The Complete Guide To Successful Financial Markets Trading

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The Basics Of Foreign Exchange Trading

The Biggest And Most Transparent Market In The World

In broad terms, the global foreign exchange (FX) market is the biggest financial market in the world – larger than the equity, bond and commodity markets added together – with a daily average trading volume of USD5.1 trillion in 2016, according to that year's 'Triennial Central Bank Survey' by the Bank for International Settlements (BIS). In practical terms, this translates into it being **the most transparent of these markets to trade, less subject to manipulation by traders from leading banks and fund managers in the loop of information about deal orders and flows that is not available to retail traders.**

For many traders starting out, though, the FX market can appear a more daunting prospect than the equity market or even the commodity market as it involves simultaneously handling two assets and, in effect, two transactions in one trade (the bond market often appears almost as confusing, given the pricing structure to be discussed later in this section). However, this should not deter the trader, as the benefits of trading such a big, transparent and wide-ranging market far outweigh overcoming any initial difficulty in understanding the bare mechanics of FX trading.

The Conventions Of An FX Trade

If a trader thinks, for example, that the British pound is going to strengthen he cannot just 'buy the pound', he needs to buy it against another currency, which, at the same time as buying the pound, he must sell; it is an exchange of currencies. Alternatively, if a trader thinks that the British pound is going to weaken he cannot just 'sell the pound', he needs to sell it against another currency, which he buys at the same time as selling the pound. In fact, **all FX trades**

involve two currencies (although the Dollar Index is the rate of the US dollar against a basket of other currencies), from which is derived the 'foreign exchange rate' for any currency pairing at a given point in time.

Looking at any FX rate in a newspaper, website or TV will show either of the following formats: e.g. £/$1.2441 or GBPUSD1.2441. In this case, the rate shown is for the British pound against the US dollar and is the 'mid-rate' price; that is the mean average price between the 'bid' price and the 'offer' price (see below). In the first format, symbols are used for each, but for the vast majority of currencies there are no easily recognisable symbols. Consequently, **every currency in the world has a currency code of three letters**, which generally is comprised of two key letters in the name of the country appearing first and then the first letter of the unit of currency. In this case, then, GBP is comprised of the 'G' from Great and the 'B' from Britain, plus the 'P' from pound, whilst USD is comprised of the 'U' from United and the 'S' from States, plus the 'D' from dollar. Other commonly trading currency codes are: JPY (Japanese yen), EUR (euro) and CHF (Swiss franc, with the 'CH' being derived from the Latin name for the country, Confoederatio Helvetica), but the trader can look up any currency code on the internet by just typing into the search engine the name of the country and 'currency code'.

Here are some of the most traded codes for currencies and a few others mentioned in this book, for convenience:

GBP = Great British pound
USD = US dollar
EUR = euro
JPY = Japanese yen
CHF = Swiss franc
AUD = Australian dollar
NZD = New Zealand dollar
CAD = Canadian dollar
HKD = Hong Kong dollar
RMB = Chinese renminbi

It is also essential for the trader to know two extra pieces of basic information regarding the way in which the FX market actually works in a trading scenario:

1. **All FX trades are quoted with a 'base currency' on the left hand side of the quote and the 'counter currency' on the right hand side of the quote.** The FX rate shows how much one unit of the counter currency is required to exchange it for one unit of the base currency. So, in the example above, GBPUSD1.2441, 1 US dollar and slightly over 24 cents are required in exchange for one British pound.

2. FX trading quotes (on, say, a trading platform, or from a bank) comprise two prices (as do all trading quotes, in fact): the one on the left is the price at which whomever the retail trader is trading with will buy the base currency (see below) and, therefore, sell the counter currency (see below) – known as the **'bid price'** – and the one on the right is the price at which whomever the retail trader is trading with will sell the base currency (see below) and, therefore, buy the counter currency (see below) – known as the **'offer price'**.

So, if a retail trader wants to sell the base currency then the trading platform will be buying the base currency, so the price on the left is the one that the trader needs to look at. If the retail trader wants to buy the base currency (which means the trading platform is selling the base currency), then the trader needs to look at the price on the right.