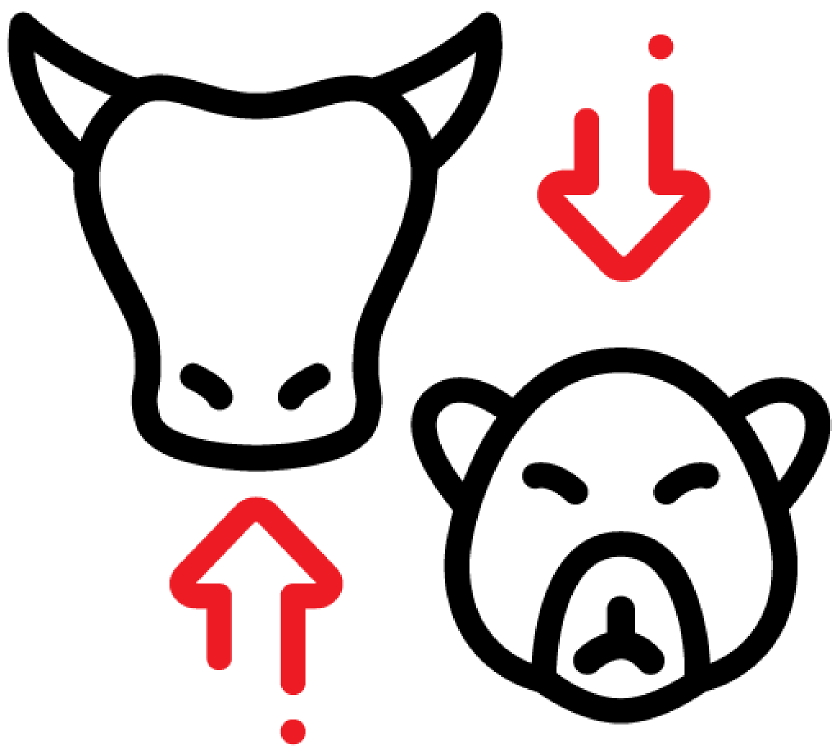
Introduction to Forex

eBook

What is Forex?

- Forex or FX is an acronym for FOReign EXchange.
- The FX market is the market where you can trade currencies.
- It is an over-the-counter market. It is a decentralized market with no actual central exchange.
- It is open 24 hours a day, 5 days a week. (It is closed only on weekends).
- It is the world's **BIGGEST MARKET.**



Who trades Forex?

Governments and Central banks
Intervening in the market to strengthen/weaken their currency.

Banks and other Financial institutions
People who need foreign currency for small-scale transactions deal with local banks.

Corporations repatriating profits. A Japanese company that operates in US as well, has to change its dollar profits back to the Japanese currency when repatriating.

Investors buying assets in foreign countries. A European investor wants to buy shares of an Australian company. He has to buy the Australian currency before buying the shares.

Speculators
Speculation is the practice of engaging in risky financial transactions in an attempt to profit from short-term fluctuations in the market value of a tradable financial instrument.

Tourists visiting other countries

Currencies

The currency of the US is the US dollar. In Eurozone, we have the euro, which is shared among 19 of the 28 EU member states. The UK has the pound, Japan the yen etc.

The International Organization for Standardization (ISO) has determined standard abbreviations for currencies:

CURRENCY	CODE	CURRENCY	CODE
US Dollar	USD	Swedish Krona	SEK
Great Britain Pound	GBP	New Zealand Dollar	NZD
Japanese Yen	JPY	Korean Won	KRW
Euro	EUR	Singapore Dollar	SGD
Australian Dollar	AUD	Norwegian Krone	NOK
Swiss Franc	CFH	Mexican Peso	MXN
Canadian Dollar	CAD	Russian Ruble	RUB

How are currencies traded?

- The idea is more or less the same as buying stocks.
- You buy a share of a company if you think the company is doing well and its share will increase in value.
- In FX, instead of buying shares of companies, you buy “shares” of countries with the same logic, i.e. currencies.
- If you believe that the economy of a specific country is doing well, you expect its currency to appreciate and therefore, you buy it.

When you buy American shares, you use dollars. When you buy European equities, you use euros. You need money to buy something, even stocks.

- How do you buy money?

- Again with money of course. You can buy euros with pounds, dollars with yens, yens with Australian dollars.

You’ve probably done an FX transaction yourself, when you’ve been to a country that uses a different currency than your country.

WHEN YOU BUY A CURRENCY, YOU SIMULTANEOUSLY SELL ANOTHER CURRENCY.

Currency Pairs

- As we noted, when you buy one currency, at the same time you sell another one.
- That's why we have FX rates or currency pairs. (EUR/USD, USD/JPY, GBP/USD, EUR/GBP)
- Your aim is to buy the currency you expect to appreciate relative to the currency you sell.
- That's why we use expressions:
- "The euro appreciated against the dollar"
- "The yen depreciated against the pound"
- Just saying "The yen depreciated", has much less value as an information.

Currency Pairs

MAJOR CURRENCY PAIRS | They have the US dollar on one side and they are the most frequently traded pairs in the world. They constitute the largest share of the foreign exchange market.

EUR/USD, USD/JPY, GBP/USD, USD/CHF, USD/CAD, AUD/USD, NZD/USD

CROSS CURRENCY PAIRS OR MINOR CURRENCY PAIRS | Currency pairs that do not include the USD are called “cross rates” or “crosses”. They are also known as “minors” and the most actively traded are derived from the three major non-USD currencies: EUR, JPY, and GBP (For example: EUR/GBP, GBP/JPY, EUR/CAD).

EXOTIC CURRENCY PAIRS | They are made up of one major currency paired with the currency of an emerging economy or a small economy from a global perspective, such as Hong Kong or Singapore, and several European countries outside the Eurozone (i.e. EUR/HUF, USD/ZAR).

Cyprus-UK example:

The currency pair I am trading is EUR/GBP.

If EUR/GBP is trading at 0.9000, that means that 1 euro buys 0.90 pounds, or I need 0.90 pounds to get 1 euro.

It is how much of the variable currency I buy with 1 unit of the base currency.

If I want to change EUR 500 for my trip, I will get GBP 450 (=500*0.90).

Let’s say that the following year, EUR/GBP=0.9500. Now EUR 500 buy GBP 475 (=500*0.95). With the same amount of euros, I get more pounds. This means the euro appreciated relative to the pound, or the pound has depreciated against the euro.

The rate is determined by the main market forces of supply and demand.

Trading Forex

Trading forex is buying a currency (and at the same time selling another) with the idea that the currency I bought will go up, or the currency I sold will go down.

Buy EUR/USD: Buy euros and sell dollars.
Sell EUR/USD: Sell euros and buy dollars.

The evolution of forex trading

Before 1996, the only groups that were able to trade forex were large financial institutions, central banks, corporations, governments, hedge funds and extremely wealthy individuals. It was very difficult to take part in the forex market because you needed much larger balances than you need today in order to exploit decent profits. In order to profit from fluctuating exchange rates, you had to create multiple bank accounts, each one denominated in a different currency and transfer funds from one

In 1996, forex trading started becoming more practical and more accessible by individuals due to the development of internet-based trading and the allowance of trading on margin. You can now trade currencies in a matter of seconds, with just a click of your mouse, and you need to commit only a small percentage of the amount

Retail FX trading

Retail FX trading is a small segment of the overall foreign exchange market. Individuals do not actually buy or sell currencies. You don't need to have yens in your pocket to buy pounds, or Swiss francs to buy Russian roubles. It is speculation on the exchange rate between two currencies through contracts for differences (CFDs). If you expect the rate of a currency pair to go up, you enter a long position (this is like buying the base currency and selling the variable). If you believe that the rate will go down, you initiate a short position (selling the base currency and buying the variable).

What are CFDs?

A contract for difference (CFD) is a financial instrument that allows market participants to invest in an asset without actually owning the asset. CFDs are derivatives that allow traders to take advantage of both prices going up and prices moving down on underlying financial instruments and are often used to speculate in those markets. The CFD is a contract between two parties: The investor (buyer of the contract) and the broker (seller of the contract). It states that the seller will pay the buyer the difference between the current value of the underlying asset and its value at “contract time” (closing of the position). If the difference is negative, the buyer pays the seller.

Margin & Leverage

- Usually, when something costs EUR10000, you need to pay EUR10000 for it.
- But in FX, you don't need to have the whole price of what you are buying. In one trade you can commit much less than the amount you want to trade. The amount you commit is called margin. The trade size is usually a multiple of your margin and the multiplier is called leverage.
- If EUR/USD is trading at 1.1000 and you choose to use 1:10 leverage, then you only have to put up the 1/10th of the investment (EUR 10000) as a margin, meaning EUR1000 or USD1100.
- 1:100 leverage means margin is EUR 100 or USD110
- 1:500 leverage means margin is EUR20 or USD22
- Advantage: Much higher return on capital.
- Disadvantage: A small price movement in the opposite direction can eliminate the whole amount you committed.
- Now let's assume that EUR/USD goes up to 1.1100. If you close position, your profit is USD 100 (0.01*10000).
- If your leverage is 1:1, your profit is a fraction less than 1% (=100/11000 USD). But if the leverage is 1:500,your profit is around 455% (100/22 USD). That's much higher relative to the amount invested.
- A small movement in your position causes a big movement in your profit/loss statement.
- If EUR/USD declines to 1.0978, your margin will be all used and you lose all the money you committed

Trading sizes

- Currency pairs are traded in fixed contract sizes.
- The standard size is called “a lot” and is 100,000 units of the base currency.
- 1 lot in USD/JPY is worth 100,000 USD. 1 lot in EUR/USD is 100,000 EUR, and 1 lot in GBP/USD is 100,000 GBP.

DIVISIONS OF THE STANDARD SIZE:

Mini lot = 1/10th of the lot, 10000 of the base currency.

Micro lot = 1/100th of the lot, 1000 of the base currency.

Pip & Pip value

WHAT IS A PIP?

A pip is the smallest amount of change in a currency pair. For currency pairs displayed in four decimal places a pip equals a change of 0.0001. Yen crosses are displayed in only two decimal places and one pip in these crosses equals 0.01.

FRACTIONAL PIP | Some brokers offer 1 extra digit in order to provide more precision when quoting exchange rates. The extra digit is equivalent to 1/10th of the pip and is called a fractional pip.

PIP VALUE

Pip value is how much one pip is worth in monetary terms. It depends on three factors:

- ✔ The currency pair.
- ✔ The exchange rate.
- ✔ The size of the trade.

In the previous example, the increase in EUR/USD was 0.0100 or 100 pips. My profit was USD 100, so each pip has value of 1 USD. If my position was 1 lot, my profit would be USD 1000 (=100000*0.0100). So, for 1 lot, the pip value is USD10.

Conclusion: Position size is in terms of the base currency, but the pip value is in terms of the variable currency.

Calculation: Pip value = Pip size * Position size. (For 1 lot EUR/USD= 0.0001*100000 = USD10)

If I want to convert the pip value in terms of the base currency:
Pip value = (Pip size * Position size) / (Ex. rate)

If my account is in pounds and I want to know the pip value in pounds, I change the dollar pip value using the GBP/USD rate.
For 1 lot: 10 / (GBP/USD).

Types of Orders

Market Order

It is an order to buy or sell immediately at the current market price. You push a button and you enter a short or long position immediately. Exiting the position with a button push at current price is also a market order.

Pending orders to enter:

- **BUY STOP:** A pending order to buy at a price that is higher from the current market price.
- **SELL STOP:** A pending order to sell at a price below the current price.
- **BUY LIMIT:** A pending order to buy at a level below the current price.
- **SELL LIMIT:** A pending order to sell at a level above the current price.

Types of Orders

Pending orders to exit:

- **STOP LOSS |** An order to exit if the market moves in the opposite direction of your position. It is set at a specific level in the opposite direction of your trade.
- **TAKE PROFIT |** An order to exit if the market moves by a predetermined distance in the direction of your position. You set a take profit at a specific level you want to realize profits.
- **TRAILING STOP|** A modified stop loss order that as long as the price moves in the desired direction, the stop-loss order automatically follows the market by a specific distance. For example, in a long position, I can place a trailing stop which is set at 20 pips distance below the price. When the price moves 10 pips in the desired direction, the stop loss will

Bid, Ask, and Spread

Until now, we referred to an exchange rate as being quoted in one price. In practice, things are different. When you start using a trading platform, you will see that exchange rates are quoted in two prices. The first price in the quote is the "bid price". It is the price at which the broker is willing to buy from you. In simple words, it is the price you sell. The second price is the "ask" or "offer" price. It is the price at which your broker is willing to sell you the pair. It is the price you buy. The difference between the bid and the ask prices is called the spread. It is your cost for entering a trade.

SWAP

A forex "Swap" or a "Rollover" is the interest added or deducted for holding a position open overnight. From Wednesday to Thursday, the swap is tripled. The swap rates are calculated as the overnight interest rate differential between the two currencies. Swap rates can potentially generate extra profit or loss to one's trade.

More key definitions

Balance

It is the amount of money you have in your account. Unrealized profit or losses are ignored. For example, if you have USD 5000 in your account and USD 200 unrealized losses from open trades, your balance is USD 5000.

Equity

It is the amount of money that you will have in your account, if you simultaneously close all your open positions.

Equity = Balance +P/L.

In the previous example, your balance is USD 5000, but your equity is USD 4800.

Free Margin

It is the difference of your equity and the open positions’ margin.

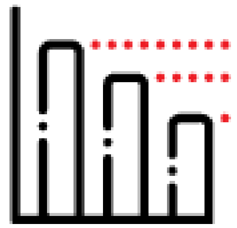
Free margin = Equity – Margin.

For example, let’s say that you want to open 1 lot of EUR/USD at 1.0500 and you have USD 10000 in your account. Using 1:100 leverage, your margin is USD 1050. So your free margin is 10000-1050 = USD 8950.

Indicators to watch

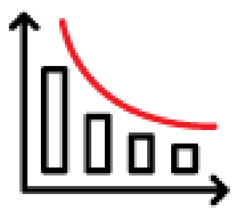
Margin Level

It is the percentage ratio of equity to margin.
Margin level = **(Equity/Margin)*100.**
In the previous example, our margin level is (10000/1050)*100 = 952.4%. If your open positions make money, your equity increases and so does your margin level. As you commit more money into trades and your equity declines due to losses, the margin level falls.



Stop out Level

It is the limit at which your margin level can fall. At that level, you can still close positions but you are not allowed to initiate new ones. If the margin level falls below the stop out level, your trades start to close automatically beginning with the ones losing the most in order to free equity.



Margin Call Level

It is the level below which you get a warning from your broker that your account will soon reach the stop out level. Sometimes the Margin call and Stop out levels are equal.

IronFX is a trade name of Notesco Limited. Notesco Limited with registration number 51491 is a company registered in Bermuda.

HIGH RISK TRADING WARNING

Our services include products that are traded on margin and carry a risk of losing all your initial deposit. Before deciding on trading on margin products you should consider your investment objectives, risk tolerance and your level of experience on these products.
Trading with high leverage level can either be against you or for you. Margin products may not be suitable for everyone and you should ensure that you understand the risks involved. You should be aware of all the risks associated in regards to products that are traded on margin and seek independent financial advice, if necessary.

Disclaimer: The information in this document should not be considered as an investment advice or investment recommendation but instead as educational material only. This material is just the personal opinion of the author(s) and client's investment objective and risks tolerance have not been considered.
IronFX is not responsible for any loss arising from any information herein contained.
Redistribution of this material is strictly prohibited.

IronFX™

SOLID TRADING