



FOREX BASICS

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Foreword	

Trading is an incredibly hard past time. Many people have become rich by trading in the forex market but, nevertheless many others have lost. Education is key to your development but with so many websites, videos, and general material it's hard to know what will help.

It's always best to stick to the basics, and then move forward to a more advanced level. The eBooks give you the basic information and look to build on that base knowledge to leave you in the best position to continue or begin your trading journey. The information provided is not just for beginners but can be used by traders with different skill sets, even as a simple reminder.

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No representation is being made that any account or trader will or is likely to achieve profits or losses similar to those discussed in this e-book.

Trading Divergences

In the forex markets, or for that matter, even futures or stocks, divergence is often related to the price and the oscillator that is tracking the prices. Divergences can be spotted by use of oscillators only and among the many different oscillators, the MACD, Stochastics, RSI, Awesome Oscillator, CCI, Williams %R are some of the more commonly used oscillators.

An oscillator is used to track the overbought and oversold prices. Because most of the oscillators are based on price and the relative momentum or volume, oscillators are the best choice for understanding momentum in prices which signal how strong the prevailing trend is.

When prices reverse or retrace, the oscillator tends to follow the same pattern. Therefore, when prices are making higher highs or higher lows, the oscillator tends to mimic the same pattern.

Conversely, when prices are making lower highs and lower lows, the oscillators tend to print the corresponding lower highs and lower lows. This is what we already knew as convergence.

When price makes a high or a low and the oscillator fails to confirm the same, it is known as divergence. By spotting these divergences, traders are usually signaled to a potential change in the direction of prices.

There are TWO types of divergence:

- Classic
- Hidden

Classic Divergence

Regular divergence is the classic sense of divergence that occurs when the price action makes higher highs or lower lows while the oscillating indicator does not. This indicates a weakness in the price action and a nearly warning that the trend could be coming to an end. In other words, regular divergence indicates that a probable trend reversal could occur through it does not indicated when this will occur. For this reason, chartists often turn to trend lines, chart patterns and candlestick patterns to time the entry into the trade.

Classic Bullish Divergence

Occurs in a down trend when the price action prints lower lows that are not confirmed by the oscillating indicator. This indicates a weakness in the down trend as selling is less urgent or buyers are emerging. When the oscillator fails to confirm the lower lows on the price action, it can either makes higher lows, which is more significant, or it can make double or triple bottoms. The latter occurs more often on oscillators, such as RSI and Stochastics that are range bound and less often on oscillators such as MACD that is not range bound.

Classic Bearish Divergence

Occurs in an uptrend when the price action makes higher highs that are not confirmed by the oscillating indicator. This indicates a weakness in the uptrend as buying is less intense and selling or profit taking is increasing. As with positive divergence, the oscillator can fail to confirm the higher highs on the price action by either making lower highs, which is more significant, or by making double or triple tops. As with positive divergence, double and triple tops are more prevalent on range bound oscillators.

Hidden Divergence

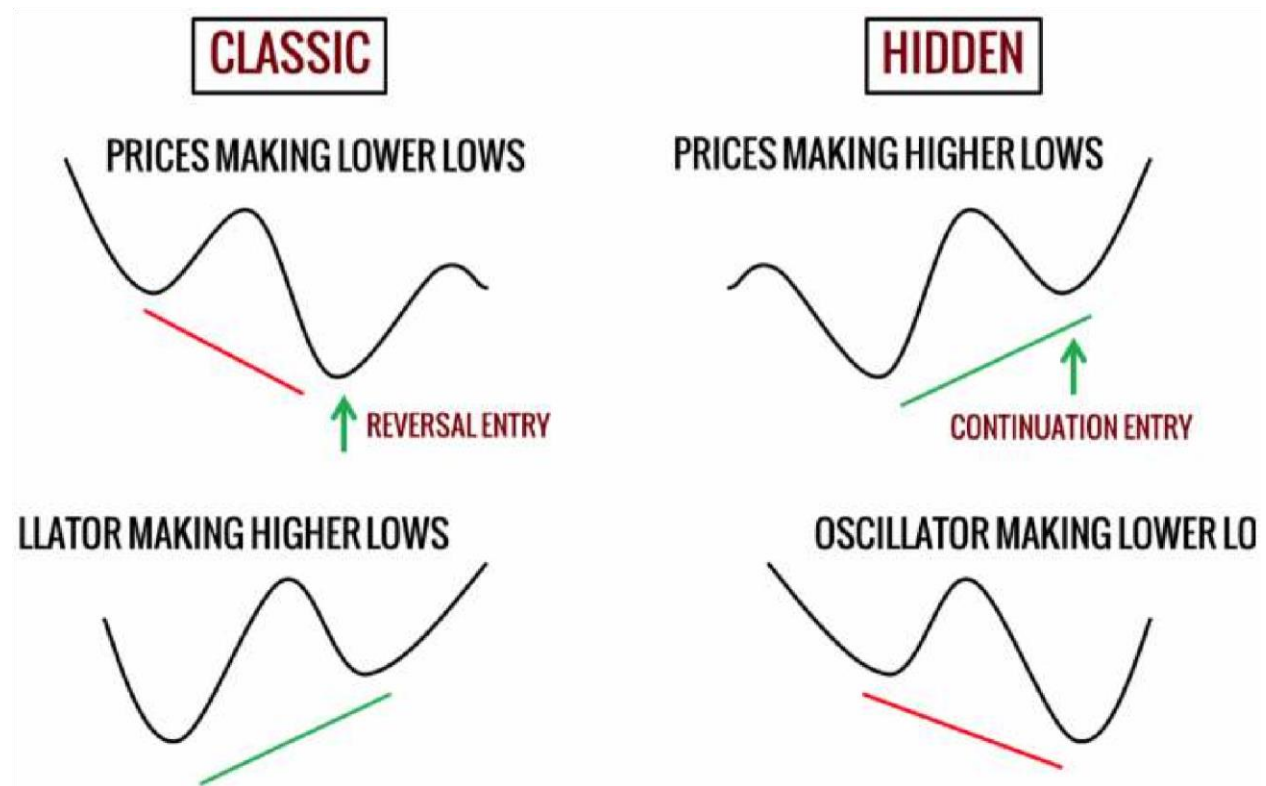
Hidden divergence occurs when the oscillator makes a higher high of lower low while the price action does not. This often tends to occur during consolidation or corrections within an existing trend and usually indicates that there is still strength in the prevailing trend and that the trend will resume. In other words, hidden divergence is akin to a continuation pattern. As with regular divergence, hidden divergence can be bullish or bearish.

Hidden Bullish Divergence

Occurs during a correction in an uptrend when the oscillator makes a higher high while the price action does not as it is in a correction or consolidation phase. This indicates that there is still strength in the uptrend and that the correction is merely profit taking rather than the emergence of strong selling and is thus unlikely to be last long. Thus, the uptrend can be expected to resume.

Hidden Bearish Divergence

Occurs during a reaction in a down trend when the oscillator makes a lower low while the price action does not as it is in a reaction or consolidation phase. This indicates that the selling has not waned and that that down trend is still strong. The reaction is merely profit taking rather than the emergence of strong buyers and is thus likely to be short lived. As a result, the down trend is more likely to resume in due time.



Know Your Trading Environment

There are different environments that a currency can trade in, and being aware of that environment might help you make better trading decisions.

A trading environment is the type of price action that has been occurring recently and will likely continue into the near future. For example, a currency could be ranging, where it is stuck between two points, or it could be trending, where it has a consistent movement in one direction.

Some trading strategies work better than others in certain trading environments, which is why it's important to be aware of it. For example, a spinning top indicator can signal a reversal, but the indicator works much better when the currency is trending.

The trading environment can be classified into three scenarios: Trending up, Trending down and Ranging

What is a Trending Market?

A trending market is a market that is trending in a specific direction. Markets can have bullish, bearish or sideways trends.

A trending market can provide multiple trading opportunities for technical analysts. Technical analysts will chart the price pattern of a security or market index to identify trending directions for placing investment trades. Investors may also follow the trending direction of an index that serves as a benchmark for a specific security. These trending market lines can serve as an overlay to a security price chart which can help to form an additional indicator for market trends.

Trending markets are of primary interest in technical analysis. Technical analysts believe that trending markets occur with some degree of regularity and predictability. The ability to correctly discern these trends can have a substantial impact on investment returns.

ADX in a Trending Market

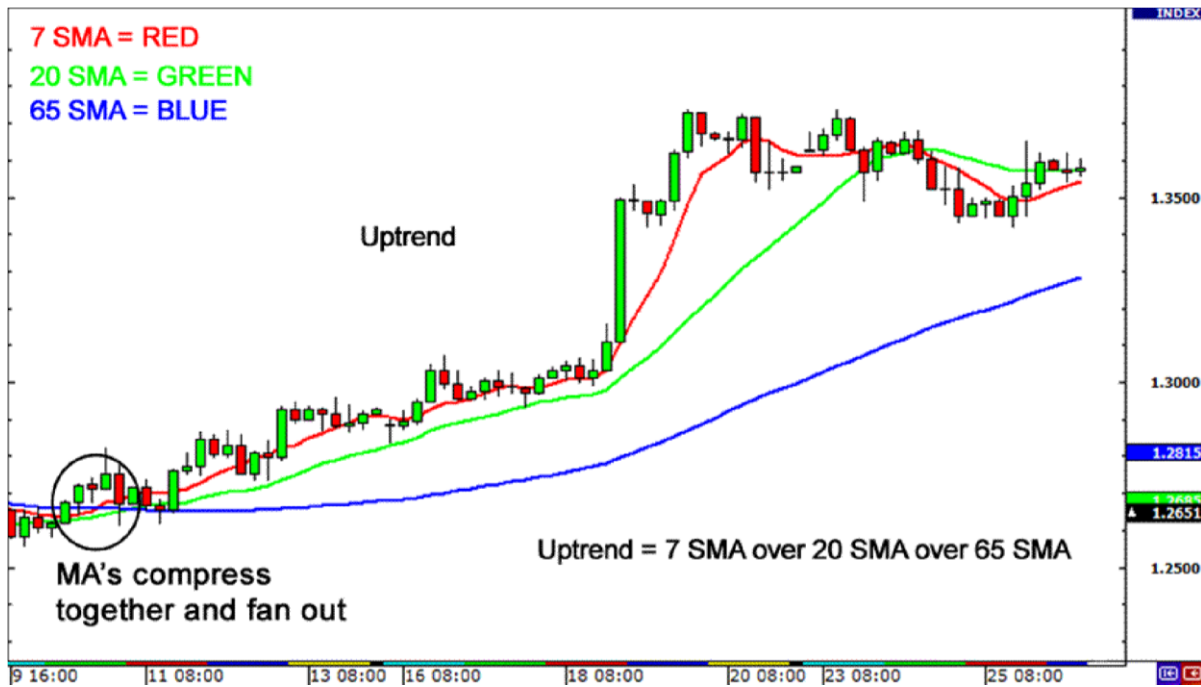
A way to determine if the market is trending is through the use of the Average Directional Index indicator or ADX for short.

Take a look at this example. Price is clearly trending downwards even though ADX is greater than 25.



If you're not a fan of the ADX, you can also make use of simple moving averages. Check this out! Place a 7 period, a 20 period, and a 65 period Simple Moving Average on your chart. Then, wait until the three SMA's compress together and begin to fan out.

If the 7 period SMA fans out on top of the 20 period SMA, and the 20 SMA on top of the 65 SMA, then price is trending up.



On the other hand, if the 7 period SMA fans out below the 20 period SMA, and the 20 SMA is below the 65 SMA, then price is trending down.

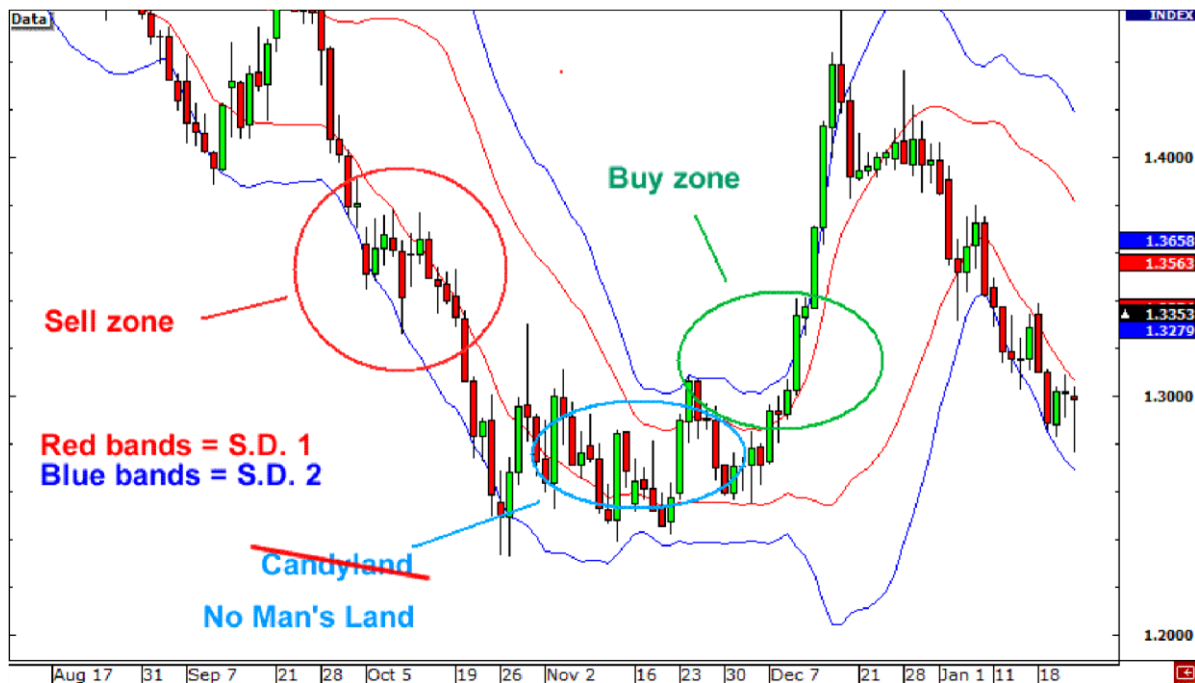


Bollinger Bands in a Trending Market

Bollinger bands actually contain the standard deviation formula.

Here's how we can use Bollinger bands to determine the trend!

Place Bollinger bands with a standard deviation of 1 and another set of bands with a standard deviation of 2. You will see three set of price zones: the sell zone, the buy zone, and the "Noman's Land."



The sell zone is the area between the two bottom bands of the standard deviation 1 (SD 1) and standard deviation 2 (SD 2) bands. Bear in mind that price has to close within the bands in order to be considered in the sell zone.

The buy zone is the area between the two top bands of the SD 1 and SD 2 bands. Like the sell zone, price has to close within the two bands in order to be considered in the buy zone. The area in between the standard deviation 1 bands is an area in which the market struggles to find direction.

Price will close within this area if price is really in “No-Man’s Land”. Price direction is pretty much up for grabs.

The Bollinger bands make it easier to confirm a trend visually.

Downtrends can be confirmed when price is in the sell zone.

Uptrends can be confirmed when price is in the buy zone.

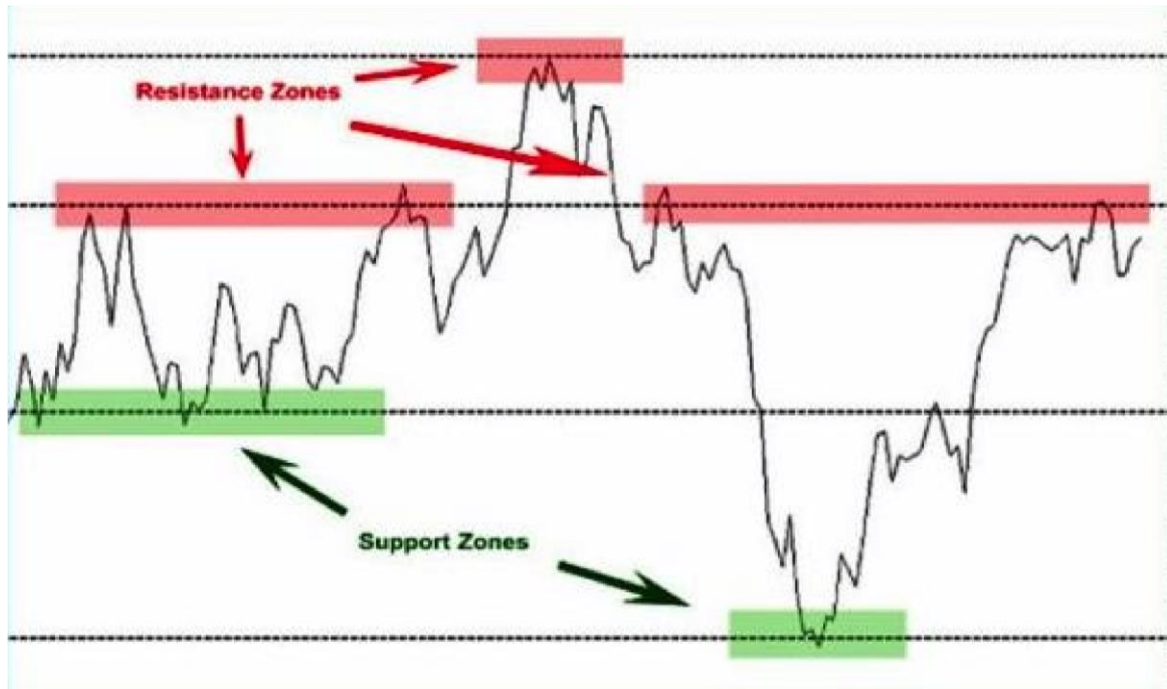
What is a Range-Bound Market?

A range-bound market is observed as a trading strategy that identifies stocks trading in channels. By finding major support and resistance levels with technical analysis, a range-bound trader buys stocks at the lower level of support (bottom of the channel) and sells them near resistance (top of the channel).

The present range-bound market represents the typical trading strategy characteristics, with the top of the trading range being called the resistance, because it is known as the price limit within the current trading range: and, the bottom level is called the support, which is the lowest price that a stock has recently traded at.

The resistance is the highest price that buyers have recently paid. Resistance is the price level at which selling is thought to be strong enough to prevent the price from rising further. The logic dictates that as the price advances towards resistance, sellers become more inclined to sell, and buyers become less inclined to buy. By the time the price reaches the resistance level, it is believed that supply will overcome demand and prevent the price from rising above resistance. If resistance is ever passed, technicians see that as an indication that the price may rise further.

Conversely, in a range-bound market, support is the price level at which demand is thought to be strong enough to prevent the price from declining further. The logic dictates that as the price declines towards support and gets cheaper, buyers become more inclined to buy, and sellers become less inclined to sell. By the time the price reaches the support level, it is believed that demand will overcome supply and prevent the price from falling below support. If a stock's price falls below current support, it may signal a declining trend to a lower trading range.



ADX in a Ranging Market

One way to determine if the market is ranging is to use the same ADX that we discussed earlier.

A market is said to be ranging when the ADX is below 25.



Bollinger Bands in a Ranging Market

In essence, Bollinger bands contract when there is less volatility in the market and expand when there is more volatility.

Because of that, Bollinger bands provide a good tool for breakout strategies.

When the bands are thin and contracted, volatility is low and there should be little movement of price in one direction.

However, when bands start to expand, volatility is increasing and more movement of price in one direction is likely.



Generally, range trading environments will contain somewhat narrow bands compared to wide bands and form horizontally.

In this case, we can see that the Bollinger bands are contracted, as price is just moving within a tight range.

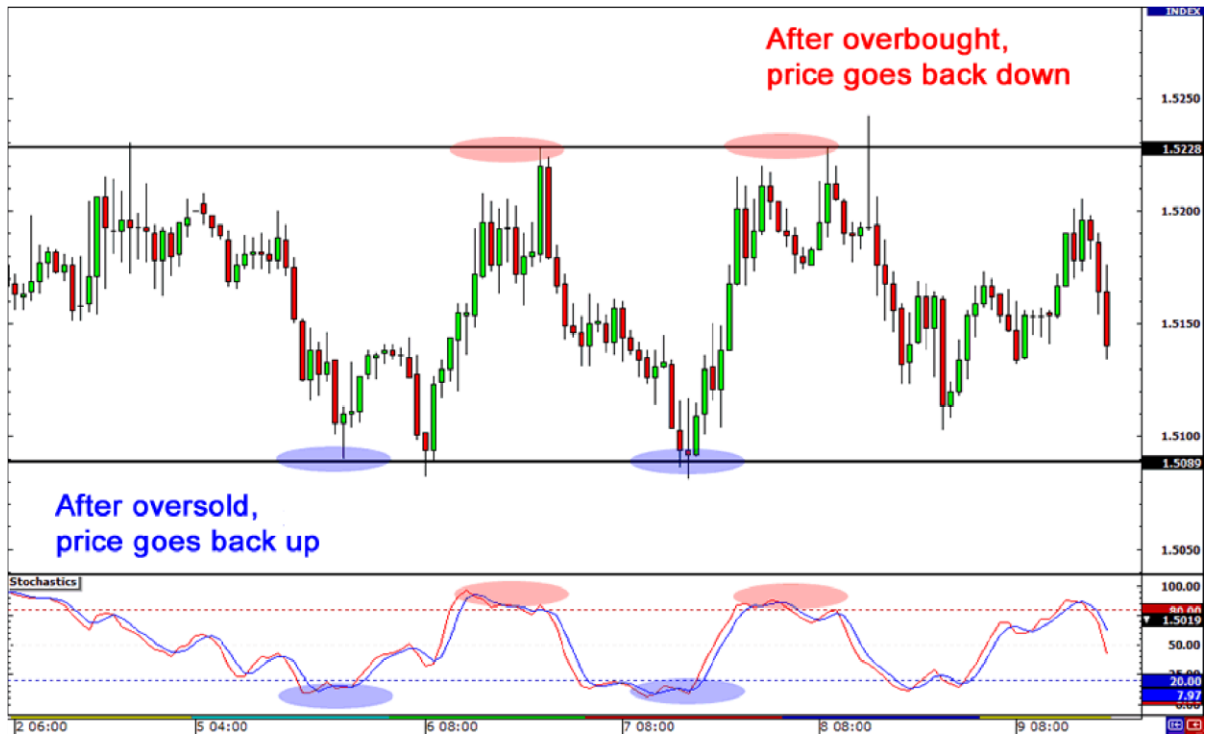
The basic idea of a range-bound strategy is that a currency pair has a high and low price that it normally trades between.

By buying near the low price, the forex trader is hoping to take profit around the high price. By selling near the high price, the trader is hoping to take profit around the low price.

Popular tools to use are channels such as the one shown above and Bollinger bands.

Using oscillators, like Stochastic or RSI, will help increase the odds of you finding a turning point in a range as they can identify potentially oversold and overbought conditions.

Here's an example using GBP/USD.



Trend Retracement or Reversal?

Imagine this scenario. Price starts to rise. Keeps rising. Then it starts falling.

And falling some more. And then it starts going back up.



This is called the “Smooth Retracement!”

In the above example, the forex trader failed to recognize the difference between a retracement and a reversal.

What are Trend Retracements?

Retracements are temporary price reversals that take place within a larger trend. The key here is that these price reversals are temporary and do not indicate a change in the larger trend. Notice that, despite the retracements, the long-term trend shown in the chart below is still intact. The price of the stock is still going up. When the price moves up, it makes a new high, and when it drops, it begins to rally before reaching the previous low. This movement is one of the tenets of an uptrend, where there are higher highs and higher lows. While that is occurring, the trend is up.

It is only once an uptrend makes a lower low and lower high that the trend is drawn into question and a reversal could be forming.



What are Trend Reversals?

A reversal, on the other hand, is when the price trend of an asset changes direction. It means that the price is likely to continue in that reversal direction for an extended period. These directional changes can happen to the upside after a downward trend or the downside after an upward trend.

Most often the change is a large shift in price. However, there may be pullbacks where the price recovers the previous direction. It is impossible to tell immediately if a temporary price correction is a pullback or the continuation of the reversal. The change can be a sudden shift or can take days, weeks, or even years to materialize.

The moving average (MA) and trendlines help traders to identify reversals. Intraday reversals are important to day traders, but longer holding funds or investors may focus on changes over

months or quarters. As shown on the image below, when the price drops under the MA or a drawn trendline, traders know to watch for a potential reversal.



How to Identify Reversals

Properly distinguishing between retracements and reversals can reduce the number of losing trades.

Classifying a price movement as a retracement or a reversal is very important.

There are several key differences in distinguishing a temporary price change retracement from a long-term trend reversal. Here they are:

RETRACEMENTS	REVERSALS
Usually occurs after huge price movements.	Can occur at anytime.

Short-term, short-lived reversal.	Long-term price movement
Fundamentals (i.e., the macroeconomic environment) do NOT change.	Fundamentals DO change, which is usually the catalyst for the long-term reversal.
In an uptrend, buying interest is present, making it likely for price to rally. In a downtrend, selling interest is present, making it likely for price to decline.	In an uptrend, there is very little buying interest forcing the price to fall lower. In a downtrend, there is very little selling interest forcing the price to rise further.

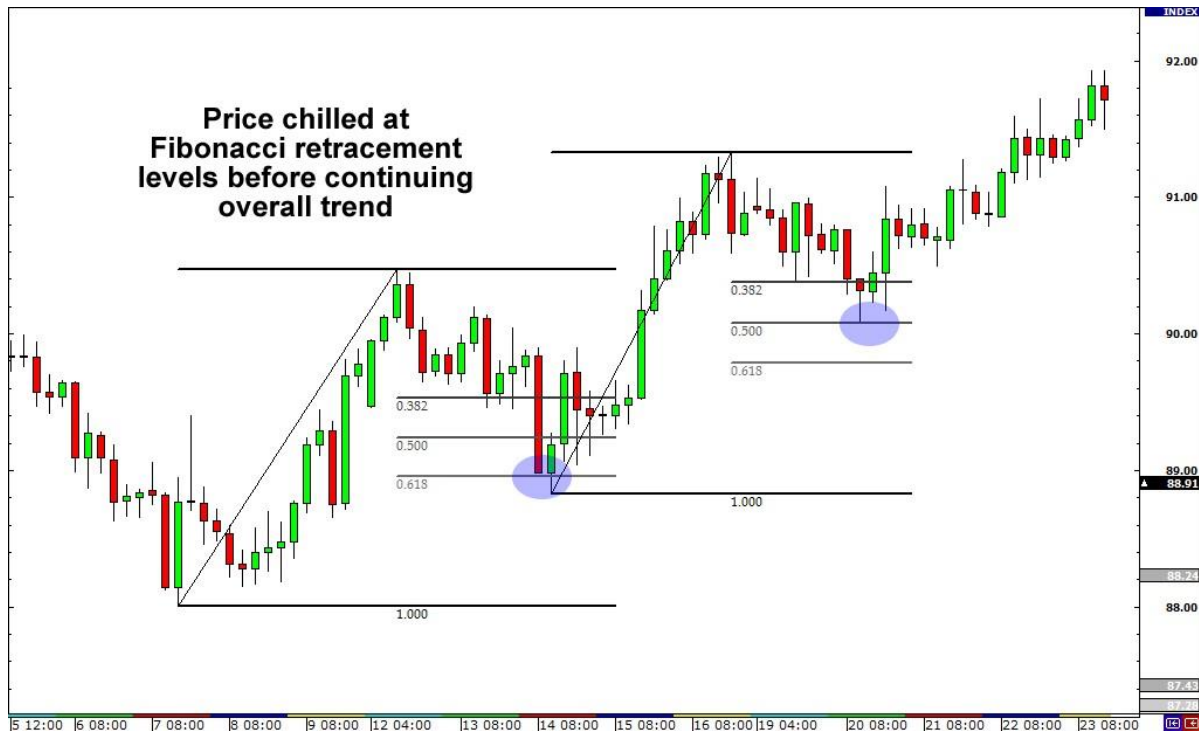
Identifying Retracements

Method #1: Fibonacci Retracement

A popular way to identify retracements is to use Fibonacci levels.

For the most part, price retracements hang around the 38.2%, 50.0% and 61.8% Fibonacci retracement levels before continuing the overall trend.

If price goes beyond these levels, it may signal that a reversal is happening. Notice how we didn't say will.



In this case, price took a breather and rested at the 61.8% Fibonacci retracement level before resuming the uptrend.

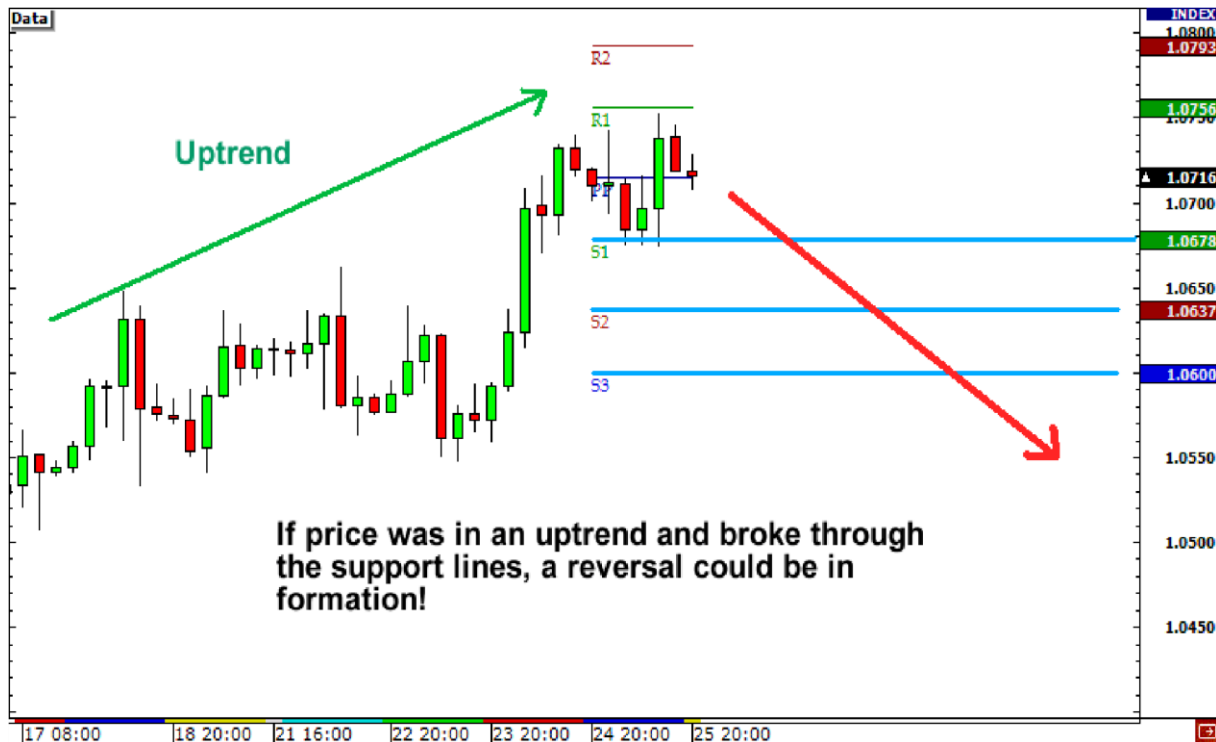
After a while, it pulled back again and settled at the 50% retracement level before heading higher.

Method #2: Pivot Points

Another way to see if price is staging a reversal is to use pivot points.

In an UPTREND, traders will look at the lower support points (S1, S2, S3) and wait for it to break.

In a DOWNTREND, forex traders will look at the higher resistance points (R1, R2, R3) and wait for it to break.



Method #3: Trend Lines

The last method is to use trend lines. When a major trend line is broken, a reversal may be in effect.

By using this technical tool in conjunction with candlestick chart patterns discussed earlier, a forex trader may be able to get a high probability of a reversal.



What is the Carry Trade?

Leveraged Carry Trade Example:

Let's say you borrow \$1,000,000 at an interest rate of 1%.

The bank won't just lend a million bucks to anybody though. It requires cash collateral from you: \$10,000.

You'll get it back once you pay back the money.

Then you turn around, walk across the street to another bank and deposit the \$1,000,000 in a savings account that pays 5% a year.

A year passes. What's your profit?

You *earned* \$50,000 in interest from the bond ($\$1,000,000 * .05$).

You *paid* \$10,000 in interest ($\$1,000,000 * .01$).

So your net profit is \$40,000.

With a measly \$10,000, you earned \$40,000!

That's a 400% return!

What is a Currency Carry Trade?

Carry trading is one of the simplest strategies for currency trading that exists. A carry trade is when you buy a high-interest currency against a low-interest currency. For each day that you hold that trade, your broker will pay you the interest difference between the two currencies, as long as you are trading in the interest-positive direction.

For example, if the Pound (GBP) has a 5 percent interest rate and the US Dollar (USD) has a 2 percent interest rate, and you buy or go long on the GBP/USD, you are making a carry trade. For every day that you have that trade on the market, the broker is going to pay you the difference between the interest rates of those two currencies, which would be 3 percent.

Such an interest rate difference can add up over time.

Know When Carry Trades Work and When They Don't

Carry trades work best when investors *feel* risky and optimistic enough to buy high-yielding currencies and sell lower-yielding currencies.

Economic conditions may not be good, but the outlook of the buying currency does need to be positive.

If the outlook of a country's economy looks good, then chances are that the country's central bank will have to raise interest rates in order to control inflation.

This is good for the carry trade because a higher interest rate means a bigger interest rate differential.

On the other hand, if a country's economic prospects aren't looking too good, then nobody will be prepared to take on the currency.

Especially if the market thinks the central bank will have to lower interest rates to help their economy.

To put it simply, carry trades work best when investors have *low risk aversion*. Carry trades do not work well when risk aversion is HIGH (i.e. selling higher-yielding currencies and buying back lower-yielding currencies).

When risk aversion is high, investors are less likely to take risky ventures.

When economic conditions are uncertain, investors tend to put their investments in safe haven currencies that offer low interest rates like the U.S. dollar and the Japanese yen.

Carry Trade Criteria

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

- Find a high interest differential.
- Find a pair that has been stable or in an uptrend. This gives you the ability to stay in the trade AS LONG AS POSSIBLE and profit off the interest rate differential.

For example between January 2000 and May 2007, the Australian dollar/Japanese yen currency pair (AUD/JPY) offered an average annual interest of 5.14%. For most people, this return is a pittance, but in a market where leverage is as high as 200:1, even the use of five- to 10-times leverage can make that return extremely extravagant. Investors earn this return even if the currency pair fails to move one penny. However, with so many people addicted to the carry trades, the currency almost never stays stationary. For example, between February and April of 2010, the AUD/USD exchange rate gained nearly 10%. Between January 2001 and December 2007, the value of the AUD/USD increased approximately 70%.



Carry Trade Risk

While carry trades might seem an attractive way of profiting from your forex trading activities and wide interest rate differentials between currencies, be aware that these trades also have a substantial potential for loss, as well as profit. The following list includes some of the primary risks commonly associated with carry trades:

Currency Risk: Since carry trades will generally be held unhedged, this means that any return from the interest rate differential needs to be in excess of any adverse exchange rate movements in the carry trade currency pair.

As a result, a currency pair will usually be chosen for the carry trade for which the trader forecasts the higher interest rate currency will appreciate over the chosen time frame relative to the lower interest rate currency.

The carry trader might make this forecast based on a suitable combination of technical and fundamental analysis, since it will usually be for a fairly long time frame.

Leverage Risk: An important risk factor for retail forex traders to consider with the carry trade is that if substantial leverage is used to implement it, then sharp unfavorable market movements could result in losses that may prompt margin calls or the position being automatically stopped out by your forex broker.

Interest Rate Shift Risk: When carry traders seek to compound their interest on a monthly or even daily basis to increase their overall returns, they can then be subject to returns that can vary depending on movements in the interest rate differential.

For example, if the interest rate differential widens, this will generally be a move in the carry trader's favor, which they can take advantage of in the next compounding period.

On the other hand, when interest rate differentials narrow, the carry trader will then receive a lower return than anticipated in their next interest compounding period.