WHY TRADE CURRENCIES?

TRADER ON THE STREET

AS A PRIMER, THIS GUIDE WILL FOCUS YOUR UNDERSTANDING OF:

- Why do people trade the Foreign Exchange market?
- How does it work?
- The best time to buy and sell
- What are “pips?”
- What are “lots?”
- How do you determine profits?

INTRODUCTION

Trader on the Street prepares traders for a lifetime of trading in the Foreign Exchange market. This is done through extensive educational modules and live trading sessions.

And of course, this means starting from the very beginning. The Forex markets carry a lot of complicated terminology and minutiae, but knowing them is not required if you want to start trading. However, it’s important to understand its internal functions, so you can establish the building blocks of your trading career.

To guide you on the right path, these next chapters are built to help you gain a good grasp of the Foreign Exchange market. If you’re a beginner trader, this guide will have what you need to get started. The same goes for more experienced traders, as it is always helpful to refresh your knowledge.

Keep this guide handy and come back to it as much as possible. We want to make sure all the concepts explained sink in and become second nature to you as a trader. And hopefully, it will help you expand your trading vocabulary.
Consider this very much an introductory course to currency trading, and it’s just one of the many steps in the process of becoming a successful trader. But it’s the most important. Think of trading as more of a journey and less about the destination, in which making the right stops will mean your experience is memorable.

Let’s get started with some of the basics of currency trading...

WHY CURRENCIES?

To answer this question, we must understand why people invest/trade in the first place. There are many financial markets out there for traders to choose from: commodities, stocks, options, futures.

So, one of the major reasons investors turn to these markets is simple. The dichotomy between buyers and sellers and trends in supply and demand continue to create value.

And these constant changes in value create opportunities. The more opportunities there are, the more chances traders have at making profits.

This is also true for the Foreign Exchange market. Every country goes through lapses of profit and loss, and prosperity or recession. And these movements are often not correlated- one country could be on the decline and another might be experiencing rapid economic growth.

To put it simply, you might buy a strong currency against a weakening one. So, if the weaker currency depreciates in value, experienced traders use this to their advantage. If you continue to sell weak currencies to buy strong ones, your profit margins will steadily increase.

Best of all, did you know you can trade the Foreign Exchange market virtually 24 hours a day? We have the earth’s rotation to thank for that. Therefore, all the international central banks maintain constant communication with one another, as they attempt to foster good relationships and process major banking deals.

What does this mean for traders? Well, basically, it means you can trade around the globe any time of day, 5 days a week. The currency markets operate starting at 5:00PM Eastern on Sundays and close Fridays at 5:00PM Eastern. This is what attracts traders to the currency markets; it’s a fast-moving, volatile exchange in which traders with the necessary training can use to their advantage.

HOW DOES IT WORK?

Think of it like this: if you believe the Euro’s value will appreciate in time, you might use U.S. dollars to buy Euros.

Say you take out $1,000. If a day or two later, the Euro rises to $0.01, or one penny, then the Euro’s value is $1,100. In order to lock in this profit, you might sell your Euros, which in turn gives you a profit of $100. That would be the original investment minus the rate of exchange, in this case $1,100 minus the original investment of $1,000.

In the currency market, all currencies are quoted in pairs. For the previous example, we used two different currencies to place a trade. So, we bought Euros against the value of the U.S. Dollar. Why are currencies quoted in pairs? That’s because in currency transactions, one currency is purchased in exchange for the other.

With currency pairs, the first currency is referred to as the "base currency." And the second is the "quote currency." The base is the linchpin of the sale. Whenever you buy, you're buying the base currency.

When you want to purchase Euros against the relative value of the U.S. dollar, you're buying the EUR/USD pair. Once you wish to liquidate the trade, you're selling the EUR/USD. These are the two sides of trading: buying and selling.

In terms of buying currencies, you need to pay attention to the exchange rate. It's meant to tell you how much of the quote currency you need to buy base currency. Let's take a look at this example:

EUR/USD = 1.1505

What does this mean? When you want to buy one Euro, you'd have to pay 1.1505 U.S. dollars.

Once you sell, the opposite comes into play. In this case, when you sell one Euro, you will receive 1.1505 U.S. dollars.

THE BEST TIME TO BUY AND SELL

Trading comes with knowing which currencies you expect to increase or decrease in value. If you expect the base currency to become more valuable than the quote currency, you buy the pair.

When you sell, it means you expect the base currency to fall in value relative to the strength of the quote currency.

Relativity is always in play when trading currencies because they're traded in pairs. Whenever a particular currency looks to be increasing in value in comparison to others, it's becoming more valuable than other currencies, and thus, holds more global value. Inversely, if a currency is gaining value, but not on a global scale, then the other currency is just experiencing levels of weakness.

It's important to note that in currency trading, no physical exchange is taking place. Traders are not flipping out their wallets and exchanging bills with one another. Rather, it's all performed electronically. Currency traders look at real-time charts and data to make buy or sell decisions using the internet. There is no localized central exchange for currencies you need to contact or travel to.

WHAT ARE "PIPS?"

You may have heard this term before, and it's one of the most important factors in a trade's performance. When looking at the exchange rate between two currencies, the numerical value by which it goes up or down is called a "pip."

It's actually an acronym, and it means " Percentage in Point," but that's not what should matter to traders. Pips are used to denote small price changes in exchange rates, and they are quoted to the fourth decimal place. Say the EUR/USD exchange rate is 1.2501. If the value goes up to 1.2502, then it has moved one pip. In the same vein, then the value goes up to 1.2551, it has increased to 50 pips.

Most currency pairs, save for the Japanese Yen, are quoted to the fourth decimal point. The Yen uses the third decimal place as the pip count. In recent trading, major banks and brokers have added another decimal place to their quotes, and that's referred to as a "point." So, you might hear that one pip is worth 10 points. However, it's common to just use pips to refer to a currency's difference in value.

WHAT ARE "LOTS?"

If you want to trade currencies, you need to decide how much you're willing to buy or sell. These are called "lots," and they determine how much profit is made from your trading. For example, the standard lot size is 100,000 units of the base currency. So, if you're trading the USD/ CAD pair, one lot is $100,000, and two lots is $200,000, etc.

This means that if you buy one lot of USD/CAD, you're gaining how much $100,000 is worth in Canadian dollars in respect to the relative value set by the exchange rate.

Simply put, if you trade one lot of USD/CAD at an exchange rate 1.2000, then you're gaining $100,000 in exchange for $120,000 Canadian dollars. Therefore, it's calculated as the lot size times the exchange rate ($100,000 x 1.2000).

When you sell, the opposite comes into play. So, selling one lot of USD/CAD at that same exchange rate, then you're exchanging $100,000 for a return of $120,000 Canadian dollars.

HOW DO YOU DETERMINE PROFITS?

After all this information is digested, the question remains:" how much did I make?" Luckily, your software does this for you. But it's important to know exactly how.

In this example, let's say you buy one lot when the exchange rate is 1.2900. You leave the trade to move and it has gone up to 1.2950. That means you can book 50 pips in profit. You close it and lock it in.

Now, what's next? You bought the pair, which means that once you close it, you're selling it at that rate. And then, once you click the button and make it a done deal, you've just made a trade worth 50 pips! And when calculating what that translates into when talking about profits, it will look like this:

Difference in exchange rate x Position size.

With the information from this trade, your profits are as such: **0.0050 x 100,000= 500**

You've made $500 on one trade!

One factor you need to consider when calculating profits is the "spread." While there is no central exchange for currency trading, the bank and broker need a commission; this is often around 2 pips. Note that this is the difference between the amount for which currencies are bought and sold. For this 50-pip trade, if the spread is 2 pips, then those pips will be subtracted from the total pip count. So, out of those 50 pips, your profit is calculated from 48 pips, which means your total would be $480.

WHAT'S NEXT?

This guide will serve as a primer for beginner traders before getting into the real meat of it. Regardless of your experience level with trading, the information should prove to be always helpful. And as you start this journey with us, we hope your experience is pleasurable and you enjoy continued success in trading. Remember that this is all about the process and developing skills, the profits will come after that.

As we extend to you this introduction to currency trading, we implore you to continue to explore the wonderful world of trading. As they say, knowledge is power, and the best way to become a better trader is to focus on gaining as much knowledge as possible. Feel free to explore Trader on the Street's educational modules and expand your library and vocabulary along the way.