

How Does The Forex Market Work?

Raghee Horner

*Raghee Horner is a trader, teacher, and author, with more than 15 years' experience in the markets. She is a highly sought-after educator and has taught her brand of technical analysis and charting strategies all over the world, conducting seminars throughout the US, Canada, the Caribbean, and Asia. The author of the works *Forex Trading For Maximum Profit* and the upcoming *Thirty Days Of Trading*, she has taught foreign exchange, futures, and equities trading for more than a decade. Emphasizing charting and price action, Horner teaches the tools and strategies that encourage self-directed traders to pursue the study of chart analysis and market psychology. Not only that, she has offered education and analysis on her own radio program and currently produces a daily multimedia commentary for *TradeDirectFX.com*. She also offers analysis about the forex market for *eSignal* and is a frequent speaker at the *Forex Trader Expo*.*

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Raghee, how did you get into forex trading?

Like a lot of traders, I first got interested because I was already trading other markets, and — also like a lot of other traders — I was on the lookout for new trading opportunities. I just don't think of myself as "just" a foreign exchange trader; I trade futures, and on occasion, I'll trade stocks. I actually got my start trading commodity futures, so I was exposed to currency trading via currency futures. So it really felt like a natural move to include the forex market to my trading approach and portfolio. More traders should think of themselves as traders. The market you trade should be secondary to the fact that you have a methodology.

Were you working with a firm?

No, I've never worked with a firm or managed other people's money. I've always been a private trader.

When did you start?

That's its own funny story, actually! When I was a kid, my mom was very

much a typical Indian mother: school, school, school, homework, homework, homework. But I wanted an after-school job. She said, "Well, if you're going to get a job, you have to give me 25% of what you make, and I'll invest it for you." Of course, being a typical teenager, I was upset at that, but I found out that my mom was putting my money in stocks and mutual funds. So I thought, "You know, if that's where my money is going, I'd better see what this is all about." So at 16 or 17, I took some of my father's old engineering draft paper and began to plot the closes, not really understanding this was my first foray into charting. That's how I got started.

I have to give my mom credit: she got me into it whether I liked it or not! And my interest grew from there.

From your experience, what are some important issues that anyone who wants to venture into forex should consider?

That's a good question, because too many people think there is some new way that they should approach the forex

market. Again, it's my experience that the general public migrating over to forex have already had exposure to the stock market, and even, to a lesser degree, the futures market. I always tell them it's similar to what they're already doing. They're already accustomed to news events and reports, to charts and price action.

I think forex traders have to become "big picture" people. The moves in the forex market are affected by the currencies, underlying equities markets, the news and events of that country... and again, by the same factors for the other half of the pair.

For example, if you and I were trading the euro/US dollar pair, I'd tell you to really focus on the word "pair." Consider you're really thinking about *two* currencies, *two* equities, *two* equities markets. During the European sessions, the euro/USD is trading for about five to six hours without *any* US market participation. That's one dynamic there.

And then about 7 am or 8 am Eastern time, we see the UK markets begin to overlap with the US markets that are just opening. That's another dynamic. After 8 am, we're in a great market overlap. We have the US markets opening and the afternoon session in the UK. I have to emphasize the London market, because if New York is the center of the stock universe, then London is the most active trading center of the forex universe, followed by the US.

So to answer your question, if I had to pick one major aspect to specifically consider in forex, it would be time. Being keenly aware of Sydney, Tokyo, Hong Kong, London, Singapore, and New York, and all of their trading times, is the key component to any forex trading approach. In fact, I'll tell my students, "Before you get into a trade, ask yourself, 'Who's awake?' before you push that buy or sell button." If nobody's awake, there's no participation. To me, *global time* is the aspect that stocks and futures traders may not think about.

When people migrate from stocks into futures, or forex, for that matter, the issue of leverage comes in. Is that something they have to be mindful of?

Absolutely. The overall opinion of forex trading is that it is extremely risky. But I come at it from a different perspective. Of all the markets, forex is the safest, followed by futures. To me, stocks are the least safe.

Why is that?

Maybe stocks have a better public relations department! Even large, well-known companies can come and go, but corn will always be bought and sold. So will the euro, the pound, and the dollar. You mention risk, and what *is* risky is leverage. Leverage is what makes futures and forex such different animals from stocks. Stocks offer little leverage. The underlying, tangible value of forex and futures is much greater than that of stocks, but forex and futures are all about leverage. The buying power for most forex accounts is somewhere in the vicinity of 100:1 or 200:1. I love the horsepower, no question! But you have

to control it. *That's* the risk. Your wins and losses in forex and futures are amplified.

Leverage is a very real consideration, but what it really comes down to is the risk and trade management. If someone is going to wing it in forex or futures, you and I both know that account is going to hemorrhage capital.

Another consideration is the 24-hour market. It's always perceived as a pro, but it can be a con too. On the one hand, it makes risk and trade management easier — really, the best of any of the markets — but on the other hand, we have to eat, we have to sleep ... we miss trades on occasion. I'll take the good with the bad, and I also think the order entry is very good with forex.

Do you get better fills?

I've been trading with GAIN Capital for years, and having access to the "one order cancels the other" (OCO) orders and the if-then with the OCO allows me to step away from my computer, knowing I'll still be able to actively manage a position. People coming over from futures and stocks don't realize that a 24-hour market gives you the most effective and real-world executions for your risk management. Stop-losses aren't going to be as susceptible to those gaps that happen with a market that opens and closes.

So I'll take the occasional frustration of missing a trade while I was asleep because I know I'm getting great order-entry flexibility, a 24-hour market, and better risk management: It's a trade-off.

Do you develop trading systems, or are you discretionary?

Without a doubt, I am discretionary. Even more specifically, I am a chartist. To me, being a discretionary trader doesn't mean that I *don't* have a systematic approach. It means that I have a number of approaches that I follow systematically in certain market environments.

For example, I personally have three specific entry strategies that I'll use, depending on current price action, and I'll measure the market with something I call "the wave." It's a trio of exponential moving averages (EMAs), a 34-

period EMA on a high, low, and close. By using the wave, I'll gauge the trend of the market that's trading. More than anything, each approach is going to have its own set of tools, such as my three, but I apply them *systematically* in a *discretionary* manner. To most folks, discretionary means going by your gut, but I don't think that's true.

When you're viewing charts, do you look at your three-trade setup?

Obviously, I use the wave, but my three trade setups are momentum setups, swing-trade setups, and then something I use with the commodity channel index (CCI) and the wave. Even though I am very much a chartist — I really do believe that price action represents everything that's going on in the news and fundamentals — I have to acknowledge that there are certain hot zones that the news and fundamentals create. So while I don't gauge my entries on the news and fundamentals, I know that the increased volatility could trigger my technical or charting setup.

How do you measure momentum in the forex market?

I use the wave. That 34-period EMA trio. I use a clock face to gauge the angle at which the wave is moving. If you have an analog watch or a clock in the room, if a wave is setting up between 12 and 2, I'll know the market is in an uptrend. If the wave is setting up between 4 and 6, it's a downtrend. That's why it's so great to be a trader and teacher: a lot of what I do might be experience that has become instinct for me, but my students will ask, "Why did you do that?" And I have to find a way in a black & white, on/off, easy way for them to see what I'm seeing, so I have to deconstruct a lot of what I do to explain. It's great for traders to teach, because it holds us to a higher standard.

So you do a lot of teaching now?

I do. It's amazing — once you write the book, you don't have time to teach as much! The teaching wasn't even something I wanted to do when I was getting into the commodity markets. Back then, I used to have those big charts mailed to

me once a week, and I would update them by hand. This was before the Internet. Traders today don't know how spoiled they are! I also had a satellite dish on my house that gave me the datafeed, and since this was also before satellite dishes were common, people started asking why I had a dish and what I was doing working from home. This was in the mid-1990s. I was an oddity in the neighborhood, and people are naturally curious about the stock market. And that's when I started teaching.

How many charts do you view at a time?

I focus on five time frames, so when it comes to how many charts I look at, it's a minimum of five. But I don't use multiple time frames for confirmation. Each chart is a standalone and I use the chart that shows the clearest signal. It's not unusual I'll be trading on my laptop, and sometimes I'll only have those five time frames. My shortest is a 30-minute time frame, so it's not as though I'm trading in a rapid-fire, bang-bang, knee-jerk way. With that in mind, I have a 30, 60, 180, 240, and the daily.

Why the 180 and the 240?

Those came from my students when I was doing a lot of futures trading. They mentioned these time frames were really popular for forex. I had no idea because in the US, three- and four-hour charts are unusual. I heard a lot of that from my students over in Europe. I decided if this was psychologically relevant in the most important financial centers for forex, I'd better keep an eye on them.

The 30-minute became my smallest time frame. With a 24-hour trading period, a 30-minute chart can yield enough candles or setups so I don't lack setups using the 30-minute chart. In my trading office, I'll expand a bit, since I have about four monitors in the office. But I always say, "Take away my monitors, take away my PCs, leave me my laptop and my five charts, and I will be just fine."

If you let me go off on a tangent here, my husband and I both ride motorcycles, sport bikes. There's this classic road-racing book called *Twist Of The*

Wrist, and in it there's this discussion on the concept of your attention being like a dollar bill. There's only so much of that dollar you can spend on all the stimuli around you!

Of course, this is geared toward road-racing a motorcycle at 150 miles per hour, but I think there's so much analogy to trading here — if you put yourself in front of 15 different monitors and 80 different charts, there's only so much stimulation you can take. More *isn't* better. If you take that one dollar of attention and spend it on less stimulus, but in a deeper way, that's better. A lot of new traders think they have to be surrounded by 15 monitors and fancy displays to be a trader, and it's just not so. I'm on my two-year-old laptop most of the time!

Speaking of the money aspect, do you think there's a minimum account size a trader should start with when they're trading forex?

A lot of the appeal of futures and forex is the idea of starting with very little money and making a lot. You and I know that's not necessarily true, but it does allow us the ability to take a smaller sum and make it larger, unlike most daytraders in stocks, where \$25,000 is the minimum. You don't need nearly that much in forex. More money doesn't necessarily mean more success, but you do have to approach it like a business. An undercapitalized business will be at a severe handicap compared to a well-capitalized business that can handle the ebb and flow of the learning process. If someone were to ask how much they would need to get started, I'd say no less than \$5,000, but not much more than \$10,000.

Another wonderful thing is the mini accounts out there. Paper-trading or demo trading is a great marketing tool, but it's worthless when it comes to teaching someone what it's like to trade. Even if you're only trading a mini-account, and even if you're looking at one pip being one dollar, you're engaged in it. It's not a lot of money, but there's this kinesthetic reaction we get, even when it's just one dollar. It's like Las Vegas — we drop a quarter in that

slot machine, and all of a sudden, we're really involved with the outcome. The same is true with a mini account. With a lot of mini accounts, you can get the idea of real trading and real execution for less than \$1,000.

In that regard, forex has given new traders a great tool with which they can feel what it's like to be in the market, but if they make a mistake, it won't be a career-ender. In that sense, there's a little bit of a leg up with forex.

When you were talking about the different time frames, you mentioned that the 180 and the 240 were psychologically relevant. How important is psychology in trading?

I always have to give a plug for my sister. She has a doctorate in psychology and I'm so proud of her. I rely on her heavily. She and I have had many great discussions, debates, even arguments about trading and its psychology.

When it comes to trading psychology, there are two elements. One is to understand the time frames that are psychologically relevant. There are also price levels with psychological relevance, like the 20-pip and the 80-pip, as minor psychological numbers, and the double-zero pip and the 50-pip as major relevance. Traders and orders gravitate toward those numbers, and they inherently become support and resistance levels. Then there is the psychology of discipline, of obeying stops, or taking your profits out at predetermined targets and so forth ... 80% really is psychological, and maybe 20% is actually knowledge and trading methodology.

After discussing with my sister the mindsets that lead to not following a trading plan, I actually took a test, and it gave me a good idea of what my personal weaknesses and strengths are. So many of us go through this unconsciously. We don't know how we react to certain stimuli. I always tell traders coming into the market that they have to be conscious of the way they process the market's messages. And it *is* a process. Some traders see prices heading up to resistance and think, "I want to

short that.” Another trader waits to play the breakout, thinking, “I want to buy that.” It’s the same move, but with two different thought processes behind it. That’s what makes the market work.

People should spend time understanding that factor.

Discipline is a byproduct of the trading plan. To me, discipline is freedom. Not a lot of people think that way, but to follow a trading plan, first you have to have one! I can’t tell you how many times I’ve seen traders get into a market without a plan, without knowing the risk/reward ratio, without knowing the current market cycle. All of that is the 20% of knowledge I mentioned that’s outside the discipline.

For example, let’s look at a losing trade. The way people absorb the emotions of a losing trade involves understanding that placing your stops should start with knowing when the trade is no longer valid. The price at which you enter the market and the amount of money you want to risk has no bearing on what the market is going to do. The market couldn’t care less that I only want to risk 20 or 40 pips. If I place my stop based on that fixed number, I’m certainly not basing my stop-loss on any reality outside of my own desire to lose no more than 20 or 40 pips. Understanding my risk tolerance and whether a trade is appropriate for my account is best done before the trade, during the setup period. Beyond that, the discipline is trusting your charts, finding the support and resistance, and using those levels to enter and exit.

Can you give a step-by-step approach to how someone should set up a trading plan before they trade?

First, you have to start with the wave. That’s important because there are four market cycles. For example, accumulation and distribution are the two sideways phases of the market cycle. You also have a mark up and a mark down, which is basically an uptrend and downtrend. When they are going to trade, it’s important for traders to differentiate between momentum and swing-trading opportunities, because

there’s an entry specific to each.

So first, I look to recognize one of my setups. Take momentum trading. If I see a 3 o’clock wave reading, I know the market is heading sideways, and I’m looking for that breakout or breakdown. Typically, these will come in the form of chart patterns like triangles or rectangles, narrow sideways channels, and so forth. Rather than focusing on a specific chart pattern, which I think is a mistake, I would rather see a trader draw all the support, resistance, and trendlines first, take a step back, then see if those lines form a chart pattern. That is very different from looking for the triangle or rectangle.

Once I have that momentum trade — the triangle setup — and I’m waiting for the breakout or breakdown, I’ll confirm that breakdown with the moving average convergence/divergence histogram (MACD). That’s one way I’ll look for a setup. I guess you could call that #1.

Swing trading is the entry style used within the context of a trend. Again, that brings me back to the clock-face angles. We’re talking about the trend either being the wave traveling up between 12 and 2 or traveling down between 4 and 6. Either way, we need to identify some sort of trending market. It’s funny — there are all these truisms that traders have to wade through when they’re trying to learn *why* the trend is their friend. But it’s only your friend if you’re *already* in the trade!

That’s true!

It’s difficult to enter an established trend. That’s why I tell people to recognize momentum trades because you’re getting in on the beginning of the trend. Simply getting long in an uptrend or short in a downtrend is a high-risk entry. You have to look for those measured pullbacks or those measured bounces. Call them retracements or corrections, but you need a way of measuring them. I use Fibonacci levels, but that’s really up to the individual.

In the context of a trend, I’m looking for the opportunity that comes with a retracement. I’d go so far as to say that when you’re swing trading — which is a completely different game from mo-

mentum — the goal is to get long at the pullback and short at the bounces. The chart will tell you where that is. Those are the best two ways to go about setting up a trade.

What about placing stops?

Whether you’re a swing or momentum trader, your entry style dictates the type of trade, not the length of time in the trade, or even the time frame of the chart. I could be momentum trading on a daily chart and swing trading on a 30-minute chart. It’s the way you enter, the market environment, the cycle you’re in. But when it comes to managing the trades, I manage all my trades the same way. I use a single entry, and I never scale in. But I have multiple profit targets, so I do scale out. As far as stop placement goes, I could spend all day on that!

However, the main thought behind any stop-loss placement is not a fixed pip or fixed percentage — I don’t think that’s appropriate for trading, although you could use a cap like the ever-popular 2%. But the actual price level where you place your stop should represent where the trade is no longer valid. That philosophy and that level doesn’t care about a fixed pip or a fixed percentage. It’s based off of the chart setup.

Often, traders will use a chart setup to get in, but they’ll abandon the chart when it comes to managing the trade. They’ll go to fixed levels, and that’s the absolute wrong thing to do. Keep relying on those charts. They got you into the trade, and they’re equally capable of getting you out in terms of the two exits you have to think about, one being the stop-loss and the other being the profit target.

When it comes to placing stops, support levels when you’re long and resistance levels when you’re short are obvious choices for finding potential stop placements. Again, knowing those levels and understanding your risk/reward ratio *before* you get into the market are key. Because you’re using the charts to measure risk and reward instead of just putting some haphazard (or standard) 20- or 40-pip stop-loss, it really does matter whether your first profit target and your first stop-loss give you risk/reward ratio that’s appropriate for your

personal risk tolerance and for your account. You may set up a trade that *looks* great but isn't appropriate for you. The only way to know that is to set up the trade beforehand and use the charts to decide where these support or resistance levels are waiting.

But what if the pattern or chart doesn't go the way you think it will?

Now you're thinking of the risk-management, stop-loss side of things.

I guess the trade is no longer valid, then.

Right, it's literally when the trade is no longer valid. You have to go back to psychology. You have to have your stop placed in the market as soon as you get your entry. Your mental stops and mental profit targets only come after years of good habits, and *practicing* those habits until they become second nature. But the worst trade that anyone could possibly have — the *most* dangerous trade — is that one where you broke all the rules and you didn't follow your trading plan, but you *still* won! That single trade will create the mindset that you can get away with breaking the rules next time.

Even though the trader should feel that following that stop-loss and obeying that level is a successful trade, we go back to psychology. There are the five stages of loss. We all go through these stages with our losing trades! Recognizing those stages of denial, anger, bargaining, depression, and acceptance is key. I'm not trying to put a loss of life and a trading loss on the

same level, but the stages and emotional patterns are similar.

You see that on a winning trade as well — people think, "Why did I get out of that trade so early?"

A trap that most people don't even consider is that profit target trap. Their prices reach a predetermined profit target, and if the trader does not have the order waiting, they get greedy. They want to see how much more they can squeeze out before it begins to reverse.

They find out the hard way.

The first thing that happens is that a bit of profit starts to tick away. The first stage kicks in: denial. "Oh, the market is just getting ready for the next move up!" And the market continues to go against them, and they get angry. "I should have gotten out!" Then the bargaining kicks in. "If it comes back to where I was, I promise I'll get out!" Who they promise to, I don't know. Then there's depression. "I gave back all my profit," or worse, they let a profitable trade go negative. And at some point, there has to be acceptance, either in the form of a trade going positive, or maybe it got stopped out. But we all do this.

What's the best way to combat this? Does it come with practice?

In most ways, it's the same mindset when it comes to obeying a stop-loss or a profit target. They are still exits, although one is certainly more pleasant than the other. First, traders have to embrace the feeling that being stopped

out is still following your plan and that *is* success. Exiting at your predetermined profit target is following a plan, and that plan must be developed before you enter the trade. You hammer your first nail into a home *after* you have the blueprints. You don't enter a trade until *after* you have a trading plan.

Discipline *seems* like a bad word. It makes you feel like you're on that diet where you have to eat salad *all* the time. Nobody can just discipline their way 100% through trading. It becomes a mindset where you do the little things right every day. Spend the time on the charts, do your homework, learn to recognize the support and resistance levels, and you'll recognize it's working. Recognize those small things, do those small things that add to your confidence. Once you have the confidence in your charts and you're following your trading plan consistently, *then* the discipline takes care of itself. You're developing good habits following that trade plan.

I don't know anyone who was just born with that mindset. You have to work on it until it becomes second nature, and that means doing the homework. You can't just wake up and turn the computer on and say, "I'm going to trade today."

All good things to keep in mind. Thank you, Raghee.

†See Traders' Glossary for definition



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