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Forex Trading Demystified – part 3 of 6

In the last two sequels, we learnt how to trade foreign currencies, the mind set of a trader and the tools to be deployed for the same. This part onwards, the learning curve gets steeper, we get to the "how to" aspect of making money in forex.

Technical analysis is the defacto backbone that supports a forex traders decision making process as fundamentals of a country do not change as fast as forex prices fluctuate. Clearly, demand supply, sentiments and expectations play a large role in what traders feel like paying for a currency. Here we discuss a few chart patterns that work better than the rest and ones that I find highly profitable in comparison to the other patterns.

Breakouts - as the name suggests, a breakout is an event wherein a tradable instrument moves in a predictable (mostly sideways, though not necessarily so) pattern for some time and suddenly changes course. Many traders are taken by surprise and some confusion is bound to occur. This volatility provides profit making opportunity for the prepared trader who grabs the opportunity by the horns and initiates a trade.

Underlying psychology - suppose you take a restless puppy dog for a walk, control it with a leash. The puppy swings away from you in left / right direction to the extent of the leash. This limited movement is called "range bound trading" in tradable markets. Now imagine the puppy gives a powerful tug at the leash, snatches it out of your hand and makes a run for it. It will be some distance before you make a dash for it and manage to grab the leash again. Currencies too behave like this mischievous puppy and tug at the boundaries of the leash of range bound movement. When the breakout occurs, it is powerful, has momentum and goes a distance before it can be arrested. Caught early and exploited well, the result is a windfall gain.

Graphic example - the graph below shows the first (prompt month in international fx markets) futures of the US Dollar vis-a-vis the INR (Rupee). The compression period is between November 2008 - March 2009. Note how the USD traded within a tight band (marked by green parallel trend lines) between the 48.40 - 49.05 range. Since the currency was trading within this range, traders were lulled into believing that this price action would persist. However, a strong breakout occurred on February 17 2009 which saw the USD closing clearly above the range. Did this breakout have strong legs ? Should you bet your money on this signal ? Would this "puppy" run a lot before it's leash was caught ? Lets decipher the ancillary (supporting) evidence for re-assurance.

Note the window below the price, which shows the Relative Strength Index (RSI), as the name suggests, it measures strength. The RSI too was range bound and indicated a breakout. That shows a confirmation of the buy decision. How about market participants ? Were they convinced ? Observe the last window, where the traded volumes were logged. There was a sharp spike in turnover as traders rushed to exploit this trade. The high volumes assure a fresh trader of two things - existing shorts were forced to square up (short squeeze) and fresh buying occurring concurrently. Which means you are alone in buying. Which also means that the upthrust would sustain.

Even if a buy is initiated on the next day - Feb 18 2009 a day after the breakout, at opening levels at 49.80, the USD scaled up to 52.37 levels on March 03 2009 before reacting lower. A trader having entered long would have clearly availed of an opportunity (hypothetically) of earning 50 % returns on the span margin invested in the trade in 12 calendar days, excluding execution costs and statutory expenses. That is a fantastic rate of return by any yardstick, and veteran forex traders are used to this type of opportunity atleast a few times every year.

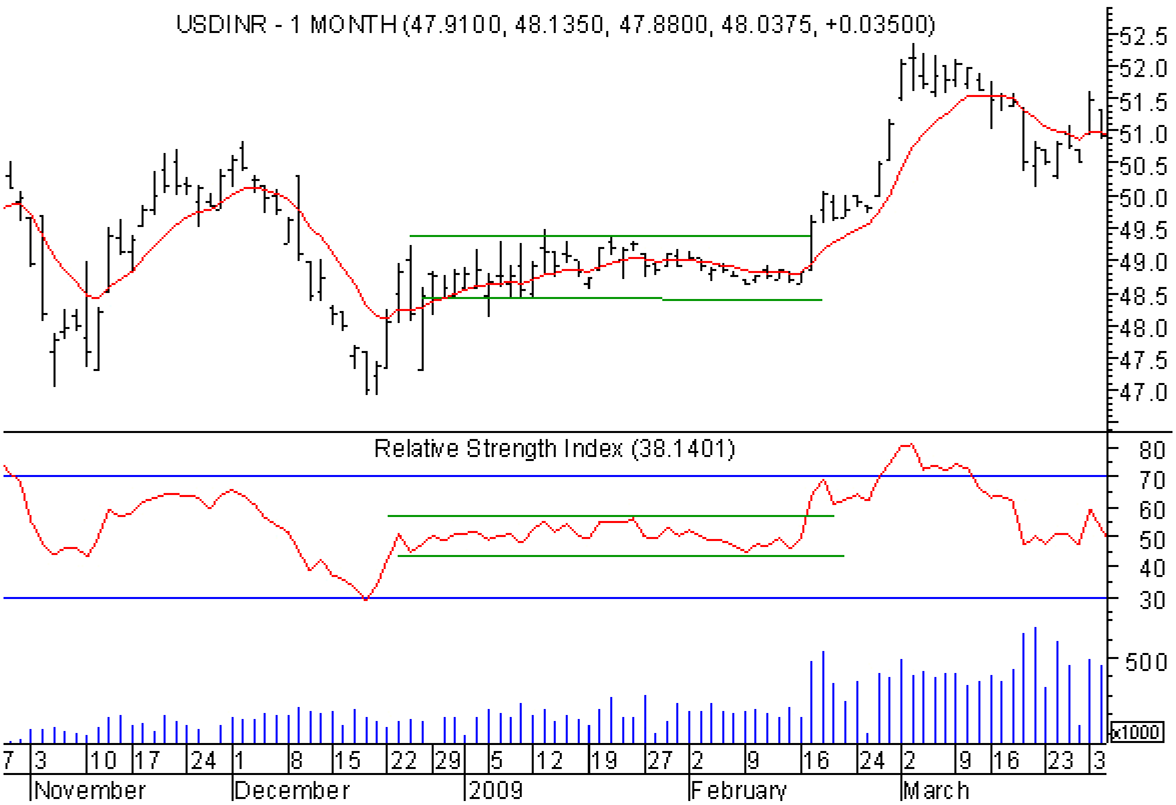

Chart courtesy – Metastock Software. www.Equis.com

Next week, we look at more such strategies that will upgrade your skills further as a prospective forex trading champion !

Note - trading forex futures is a risky activity. These studies do not assure profits. Please consult a certified financial analyst before trading.

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