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MINUTE
FOREX™

By Beau Diamond

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Chapter 1

Introduction to Currency Trading on the FOREX Market



Brief History and Explanation of the Forex Market



The FOREX Market is very new compared to other speculative markets of the world. Most of the trading in this market has only taken place over the last 22 years. The following is a brief history of how the FOREX market was created, how it works, and what it is today.

1944: The major Western industrialized nations agreed to a "pegging" system at Bretton Woods, New Hampshire. This established a par value of major currencies vis-a-vis the U.S. Dollar, which in turn was pegged at \$35.00 to one Troy ounce of gold. This was known as the Gold Standard.

1971: President Nixon abandoned the Gold Standard, directly pegging major currencies to the U.S. Dollar.

1978: Following the second major devaluation of the U.S. Dollar, the fixed-rate mechanism was totally discarded by the U.S. government and replaced with the floating rate. This floating rate was, in turn, adopted by other major currencies, transforming each of these currencies into a commodity, fluctuating in value subject to the forces of supply and demand. This free-floating currency exchange rate between all of the currencies in the world was the birth of the Foreign Exchange (FOREX) market.

WHAT IS FOREX?

The vast currency market is a foreign concept to the average individual. However, once it is broken down into simple terms, one can begin to easily understand the foreign exchange market and see what a profitable avenue of income participating in the trading of Forex can be. Whether or not you are aware, you already play a role in the foreign exchange market, also known as the Forex market. The simple fact that you have money in your pocket makes you an investor of currencies, and more particularly, an investor of U.S. Dollars! The cash in your wallet and money in your savings account are in U.S. Dollars. The value of your mortgage, stocks, bonds, and other investments are expressed in U.S. Dollars. In other words, unless you are among the few Americans who have foreign bank accounts or have bought a modest amount of foreign currencies or securities, you are an investor of U.S. Dollars. By holding U.S. Dollars, you have basically elected not to hold the currencies of other nations. Your purchase of stocks, bonds, and other investments, along with money deposited into your bank account represent investments that rely heavily on the integrity of the value of the currency in which it is denominated – the U.S. Dollar. Due to the constant increasing and decreasing value of the U.S. Dollar and the resultant fluctuation in exchange rates, your investment



portfolio may have experienced changes in value, thus affecting your overall financial status. With this in mind, it should be no surprise that many shrewd investors have taken advantage of the fluctuation in exchange rates using the volatility of the foreign exchange market to trade currencies and put more money in their pockets.

The foreign exchange market has experienced many changes since its inception. For years, as you learned above, the United States and its allies, under the Bretton Woods Agreement, participated in a system in which exchange rates were tied to the amount of gold reserves belonging to the nation. However in the summer of 1971, President Nixon took the United States off the gold standard, and floating exchange rates began to materialize. Today, supply and demand for a particular currency, or its relative value, is the driving factor in determining exchange rates. There have been many radical global economic changes over the last decade. Some of these changes have decreased obstacles and increased opportunities in world trade, such as the fall of communism in the Soviet Union and Eastern Europe, the renewed political reform in South America and the continuing liberalization of the Chinese economy have boosted the worldwide economy by opening up new markets and opportunities. These events have lifted traditional trade barriers resulting in a tremendous increase in foreign investment. With this increase however, all nations are more interrelated and dependent upon one another.



Increasing trade and foreign investment have made the economies of all nations more and more interrelated. Fluctuations in economic activity in one country are reflected in that country's currency and immediately transmitted to its partners, altering the relative price of products and thus affecting costs and profits, which in turn affect changes in currency values. Regularly reported economic figures around the world, such as inflation or unemployment levels, as well as unexpected news, such as natural disasters or political instability, alters the desirability of holding a particular currency, thus influencing international supply and demand for that currency. The U.S. Dollar, therefore, fluctuates constantly against the currencies of the rest of the world. The current web of international trade and the resultant fluctuations in exchange rates have created the world's largest market – the foreign exchange market, a market whose vast size makes it the most efficient, fairest, and liquid of all markets. The Interbank Foreign Exchange Market is an unregulated, decentralized international forum that deals in the various major currencies of the world, with virtually no direct government regulation or interference.



The Interbank Foreign Exchange Market involves trading one nation's currency for the currency of another nation. Foreign exchange, however, is not a "market" in the traditional sense since there is no centralized location for trading activity. It is an electronically linked world-wide network of currency traders



dispersed throughout the leading financial centers of the world. An international community of approximately 400 banks make the daily currency exchanges for buyers and sellers worldwide who conduct business linked by the Internet, phones, computers, fax machines and other means of instant communication. Trading occurs over the telephone and through computer terminals at thousands of locations worldwide. The direct Interbank market consists of dealers with currency settlement capabilities trading as principals. It is this dealer segment of the market that is responsible for generating a large portion of the overall foreign exchange volumes. Trading between dealers creates the largest turnover in the market, making foreign exchange the most liquid of all markets. Trading approximately \$1.5 trillion every day, the foreign exchange market is the largest financial market in the world. Traditionally, the foreign exchange market has only been available to banks, money managers, and large financial institutions. Over the years, these institutions, including the U.S. Federal Reserve Bank, have realized large gains via currency trading. This growing market is now linked to a worldwide network of currency traders, including banks, central banks, brokers, and customers, such as importers and exporters. Today, the foreign exchange market offers opportunities for profit not only to banks and institutions, but to individual investors as well. A great advantage is the size and volume of the Forex Interbank market makes it impossible to manipulate the market for any length of time. Unlike the equity markets, no really effective "*insider*" interference is possible for any length of time in the Forex market. As a result Forex is an action based, decentralized international market that allows various major currencies of the world to seek their true value. It operates as the purest form of supply and demand for currencies as a tradable commodity. This is why many analysts refer to it as the most efficient market in the world.

WHAT CAUSES THE FOREX MARKET TO MOVE?

The foreign exchange markets move when some force makes one currency either more or less valuable than another. The cumulative **purchase** and **sales** of a currency cause it to move up or down and to become more or less valuable in relation to other currencies. The primary factors influencing exchange rates include:

- The balance of payments
- The state of the economy
- Implications drawn from chart analysis
- Political and psychological factors
- Ebb and flow of capital between nations, otherwise known as **Purchasing Power Parity (PPP) is the central factor that determines market momentum.**
- A change in government or central bank policies
- Slowly shifting economic and social conditions
- Fundamental economic forces such as inflation and interest rates
- Faith in a government's ability to stand behind its currency will also impact currency prices
- Activities by professional currency managers, generally on behalf of a pool of funds, have also become a factor in moving the market.

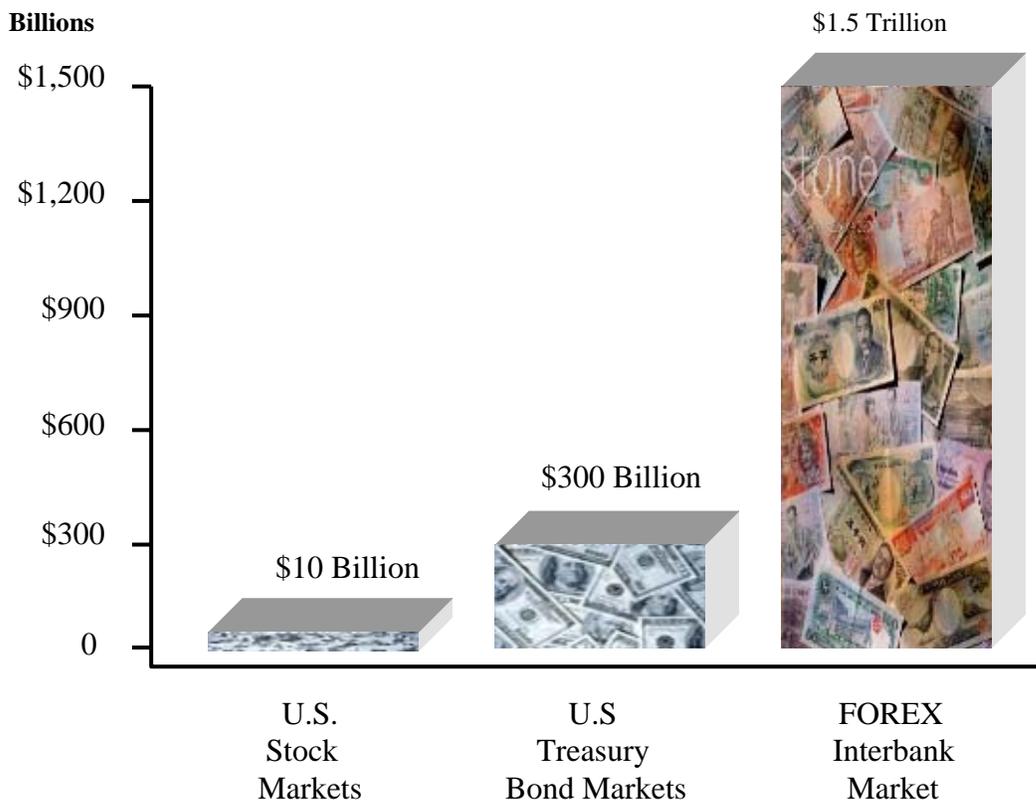
All these things create movements in currencies that usually tend to persist once they begin. Professional currency traders usually keep their eyes out for changes in monetary policies and the forces that shape currency trends.

WHY TRADE THE FOREX MARKET AND WHY IS IT ATTRACTING SO MANY NEW PARTICIPANTS?

The Forex market is vital to the general prosperity of the free world economy. Why? Some **\$1.5 trillion dollars worth of international currencies are bought and sold every single trading day**. It is by far the largest traded market in the world. This volume of trade is equivalent to over six months of trading in the New York Stock Exchange, which has an average daily volume of \$10 billion dollars. Even though the major focus in this country in reference to investing has always been and still is the stock and equity markets, the Forex market is 150 times larger than the New York Stock Exchange. See the chart below for an illustration of the daily trading volume of the New York Stock Exchange, the US Bond market, and the Forex market.



Comparative Daily \$ Dollar Trading Activity



As you can see the Forex market is by far the largest market in the world. Unfortunately from 1971 until very recent years the virtual owners of this market were the major banks, large brokerage firms, and multinational corporations. Major banks, even the Federal Reserve (which most Americans are unaware is a privately owned bank owned by mega-wealthy international bankers) realize a large segment of their profits (sometimes as much as 40% or more) from trading currencies. Up until recently if an individual wanted to trade currencies on the Forex market, the only way possible was to invest with a bank, which required not only a minimum of a one million dollar cash deposit, but this large deposit also had to be backed by a five to ten million dollar net worth. As some time progressed a slightly better option was trading with a brokerage firm, which asked for a minimum deposit on average of a quarter million dollars. Then factor in the myriad of sophisticated communication and trading facilities necessary to trade, and this profitable market was unreachable to most individuals.



Accessibility. Fortunately for you and me, the Forex market has now been opened up to small-scale investors. Unlike the enormous amounts previously required by the banks and brokerage firms, comparatively far lower margin requirements are finally available, which now allows virtually any individual to trade this highly profitable market. There are now many brokerage firms that specialize in trading currencies, which allow a minimum deposit that is much more reachable to most of us. In addition, the recent boom in computer and communication technologies has made this market accessible in ways previously exclusive only to large players. Thanks to the Internet, electronic trading is now possible for anyone with a computer and access to the internet to trade currencies.



Liquidity. There are many reasons that investors are being attracted in large numbers to the Forex market. One major reason is liquidity. This market can absorb trading volumes and per trade sizes that dwarf the capacity of any other market. On the simplest level, liquidity is always a major attraction to any investor as it allows one the freedom to open or close a position at will. Another desirable aspect of Forex is when day trading currencies your trading account is always liquid. At the end of each day trading your account is liquid cash, totally accessible, unlike stocks and mutual funds, which normally tie up your capital for months at a time.

High Profit Potential and Predictability. Years ago, like stocks, futures markets generally moved slowly and steadily toward price points (up or down). However, since about the early 1980's virtually all currency markets have become increasingly volatile, and the time required for the same price movement has become considerably shorter. Now, with long-term speculation with stocks or equities becoming increasingly risky,



trading Forex and taking advantage of its clear and predictable price trends is becoming increasingly popular. Many investors are choosing to focus their energy on the currency markets simply because they offer the greatest predictable daily price movements, with the least risk. While professional fund managers at major banks may behave independently and view the market from a unique perspective, most, if not all, are at least aware of important technical chart points in each major currency. As these important levels approach, the behavior of the market becomes more technically oriented and the reactions of many managers are often predictable and similar, thus market movements at these important technical levels can be predicted through simple technical analysis. These market periods may result in large price swings as substantial amounts of capital are invested in similar positions. Furthermore, thanks to the computer revolution, home computers have become increasingly more powerful and affordable. This power, coupled with the ease of Internet access has afforded the most casual of investor the same real-time access to the market that the professional trader on the trading floor has available. If it weren't for the instantaneous delivery of price information, and the ability of our computers to quickly analyze incoming information, day trading would not be possible.

Simplicity. Instead of attempting to choose a stock, bond or mutual fund from thousands available in the equity markets, the foreign exchange market deals primarily with just eight to ten different currencies. Along side the U.S. Dollar, four major currencies dominate the trading on the \$1.5 Trillion dollars traded daily on the Forex markets. This is due by nature of their popularity, activity, volume, stability, and confidence.



Clear Trends. Any professional trader knows that trends are the essence of profitable trading, and knowing this makes the idea of trading currencies very attractive, because currencies are the worlds best trending markets! Many studies of trend following systems prove that currency trends are the most consistent and profitable! Regardless of the type of trend following system used; long term, intermediate term or short term, currencies invariably outperform all other markets including stocks, bonds and other commodities. It should come as no surprise that some of the worlds' most successful traders are currency traders. Traders such as George Soros, Bill Lipschutz, and Bruce Kovner earn hundreds of millions of dollars per year trading currencies! It is a well-known fact in the world of currency trading that on one occasion the billionaire George Soros made in excess of **ONE BILLION DOLLARS** in **ONE DAY** with a trade he executed on the British Pound/US Dollar.

One reason currencies trend better than every other market is because of their macro-economic nature. Unlike many commodities whose supply and demand fundamentals can literally change with the weather, currency fundamentals are much less random and far more predictable. In summary, currencies are one of the best all around markets, currencies represent the worlds' largest marketplace, and have the most powerful and

persistent price trends, in other words, immense opportunities for profit. In addition each individual currency offers it's own unique pattern of movements and trends, which provides investors diversification within the Forex market.

CASH FOREX VERSUS CURRENCY FUTURES

There are two markets in which one can trade currencies and you should understand the fundamental difference between the two; cash Forex and currency futures. In currency futures, the contract size is predetermined. Futures traders exercise leverage by utilizing a performance bond or margin to control a futures contract. (Margin is money deposited by both the buyer and seller to insure the integrity of the contract.)

But with liquidity in mind, the futures market may seem limiting because the data flow comes to a stop at the end of the business day (just as it does with the stock market) thus disrupting your perception of the market. For some traders this could lead to a certain level of anxiety. For example, if an important data comes in from England or Japan while the U.S. futures markets are closed, the next day's opening could be wildly volatile. The currency futures market is also much smaller than the Forex market in relation to the average daily volume. The trading of currency futures contracts is estimated at only \$14 billion dollars per day, which pails in comparison to the some \$1.5 trillion dollars a day traded on the cash Forex market.

In contrast to the futures market, the spot Forex market is a 24-hour, continuous currency exchange that never closes. There are dealers in every major time zone, in every major dealing center (i.e., London, New York, Tokyo, Hong Kong, Sydney, etc.) willing to quote two-way markets. The size of this market, a one and a half trillion dollar per day market gives you tremendous liquidity. Because of the advantages of sheer volume and daily volatility, the excitement and endless profitability of this market is unparalleled.

ADVANTAGES OF CURRENCIES OVER STOCKS

Simplicity. There are usually the same four major currency pairs traded on the Forex market, therefore you may be able to get a feel for price movement patterns and currency behavior very quickly. There are thousands of securities on the stock market, and it is hard to understand why each particular stock will go up or down on any given day. Choosing the right stocks from thousands, on a daily basis, is not easy thing.

High Profit Potential with Smaller Investment. The minimum amount needed in order to open a trading account on the Forex market is now only \$300 with a Forex mini account. This relatively small amount of money gives you an opportunity to earn potentially hundreds of dollars per week. To have an opportunity to this much in the stock market, you would probably have to have at least \$5000 in your account. Certainly you can lose in both markets, but with Forex you can make good income with a much smaller amount of trading capital than would be needed with stocks.

Liquidity. Again, the Forex market is the largest market in the world, originally created for the big players - banks, investment funds, corporations and other financial institutions. It doesn't matter how many individual traders participate on this market at the current moment of time - they can't move this market at all. On the stock market, which is much smaller, tens of millions of unprofessional investors greatly affect this market by their often chaotic trades, making the possibility to predict its movement more difficult.

The Opportunity to Profit in Either Direction. There is no "bull" or "bear" market in Forex. You always can earn money either buying or selling currency. It doesn't matter if there is a booming economy, or a deep recession. On the stock market, most of the money is made during a period of booming economy, when the stock market goes up, which in turn is very limiting. But economic development is cyclical - and periods of growth will eventually be replaced by periods of recession. And in this case, when the stock market is going down, you can't win as a day trader. On the other hand, during all times of the year, regardless of the strength or weakness of the US economy or other major economies, currency exchange rates are always fluctuating, thus giving traders year round, continuous opportunities for profitable trading

Demo Account. When trading the Forex market you have a unique feature - a "Demo Account" or simulated account, which allows you to participate in trading using real-time prices on the Deal Station with the same interface and functions as on real trading, using the same news and technical analysis tools to predict market movements, from the comfort of your home and via the Internet. You can gain experience in trading without risking any of your real money. On the stock market you don't have such a unique training tool for Internet day trading. In order to take a shot at the stock market, you have to put down your money first - your real money.

Now you can understand why more and more people are beginning to realize why trading Forex is so much more attractive than trading stocks. It is convenient and inexpensive. It gives you the opportunity and the time to develop your personal trading system, using demo trading, allows you to make large returns on trades that only last a few hours, and best of all, your money is always liquid.

Forex is clearly the market of the 21 Century!

Chapter 2

Basics of Trading FOREX



GLOBAL CURRENCY ZONES

With the introduction of the euro (EU) in January 1999, there now exist three major global currency zones along which capital flows - the United States, Japan and Europe. By dividing the world into three separate zones, you can easily see how capital flow into one zone directly effects the price determinants of the others. In this way, as one zone loses economic strength, the other gains and attracts capital. This new influx of capital drives up currency values.

UNDERSTANDING THE THREE MAJOR CURRENCY ZONES

The United States Dollar, the Japanese Yen, and the European Union's euro represent the three major Global Economic Powers of the world. The aim of each power is to create a strong investment environment, which will attract capital to a country and cause its currency to appreciate. Here's what to look for:



US DOLLAR (\$) - The US Dollar is the most dominant currency in the world today - one side of over 90% of all the world's Interbank foreign exchange transactions involve the dollar. The 12-year US bull market has attracted money from around the world and also kept money at home. Vast inflows of new capital from Japan and Europe, seeking our higher interest rates and our booming stock market, have characterized the rise of the US dollar in the 90's. As we begin the new century however, creeping fears of higher interest rates, virtually full employment, and hints of inflation are causes of worry. As non-US markets appear to finally be improving, concerned investors may move funds out of the US in favor of expected growth in Japan and Europe.



JAPANESE YEN (¥) - Since the World War II, Japan has focused all its energy and resources in developing its economy. With unique traditions and management skills, Japan has turned out to be one of the biggest economic powers in the world. The Yen ruled the economic landscape of the 80's only to see the bubble burst amid rampant speculation in real estate and foreign acquisitions. Restrictive government policy coupled with the 'Asian contagion' have kept the recovery from gaining significant momentum. However, an improving stock market in 1999 and increased economic expansion have created huge capital inflows into Japan, resulting in a much stronger Yen. Too strong a Yen pressures export profits, too weak a Yen puts a drag on the economy; with interest rates now returning near zero per cent, Japan now has a tough balancing act to perform.



EURO (€) - The euro was introduced on January 1, 1999 at \$1.16675. As it unified 11 currencies, it was to be the economic unit for the European Union (EU) constituting a larger economy than the US. Initial support waned as member countries have failed to rev up their economies. High tax rates, burdensome regulations and high unemployment have cut into the euro's growth potential. These fundamentals have caused the euro to fall through parity against the US dollar in November 1999. The early indications that European companies will issue more debt this year to attract capital is a good sign. The European

Central Bank and friends have also intervened many times recently, temporarily pushing the euro up trying to finally put it on a firm up-trend against the dollar and save it from falling to levels that would mock the very idea of having a unified European currency.

WHEN DO I TRADE?



FOREX trading follows the sun around the world - starting in Tokyo (12% of the daily volume of Forex), the market activity moves through to London (36% of the daily volume of Forex), the last banking center in Europe, before traveling on to New York (18% of the daily volume of Forex) and finally returning to Japan via Sydney. The Interbank market has three sessions of trading. The first begins on Sunday at 7:00 p.m., NYT, which is the Asia session. The second is the European (London) session, which begins at approximately 3:00 am; and the third and final session is the New York, which begins at approximately 8:00 am and ends at 5:00 p.m. The majority of all trading occurs during the London session and the first half of the New York session. As a result, buyers and sellers are available 24 hours a day. Investors can respond to currency fluctuations caused by economic, social and political events at the time they occur -day or night. *The most important trading time, where the majority of the \$1.5 trillion dollars is traded daily is between 2:00 am and 12:00 pm, EST. This is the time window that there are the most trading opportunities in the Forex market.*

PAIRS THAT I RECOMMEND YOU TRADE

Even though the Foreign Exchange market includes the currencies from almost every country on Earth, along with cross rates of all these currencies, most of the trading is done on what are called the 'major 4' and crosses of the major 4 which are:

Eurodollar
British Pound
Swiss Franc
Japanese Yen

I have found the following eight pairs to be the only ones worth trading.

 **EUR/USD**

 **GBP/USD**

 **USD/CHF**

 **USD/JPY**

 **EUR/JPY**

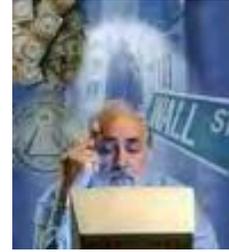
 **GBP/JPY**

 **AUD/USD**

 **USD/CAD**



My favorite pair to trade which has been the most profitable is the Eurodollar against the dollar. One thing to note about the Eurodollar and the Swiss Franc is that they move in exact accordance with each other. As one weakens against the dollar, so does the other. This will appear on the charts as whenever the Eurodollar's prices are rising, the Swiss Franc's prices are falling. They basically are mirrors of each other on the charts. When one goes up, the other goes down, so remember that if you trade the EUR/USD and the USD/CHF at the same time, if you lose on one, you almost definitely will lose on the other as well. These two pairs have so far been the most predictable and the most profitable to trade. The GBP/USD is also just as profitable. I have not found the Yen to be a profitable currency to trade. Compared to the major European currencies against the dollar it has choppy, unpredictable trends. The USD/CAD and AUD/USD are not very profitable when day trading, but for long term trading, such as the 5Minute Forex System, they have very nice, long sustained trends. You will not make the same profits as quickly with these currencies as with the EUR/USD or the USD/CHF but they are still profitable nonetheless. As investors know however, diversification is important when it comes to investing, and it makes sense to have many currencies to trade, not just a few.



HOW IS PROFIT MEASURED WHEN TRADING, AND WHAT IS THE VALUE OF EACH POINT OR 'PIP' FOR EACH CURRENCY?

The way profit is measured in a currency is by "pips". For every currency you will be trading, with the exception of the Yen and the Yen cross rates, a pip is .0001 of the currency's price unit. For the Yen and Yen crosses, a pip is .01 of a currency's price unit. For example a price movement of the British Pound from 1.4250 to 1.4275 would be 25 pips, or points. A price movement of the Euro from .9120 to .9170 would be 50 pips, or points. A price movement of the EUR/JPY from 93.40 to 93.95 would be 55 pips or points. The pip value for the GBP/USD and the EUR/USD are fixed, and always the same. For every other currency pair the pip value is variable based on the current exchange rate of the pair. For the USD/CHF pip value just divide 100 by the current exchange rate. For the USD/JPY, Yen cross rates and Canadian and Australian pairs the pip value is very close to \$9 per pip.

CURRENT DOLLAR VALUE PER PIP, PER \$1000 LOT AS OF THIS WRITING

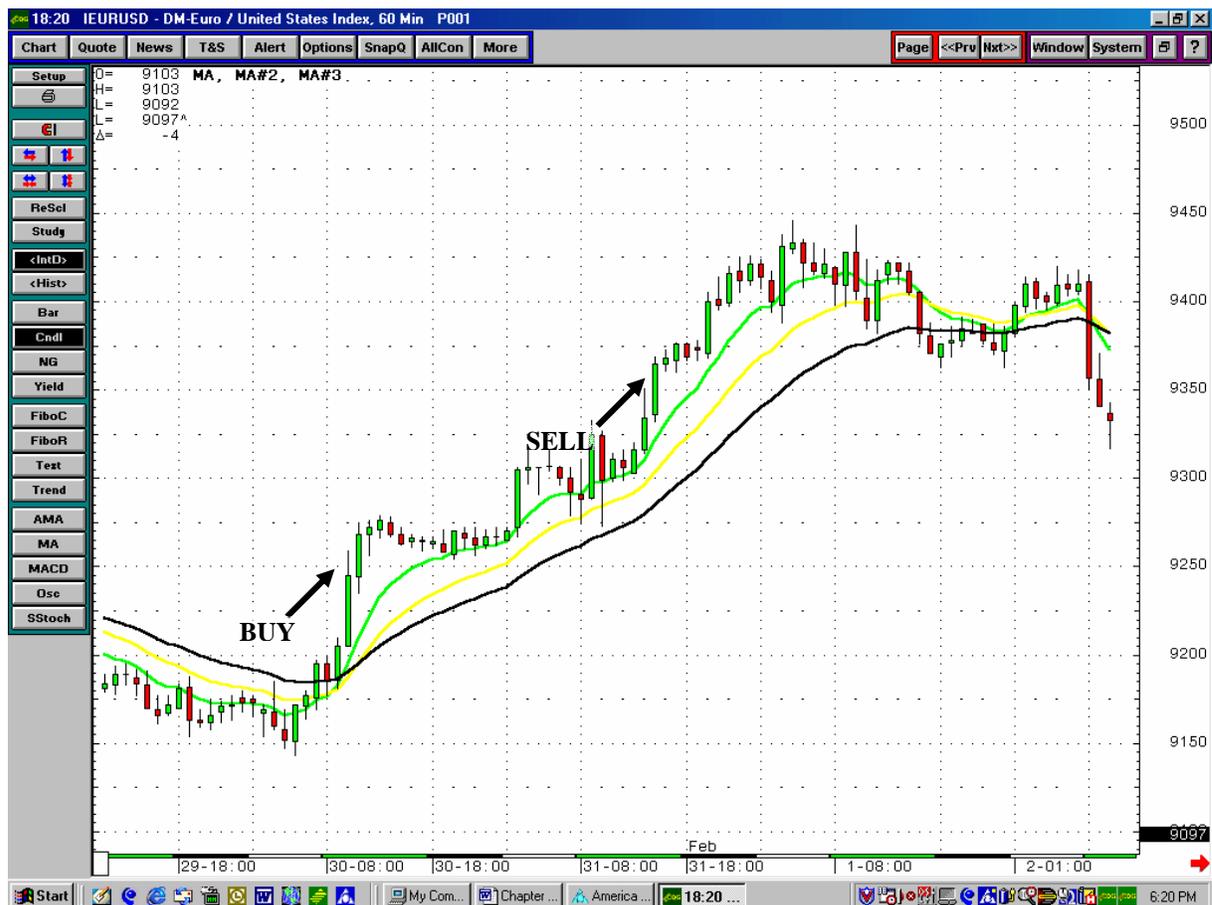
	EUR/USD – Eurodollar/US dollar.....	\$10
	GBP/USD – British Pound/US dollar.....	\$10
	USD/CHF – US dollar/Swiss Franc.....	\$7.3
	USD/JPY – US dollar/Japanese Yen.....	\$9
	EUR/JPY – Eurodollar/Japanese Yen.....	\$9
	GBP/JPY – British Pound/Japanese Yen.....	\$9
	AUD/USD – Australian dollar/US dollar.....	\$9
	CAD/USD – Canadian dollar to US dollar.....	\$9

LOT SIZES, MARGIN, AND LEVERAGE

One of the big advantages to trading currencies on the Forex market is the high degree of leverage couple with the low degree of comparative risk associated with trading. On the Forex market \$1000, which is considered one “lot” is the smallest transaction one can make when buying/selling currency on a regular account. That \$1000 dollars, depending on what brokerage company one uses is typically leveraged 100 to 1, which means that \$1000 is actually controlling \$100,000 in currency. The \$1000 needed to control \$100,000 in currency is also referred to by the brokerage companies as “margin”. The margin requirements have recently changed on the EUR/USD and the GBP/USD, and is \$1400 per lot and \$2000 per lot respectively.

With an e-mini account which one may open with as little as little as \$300, the minimum lot size is \$100, which controls \$10,000 in currency. The margin’s have changed for mini accounts as well, so on the EUR/USD and GBP the margin per lot is \$140, and \$200 per lot, respectively.

With this margin, or leverage, only a one-percent relative change in a currency in the investor’s favor would equate to approximately a 100 percent return on the investment. As far as risk, when we trade we have stop losses that limit our losses to no more than three percent of the total account per each trade. An example is that if the investor bought one lot of EUR/USD at .9250 and the euro went up 100 points or pips and the investor sold the lot at .9350. This would be approximately a one percent relative change in the currency, and the investor would make a net profit of \$1000. See chart below for a real life example:



In the above example you made 100 pips, at \$10 per pip, so your profit would be exactly 100 percent of whatever amount was traded. If you bought 1 lot (\$1000) at .9250 and sold at .9350 your profit would be \$1000. If you bought 8 lots (\$8,000) your profit would be \$8,000 etc.

Differences of Going “Long” or “Short”

When doing currency trading, or any type of trading on any market for that matter, it is possible for us to make money whether the market goes up or down. If the market goes up we buy low and sell at a higher price for a profit. If the market goes down we sell short high and buy back at a lower price. Selling short is a promise to the broker to buy it back. When we buy to enter the market it is referred to as “going long” and when we sell to get in the market it is referred to as “going short”. Whether we go long or short we can make the same amount of money. See the two charts below for examples.



Chapter 3

Money Management



Money Management

There are three key elements to being a successful trader.

- 1. Money Management**
- 2. Market Analysis and A Good Trading System &**
- 3. Sound Personal Psychology**

We will cover all three of these in this course. Each of these three key elements are equally important and without all three you will not succeed as a trader. Borrowing an analogy from Dr. Alexander Elder, a respected psychiatrist and professional trader, in his book *Trading for A Living* he says “These three essentials are like three legs of a stool – remove one and the stool will fall, together with the person that sits on it. Losers try to build a stool with only one leg, or two at the most. They usually focus exclusively on trading systems.” This chapter covers the first of the three, money management.

Trading without proper money management is like trying to cross a desert with no water - you won't make it. As traders, our first goal of money management is to insure survival. The second goal is to generate a steady rate of return, and the third goal is to make a high rate of return, survival however, is the first.

NEVER RISK YOUR WHOLE ACCOUNT on one trade is your very first rule of trading. People who lose money frequently violate it by risking too much of their account on a single trade. They continue trading the same or even bigger sizes during a losing streak. Most losers get killed trying to trade their way out of a hole. Luckily, good money management can keep you out of the hole in the first place.

Let me illustrate how the more money you lose the more difficult it becomes to try to earn it back. If you have a \$10,000 account and you lose 10 percent, (\$1000 of your account), you have to make 11 percent on the account which is now \$9000 to recoup that loss. If you lose 20 percent (\$2000) you need to make 25 percent on what is now \$8000 to come back. If you lose 40 percent (\$4000), you need to make a whopping 67 percent of what is now \$6000, and if you lose 50 percent of your account which would make it \$5000 you need to make **100 percent** just to recover your money. While losses grow mathematically, the profits that are required to recoup them increase almost exponentially.

This is why it is absolutely crucial never to let these kinds of losses occur, and the only way to do this is to employ and adhere to strict rules of money management. Amateurs often ask what percent profit they can make per week, per month, or per year trading currencies. The answer to that question depends on their skills (or lack of skills) as a trader, the quality of their trading system, and market conditions. Amateurs however never ask a more important question: “What can I do to insure that I do not lose my money?” You must be sure you are not going to lose your money before you worry about

how much you are going to make. Proper money management is your best insurance policy on your trading capital.

HOW MUCH TO RISK

Most traders get wiped out by one of two things, ignorance or emotion. Amateurs act on hunches and spontaneous urges to stumble into trades they never should have taken because of unfavorable conditions in the market. Those who survive this stage of naivete learn to design a better way of trading. When they become confident, the second enemy comes to their door. Confidence makes them greedy, they risk too much money at one time, and a short string of losses blows them out of the market.

If you trade with half of your account on every trade, your ruin is absolutely guaranteed. If you risk a quarter of your account on each trade, you also likely will never survive long term in the market. A short losing streak will completely wipe you out. Even risking a tenth of your account on every trade is being more risky than one should if they want to stay in the market long term.

Professional traders cannot afford to lose more than a tiny percentage of their equity on a single trade. An amateur has the same attitude towards trading as a foolish gambler has in Las Vegas. The more money they bet, the more they'll make. **WRONG**, even the most successful traders in the world have losing trades, even strings of losing trades and traders have to insure that the least amount of their capital possible is to be risked each time.

This is one of the areas of trading where it is absolutely vital to treat trading as a business. It cannot be treated like a game if one wants to make money. No smart businessperson would do something to risk half, a quarter, or even a tenth of their business in a single transaction. Trading has to be dealt with in the same manner. The general rule to follow is if **you are day trading** to never risk more than **2-2.5%** of your total equity on any given trade. This means that on every trade, if you trade with 10 percent of your equity, and you will have a stop loss that limits your losses to no more than 25 percent of that amount. When doing long term trading, like with the 5Minute FOREX™ System our stop loss and risk per trade is normally much higher, but this is okay because of how infrequently you trade compared to day trading. The second rule is to never have more than three trades open at any given time. So the maximum about you will ever have at risk is 6-7% of your account when day trading. For those starting with less than \$10,000 the rule for them is to only trade one currency at a time until your account reaches \$10,000. If you are trading with an e-mini account then it is the same, except you would trade one currency at a time until your account reaches \$2000. Trading in this way will insure that you do not ever wipe out your entire account with a short string of losses, which can happen with even the best of trading systems and the sharpest of traders. There is no system in the world that wins 100 percent of the time.

Most beginners have absolutely no rules of money management in their trading strategy. They risk more capital on trades that look really good to them. They risk less capital on

trades they are less sure about. This never works in the long run because there seems to be a frustrating version of Murphy’s Law found in this aspect of trading: trades that you risk more money on will almost always be the losers and trades that you risk less capital on will almost always be the winners. So now we move on to another way to use money management to insure a steady increase in profits.

PYRAMIDING YOUR PROFITS

Not only will you never trade with more than 10 percent of your account but you will also never trade with *less* than 10 percent of your account. Doing this is called pyramiding your profits. Regardless of how much you have in your account, you will always trade with 10 percent. Trading in this way causes your account to grow exponentially, because compound interest as Albert Einstein said is indeed “...one of the most powerful forces in the universe.” Due to the fact that the minimum size we can trade with in the Forex market on a regular account is \$1000, those starting with a four or five figure account will have to round down when trading with 10 percent at a time until their account reaches at least \$110,000. Below you can see an illustration of this strategy. This strategy shows exactly how many lots to trade with on each trade from account sizes of \$5,000 to \$110,000.

10k – 20k	20k – 30k	30k – 40k	40k-50k	50k – 60k
1 lot	2 lots	3 lots	4 lots	5 lots

60k – 70k	70k – 80k	80k-90k	90k – 100k	100k – 110k
6 lots	7 lots	8 lots	9 lots	10 lots

By following this rule it will take the guesswork out of wondering how much capital to risk on each trade. If you ever feel inclined to trade with a lot less than 10 percent of your account then the rule is *don’t trade at all*. If you aren’t sure about a trade you should stay out of the market completely and wait for a trade you are confident in. If you ever feel an urge to trade with more than 10 percent of your capital on one trade remember that is the sure way to be a losing trader. Don’t get greedy. Trading is by no means a magical way to make a million dollars overnight. Strive for slow, steady gains and small consistent profits. You’ll be surprised at the end of a year how much money you have made by small consistent gains compounding. Make sure you follow these strict rules of money management because they are your very best friends when trading. By following these guidelines your profits will literally grow exponentially and your losses will be cut to an absolute minimum. As said earlier, proper money management is the closest thing you have to an insurance policy on your capital.

The following are the same rules for an e-mini account:

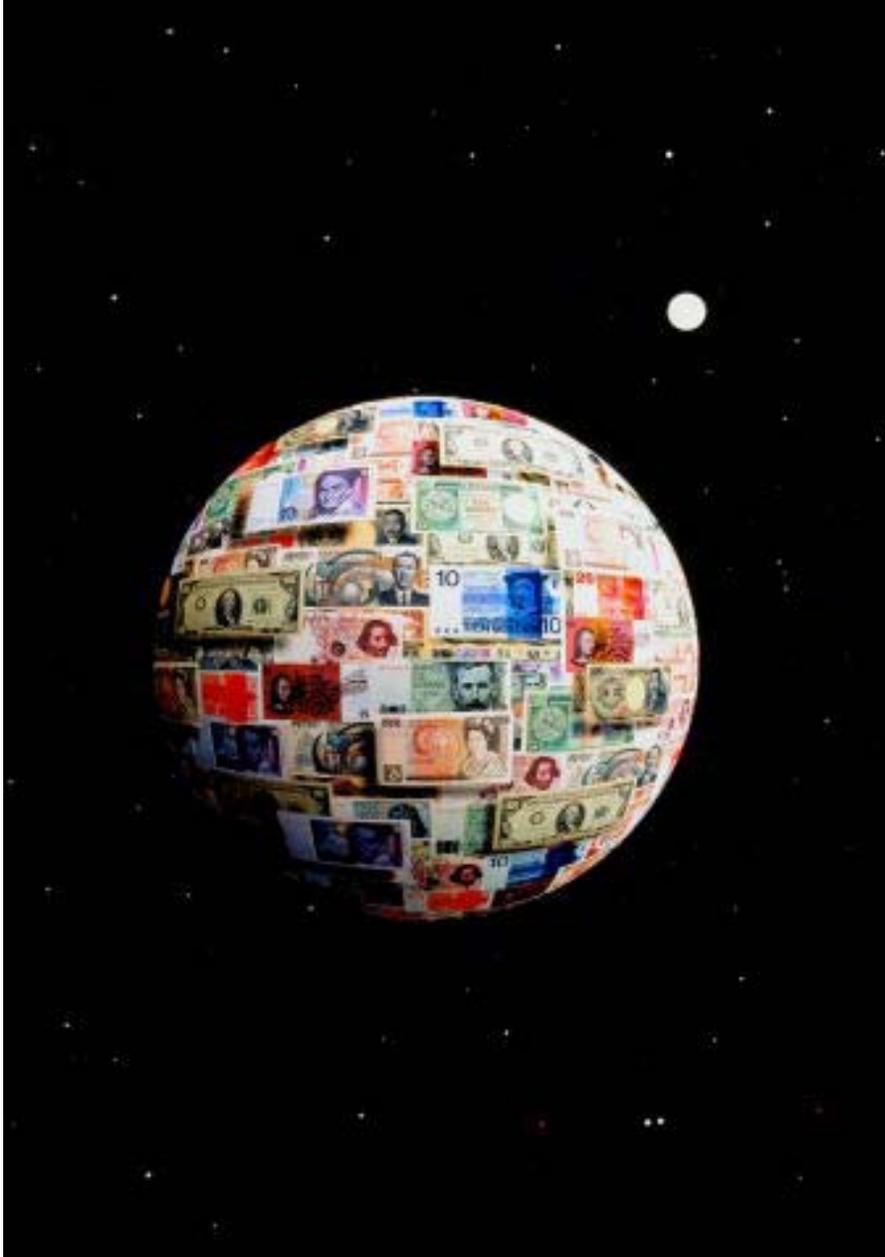
It is not recommended that you trade with less than \$2000 on an e-mini account because you are then forced to risk more per trade that is wise for good money management, but if you are unable to open with at least that then follow the table below for how many lots to trade with per trade.

\$300-\$2000	2k-3k	3k-4k	4k-5k	5k-6k
1 Mini Lot	2 Mini Lots	3 Mini Lots	4 Mini Lots	5 Mini Lots

6k-7k	7k-8k	8k-9k	9k-10k	10k-20k
6 Mini Lots	7 Mini Lots	8 Mini Lots	9 mini Lots	Refer Above

Chapter 4

Fundamental Analysis



Fundamental Analysis

There are two major types of analysis used when trading any financial market; fundamental and technical. This manual focuses on technical analysis as it is the preferred method of trading for most professional traders, especially currency traders. Fundamental analysis is trading based on following political and economic factors that move the market rather than studying charts for trading signals. For educational purposes, the following guides help to understand the essential fundamentals and practical factors impacting key Forex rates. These guides identify pertinent officials, institutions, and economic indicators most likely to move the Forex market for those interested in fundamental Analysis.

The only way I recommend you use fundamental analysis is to know WHEN specific economic reports are coming out. These reports almost always have an effect on the market and cause movements, but I do not recommend you try to guess the direction of the movements, rather that you leave that up to the technicals. The important ones to watch for are interest rate changes, unemployment reports, consumer confidence indexes, announcements of any kind by the Federal Reserve chairman Alan Greenspan, industrial production reports, housing figures, job figures, trade deficits, basically any information that comes out that is relevant to the economy generally causes some movement. The time almost all of these figures are released is 8:30 AM EST. If you go to www.dailyfx.com/calendar/Calendar.html you will see a list of what reports are to be released each week. You will notice a lot of significant figures are often released on Fridays, and Fridays when important figures are to be released will often be very quiet until 8:30 when they are released. The website www.dailyfx.com is a great site owned by the brokerage company I recommend you use. I highly suggest you take advantage of the various free services to the Forex trader the site offers.

Factors Affecting the US Dollar

Federal Reserve Bank (Fed): The U.S Central Bank has full independence in setting monetary policy to achieve maximum non-inflationary growth. The Fed's chief policy signals are: open market operations, the Discount Rate and the Fed Funds rate.

Federal Open Market Committee (FOMC): The FOMC is responsible for making decisions on monetary policy, including the crucial interest rate announcements it makes 8 times a year. The 12-member committee is made up of 7 members of the Board of Governors; the president of the Federal Reserve Bank of New York; while the remaining four seats carry one-year term each, in a rotating selection of the presidents of the 11 other Reserve Banks.

Voting Members in 2003

Alan Greenspan, Board of Governors, Chairman

Ben S. Bernanke, Board of Governors

Susan Schmidt Bies, Board of Governors

J. Alfred Broaddus, Jr., Richmond

Roger W. Ferguson, Jr., Board of Governors

Edward M. Gramlich, Board of Governors

Jack Guynn, Atlanta

Donald L. Kohn, Board of Governors

Michael H. Moskow, Chicago

Mark W. Olson, Board of Governors

Robert T. Parry, San Francisco

Alternate Members

Thomas M. Hoenig, Kansas City

Cathy E. Minehan, Boston

Sandra Pianalto, Cleveland

William Poole, St. Louis

Jamie B. Stewart, Jr., First Vice President, New York

William Poole, St. Louis

Jamie B. Stewart, Jr., First Vice President, New York

Interest Rates:

Fed Funds Rate: Clearly the most important interest rate. It is the rate that depository institutions charge each other for overnight loans. The Fed announces changes in the Fed Funds rate when it wishes to send clear monetary policy signals. **These announcements normally have large impact on all stock, bond and currency markets.**

Discount Rate: The interest rate at which the Fed charges commercial banks for emergency liquidity purposes. Although this is more of a symbolic rate, changes in it imply clear policy signals. The Discount Rate is almost always less than the Fed Funds Rate. 30-year Treasury Bond: The 30-year US Treasury Bond, also known as the long bond, or bellweather treasury. It is the most important indicator of markets' expectations on inflation. Markets most commonly use the yield (rather than price) when referring to the level of the bond. As in all bonds, the yield on the 30-year treasury is inversely related to the price. There is no clear-cut relation between the long bond and the US dollar. But the following relation usually holds: A fall in the value of the bond (rise in the yield) due to inflationary concerns may pressure the dollar. These concerns could arise from strong economic data.

Depending on the stage of the economic cycle, strong economic data could have varying impacts on the dollar. In an environment where inflation is not a threat, strong economic data may boost the dollar. But at times when the threat of inflation (higher interest rates) is most urgent, strong data normally hurt the dollar, by means of the resulting sell-off in bonds. Being a benchmark asset-class, the long bond is normally impacted by shifting capital flows triggered by global considerations. Financial/political turmoil in emerging markets could be a possible booster for US treasuries due to their safe nature, thereby, helping the dollar.

3-month Eurodollar Deposits: The interest rate on 3-month dollar-denominated deposits held in banks outside the US. It serves as a valuable benchmark for determining interest rate differentials to help estimate exchange rates. To illustrate USD/JPY as a theoretical example, the greater the interest rate differential in favor of the eurodollar against the euroyen deposit, the more likely USD/JPY will receive a boost. Sometimes, this relation does not hold due to the confluence of other factors.

10-year Treasury Note: FX markets usually refer to the 10-year note when comparing its yield with that on similar bonds overseas, namely the Euro (German 10-year bund), Japan (10-year JGB) and the UK (10-year gilt). The spread differential (difference in yields) between the yield on 10-year US Treasury note and that on non US bonds, impacts the exchange rate. A higher US yield usually benefits the US dollar against foreign currencies.

Treasury: The US Treasury is responsible for issuing government debt and for making decisions on the fiscal budget. The Treasury has no say in monetary policy, but its statements on the dollar have a major influence on the currency.

The Key Treasury Officials are:

Lawrence Summers: Treasury Secretary

Stuart Eizenstat: Deputy Secretary

Timothy Geithner: Undersecretary of International Affairs

Gordon Gensler: Undersecretary

Economic Data: The most important economic data items released in the US are: labor report (payrolls, unemployment rate and average hourly earnings), CPI, PPI, GDP, international trade, ECI, NAPM, productivity, industrial production, housing starts, housing permits and consumer confidence.

Stock Market: The three major stock indices are the Dow Jones Industrials Index (Dow), S&P 500, and NASDAQ. The Dow is the most influential index on the dollar. Since the mid-1990s, the index has shown a strong positive correlation with the greenback as foreign investors purchased US equities. Three major forces affect the Dow: 1) Corporate earnings, forecast and actual; 2) Interest rate expectations and; 3) Global considerations. Consequently, these factors channel their way through the dollar.

Cross Rate Effect: The dollar's value against one currency is sometimes impacted by another currency pair (exchange rate) that may not involve the dollar. To illustrate, a sharp rise in the yen against the euro (falling EUR/JPY) could cause a general decline in the euro, including a fall in EUR/USD.

Fed Funds Rate Futures Contract: Interest rate expectations can be made through the Fed Funds rate in the futures market. The contract's value shows what the Fed Funds interest rate (overnight rate) is expected to be in the future, depending on the maturity of the contract. Hence, the contract is a valuable barometer of market expectation vis-à-vis Federal Reserve policy. The rate is obtained by subtracting the contract's value from 100, and comparing the result to the prevailing Fed Funds rate in the cash/spot market.

3-month Eurodollar Futures Contract: While the Fed Funds futures contract reflects Fed Funds rate expectations into the future, the 3-month Eurodollar contract does the same for the interest rate on 3-month Eurodollar deposits. To illustrate, the difference between futures contracts on the 3-month Eurodollar and euro/yen deposits is an essential variable in determining USD/JPY expectations.

Factors Affecting USD/JPY

Ministry of Finance (MoF): The MoF is the single most important political and monetary institution in Japan. Its influence in guiding the currency is more significant than the ministries of finance of the US, UK or Germany, despite the gradual measures to decentralize decision-making.

MoF officials often make statements regarding the economy that have notable impacts on the yen. These statements include verbal intervention aimed at avoiding undesirable appreciation/depreciation of the yen. **Key officials most likely to move the market are the following:**

Kiichi Miyazawa: Finance Minister

Haruhiko Kuroda: Vice-Minister for International Affairs.

Zembei Mizoguchi: Head of MoF's International Bureau

Eisuke Sakakibara: Former vice-minister of international affairs. Also dubbed as "Mr Yen" for his ability to move the currency with his statements. Although Mr. Kuroda has succeeded him, Mr. Sakakibara can still come forward and give market-moving statements.

Bank of Japan (BoJ): In 1998, Japan passed new laws giving the central Bank (BoJ) operational independence from the government (MoF). While complete control over monetary policy has shifted to the BoJ, the MoF remains in charge of foreign exchange policy. Masaru Hayami is the BoJ Governor.

Interest Rates: The Overnight Call Rate is the key short-term interbank rate. The call rate is controlled by the BoJ's open market operations designed to manage liquidity. The BoJ uses the call rate to signal monetary policy changes, which impact the currency.

Japanese Government Bonds (JGBs): The BoJ buys 10 and 20-year JGBs every month to inject liquidity into the monetary system. The yield on the benchmark 10-year JGB serves as key indicator of long-term interest rates. The spread, or the difference between 10-year JGB yields and those on US 10-year treasury notes, is an important driver of the \$/JPY exchange rates. Falling JGBs (rising JGB yields) usually boosts the yen, and weighs on USD/JPY.

Economic Planning Agency (EPA): Government agency responsible for formulating economic planning programs and coordinating economic policies including employment, international trade and foreign exchange.

Taichi Sakaiya: Head of the EPA and frequent speaker on market wires.

Ministry of International Trade and Industry (MITI): Government institution aimed at supporting the interests of Japanese industry and defending international trade competitiveness of Japanese corporations. MITI's power and visibility is not as significant as it used to be in the 1980s and early 1990s, when US-Japan trade issues were the "hottest" topics in FX markets.

Kaoru Yosano: Minister

Osamu Watanabe: Vice-Minister

Economic Data: The most important economic data items from Japan are: GDP; Tankan survey (quarterly business sentiment and expectations survey); international trade; unemployment; industrial production and money supply (M2+CDs).

Nikkei-225: Japan's leading stock index. A reasonable decline in the yen usually lifts stocks of export-oriented companies, which tends to boost the overall stock index. The Nikkei-yen relationship is sometimes reversed, wherein a strong open in the Nikkei tends to boost the yen (weighs on USD/JPY) as investors' funds flow into yen-denominated stocks.

Cross Rate Effect: The USD/JPY exchange rate is sometimes impacted by movements in cross exchange rates (non-dollar exchange rates) such as EUR/JPY or EUR/USD. To illustrate: A rising USD/JPY (rising dollar & a falling yen) could be a result of an appreciating EUR/JPY, rather than direct strength in the dollar. This rise in the cross rate could be highlighted due to contrasting sentiment between Japan and the Eurozone. Another example: Both EUR/JPY and EUR/USD rally because of a general strengthening in the euro. For some particular factors (such as better prospects in Japan), this could have a larger impact on the dollar than it does on the yen. As a result, USD/JPY weakens since the yen is relatively less hurt by the appreciating euro.

Factors Affecting EUR/USD

The Eurozone: The 11 countries that have adopted the euro in order of GDP: Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Portugal, Ireland and Luxembourg.

European Central Bank (ECB): Controls monetary policy for the eurozone. The decision making body is the Governing Council, which consists of the Executive Board and the governors of the national central banks. The Executive Board consists of the ECB President, Vice-President, and four other members:

ECB President- Wim Duisenberg (Netherlands)

Vice President- Christian Noyer (France)

Board Member (Chief Economist)- Otmar Issing (Germany)

Board Member- Tommaso Padoa-Schioppa (Italy)

Board Member- Eugenio Domingo Solans (Spain)

Board Member- Sirkka Hamalainen (Finland)

Selected National Central Bank Governors:

Germany: Ernst Welteke

France: Jean-Claude Trichet

Italy: Antonio Fazio

ECB Policy Targets: The primary objective of the ECB is price stability. It has two main "pillars" of monetary policy. The first one is the outlook for price developments and risks to price stability. Price stability is defined as an increase of the Harmonized Index of Consumer Prices (HICP) of below 2%. While the HICP is very important, a broad number of indicators and forecasts are used to determine the medium term threat to price stability. The second pillar is monetary growth as measured by M3. The ECB has a "reference value" of 4.5% annual growth for M3.

The ECB holds a Council meeting every other Thursday to make announcements on interest rates. At each first meeting of the month, the ECB holds a press conference in which it gives its outlook on monetary policy and the economy as a whole.

Interest Rates: The ECB's refinancing rate is the Bank's key short-term interest rate used for managing liquidity. The difference between the refinancing rate and the US Fed Funds rate is a good indicator for the EUR/USD.

3-month Eurodeposit (Euribor): The interest rate on 3-month Euribor, deposits held in banks outside the Eurozone. It serves as a valuable benchmark for determining interest rate differentials to help estimate exchange rates. Using a theoretical example on EUR/USD, the greater the interest rate differential in favor of the euribor against the eurodollar deposit, the more likely EUR/USD is to rise. Sometimes, this relation does not hold due to the confluence of other factors.

10-Year Government Bonds: Another important driver of the EUR/\$ exchange rate is the difference in interest rates between the US and eurozone. The German 10-year Bund is normally used as the benchmark. Since the rate on the 10-year Bund is below that of the US 10-year note, a narrowing of the spread (i.e. rise in Germany yields or fall in US yields or both) is theoretically expected to favor the EUR/\$ rate. A widening in the spread, will act against the exchange rate. So the 10-year US-German spread is a good number to be aware of. The trend in this number is usually more important than the absolute value. The interest rate differential, of course, is usually related to the growth outlook of the US and eurozone, which is another fundamental driver of the exchange rate.

Finance Ministers:

Germany: Hans Eichel, who took over when his more left-wing predecessor, Oskar Lafontaine, resigned in March 1999.

France: Christian Sautter replaced Dominique Strauss-Khan who resigned in November 1999.

Italy: Finance Minister Vincenzo Visco, Treasury and Budget Minister Giuliano Amato.

Economic Data: The most important economic data is from Germany, the largest economy, and from the euro-wide statistics, still in their infancy. The key data are usually GDP, inflation (CPI and HICP), Industrial Production, and Unemployment. From Germany in particular, a key piece of data is the IFO survey, which is a widely watched indicator of business confidence. Also important are the budget deficits of the individual countries, which according to the Stability and Growth Pact, must be kept below 3% of GDP. Countries also have targets for reducing their deficits further, and failure to meet these targets will likely be detrimental to the euro (as we saw with Italy's loosening of its budget deficit guidelines).

Cross Rate Effect: The EUR/USD exchange rate is sometimes impacted by movements in cross exchange rates (non-dollar exchange rates) such as EUR/JPY or EUR/JPY. To illustrate: EUR/USD could fall as a result of significantly positive news in Japan, that filters through a falling EUR/JPY rate. Even though, USD/JPY may be declining, euro weakness spills onto a falling EURUSD.

3-month Euro Futures Contract (Euribor): The contract reflects markets expectations on 3-month euro-Euro deposits (euribor) into the future. The difference between futures contracts on the 3-month cash eurodollar and on the euro-Euro deposit is an essential variable in determining EUR/USD expectations.

Other Indicators: There is a strong negative correlation between EUR/USD and USD/CHF, reflecting a steadily similar relation between the euro and the Swiss franc. This is because the Swiss economy is largely dependent upon the Eurozone economies. In most cases, a spike (dip) in EUR/USD is accompanied by a dip (spike) in EUR/CHF. The inverse also usually holds. This relationship sometimes fails to hold in the event of data or factors pertaining solely to either of the currencies.

Political Factors: As with all exchange rates, EUR/USD is susceptible to political instability such as a threat to coalition governments in France, Germany or Italy. Political or financial instability in Russia is also a red flag for EUR/USD, because of the substantial amount of Germany investment directed to Russia

Factors Affecting GBP/USD (Cable)

Bank of England (BoE): Under the Bank of England Act of June 1997, the BoE obtained operational independence in setting monetary policy to deliver price stability and to support the government's growth and employment objectives.

The price stability objective is set by the government's inflation target, defined as 2.5% annual growth in Retail Prices Index excluding mortgages (RPI-X). Hence, despite its independence in setting monetary policy, the BoE remains dependent upon having to meet the inflation target set by the Treasury.

Monetary Policy Committee (MPC): The BoE's Committee responsible for making decisions on interest rates. The 9-member Committee comprises of the following:

Eddy George: Central Bank Governor
Mervyn King: Deputy Governor
David Clementi: Deputy Governor
Ian Plenderleith: Executive Director
John Vickers: Executive Director
Willem Buiter: Stephen Nickell
Charles Godheart: Christopher Allsopp
DeAnne Julius: Outside Expert
Sushil Wadhvani: Outside Expert

Interest Rates: The Central Bank's main interest rate is the minimum lending rate (base rate), which it uses to send clear signals on monetary policy changes at the first week of every month. Changes in the base rate usually have a large impact on sterling. The BoE also sets monetary policy through its daily market operations used to change the dealing rates at which it buys government bills from discount houses (specialized institutions in trading money market instruments).

Gilts: Government bonds known as gilt-edged securities. The spread differential (difference in yields) between the yield on the 10-year gilt and that on the 10-year US Treasury note usually impacts the exchange rate. The spread differential between gilts and German bunds is also important, as it impacts the EUR/GBP exchange rate, which could affect GBP/USD (see cross-rate effect).

3-month Eurosterling Deposits: The interest rate on 3-month sterling-denominated deposits held in banks outside the UK. It serves as a valuable benchmark for determining interest rate differentials to help estimate exchange rates. Using a theoretical example on GBP/USD, the greater the interest rate differential in favor of the eurodollar against the euro/sterling deposit, the more likely GBP/USD is to fall. Sometimes, this relation does not hold due to the confluence of other factors.

Treasury: The Treasury's role in setting monetary policy diminished markedly since the Bank of England Act of June 1997. Yet, the Treasury still sets the inflation target for the BoE and makes key appointments at the Central Bank.

Gordon Brown: Chancellor of the Exchequer (Head of Treasury).

Sterling and EMU Membership: British Prime Minister Tony Blair often impacts the sterling when he makes vital references regarding Britain's possible membership into the single European currency, the euro. In order for Britain to join the single currency, UK interest rates will have to converge down to the levels of the Eurozone. If the British people vote in favor of adopting the euro (vote expected after 2001), the sterling will have to decline against the euro so as to achieve sufficient trade advantage for British industry. Thus, any signs (speeches, remarks or polls) indicating a closer UK to the euro, is expected to have a downward impact on the sterling.

Economic Data: The most important economic data items released in the UK are: Claimant unemployment (number of unemployed); claimant unemployment rate; average earnings; RPI-X; retail sales; PPI; industrial production; GDP growth; purchasing managers' surveys (manufacturing and services); money supply (M4); balance of payments and housing prices. 3-month Eurosterling Futures Contract (short sterling): The contract reflects markets expectations on 3-month euro sterling into the future. The difference between futures contracts on the 3-month eurodollar and eurosterling deposits is an essential variable in determining GBP/USD expectations.

FTSE-100: Britain's leading stock index. Unlike in the US or Japan, Britain's main stock index has relatively less influence on the currency. Nevertheless, the positive correlation between the FTSE-100 and the Dow Jones Industrial Index is one of the strongest in the global markets. Cross Rate Effect: GBP/USD is sometimes impacted by movements in cross exchange rates

(non-dollar exchange rates) such as EUR/GBP. To illustrate: A rise in EUR/GBP (fall in sterling)--triggered by strengthening expectations of UK membership into the euro-- could lead to a decline in GBP/USD (cable). Conversely, reports indicating that the UK may not join the single currency project, will hurt the EUR/GBP, thereby boosting cable.

Factors Affecting USD/CHF (Swiss Franc)

Swiss National Bank (SNB): The Swiss Central Bank has maximum independence in setting monetary and exchange rate policy. Unlike most Central banks, the SNB does not use a specific money market rate to guide monetary conditions. Until fall 1999, the Bank used foreign exchange swaps and repurchase agreements as the main instruments to impact money supply and interest rates.

Liquidity management has characteristically affected the Swiss franc due to the use of Foreign Exchange Swaps. If the Bank wishes to inject liquidity, it buys foreign currency (primarily dollars) against Swiss francs, thereby pressuring the currency.

As of December 1999, the Bank shifted from a monetarist approach (targeting money supply) to an inflation-based approach namely; a 2.00% annual inflation rate. The Bank will use a range in the 3-month London Interbank Offer Rate (LIBOR) to stir monetary policy in order to achieve the 2.00% inflation target.

SNB officials can affect the Swiss Franc by making occasional remarks on liquidity, money supply or the currency itself. Here are the key SNB officials:

Hans Meyer: President

Jean-Pierre Roth: Vice President

Bruno Gehrig: Member of Governing Board (*tipped to be the next Bank Chief*)

Georg Rich: Chief Economist

Interest Rates: The SNB uses the discount rate to announce changes in monetary policy. These changes have a significant impact on the currency. The discount rate, however, is rarely used at the Bank's discount facility.

3-month Euroswissfranc Deposits: The interest rate on 3-month Swiss-denominated deposits held in banks outside Switzerland. It serves as a valuable benchmark for determining interest rate differentials to help estimate exchange rates. Using a theoretical example on USD/CHF, the greater the interest rate differential in favor of the eurodollar against the euroswiss deposit, the more likely USD/CHF is to rise. Sometimes, this relation does not hold due to the confluence of other factors.

Swiss franc's Changing Role as a Safe-Haven Status: The Swiss franc has historically enjoyed an advantageous role as a "safe" asset due to: SNB independence in preserving monetary stability; secrecy of the nation's banking system; and the neutrality of Switzerland's political position. Moreover, the SNB's relatively hefty gold reserves had largely contributed to the franc's solidity. Even as the currency's international role starts to wane in the mid-1990s (partly due to the emergence of the dollar and fall in gold), the Swiss franc remains a valuable alternative in Forex markets.

Economic Data: The most important economic data items released in Switzerland are: M3 (broadest measure of money supply), CPI, unemployment, balance of payments, GDP and industrial production.

Cross Rate Effect: USD/CHF is sometimes impacted by movements in cross exchange rates (non-dollar exchange rates), such as EUR/CHF or GBP/CHF. To illustrate: A rise in GBP/CHF that is triggered by an interest rate hike in the UK, could extend the franc's weakness against other currencies, including the dollar.

3-month Euroswiss Futures Contract: The contract reflects markets expectations on 3-month euro swiss deposits into the future. The difference between futures contracts on the 3-month eurodollar and euroswiss deposits is an essential variable in determining USD/CHF expectations.

Other factors: Due to the proximity of the Swiss economy to the Eurozone (specifically Germany), the Swiss franc has exhibited a considerably positive correlation with the euro. The relationship is most prominent in the highly negative correlation between USD/CHF and EUR/USD. To illustrate, a sudden move in EUR/USD (triggered by a major fundamental factor) is most likely to cause an equally sharp move in USD/CHF in the opposite direction. The relationship between these two currency pairs is one the strongest in currency markets.

Chapter 5

Technical Analysis



Technical Analysis

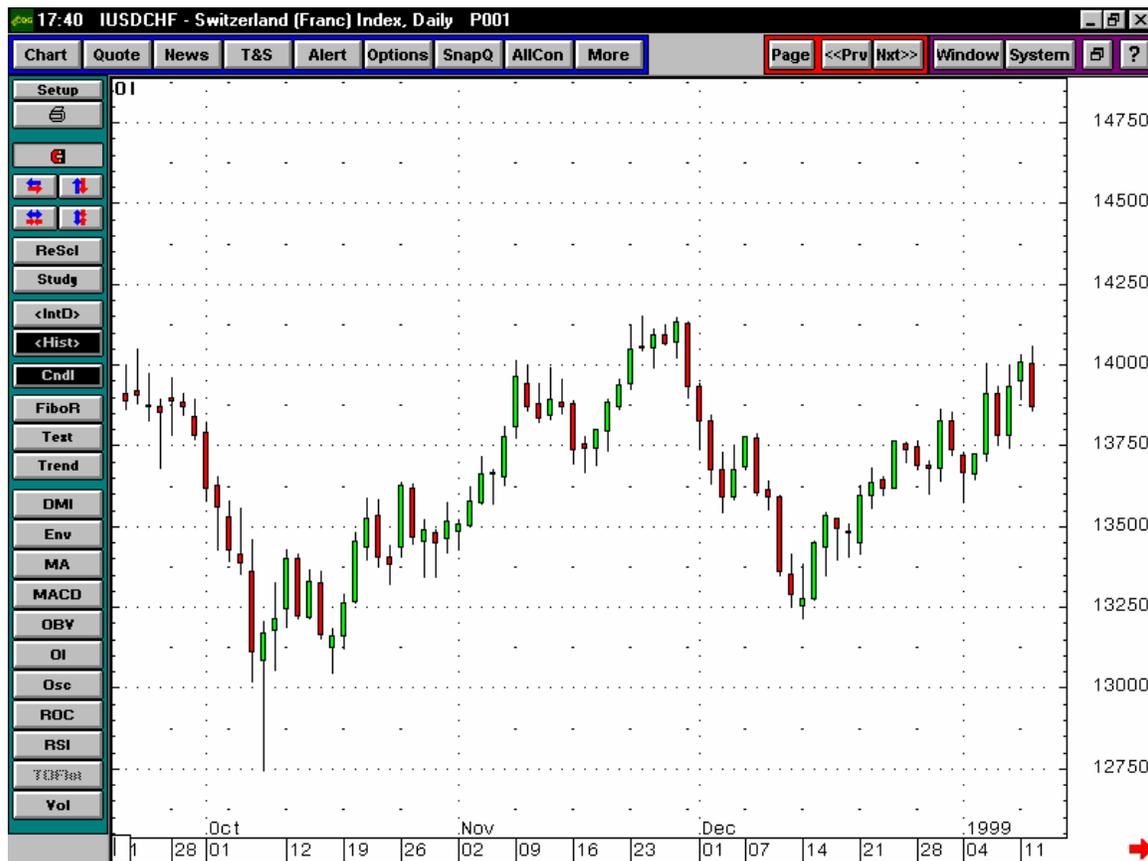


Technical analysis is the preferred method of analysis of most professional currency traders. It's the method of analysis based on market action through chart study and various technical indicators. Simply put, it's **the study of the relationship between time and price**. Today, thanks to the advancements in personal computers and the Internet, technical analysis has been made abundantly more effective, reliable, practical, and simple to use for the average investor. Before the availability of charting software for computers, a trader doing technical analysis had to go through many hours per day of tedious chart drawing by hand, based on end-of-day data for whatever market they traded. Doing short term, intraday trading simply was not possible. Now with the widespread availability of charting software together with real time streaming data via the Internet, trading based on technical analysis with computer trading software has become a very realistic and simple way for the average investor to do successful trading. Using software to help traders with technical analysis has become such a necessity to modern day traders that a trader without his computer and trading software would be like a professional basketball player with no shoes – he could still play, but not nearly as well.

You will learn strategies that show you exactly what to use to generate buy and sell signals and precisely how to trade. Although we will focus on very specific strategies using certain technical indicators, this chapter will give you information on many different types of technical analysis and various technical indicators available for educational purposes. It will also give you valuable information on how to determine

trends, common chart patterns which can help you pick up good trading opportunities and pivot points, support and resistance levels, Fibonacci retracements, and an explanation of many different technical indicators. Keep in mind throughout the course of reading this chapter that it is *not* necessary to remember or to have a thorough knowledge of every technical indicator out there. You will learn about the 5Minute FOREX™ System in chapter 8 which will lay out for you **exactly how to trade** in a very specific way. The following information is for educational purposes of gaining a general understanding of the foundations of technical analysis and for those that wish to experiment with different technical indicators and to come up with their own strategy.

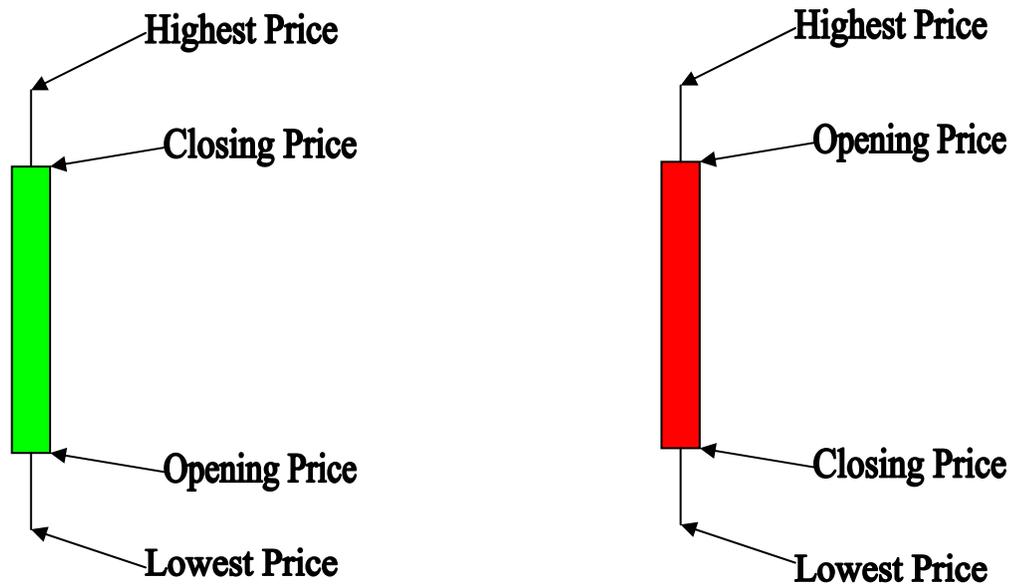
Candlestick Chart



Japanese Candlestick Charts

There are many types of charts; line charts, bar charts, volume bar charts, equivolume, point & figure, etc but candlestick charts are the most widely used in currency trading and will be emphasized in this manual. In the 1600s, Japanese rice traders developed a method of technical analysis to analyze the price of rice contracts. This technique is called candlestick charting. Steven Nison is credited with popularizing candlestick charting and has become recognized as the leading expert on their interpretation. Candlestick charts display the open, high, low, and closing prices in a format similar to a modern-day bar-chart, but in a manner that accentuates the relationship between the opening and closing prices. Candlestick charts are simply a better way of looking at

prices, they don't involve any calculations. The body of each candle represents the distance between opening and closing prices. Each candle represents a certain time period that the analyst may choose. In the chart on the previous page each candle represents 15 minutes. When you use Netdania (the free online charting software you will learn about), if the closing price is higher than the opening price, the body of the candle is green. If the closing price is lower than the opening price, the body is red. The wick through each candle represents the low and high price in the time period the candle represents. The tip of the upper wick represents the highest price, and the bottom of the lower wick represents the lowest price. See the figure below for an illustration of each aspect of the body of a candlestick and the difference between red and green candles.



The chart on the previous page is an 'empty version' of what we'll actually be using to trade, to give us buy and sell signals. It is just a simple example of a very basic candlestick chart. We'll be adding moving average lines, more colors, and a couple technical indicators so we have clear buy and sell signals. However all charts we will be using will be candlestick charts. In a candlestick chart, you will see mostly green candles in an uptrending market and mostly red candles on a downtrending market. The following section will provide you with some information on how to determine market trends.

Trends

Learning to identify trends in the market is the most fundamental, basic necessity of technical analysis. It is the foundation that all other technical analysis is built on. I originally thought of giving the subject of trends its own separate chapter because of its immense importance, but since almost all technical analysis is based on or around trends it needs to be addressed first. The very first thing to know about trends is that there are three kinds in a market:

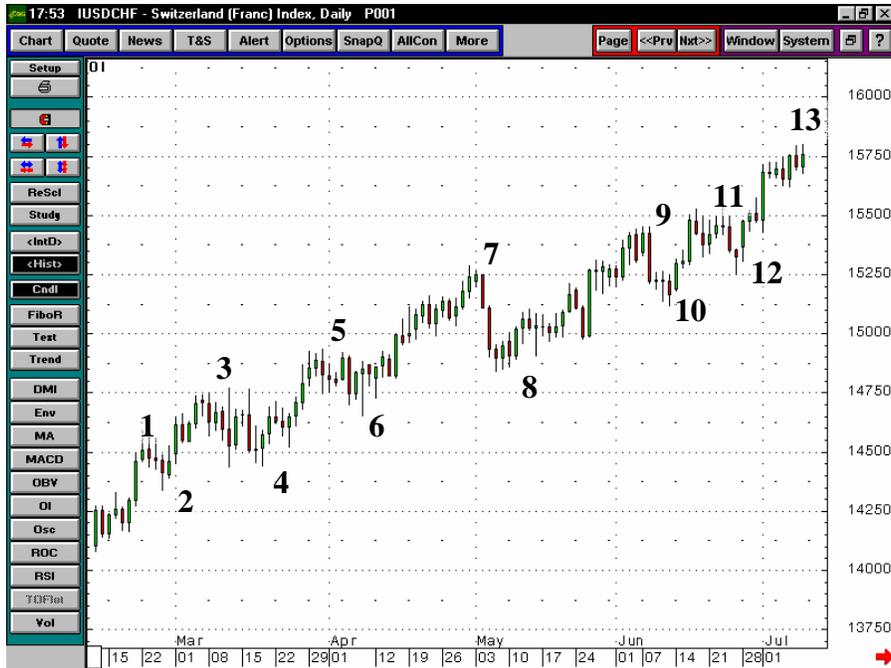
- 1. Bullish Trend (uptrend)**
- 2. Bearish Trend (downtrend)**
- 3. Trading Range (flat, sideways long term trends with small short term trading ranges)**

We as traders make money from changes in prices; we buy low and sell high (go long), or sell short high and buy back at a lower price (go short). Regardless of what market you trade, whether it is stocks, bonds, futures, commodities, options, or currencies, trends always exist in the market. Knowing the trend (or lack thereof) of a market is the very first step to being able to make money. The simple definition of an **uptrend** is when each rally upward reaches a higher level than the previous rally and each decline stops at a higher level than the preceding decline. In a **downtrend** each decline falls to a lower level than the previous decline and each rally stops at a lower level than the preceding one. In a **trading range** most rallies stop at about the same as the previous high and each decline stops at about the same previous low.

If investors are doing medium or long term trading it is very important for them to identify trends and to mainly trade in the direction of the trend. In short term trading, it is possible to trade with and against the major trend. One point to realize about trading is since we can look at a market in any number of different time periods, (eg. 5 minute, 15 minute, 30 minute, 60 minute, 2 hour, 4, hour, 8 hour, daily, weekly, monthly charts etc) there are *trends within trends within trends and so on*. The trend you pay most attention to depends totally on whether you are doing short, medium or long term trading. (See more about short, medium, and long term trading in chapter 7)

In this section most of the examples of charts will be from longer-term charts, such as daily charts instead of intraday charts. The reason is simply because trends are more relevant and more important the longer-term chart you look at, and are easier to identify. Longer-term charts enable you to see “the big picture” so to speak and are always a good idea to look at now and then, even if you are focused on short term intraday trading. It’s similar to an astronaut’s eye-view of leaving Earth from a space shuttle. As he goes higher and higher into the atmosphere and eventually into space the flat ground and many lines and contours of the Earth eventually becomes a big, round, blue, green and white, ball floating in the blackness of space. When you look at longer-term charts it is easier to see the full picture of that currency’s movements and characteristics over time.

The following page has an example of an uptrend and a downtrend on a daily chart.



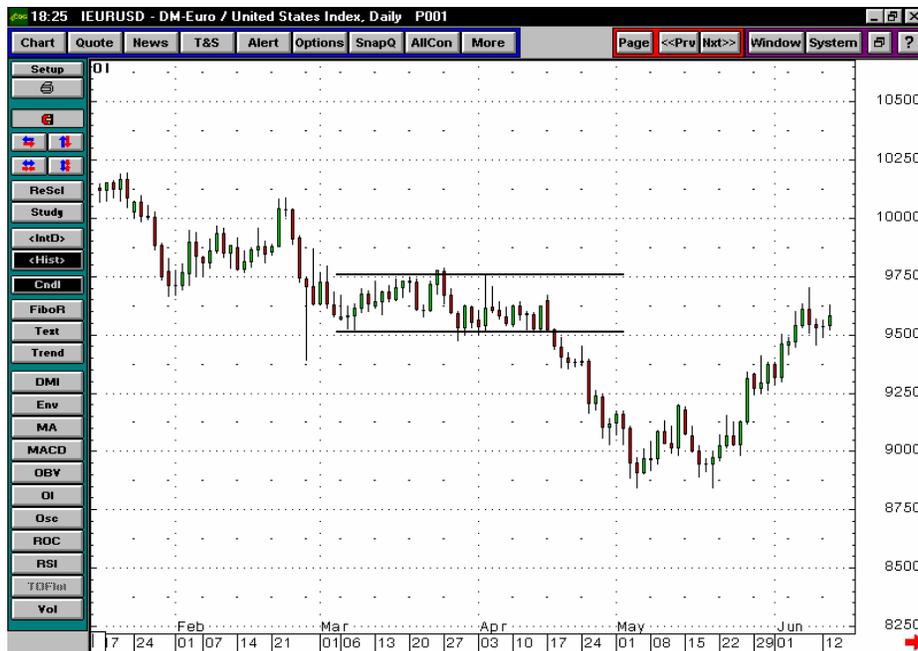
This pattern of higher tops and higher lows signifies an **uptrend**. All the odd numbers show the tops of the rallies and the even numbers show the bottoms of the declines. As you can see each rally is higher than the previous one and each decline stops higher than the previous one.



This pattern of lower bottoms and lower tops signifies a **downtrend**. All the odd numbers show the bottoms of the declines and the even numbers show the tops of the rallies. As you can see each decline falls lower than the previous one and each rally stops lower than the preceding one.



This daily chart is a perfect example of a small two-month **trading range** the GBP/USD was in. This is an example of even when you're doing intraday trading it is helpful to look at a long-term chart. In this case it shows in this two-month trading range there is a limit to the inclines and declines of the market indicating it is smart to buy near the bottom and sell near the top.



This daily chart is an example of a month and half-trading range on the EUR/USD. Even though it appears to be a very small trading range on the daily chart, each one of those horizontal dotted lines is 250 points away from the next, so there still was plenty of intraday trading profit potential in this trading range.

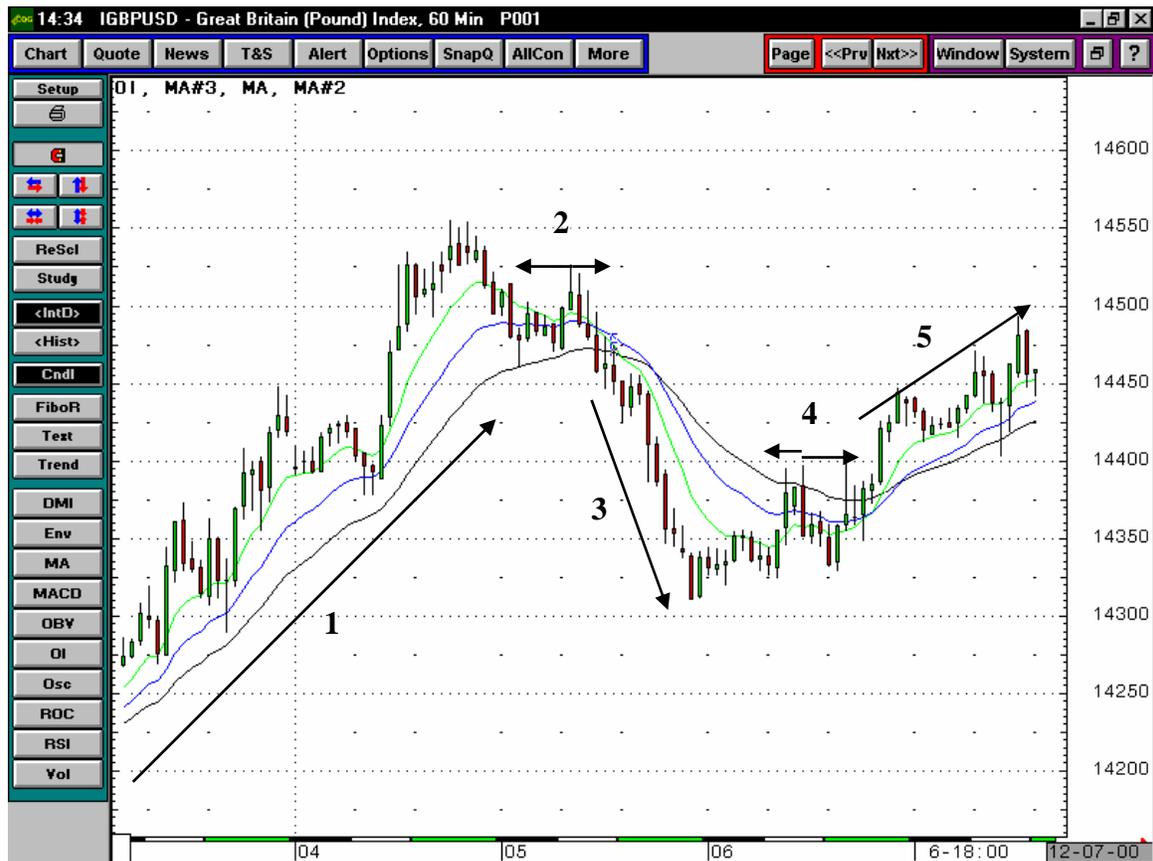
Using moving averages is one of the easiest ways to determine a trend. A moving average is very simple. It shows the average value of prices for its time period. A nine-day moving average shows the average price for the past nine days. A 12-day moving average shows the average price for the past 12 days. Traders can set the period to any value they wish. When each day's moving average value is connected, a moving average line is created. There are three main types of moving average lines: simple, weighted, and exponential.

Different lengths of moving average lines respond differently to price changes. A relatively short moving average line reacts more quickly to price changes. It responds to new trends sooner than a longer moving average line. However, it also changes its direction more often and produces more whipsaws. A whipsaw is a rapid reversal of a trading signal in the wrong direction. A relatively longer moving average line has fewer whipsaws but catches turning points in the market later.

Since computers allow us to quickly and easily change the period of moving average lines, this allows you to test numerous combinations of moving averages set to different periods. Through much research and testing, **if you are doing day trading** I have found that for the sake of determining trends, three exponential moving average lines used together set to the periods of 9, 18, and 30 respectively work well. Also using 50, 100, and 200 day simple moving average lines allow one to see various changes in trends, and on what side of the trend the market is currently trading in. When I say period that means that if you are looking at a daily chart, a 10 day moving average line averages data from 10 days back. In an intraday chart, let's say a 60 minute chart, a moving average line set to the period of 10 will average prices over the last 10 hours. A moving average line set to 10 on a 30 minute chart will average prices over the last 5 hours, etc. Modern computer trading software is very advanced and automatically changes the ratio of the period to the time frame of the chart as you switch up and back between short and long-term charts so you never have to worry about doing it manually. See the example below, which shows what a 50 day moving average line looks like on a daily chart of the EUR/USD.



This example shows what the three moving average lines look like on an intraday 60-minute chart of the GBP/USD.



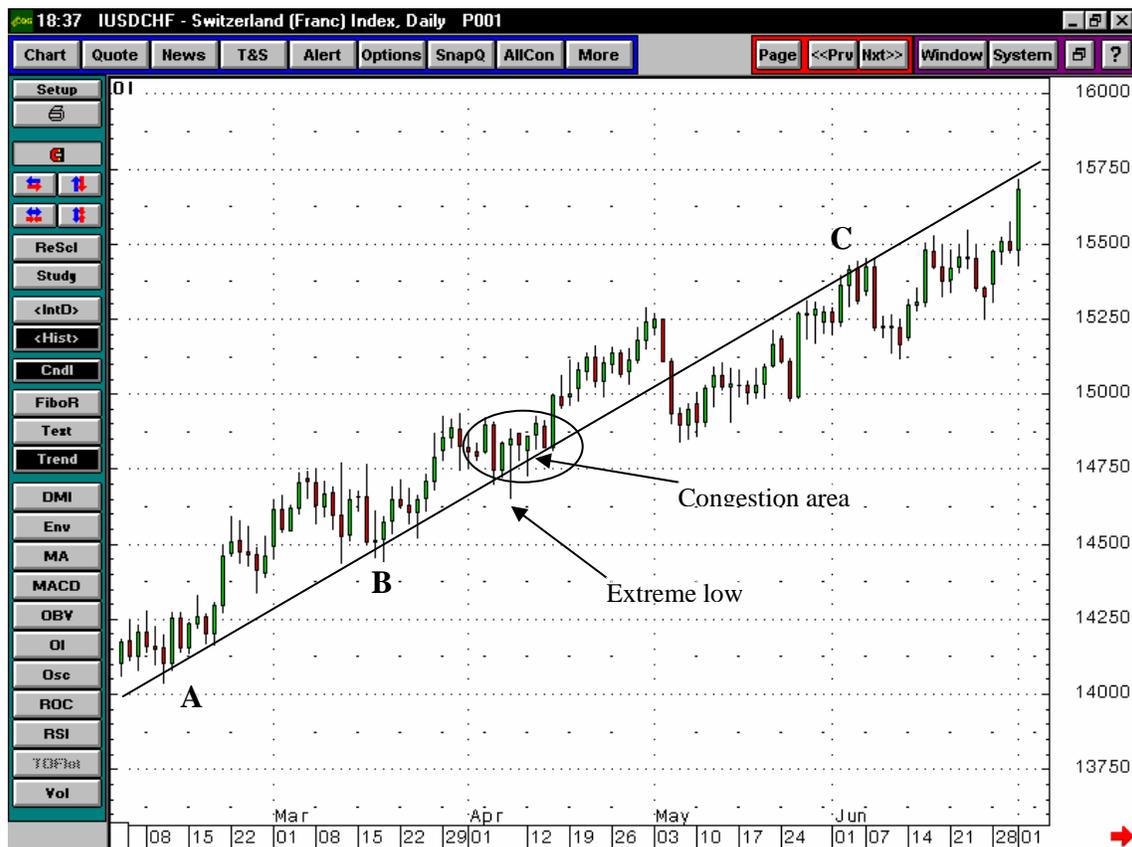
There are two very simple ways to determine the trend based on the moving average line(s):

- 1. Whether prices are above, below or on both sides of the moving average line(s).** If prices are mostly above the moving average line(s) then the market is in an uptrend. If prices are mostly below the moving average line(s) then the market is in a downtrend. If prices alternate between above and below, or rest right on the moving average line(s), the market is in a sideways trend (trading range). The five arrows in the above example of a 60-minute chart on GBP/USD show the different trends the currency was in. **1** and **5** show it was in an uptrend, since the prices are mostly above the moving average lines. **2** and **4** show it was in a sideways trend since the prices are neither clearly above nor below the moving average lines, and **3** it was in a downtrend since the prices were below the moving average lines.
- 2. What angle the moving average lines are pointed in.** If the moving average lines are pointed in an upward angle, it is in an uptrend, as you can see from **1** and **5**. If the moving average lines are in a downward slope, it is in a downtrend, as you can see from **3**. If the moving average lines are sideways, then it is in a flat trend as in **2** and **4**.

Trendlines

Traders draw trendlines to help them determine a trend, its strength, and at what point the trend could reverse. When prices incline in a rally, you draw a line across the bottoms, and when prices decline you draw a line connecting the tops. The way you draw a trendline is by picking the first major bottom of an incline (marked 'A' in the chart below) to a second major bottom of the incline (marked 'B' in the chart below) and project the line.

The most obvious and relevant feature of a trendline is its slope. If it is upward, then it is an uptrend, when the trendline is in a downward angle it's a downtrend.



As you can see from this example, when you draw a straight line from **A** to **B** you get an upward sloping trendline which signifies an uptrend. Although many beginners fail to recognize this important point; **it is better to draw trendlines across congestion areas rather than extreme highs or lows** (see above example). These spikes in the market were brief, extreme points and since the majority of trading was done at the congestion areas they are more important than the spikes. As you can see from **C** what was previously support now becomes resistance. You'll learn more about support and resistance levels, which are upside and downside barriers in the market, in the next section.

The following is an example of a weekly chart on the USD/CHF where an uptrend, a downtrend, and a trading range can all be seen.



- A. This trendline signifies the downtrend from October of 1989 to about August of 1990. As you can see it was drawn from the highest congestion area downward to the next congestion area downward which then projected the trendline all the way down to a little past 1991. The slant of this trendline signifies a very strong downtrend which as you can see lasted quite a long time.
- B. This is the trading range from about August of 1990 to about February of 1991. You can see that for a seven months the Swiss Franc was in a sideways long term trend, (trading range, but still had about a 700 point short term trading range. In that time period this weekly chart would be helpful to look at and draw the trendlines for the trading range to see that there were major upside and downside barriers to price movements in that time, and that one should go long near the bottom of the range and go short near the top.
- C. This trendline signifies the uptrend from February 1991, to about July of 1991.
- D. You can see that after the uptrendline was broken prices pulled back to the trendline, and then fell sharply downward. This point was a good shorting opportunity.

Using Trendlines to Predict Reversal Points

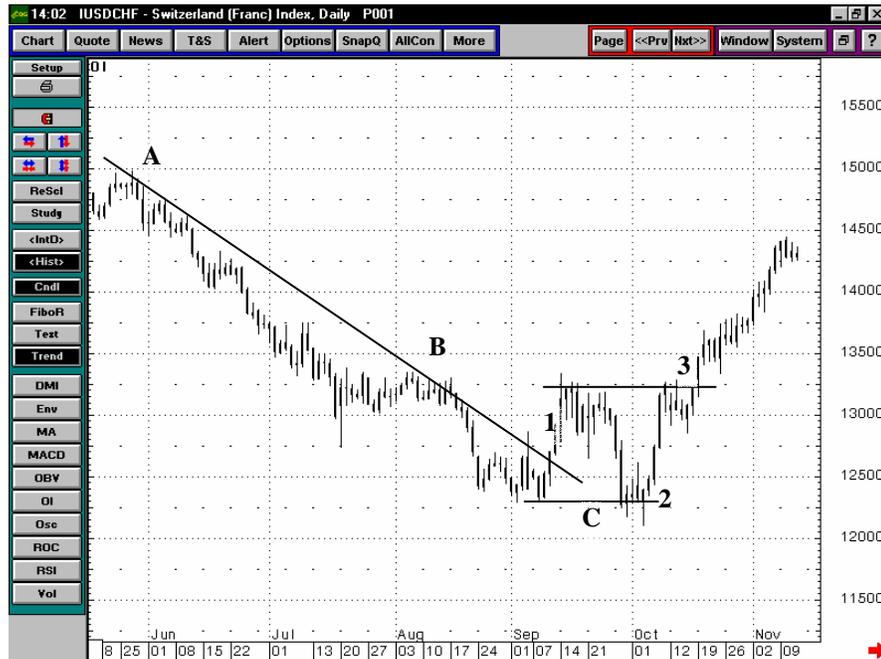
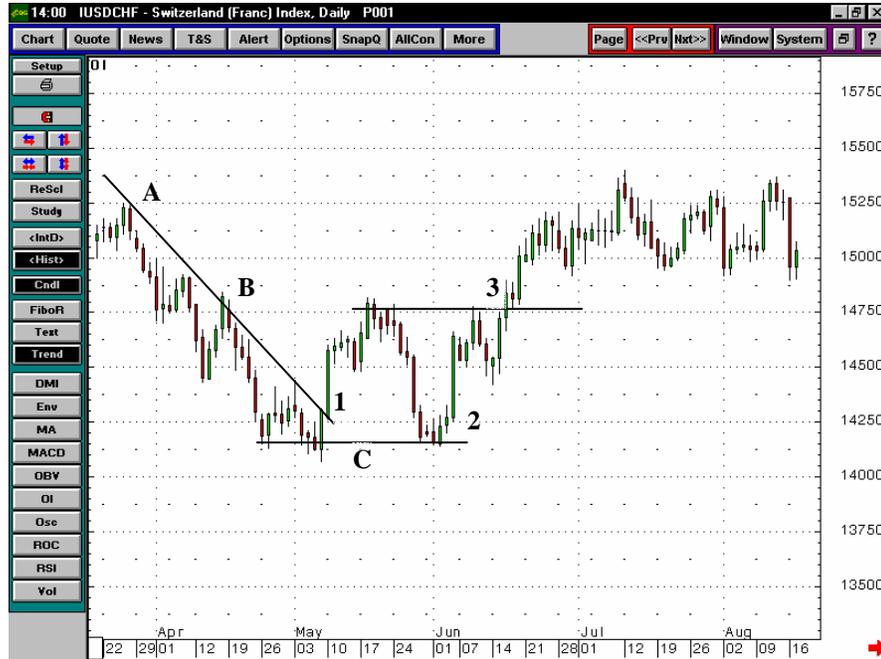
Tails are long lines at the end of a trend that stick out far away from the congestion areas. Markets almost always recoil from tails, giving good buying or selling opportunities in the opposite direction. In the first example below you would buy when the market bounced away in the opposite direction of the tail and in the second example you would sell when the market bounced off and then started to fall in the opposite direction of the tail. Tails like you see below very often signal major reversals in the markets. The first example is a daily chart of the USD/CHF and the second is a daily chart of the EUR/USD.



1-2-3 Trendline Reversal Method

Draw a trendline from the highest congestion area (A) to the next major congestion area (B) extended down. Then draw a sideways trendline connecting the two lows (C).

In both of the examples on this page you use the **1-2-3 trend line reversal method** very easily. **1** is the first signal of a trend change when the large downward trendline is broken. **2** is the second signal, which is a double bottom (you'll learn more about the double bottom formation later in this chapter) which is a retest of the previous low. **3** is the third and final confirmation when the prices break through the previous high which confirms the new uptrend. This is a fairly common formation that one can capitalize on in the longer-term charts. Especially daily and weekly charts. You would want to start buying when prices bounce off **2** and then add to your long positions when they break through **3**.



When major trendlines are broken it often provides an easy opportunity to get in and make some profits as you can see from the following examples:



In the above example of a daily chart of the British Pound/USD there is a fall of over 600 points in just two weeks after the major three-month uptrendline is broken.

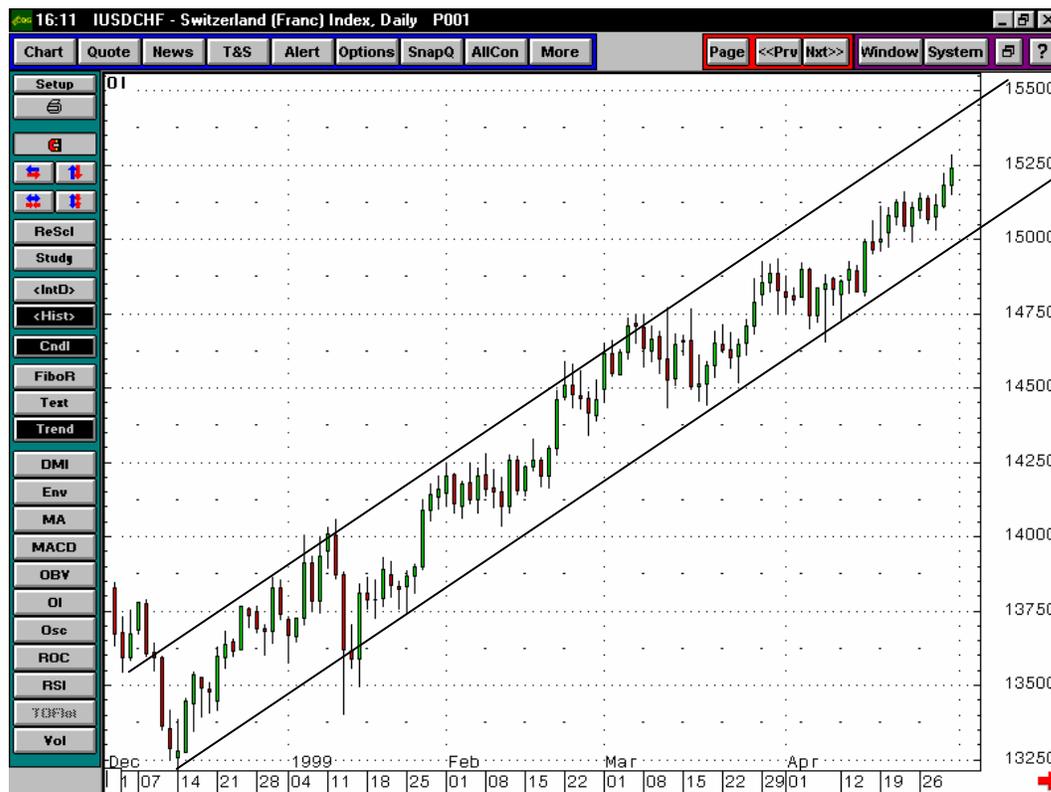


In the above example of a daily chart of the Eurodollar/USD a sizable rally of over 500 points came after the major trendline from May to July was broken.

Trend Channels

A trend channel consists of two parallel trendlines that contain prices (see example below). When you draw an uptrendline across the bottoms of price declines, you can sometimes draw a channel line parallel to it across the tops of price rallies. When you draw a downtrendline across the tops of price rallies you can also sometimes draw a channel line parallel to it across the bottoms of price declines. When you draw a channel line you should draw it along the congestion areas instead of the extreme prices, just as you would draw the trendline.

When you can draw a parallel channel line, this actually increases the validity of the trendline. The validity of the channel line varies from the number of times it was touched by prices. Normally, the wider a trend channel the stronger the trend. It is best to go long near the bottom of a trend channel in an upward trend and go short near the top of the trend channel in a downward trend. The profit target should normally be the opposite wall of the channel.



The following are two more examples of trend channels, one on the EUR/USD in an 8 hour chart and the second on the USD/CHF on a 1 hour chart. The second example actually shows three distinct trend channels. Notice how the prices stay exactly within the trend channel and often trade up and down the full range between the top and bottom walls of the channel. It is a very good idea to take into consideration how much profit to take on a trade or whether or not you should go short or long at a given point by looking to see if there is a current trend channel for the currency pair you are looking at.



Support and Resistance

You take a rubber bouncy ball and you bounce it hard on the floor and when it hits the ceiling it bounces off and falls to the ground. In this analogy, the floor is the support, the ceiling is the resistance, and the ball is price. When you can rate the strength of support and resistance in the market it can help you decide whether a trend is likely to continue or to reverse.

Support is a downside barrier to prices where buying is strong enough to reverse or interrupt a downtrend. It is the bottom, or temporary bottom of a downtrend. When prices in a downtrend hit support they bounce off.

Resistance is an upside barrier to prices where selling is strong enough to reverse or interrupt an uptrend. It is the top, or temporary top of an uptrend. When prices in an uptrend hit resistance they bounce off.

There are different degrees to support and resistance. Minor support or resistance causes trends to pause. Major support or resistance causes trends to reverse. Most of the traders in the market try to buy at support and sell at resistance. This is why support and resistance exist, because traders have memories of major levels in the markets. Traders remember that in the past prices stopped at certain levels, and they remember them. Buying and selling by large crowds of traders is what creates support and resistance.

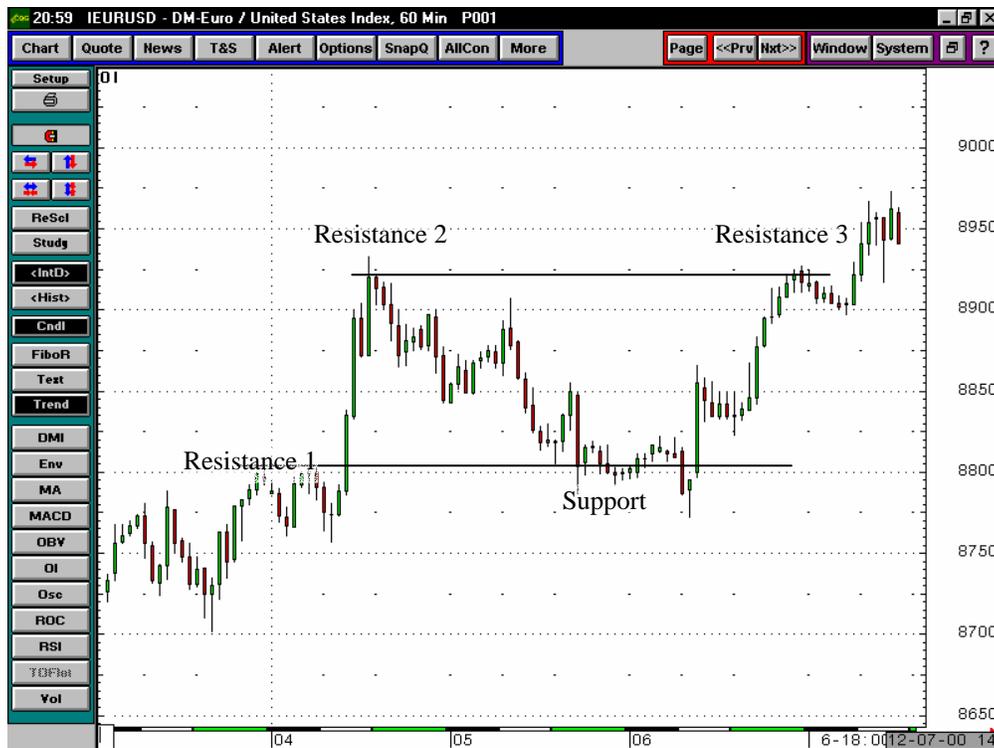
Just like trends, support and resistance levels, the strength of support and resistance levels are stronger in longer-term charts. A major support level that prices in a downtrend on a daily chart have bounced off of a few times is much stronger than in an hourly chart. The longer a support or resistance area is, both in its length of time it has not been touched or, or the number of times it has been hit, the stronger it is. A trading range that held for several months has much stronger support and resistance than a trading range that held for only a couple weeks. In the example below, what was support later became resistance.

One of the important characteristics of support and resistance is that once resistance is broken it then becomes support as you can see in this chart. On the other side of the token, once support is broken it then becomes resistance.





Notice this resistance level became stronger each time it was touched.



Notice that in this hourly chart of the Eurodollar/USD resistance 1 became support later on. Also notice that resistance 2 was again a temporary market top at resistance 3.

Trendline Support and Resistance

A significant trendline can also act as support and resistance to prices on charts. See the chart below for an example.



As you can see from this daily chart of the Swiss Franc/US dollar this trendline acted as major support for several months and then when prices finally moved below the trenline it switched its role and acted as resistance. **Moving average lines** also act as significant support and resistance similarly to trendlines as you can see from the two chart examples below.



Chart Patterns

When you learn to recognize certain chart patterns they can help you to decide if a trend is likely to continue or reverse. The two main categories of chart patterns are **continuation patterns** and **reversal patterns**. Continuation patterns include flags, rectangles, and triangles. They indicate the current trend is continuing. Reversal patterns include head and shoulders, inverse head and shoulders, double tops and bottoms, and tails. They indicate that the trend is likely to reverse. Some chart patterns can act as either continuation or reversal patterns, triangles and rectangles are examples of these. Most chart patterns are more likely to appear on longer-term charts, such as daily or weekly charts instead of intraday, hourly or 15 minute charts. Most of the examples of chart patterns here will be from daily charts, meaning every candlestick you see on the chart represents one day. When trying to identify chart patterns on longer term charts, like daily charts, it is helpful to squeeze the chart together and make the candlesticks very narrow so you can see more on one screen. You'll learn how to do this and many other techniques using the trading software in a later chapter.

Reversal Patterns

Head and Shoulders Top

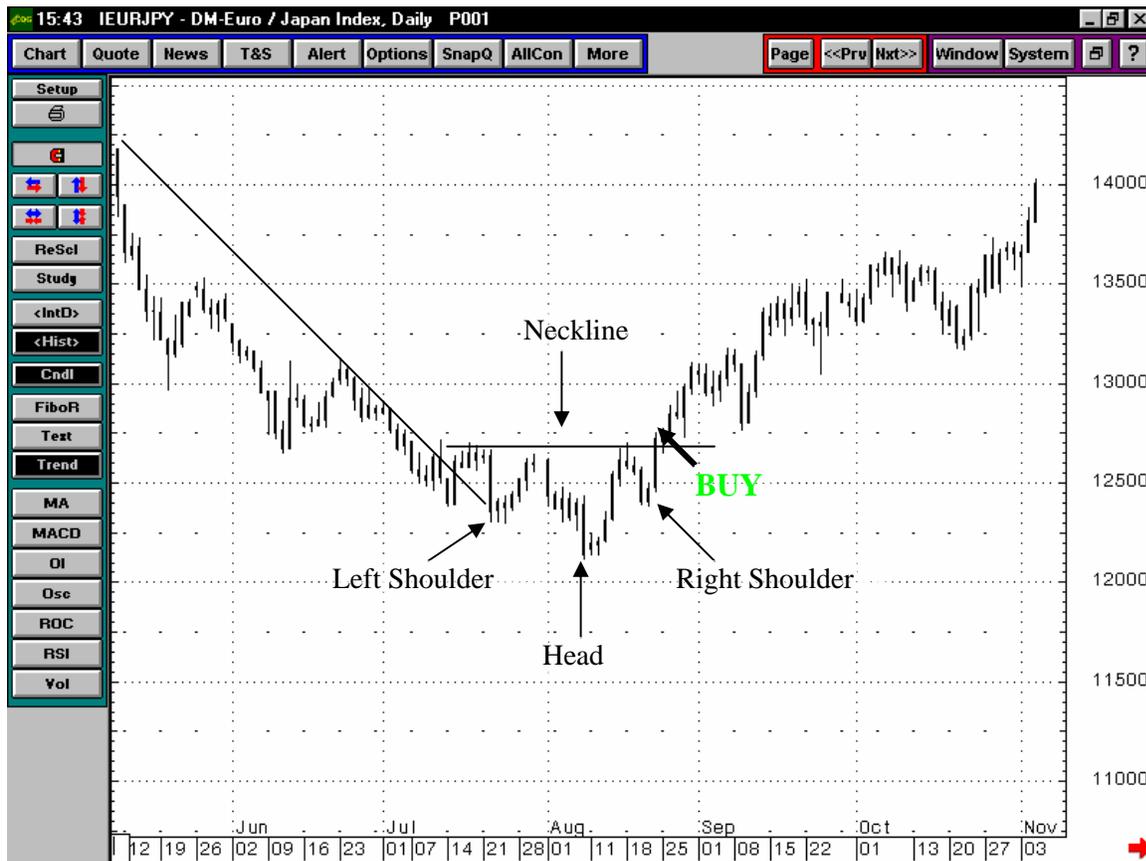
Head and shoulders patterns mark the end of an up-trend. The “head” is a price peak surrounded by two lower peaks, or “shoulders”. A neckline connects the lows of declines from the left shoulder and the head. See chart below for an example.



The previous chart is a daily chart of the EUR/USD. It contains an example of a head and shoulders formation. As you can see from the example above, the head is a price peak, which is surrounded by two lower peaks, or shoulders. The neckline connects the lows of the declines from the left shoulder and the head. When prices fail to break above the head, it is a confirmation that a head and shoulder formation is developing. As prices decline from the head and approach the neckline you watch to see if prices bounce off the low from the decline of the left shoulder before it went up to create the head. If prices bounce off this level you expect it to then form the right shoulder. At this time the neckline is complete. The neckline is not always perfectly horizontal such as in this example – it may be flat, on a slight incline, or a slight decline. A neckline on a decline indicates an even stronger signal that a downtrend is approaching. After the peak of the right shoulder and prices start to decline it will break the neckline. When this happens, it has now reversed to a down-trend and is a great time to enter the market on a short position, placing a stop loss slightly above the neckline.

Head and Shoulders Bottom

A head and shoulders bottom is basically a mirror image of a head and shoulders top. Same as a mirror image of trees you see in a calm lake, you see them upside down. A head and shoulders bottom resembles a silhouette of a person upside down. The head at the lowest point with shoulders on each side not as low as the head. If you see this pattern it means that the downtrend is starting to switch to an uptrend.

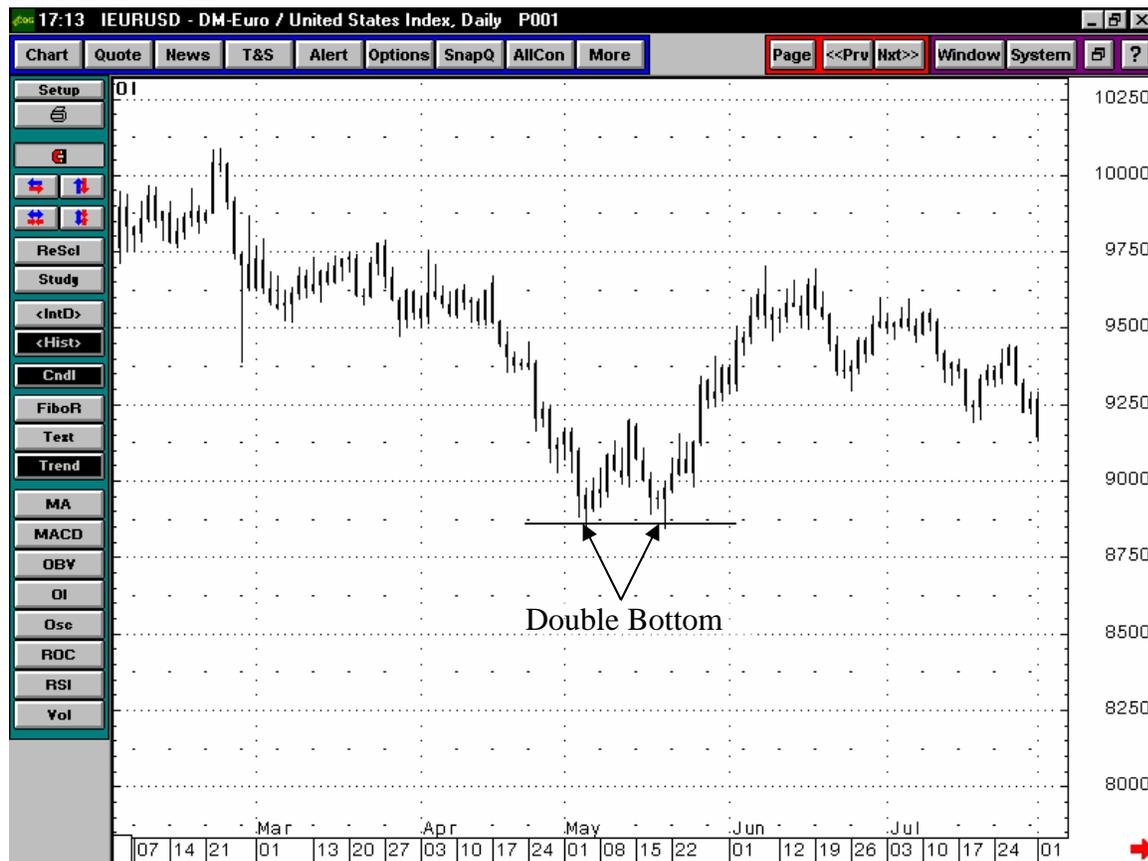


In a real downtrend, each new low falls lower than the previous low, and each incline stops short at a lower level. A strong incline in prices from the head allows you to draw a neckline. When a decline from the neckline does not reach a level as low as the head, the right shoulder is created. When prices rally from the shoulder the new uptrend is now beginning and as soon as they go through the neckline, this is the optimum buying opportunity.

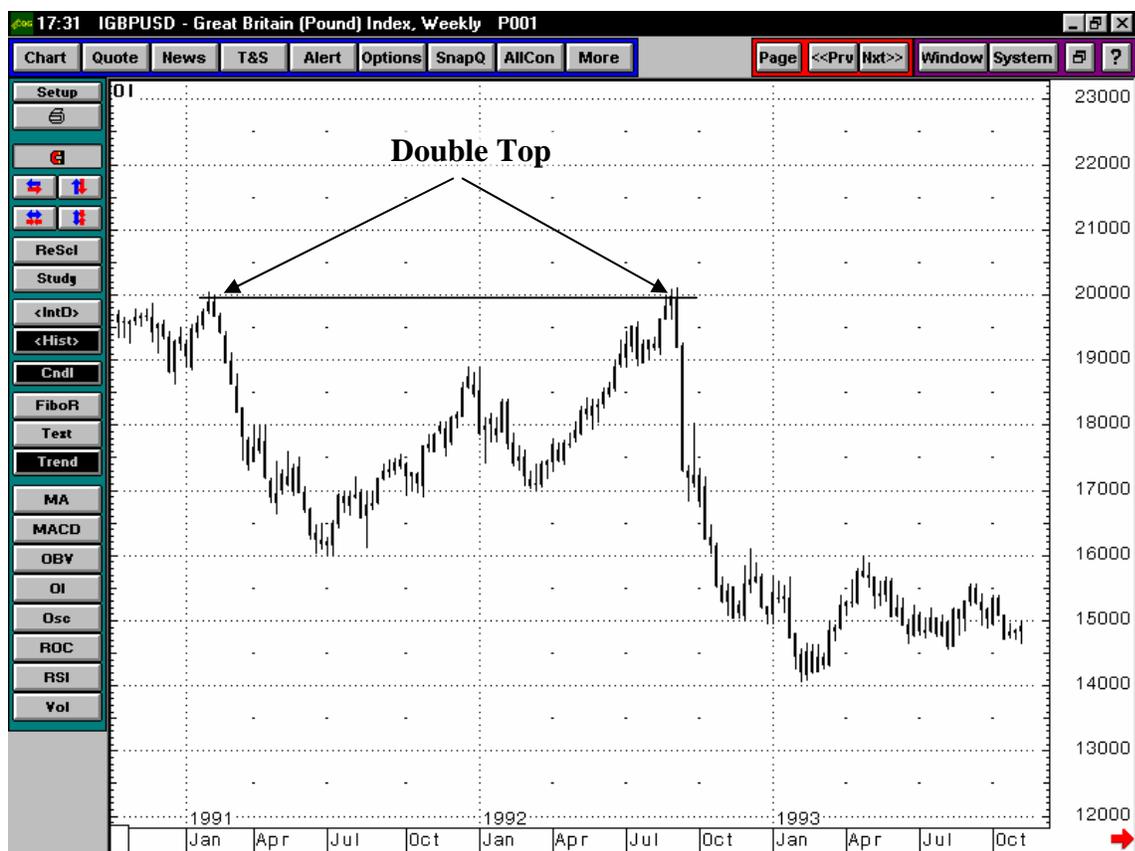
Double Top and Bottom Patterns

Double top and bottom patterns are probably the easiest to recognize. They occur simply when prices reach and bounce off of a previous high or fall and bounce off of a previous low. Below are two examples; one of a double bottom and one of a double top.

Double Bottom



This is an example of a double bottom on a daily chart on the EUR/USD. Double bottoms offer very reliable buying opportunities for buying when prices bounce off the double bottom and start to rally. Sometimes even triple bottoms occur which are even more likely to reverse in a rally. See next page for an example of a double top.



Double Top

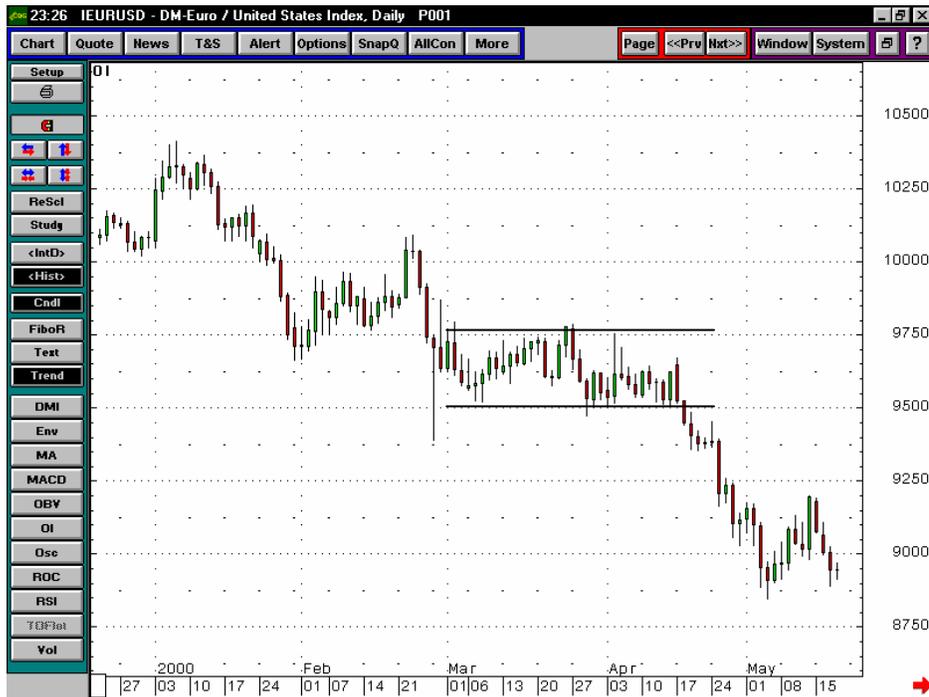
This is a “text book” example of a double top on a weekly chart on the GBP/USD. **The longer-term chart you recognize a strong chart pattern in, the more significant its effect on the market.** In this example you can see how drastically prices drop after they reached this double top in the market. A double top like this that is a repeat of a significant high is a very powerful, extremely reliable sell signal. In this example the British Pound proceeded to drop over 4000 points in just two months. For a long-term trader that would be a potential profit of 40 times the initial investment. Such a large return is highly unusual, but the longer-term chart one takes signals from the longer and larger the movements will be. If you ever see a triple top, that is an even more reliable sell signal than a double top.

Continuation Patterns

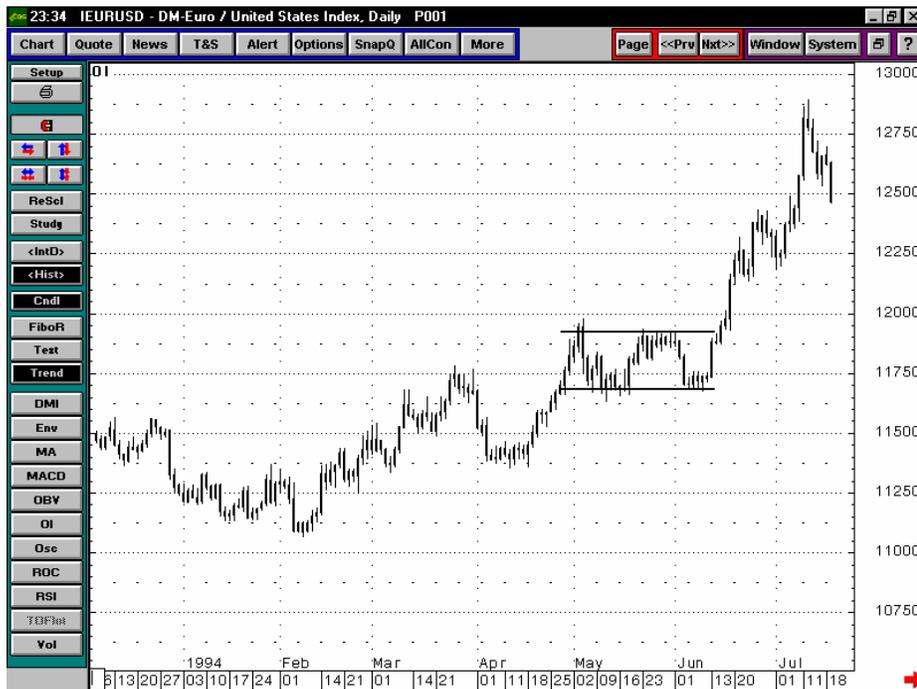
Rectangles

A rectangle is a chart pattern that contains price movements between two parallel lines. They are usually horizontal but can sometimes slant up or down. If they have a big slant then they become a “flag” formation (later in this section). Rectangles most often serve as indications of a continuation of the current trend, but they can sometimes lead to a reversal of the current trend although continuation of the trend is more likely. You need at least four points to draw a rectangle: the upper line connects at least two rally tops, and the lower line connects at least two bottoms. These lines can be drawn through the areas of congestion or the extreme highs and

lows. The following is an example of a rectangle formation in the middle of a downtrend on a daily chart of the Eurodollar/USD.



Here is an example of a rectangle in the middle of an uptrend on a daily chart of the Eurodollar/USD.



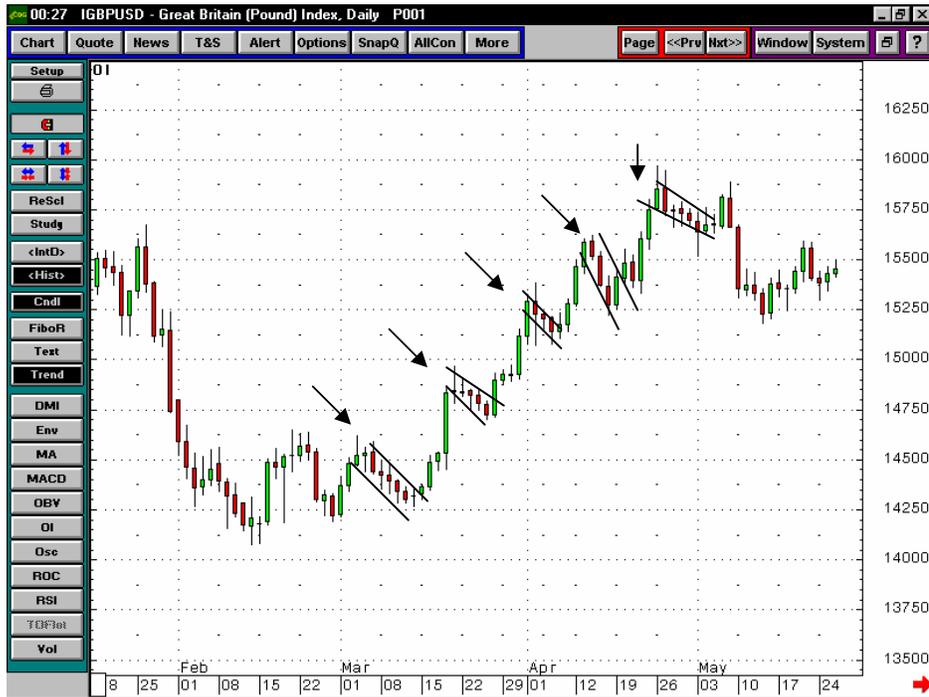
Flags

A flag is the same as a rectangle but whose parallel lines slant up or down. Breakouts from the boundaries of the flag almost always go against the slope of the flag. If a flag slants upward, then a downward movement is likely to follow and if a flag slants downward then an upward movement is likely to follow. They usually represent brief pauses after a quick move in a strong trend. Following a flag the market usually takes off, resuming its trend. The following is an example of three flags and a rectangle in the middle of a downtrend in a daily chart of the EUR/USD.

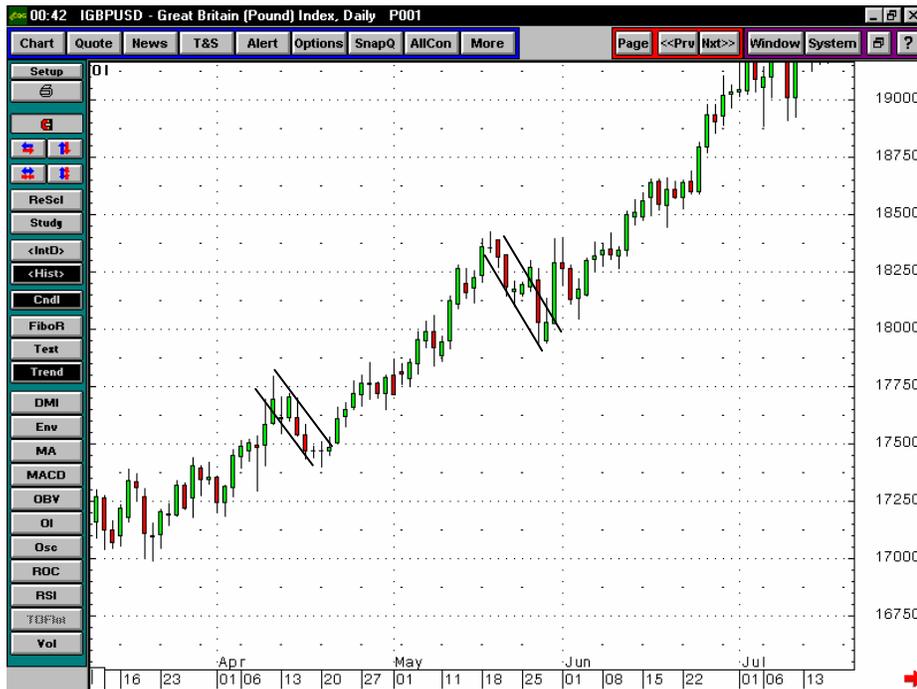


See the next page for two charts with more examples of flags.

This example of five flag formations in a strong uptrend is in a daily chart of the GBP/USD. The market continued on its upward trend after all except the last flag seen here.



Here you see another example of flags in an uptrend in a daily chart of the GBP/USD.



Triangles

A triangle is a congestion area whose upper and lower boundaries converge on the right. Most of the time triangles serve as continuation patterns, although they sometimes can indicate a reversal. A relatively small triangle, whose height is less than about 15 percent of the preceding trend usually serves as a **continuation** pattern. If the height of a triangle equals more than a third of the preceding trend it is likely to serve as a **reversal** pattern. Sometimes triangles also lead to a flat trend, or trading range. There are three major categories that triangles can be divided into:

Symmetrical Triangles: The upper and lower lines of symmetrical triangles converge at about the same angle. Whatever degree the upper line is inclined to, the lower line will be declined to the same degree, relative to horizontal. They most often serve as continuation patterns.

Ascending Triangle: The upper boundary of an ascending triangle is close to horizontal, and the lower boundary is on a rising angle. An ascending triangle usually results in the market having an upside breakout.

Descending Triangle: The lower boundary of a descending triangle is close to horizontal, while the upper boundary is on a declining angle. A descending triangle usually leads to a downside breakout.

Below you can see an example of three symmetrical triangles and an ascending triangle on a daily chart of the USD/CHF. They all lead to a continuation of the trend.

