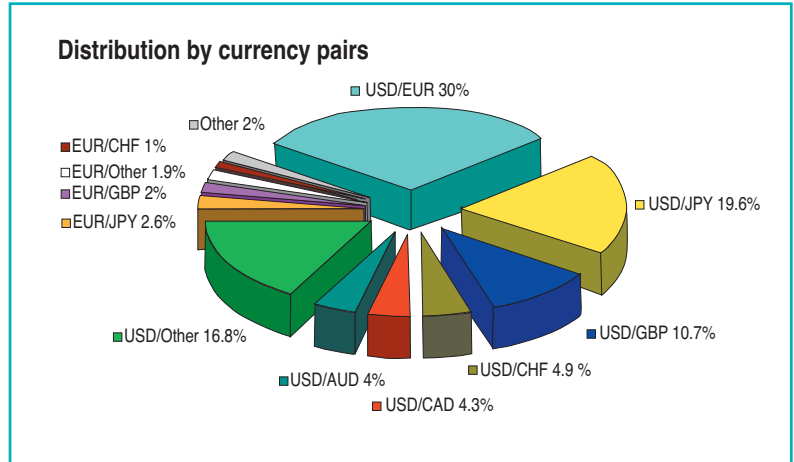
Kouznetsoff has traded for 12 years and has been a full-time forex trader for the last eight. He moved from Russia to Vancouver in 1998. I asked him about his trading style, parameters, favorite currency pairs, and technical indicators because I wanted to find out what it was like to trade as a forex professional.

**WHAT IS FOREX?**

The foreign exchange market was essentially born when the Bretton Woods Agreement was abandoned in 1971, which decoupled the US dollar from a fixed price of \$35 per ounce of gold. As a result, currencies of major industrialized nations were allowed to float, controlled mainly by the forces of supply and demand. Daily prices, volumes, and volatility increased throughout the 1970s, giving rise to new financial instruments, market deregulation, and trade liberalization, according to ForexNews.com.

Due to the sheer size of the market, with more than \$1.2 trillion traded daily, forex dwarfs all other equities and bond markets and is less prone to manipulation by even the largest participants (with perhaps the exception of comments by George Soros). For this reason, veteran traders opine that this market adheres more closely to technical indicators than the smaller equities markets.

According to the Bank for International Settlements (BIS), of the roughly \$1.2 trillion traded daily, swaps compose the



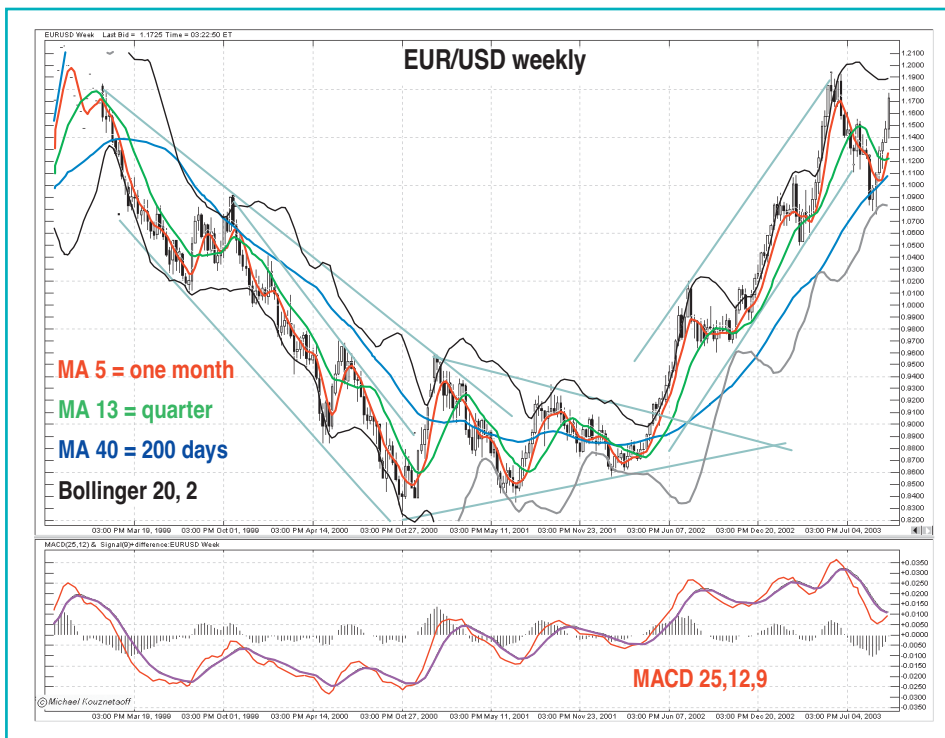
**FIGURE 2: VOLUMES TRADED BY CURRENCY PAIRS.** The euro/dollar is by far the most popular currency pair, followed by the yen/dollar and the UK pound sterling/dollar, a distant third.

largest portion with nearly \$660 billion, the spot market is next at \$390 billion, and the forward market trades roughly \$130 billion per day. Traders play the spot market, forwards are used to hedge, and swaps are used predominantly by banks. For our purposes, we will stick to the spot market since it is by far the most popular among professional traders.

A trade is executed with the simultaneous buying of one currency and selling of another. While it is possible to trade a variety of international currencies, five are by far the most popular, providing four currency pairs with the US dollar acting as the anchor in each. The currencies are the euro, the US dollar, the yen, the British pound, and the Swiss franc. In combinations, the currency pairs are the euro (euro/USD), the “cable” (GBP/USD), the yen (USD/JPY), and the Swiss (USD/CHF) (see Figure 2).

Trades can last a few minutes to one or two years, depending on the player. Some global funds execute trades that can last several years. A major trend spans many months, and often lasts longer. For those with less patience, there are weekly positions that open on Monday morning and close on Friday afternoon. Intraday positions are also possible, and a bank treasury dealer can be in and out of a trade in as little as a minute.

Forex participants include central banks, commercial banks, import/export companies, and multi-nationals, as well as commercial (including hedge and mutual funds)



**FIGURE 3: WEEKLY CHART.** Weekly chart of the euro between November 1998 and December 2002, with the preferred indicators used by Michael Kouznetsoff.

and smaller traders and investors.

Another difference with bond and equities markets is the hours of trading. The forex trading day begins in Sydney, Australia, on Monday (Sunday in North America and Europe), and ends on Friday in New York, and markets stay open 24 hours during that period. There are no commissions, only the point spread measured in pips with one pip equaling a 10th of 1% (0.01%).

In forex spot trading, the typical lot size is between USD\$5 million and \$10 million, and the minimum contract price is \$500,000. Smaller amounts can be traded on margin, but this is a double-edged sword that can hack the undercapitalized trader's account to pieces with a few bad trades.

Spreads can be as much as 50 pips or more for the thinly traded currencies pairs and as slim as three to four pips for the heavily traded euro/USD. Like stock trading, the lower the spread, the better.

### TRADE SETUP

Kouznetssoff trades using a number of time frames. On a weekly chart, he uses a five-period moving average (month), a 13-period MA (quarter), and a 40-period MA (year) together with Bollinger Bands and the moving average convergence/divergence (MACD). He has observed that the 200-period MA clearly shows major trends (see Figure 3). When daily charts are used, the moving average periods are adjusted slightly. More significantly, he finds it more useful trading shorter-period Bollinger Bands, using five periods instead of the standard 20. MACD settings are 22, 12, and 9. In addition, he uses a slow stochastic 5, 3, and 3 (see Figure 4)

Next, Kouznetssoff uses a four-hour chart with a six-period MA (representing one day), a 12-period MA (two days), a 30-period MA for the week, and finally a 132-period MA that represents one month (see Figure 5). He likes using the four-hour chart because it represents the typical shift of a bank dealer from morning to noon.

Last but not least, Kouznetssoff uses an hourly chart with four-, eight-, 24- and 120-period moving averages with a six-period slow stochastic and a 25-, 12-, and nine-period MACD (Figure 6). The

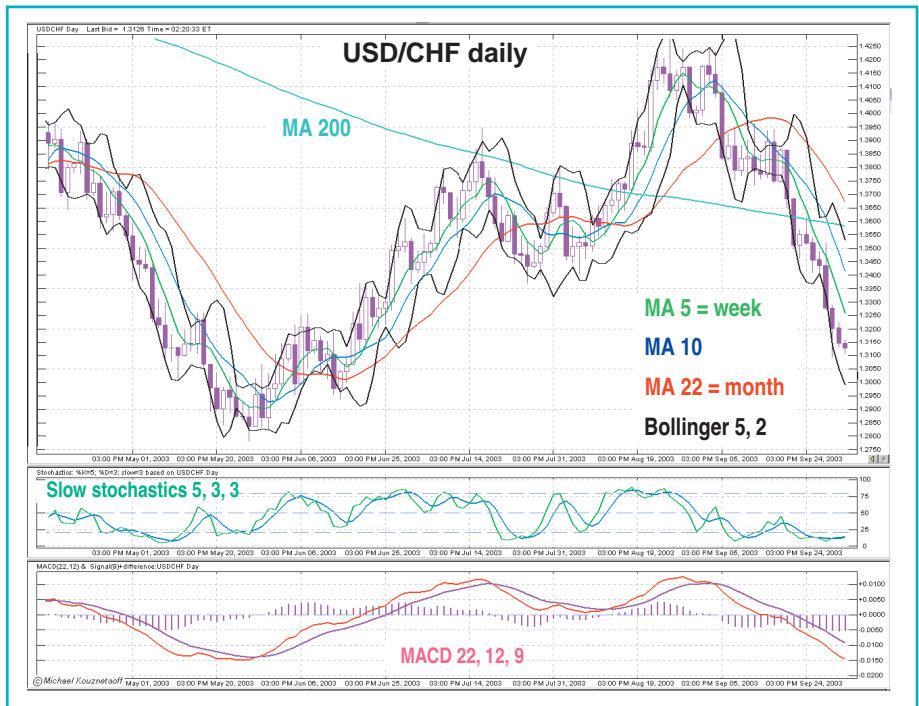


FIGURE 4: DAILY CHART OF THE US DOLLAR/SWISS FRANC

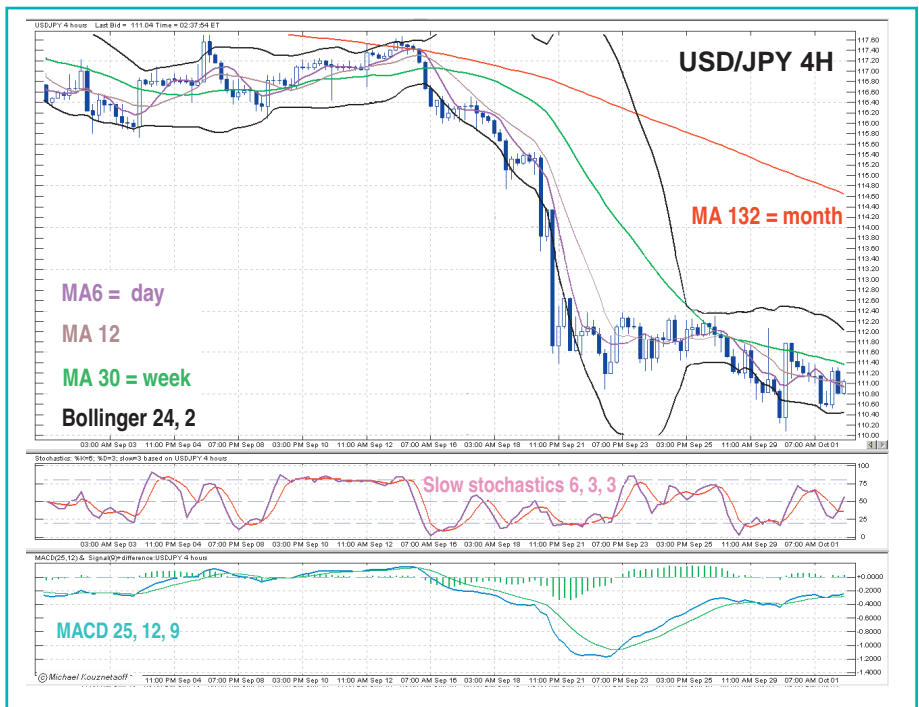


FIGURE 5: FOUR-HOUR CHART OF THE YEN (USD/YEN)

standard period for Bollinger Bands is increased from 20 to 24 periods. He has developed his preferred periods based on human time cycles with 24 hours a day, five days a week, and 22 days a month.

### THREE BROTHERS

During the trading day, Kouznetsoff uses three screens that he refers to as the “three brothers” of the same currency; these are arranged vertically. His principal screen consists of the daily chart on the left of his computer monitor. He uses the principal screen to look for big trends and to ensure that no trade is entered against them. The middle screen, which he calls his “major” screen, is the four-hour chart of the target currency. He uses this to make trading positions. On the right, his “control” screen is the one in which a one-hour chart is used to pick the best entry and exit points (see Figure 7).

The veteran forex trader says that players are not forced to close a position at the end of a trading day. Traders pay or receive interest payments for carrying a position to the next day, at a rate equal to the difference in overnight interest rates between the two currencies involved.

### THE TECHNICALS

According to Kouznetsoff, the most valuable patterns to watch for are trend channels (especially those that are accelerating), support and resistance (including Fibonacci levels), and chart patterns such as double tops or bottoms. Head & shoulders patterns are rare, a result of the lower emotional quotient in the forex market.

Since there is no centralized organization that monitors forex trading, volume data is not available other than estimates made by speaking with other participants. This includes large orders (more than \$500 million) that are usually reported by currency dealers, such as central bank trades. Volume can also be estimated by looking at the trend. The stronger it is, the greater the implied volume moving through the market. A limited amount

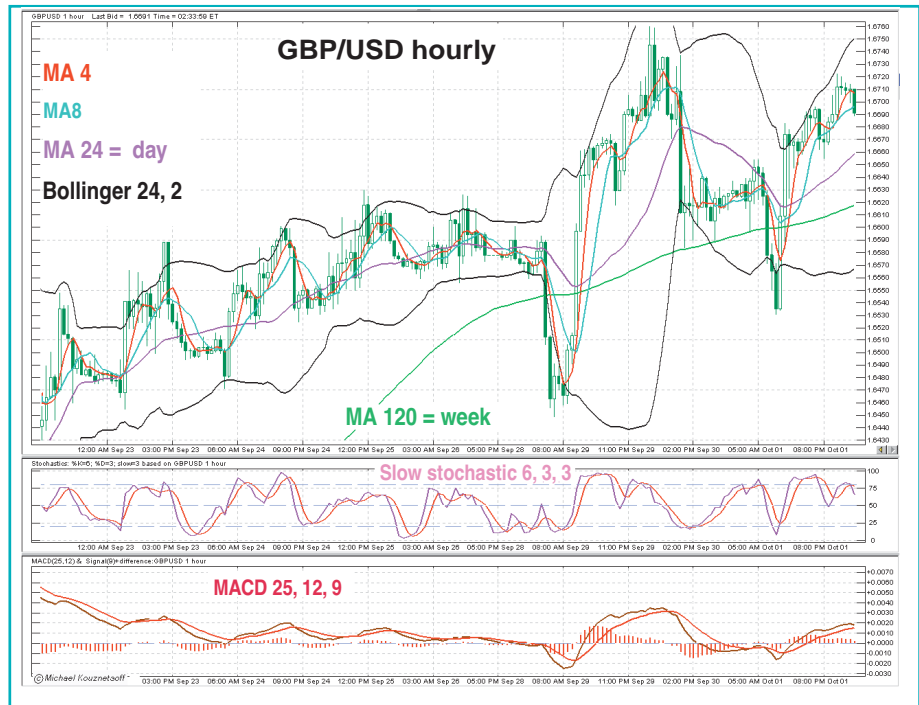


FIGURE 6: HOURLY CHART OF THE POUND/US DOLLAR

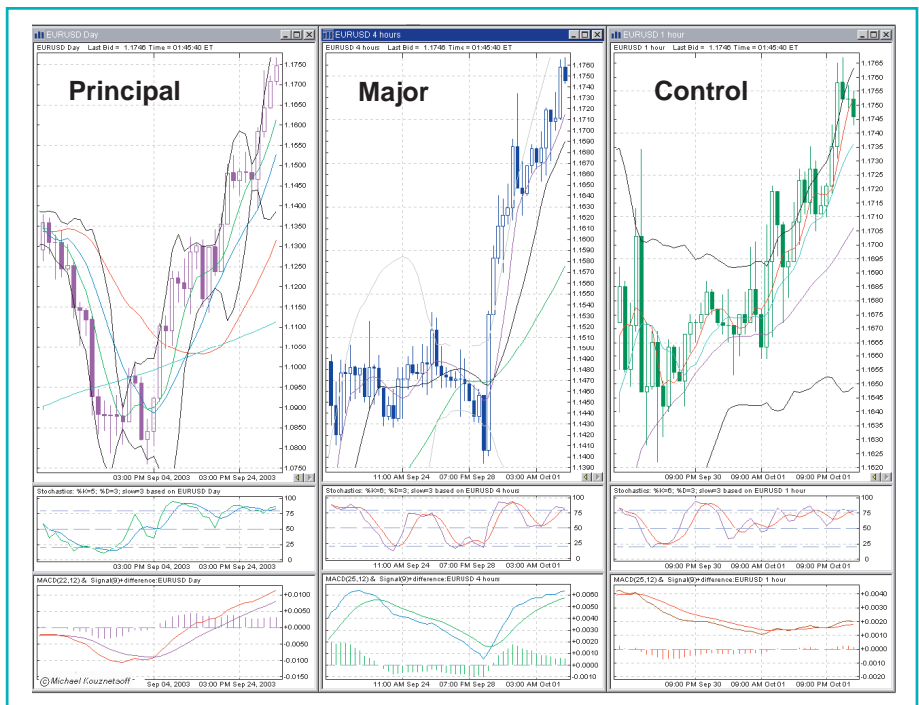


FIGURE 7: THREE BROTHERS ARRANGEMENT OF CHARTS. Different moving averages on the three charts plotted with the same color represent the same time scale. For example, the green line is a weekly moving average and corresponds to the five-period MA on the daily chart, 30-period MA on the four-hour chart, and 120-period MA on a one-hour chart.

of volume information may also be garnered from the Commitment of Traders report published by the US Commodity Futures Trading Commission (CFTC) on Fridays for currency futures, but it is a contrarian indicator, according to Kouznetsoff.

Just as with other equities, there are two basic types of markets: trending and trading range-bound or oscillating markets. Both work best with their own groups of indicators, but most traders prefer to trade trending markets and only with the trend in their favor.

Another difference between stock and forex markets is that the latter is virtually continuous. Gaps are never seen on daily charts, because the close of previous day is the open of the next. This means that candlestick patterns such as engulfing lines, harami, and doji stars are absent.

As we saw in Figure 1, Fibonacci retracement levels work well in major moves and are useful in anticipating pauses and reversals. They are good places to take profits. Kouznetsoff likes to take advantage of 50% retracements on large declines, especially when the 200-day moving average provides resistance (or support in uptrends).

Another unique trait of forex trades is that the 20- and 80-pip levels act as support and resistance (see Figure 8). They are also good places to take profits or initiate trades. The currency trader says that they are common levels at which profits are taken.

He also uses Bollinger Bands for confirmation but says that the standard parameters (20 periods, two standard deviations) don't work well. In fact, it can be downright dangerous to reverse a position around the upper 20-period bands in a trending market, according to Kouznetsoff. Instead, he prefers using five-period bands to narrow the range (see Figure 9) and opines that they provide a better representation of market behavior.

### FOREX FUNDAMENTALS

Here is a list of the fundamentals that Kouznetsoff follows, in descending

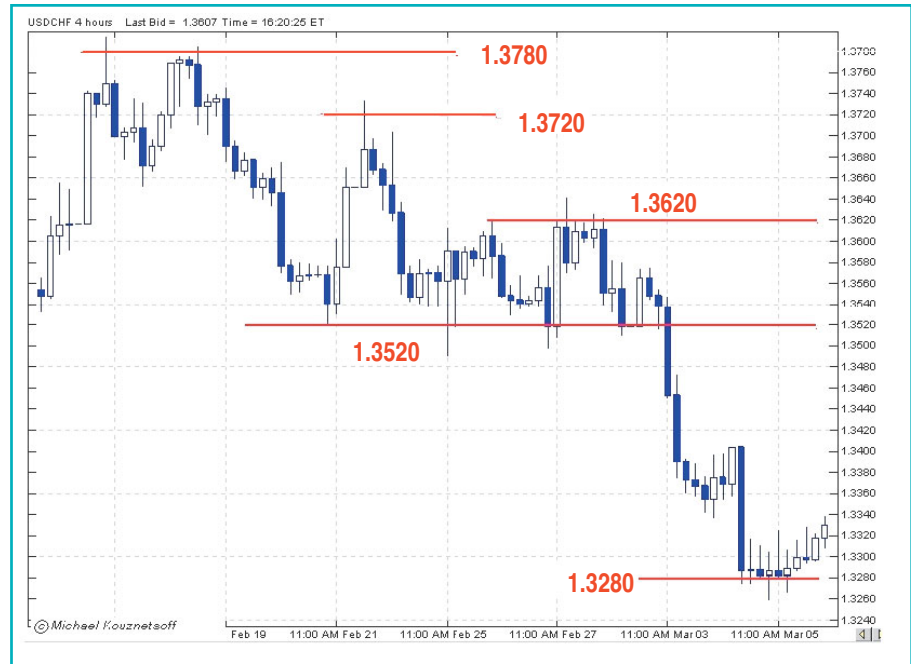


FIGURE 8: FOUR-HOUR CHART OF THE US DOLLAR/SWISS FRANC SHOWING SUPPORT/RESISTANCE AT THE 20- AND 80-PIP LEVELS

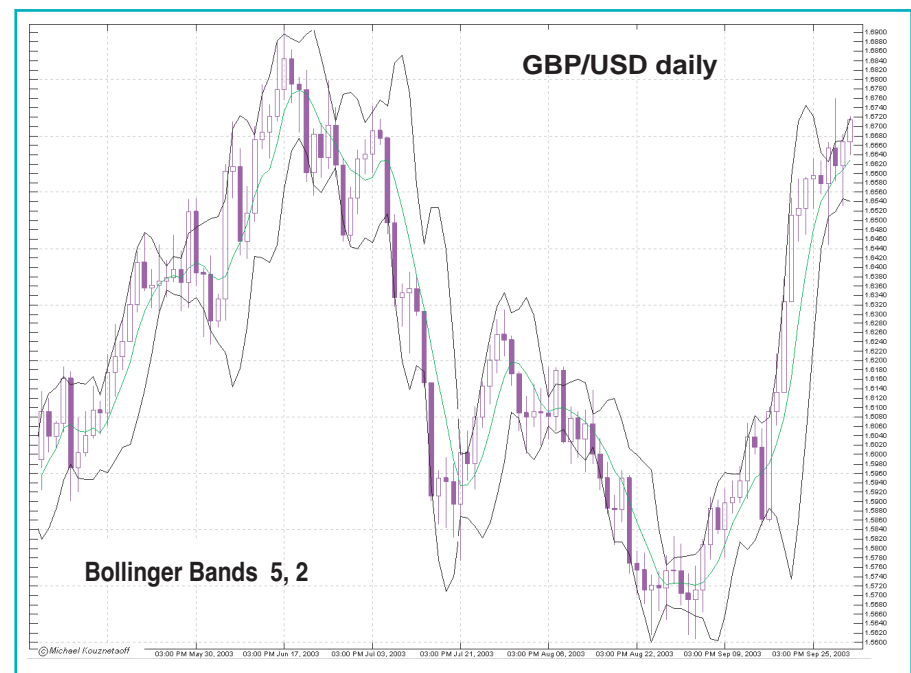


FIGURE 9: BOLLINGER BAND SETTINGS ON THE BRITISH POUND (GBP)/US DOLLAR (USD) DAILY CHART SHOWING FIVE-PERIOD SETTINGS



order of importance:

- 1 Decisions on interest rates made by national central banks such as the European Central Bank (ECB) or US Federal Reserve monthly. The minutes of the meetings are published afterward.
- 2 Quarterly GDP figures. Only preliminary national GDP figures generally have the effect of changing market sentiment.
- 3 Market sentiment data published by companies such as Reuters. Market expectations are formed from one week to two days before the event. Participants become well positioned based on expectations. If the figures are not a surprise, profit taking is often the only result.
- 4 News. National elections, the September 11th attacks, and the war in Iraq are examples of events that have affected currency values.
- 5 Institute of Supply Management (ISM) in the US and the Purchasing Management Index (PMI) in Europe are also carefully followed by traders.
- 6 National industrial production figures.
- 7 US nonfarm payrolls, Michigan sentiment figures in the US, the western German business climate or IFO index, and the Tankan quarterly survey in Japan.

## VOLATILITY

Traders generally prefer to have a degree of volatility because it profits those who anticipate moves correctly. But with volatility comes increased uncertainty. Would it not be more desirable to have a manageable level of volatility more closely concentrated around a mean? After all, volatility contained in a narrow range is more easily traded because it decreases uncertainty.

Figure 10 shows the difference in volatility between the Standard & Poor's 500 index (SPX) and the euro. The daily range for the SPX is greater than 4.5%, while the euro is much more concentrated around 1%. Out of approximately 250 trading days, the euro traded more than half of those days (142) within a 0.5% range.

## RISKS AND MONEY MANAGEMENT

Trading stocks is a negative-sum game, thanks to the cost of commissions. In contrast, there are no commissions in foreign exchange trading. But the real advantage of trading forex is that currencies are less volatile than stocks.

Other potential risks in forex trading include getting involved with an incompetent or dishonest broker, not utilizing stop-losses, or overleveraging a position. Kouznetsoff recommends a maximum leverage of 5 to 1, which means that the trader in

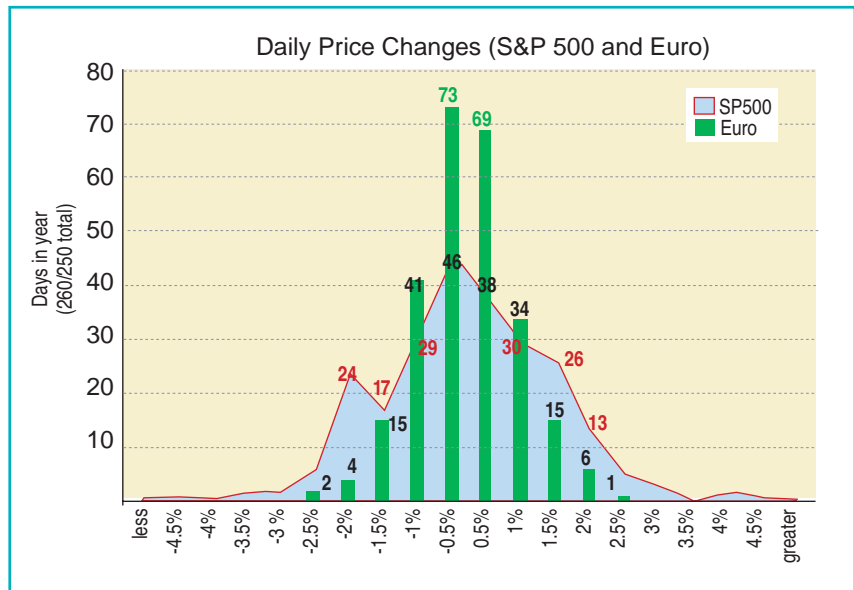


FIGURE 10: COMPARISON OF VOLATILITY IN THE 2001 TRADING YEAR BETWEEN THE SPX AND THE EURO

question must have a minimum \$100,000 to trade the smallest spot position of \$500,000. While there are some houses offering leverage as high as 200 to 1, Kouznetsoff is of the opinion that such high leverage is asking for trouble.

The veteran trader recommends risking no more than 2% to 4% of total capital per trade and setting a target that is greater than the stop-loss. This only makes sense, since having smaller targets than stop-losses will slowly but surely erode an account, given that the average professional trader only wins about 40% of the time, according to technical analyst John Murphy. Like trading any market, money management is crucial to success.

## WHERE TO TRADE

Kouznetsoff explained that he prefers to trade through a British broker where he pays no commissions. As one of the large currency centers in the world, The City of London has a reputation to maintain, which means we can expect a high degree of professionalism and integrity.

When choosing a broker, it is essential to do your homework. Trading without experience is not recommended and paper trading is a must until you feel comfortable with the trading system and market.

Currency futures and options may also be traded on the Chicago Mercantile Exchange (CME), but trading volume and open interest are insignificant compared to the forex market. Other disadvantages include a much shorter trading day (6.75 hours instead of 24), commissions that are charged, and time decay that must be accounted for, since both futures and options contracts have an expiry date. This means that they must be rolled over (and new commissions paid) before they expire on longer-term positions. That said, trading futures is a good place to get experience before trading a larger forex account.

## CONCLUSION

The foreign exchange market appeals to traders who have come up through the ranks trading other vehicles and developed the self-discipline, devised the trading system, and amassed the account size to allow them to play in the big leagues. Forex has a number of advantages over stocks and other financial instruments. Trends are longer term and more clearly defined in forex trading, there are no commissions, and there is less potential for market exploitation by larger players. Forex also offers lower volatility and a greater adhesion to technical indicators.

*Matt Blackman is a trader, technical analyst, software reviewer, and content provider for technical trading/investment websites. He is an affiliate member of the Market Technicians Association (MTA) and Canadian Society of Technical Analysts (CSTA), and is currently enrolled in the Chartered Market Technicians (CMT) program.*

## SUGGESTED READING

Rhoads, Christopher, and Michael R. Sesit [2003]. "US Dollar's Slide Could Push Europe Close to Recession," *The Wall Street Journal*; May 20.

*Brief history of the forex market:*

<http://www.forexnews.com/education/default.asp?loc=fxhist>

*Forex fundamentals:*

<http://www.forexnews.com/research/guides/default.asp>

*Forex introduction:*

<http://www.fxstreet.com/nou/content/102420/content.asp?menu=education&publicitat1=education>

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