AIQ Opening Bell Newsletter

April 2008 Vol. 17 Issue 4

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The Opening Bell Newsletter is a publication of AIQ Systems
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FOREX TRADING

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Stephen Hill is President of AIQ Systems. For the past 15 years he has been involved in all aspects of AIQ Systems, from support and sales to programming and education. Steve is a frequent speaker at events in the U.S. and Europe, talking on subjects as diverse as ***Portfolio Simulation Techniques***, ***Advanced Chart Pattern Analysis*** and ***Trading System Design***.

Trading FOREX (currency pairs) has become more popular during the last five years for anumber of reasons.

Enormous liquidity - there's never a problem getting a 'fill', the supply is to all intents and purposes limitless on the major currency pairs.

24-hour Trading - if you are a very short term trader this 24 hour trading might nights, but it does mean that there are rarely any gaps in proce action.

Very tight spreads - FOREX brokers make their money on the spread, so you're immediately 'in the hole' on a trade. However fierce competition between brokers has reduced the spread significantly.

No commission or exchange fees - brokers make the money on the spread.

High leverage for active traders - like commodities and options high leverage can give traders substantial gains (and losses).

Fewer tickers to follow - there only a dozen or so major currency pairs to monitor, many traders pick one or two to trade actively.

Basic of FOREX Pairs

Currencies are quoted in pairs, such as EURUSD or USDJPY. The first listed currency is called the base currency, while the second currency is called the counter or quote currency.l

The base currency is the "basis" for the buy or the sell. If you buy EURUSD you have bought Euros (and simultaneously sold dollars). If you sell EURUSD you sold Euros (and simultaneously bought dollars).

lFOREX is traded in lots, which represent 100,000 units of the base currency.

For example you would buy EURUSD in expectation that the Euro will rise relative to the US dollar. If the EURUSD is quoted at 1.5148, then if the market moves from 1.5148 up to 1.5158 that represents a move of ten pips. A pip is the smallest increment a currency pair can move and in most currency pairs this pip represents $10.

Concept of a Currency Trade

A currency pair represents the exchange rate between the two currencies. For example, the rate at which the EURUSD is trading represents the number of US Dollars one Euro can purchase.

An example of how currency pairs trade is if a trader believes the Bank of Japan will intervene to cause a decrease in the Yen against the US Dollar, then the trader would buy USDJPY (buy the US Dollar/sell the Yen). However, if the trader believes that Japanese investors are losing faith in the United States' economy and are pulling money out of the US into Japan, then the trader would sell USDJPY (sell the US Dollar/buy the Yen).

For example if you think that the Euro will rise relative to the U.S. Dollar you would buy one lot of the EUR/USD currency pair.

The EURUSD is trading at 1.5690 when you buy it on 4/02/08.

The EURUSD is trading at 1.5885 when you sell it on 4/23/08.

You bought at 1.5690 and sold at 1.585 for a profit of .0195 or 195 pips.

Each pip is worth $10, 195 pips x $10 = $1950 profit **(figure 1).**

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AIQ Opening Bell does not intend to make trading recommendations, nor do we publish, keep or claim any track records. It is designed as a serious tool to aid investors in their trading decisions through the use of AIQ software and an increased familiarity with technical indicators and trading strategies. AIQ reserves the right to use or edit submissions.

While the information in this newsletter is believed to be reliable, accuracy cannot be guaranteed. Past performance does not guarantee future results.

Figure 1. EURUSD daily chart

FOREX leverage and margin

In the equities market, margin traders usually pay 50% of the full amount for each position they take. In FOREX most market makers allow positions to be leveraged up to 100:1. This means that if a trader wanted to buy a "lot" worth $100,000, with 100:1 leverage the trader only has to come up with $1,000.

With leverage comes risk. Increasing your leverage increases both your opportunity to take bigger profits and incur bigger losses.

Margin is a good faith deposit, to ensure against trading losses. The margin requirement allows the traders to hold a position much larger than the account value.l

With most FOREX brokers, if funds in the account fall below margin requirements, the broker will close some or all open positions. This prevents your account falling into a negative balance.

For example a trading account with $10,000 has $10,000 of usable margin. If you use $8,000 to buy 8 lots of USD/EUR you now have $2,000 of usable margin left. If the position goes against you by more than $2,000 you are now under the margin requirement, and the position may be liquidated involuntarily.

FOREX spreads and rollovers

Like equities currency pairs have a bid and ask.

- The bid rate is the price at which traders can sell the pair.
- The ask rate is the price at which traders can buy the pair.

Generally the ask (buy) rate is higher than the bid (sell) rate and the spread is 3 pips. If a trader buys this currency pair, then the sell rate of this pair will have to go up 3 pips in order for the trader to break even.

The difference between the bid rate and the ask rate is the spread. The spread is an automatic cost that the trader incurs when making the trade, this is where the FOREX broker makes their money.

When a position is held past the close of business, the position is automatically rolled-over to the next available spot date by the broker.

When a position is rolled over, all open positions are in effect closed and reestablished for value the next business day.

The interest rate differential of the base currency versus the counter currency will determine whether a net debit or credit is applied to the client's account.

What influences currency prices?

Macroeconomics - such as inflation and, and industrial production.

Interest Rates - each currency has an overnight lending rate determined by that country's central bank. Lower interest rates usually lead to depreciation in the value of the country's currency.

Employment - the unemployment rate is a key indicator of its economic strength. High unemployment usually means a weak economy and leads to a decline in the currency value.

Geopolitical Events - key international political events like wars and trade agreements can also affect the foreign exchange markets.

Fed fund rate - any currency pair involving the USD is affected by rate changes.

FOREX techncial analysis

FOREX price action is typically composed of trends and as trends can be measured historically, this lends itself to using technical analysis to measure future trends and which direction the trend is going.

Surprisingly perhaps, technical analysis is in comparison much more common and popular within the FOREX market than in the equities and futures markets.

The FOREX markets therefore partly move because of all the technical analysis performed. FOREX allows trades in both directions and therefore up and down trends can be exploited easily.

Figure 2. EURUSD range bound mid December 2007 through mid February 2008

Support and Resistance

Support can be defined as a "floor" through which a currency pair usually ceases a downward move. The level of the support is typically the bottom of a previous down move. While mostly a subjective level it is fairly obvious in most cases.

Resistance is the upper boundary through which a currency pair has trouble breaking. Similar to support, resistance levels are somewhat subjective. If a currency pair reaches a peak after a run up, and this is the similar peak to a previous run up then it can be identified as resistance.

A support level is usually a price area where buy orders tend to be, and so it takes more than normal selling pressure to break that level. A resistance level is a price area where sell orders tend to be, and so it takes more than normal buying pressure to break that level.

Support and Resistance in Range-bound Markets

In a range-bound market support and resistance levels can be identified fairly easily. Trading the range, involving buying at support levels, and selling at resistance levels can be advantageous as the FOREX market is range-bound a majority of the time.

Gains per trade are restricted because you in a range and when the market breaks out of the range, it often makes big moves and this can result in significant losses.

Conditional trades (hedging) at the support and resistance levels can help alleviate potential losses.

Support and Resistance in Momentum Markets

When a currency pair is already in a trend in one direction, support and resistance can still apply.

Placing condition orders at support and resistance points allow the trader to take advantage of a move in whichever direction the market may go.

EURUSD **(figure 3)** over page illustrates support and resistance and how to take advantage of these levels in this up trending market.

Figure 3. EURUSD support and resistance

Currency Pairs and Technical Indicators

There are literally hundreds of different technical indicators in general use today.

With equity trading, volume reflects supply/demand characteristics. Volume reporting on currency pairs where available is often ambiguous as supply is almost always available. This tends to distort volume based indicators.

Relative Strength Index - Wilder

The relative strength index (RSI) is a momentum indicator designed by Wells Wilder it measures a tickers strength relative to its own recent past performance. The indicator is front-weighted and provides a better velocity reading than other oscillators. RSI filters out volatile movements in the price action.

Generally traders use 30 as an oversold condition and 70 and as overbought condition. Wilder designed the settings for RSI to use a period of 14 **(figure 4)**.

Divergences - when a currency pair makes new highs or lows but RSI does not, this usually indicates that a reversal in price is coming.

Chart Formations such as double tops and head and shoulder can be more visible on RSI rather than on the price charts.

MACD Indicator

The MACD is a two-component indicator based on two exponential moving price averages.

The first component of the MACD is a line which represents the difference between two moving averages, each computed for a different period of time. The second component, which is called the Signal Line, is an exponential average of the first component.

The two lines are charted together on the same time scale. Classic default values for the averages are 12 and 25, and 9 days for the signal line.

As a general rule, it is considered bullish when the MACD Line is rising and is above the Signal Line **(figure 5)**. Conversely, it is bearish when the MACD Line is falling and is below the Signal Line.

Buy and sell signals are generated by the crossing of the two lines. In general, a buy signal occurs when the MACD Line crosses from below to above the Signal Line. A sell signal is indicated when the MACD Line crosses from above to below the Signal Line.

Divergences - when a currency

Figure 4. GBPUSD RSI Wilder overbought and oversold

pair makes new highs or lows butMACDI does not, this usually indicates that a reversal in price is coming.

AIQ Phase indicator

The Price Phase is computed as the difference between two exponentially smoothed price averages. The value of this indicator depends directly on the time periods represented by the two averages.

To determine the appropriate combination of averages for the Price Phase Indicator, AIQ tested a wide range of values. This testing revealed that the best balance between stability and responsiveness was obtained with averages representing 10 and 49 days.

Change in diection of this indciator can be very responsive to price changes **(figure 6)**.

Figure 5. EURUSD classic MACD buy points

FOREX Risk Management

How much is the market going to move and where should I take a profit?

Some traders set a limit order to exit after 100 pips good enough for a profit, others let the profits run until the technical indicator shows sell.

How much am I willing to lose before I exit the position?

Set a stop/Loss order around 30 pips, this will stop you out before losing too much capital if the position goes against you.

Stop Orders should be set closer to the opening price than limit orders. If this rule is followed, you need only be right less than 50% of the time to be profitable. For example, a trader that uses a 30 pip Stop/Loss and 100 pip limit orders needs only to be right 1/3 of the time to make a profit.

Stop/Loss orders that are too tight get called by normal market volatility.

Limit Orders should reflect realistic expectation of gains given the markets current and recent trading activity.

Figure 6. USDCAD classic Price Phase

STOCK DATA MAINTENANCE

The following table shows stock splits:

Stock	Ticker	Split	Approx. Date
Hologic	HOLX	2:1	04/04/08
Steel Dynamics	STLD	2:1	04/11/08
Chindex	CHDX	3:2	04/16/08
Ritchie Bros.	RBA	2:1	04/18/08

S&P 500 Changes

Changes to the S&P 500 Index

No changes

AIQ updates the S&P 500 groups and sectors on a regular basis, to find out more visit http://www.aiqsystems.com/lists.htm