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**Forex Trading Basics**

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## Forex Trading Basics

This eBook is intended for novices. If you are past the beginner stage there are far more advanced forex eBooks available on [TradingProfits.org](http://TradingProfits.org).

We will be going through the basics of forex. We will assume you have a little knowledge of the forex markets whatsoever. It is best if you have read our Free "Forex for n00bs" eBook. In this edition we will examine a few more basic concepts about risk management, technical analysis and fundamental analysis. We will also highlight some key points about the Australian dollar and the EUR/USD currency pair.

We will be as concise as possible, with as little mumbo jumbo and filler as possible.

We will also try not to be confusing for you, the reader, whom I sympathise with. I remember when I started out, there was simply so much to learn. It gets more complicated from here.



## Forex Risk Management Strategies

Here are the basic principles of risk management in forex trading. The forex markets are unique compared to other trading markets: it is open longer hours, is fast moving, volatile and its size is enormous. No one entity, event or factor; no matter how large controls the forex markets.

Trading the forex markets is highly speculative and involves significant potential of great loss or profit. It is in the fact that the forex markets are so volatile that attracts many punters to invest in the market for profit.

Before you trade you must consider how much you are prepared to lose. How much of your capital are you prepared to risk? Consider the possible causes of risk in forex trading:

- \* Unexpected currency exchange movements
- \* High volatility
- \* Unscheduled economic announcements or decisions
- \* Fast moving markets

Remember, most of these risks are what attracts traders to forex markets and such qualities make the markets lucrative. So don't be afraid of them: be aware of them and strategize methods to mitigate (minimise) your forex trading risks.

The most important forex trading risk minimisation strategy is to know your exit plan. With every trade you must have a defined exit level that you decide upon opening your trade – this exit level



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must not be moved for any reason and must be exercised with discipline. Part of your plan would be a take profit exit at which you must have a defined systematic signal that tells you to exit. Don't just rely on your gut.

Knowing your loss minimizes your loss and allows you to live another day to trade on the forex markets. So when you are long a trade make sure to place a stop loss under your entry price (the level to be determined by your trading system – often determined through use of technical analysis methods). When you are short, put your stop loss above the entry level.

Where the trader places the stop and take profit will depend on how risk-averse you are. Stop/loss orders should not be so tight that normal market volatility triggers the order. Similarly, take profit orders should reflect a realistic expectation of gains based on the market's trading activity and the length of time you want to hold the position.

Many books and websites will tell you many things on how to minimize loss; but it all boils down to one thing: discipline in following rules. And remember, go with the flow as the markets are always right. (And you aren't.)

## Basic Technical Analysis in Forex

Technical analysis is the methodology used by forex traders to predict or weigh up the odds of future price movements and market trends by studying past market price action. The premise of this analysis technique is patterns within the prices would reveal possible trends, highs and lows based on predictable repetitive human behaviour. People are predictable and have habits: history repeats itself. Also, the price action in a chart reveals everything there is to know about that instrument since the current price action accounts for all the market factors and sentiment, supply and demand.

There are a few sub-branches to technical analysis:

- \* Oscillating indicators (RSI, Stochastics, MACD)
- \* Number theory including the mathematical Fibonacci numbers and the slightly mystical Gann numbers
- \* Elliot Wave Theory
- \* Gaps
- \* Trends and Averages

It isn't necessary to use all of them at once. Perhaps the most commonly used are oscillators like RSI and MACD, Fibonacci numbers and Trends using Moving Averages.

Oscillating indicators do just that: oscillate. On a chart they indicate overbought and oversold regions. How they are calculated is outside the scope of this ebook: but the main inputs are price and time. Here are the three most used oscillators below:



One oscillator is the Relative Strength Index (RSI): The RSI measures the ratio of up-moves to down-moves and normalizes the calculation so that the index is expressed in a range of 0-100. If the RSI is 70 or greater, then the instrument is assumed to be overbought (a situation in which prices have risen more than market expectations). An RSI of 30 or less is taken as a signal that the instrument may be oversold (a situation in which prices have fallen more than the market expectations).

Another oscillator is the Stochastic oscillator: This is used to indicate overbought/oversold conditions on a scale of 0-100%. The indicator is based on the observation that in a strong up trend, period closing prices tend to concentrate in the higher part of the period's range. Conversely, as prices fall in a strong down trend, closing prices tend to be near to the extreme low of the period range. Stochastic calculations produce two lines, %K and %D that are used to indicate overbought/oversold areas of a chart. Divergence between the stochastic lines and the price action of the underlying instrument gives a powerful trading signal.

Finally the Moving Average Convergence Divergence (MACD): This indicator involves plotting two momentum lines. The MACD line is the difference between two exponential moving averages and the signal or trigger line, which is an exponential moving average of the difference. If the MACD and trigger lines cross, then this is taken as a signal that a change in the trend is likely.

Number theory uses numbers as the basis of their technical analysis. Fibonacci numbers are numbers derived from ratios that occur naturally around the world around us. It is a beautiful theory and is often referred to as the golden ratio.



As forex traders you would use them normally to predict profit targets and price retracement levels. The Fibonacci number sequence (1,1,2,3,5,8,13,21,34...) is constructed by adding the first two numbers to arrive at the third. The ratio of any number to the next larger number is 62%, which is a popular Fibonacci retracement number. The inverse of 62%, which is 38%, is also used as a Fibonacci retracement number.

Another number theory style are Gann numbers. These are outside the scope of this book. W.D. Gann was a stock and a commodity trader working in the '50s who reputedly made over million in the markets. He made his fortune using methods that he developed for trading instruments based on relationships between price movement and time, known as time/price equivalents. There is no easy explanation for Gann's methods, but in essence he used angles in charts to determine support and resistance areas and predict the times of future trend changes. He also used lines in charts to predict support and resistance areas.

Elliott wave theory: The Elliott wave theory is an approach to market analysis that is based on repetitive wave patterns and the Fibonacci number sequence. An ideal Elliott wave patterns shows a five-wave advance followed by a three-wave decline. The five way advance would have a pattern with the first wave on an uptrend, the second on a dip down, then the third on an long up trend, then a fourth wave that is a down



trend and a fifth wave which is another up trend line: at the end of this series expect a turning point in the overall longer term trend. More advanced explanations of this wave theory is out of the scope of this book.

Gaps are spaces left on the bar chart where no trading has taken place. An up gap is formed when the lowest price on a trading day is higher than the highest high of the previous day. A down gap is formed when the highest price of the day is lower than the lowest price of the prior day. An up gap is usually a sign of market strength, while a down gap is a sign of market weakness. A breakaway gap is a price gap that forms on the completion of an important price pattern. It usually signals the beginning of an important price move. A runaway gap is a price gap that usually occurs around the mid-point of an important market trend. For that reason, it is also called a measuring gap. An exhaustion gap is a price gap that occurs at the end of an important trend and signals that the trend is ending.

A trend refers to the direction of prices. Rising peaks and troughs constitute an uptrend; falling peaks and troughs constitute a downtrend that determines the steepness of the current trend. The breaking of a trend line usually signals a trend reversal. Horizontal peaks and troughs characterize a trading range. Moving averages are used to smooth price information in order to confirm trends and support and resistance levels. They are also useful in deciding on a trading strategy, particularly in futures trading or a market with a strong up or down trend.



## Basic Fundamental Analysis in Forex

Fundamental analysis is a method of forecasting the future price movements of a financial instrument based on economic, political, environmental and other relevant factors and statistics that will affect the basic supply and demand of whatever underlies the financial instrument. In practice, many market players use technical analysis in conjunction with fundamental analysis to determine their trading strategy. Fundamental analysis focuses on what ought to happen in a market. Factors involved in price analysis: Supply and demand, seasonal cycles, weather and government policy.

Fundamental analysis is a macro or strategic assessment of where a currency should be trading based on any criteria but the movement of the currency's price itself. These criteria often include the economic condition of the country that the currency represents, monetary policy, and other "fundamental" elements.

Many profitable trades are made moments prior to or shortly after major economic announcements. It is important to keep note of important economic announcements which are related to the currency pairs you are trading.

### The Australian Dollar

It is important to be aware of the background of the currency pairs you choose to trade.

- \* Accounts for approximately 5% of the total volume of foreign exchange transactions (approximately 1.9 trillion dollars a day).
- \* Its popularity is due to the fact that there is little government intervention in the currency and a general view that Australia has a stable economy and government.



- \* The Australian dollar is now governed by its economy's terms of trade. Should Australia's commodity exports (minerals and farms) increase then the dollar increases. Should mineral prices falls or when domestic spending is greater than exports, then the dollar falls. The resulting volatility makes the Australian dollar an attractive vehicle for currency speculators and is the reason why it is one of the most traded currencies in the world despite the fact that Australia only comprises 2% of the global economic activity.
- \* The Australian dollar has usually served as a proxy for gold due to the fact that Australia is the second largest producer of gold after South Africa. Fluctuations in the price of gold have seen corresponding rise and falls in the Australian dollar.
- \* As well as its relationship with gold, like the Canadian and the New Zealand dollars, the Australian dollar is a commodity currency.
- \* Since the floating of the Australian dollar in 1983, the currency has fluctuated in an average range of 10 cents a year.

## The USD/EUR Currency Pair

Four factors are identified as fundamental determinants of the real euro to dollar exchange rate: The international real interest rate differential; Relative prices in the traded and non-traded goods sectors; The real oil price; The relative fiscal position.

The basic theories underlying the dollar to euro exchange rate:

**Law of One Price:** In competitive markets free of transportation cost barriers to trade, identical products sold in different countries must sell at the same price when the prices are stated in terms of the same currency.

**Interest rate effects:** If capital is allowed to flow freely, exchange rates become stable at a point where equality of interest is established.

The dual forces of supply and demand determine euro vs. dollar exchange rates. Various factors affect these two forces, which in turn affect the exchange rates:

**The business environment:** Positive indications (in terms of government policy, competitive advantages, market size, etc.) increase the demand for the currency, as more and more enterprises want to invest there.

**Stock market:** The major stock indices also have a correlation with the currency rates.

**Political factors:** All exchange rates are susceptible to political instability and anticipations about the new government. For example, political or financial instability in Russia is also a flag for the euro to US dollar exchange because of the substantial amount of German investments directed to Russia.

**Economic data:** Economic data such as labor reports (payrolls, unemployment rate and average hourly earnings), consumer price indices (CPI), producer price indices (PPI), gross domestic product (GDP), international trade, productivity, industrial production, consumer confidence etc., also affect fluctuations in currency exchange rates.

Confidence in a currency is the greatest determinant of the real euro-dollar exchange rate. Decisions are made based on expected future developments that may affect the currency. A EUR/USD exchange can operate under one of four main types of exchange rate systems:



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