

Forex

What is Forex Trading?

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Foreign exchange, commonly abbreviated to “Forex” or “FX” is the exchange of one currency for another at an agreed exchange price on the over-the-counter (OTC) market.
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The foreign exchange market is the "place" where currencies are traded. Simply put, it's how individuals and businesses convert one currency to another. Just like stocks, you can trade currency based on what you think its value is (or where it's headed). But the big difference with forex is that you can trade up or down just as easily. If you think a currency will increase in value, you can buy it. If you think it will decrease, you can sell it.

There are actually three ways to trade forex: the spot market, the forwards market and the futures market.

The spot market is where currencies are bought and sold according to the current price. The price is determined by supply and demand, current interest rates, economic performance, sentiment towards ongoing political situations (both locally and internationally), as well as the perception of the future performance of one currency against another. The spot market is the "underlying" real asset that the forwards and futures markets are based on.

Unlike the spot market, the forwards and futures markets do not trade actual currencies. Instead they deal in contracts that represent claims to a certain currency type, a specific price per unit and a future date for settlement. In the forwards market, contracts are bought and sold OTC between two parties, who determine the terms of the agreement between themselves. In the futures market, futures contracts are bought and sold based upon a standard size and settlement date on public commodities markets.

Currencies are exchanged directly between two parties, in what is called an over-the-counter (OTC) market. What that means in principle is that the forex market is run across a global network of banks, spread across four major forex trading centres in different time zones: London, New York, Sydney and Tokyo. And with no central location that trades have to go through, you can trade forex 24-hours a day.

Buying Goods or Services Abroad

This is the form of forex trading that most people are familiar with. Whenever an individual or a business needs to buy something in a different currency, a forex trade must be made. So for practises like international trade, forex is essential.

Speculation

Traders speculating on forex prices will not plan to take delivery of the currency itself, instead aiming to take advantage of movements in the market. You can take advantage of forex movement using leveraged products like spread betting or CFDs.

What is Leveraged Forex?

If prices are quoted to the hundredths of cents, how can you see any significant return on your investment when you trade forex? The answer is leverage. The products we offer for trading forex are leveraged, meaning that you only need to put up a fraction of the total value of your position.

When you trade forex, you're effectively borrowing the first currency in the pair to buy or sell the second currency. With a US\$5-trillion-a-day market, the liquidity is so deep that liquidity providers—the big banks, basically—allow you to trade with leverage. To trade with leverage, you simply set aside the required margin for your trade size. If you're trading 200:1 leverage, for example, you can trade £20,000 in the market while only setting aside £100 in margin in your trading account. This gives you much more exposure, while keeping your capital investment down.

But leverage doesn't just increase your profit potential. It can also increase your losses, which can exceed deposited funds. When you're new to forex, you should always start trading small with lower leverage ratios, until you feel comfortable in the market.

Your profit or loss, however, is based on the full position so it's possible to gain or lose a sum much larger than your initial outlay. While trading this way requires careful risk management, many traders use leveraged products to magnify their exposure in the market at a cost much lower than that of owning the underlying asset.

All forex trades involve two currencies because you're betting on the value of a currency against another. Think of EUR/USD, the most-traded currency pair in the world. EUR, the first currency in the pair, is the base, and USD, the second, is the counter. When you see a price quoted on your platform, that price is how much one euro is worth in US dollars. You always see two prices because one is the buy price and one is the sell. The difference between the two is the spread. When you click buy or sell, you are buying or selling the first currency in the pair.

Let's say you think the euro will increase in value against the US dollar. Your pair is EUR/USD. Since the euro is first, and you think it will go up, you buy EUR/USD. If you think the euro will drop in value against the US dollar, you sell EUR/USD. If the EUR/USD buy price is 0.70644 and the sell price is 0.70640, then the spread is 4 pips. If the trade moves in your favour (or against you), then, once you cover the spread, you could make a profit (or loss) on your trade.

Forex Trade Example

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An investment in knowledge, always pays the best interest.
- Benjamin Franklin

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Leveraged Forex Example - 2000:1

Loss Scenario

Margin Requirement (Your Funds)
£950

EUR/USD
SELL Spread - 4 pips BUY
0.70609 ← 0.70613 **-0.05%**

Leveraged Market Position
£1,999,000

Loss inc. spread = £-1,173.91*

Margin Requirement (Your Funds)
£1000

EUR/USD
SELL Spread - 4 pips BUY
0.70644 ← 0.70640 **+0.05%**

Leveraged Market Position
£2,000,000

Profit Scenario

Margin Requirement (Your Funds)
£1050

EUR/USD
SELL Spread - 4 pips BUY
0.70679 ← 0.70683

Leveraged Market Position
£2,001,000

Profit inc. spread = £826.08*

*The above example is for illustrative purposes and is not necessarily demonstrative of offered leverage rates or spreads, furthermore the example does not take into account commission costs or holding fees which would impact profit and loss.

The value of currencies may fall as well as rise. Past performance is not necessarily a guide to future performance. Using leveraged products such as Spreadbets and CFD's comes with significant risks and you can also lose more than your initial deposit. Equitrade Capital Ltd is authorised and regulated by the Financial Conduct Authority.

What are the risks?

Leveraged forex trading is considered high risk and therefore, generally, they are not suitable for most retail investors. This is because while you only need to put up a fraction of the capital compared to the actual size of the trade, your profits and losses are based on the trade's notional value and losses can therefore quickly exceed the size of your initial deposit.

FX prices are influenced by a range of different factors, including interest rates, inflation, government policy, employment figures and demand for imports and exports.

And because of the sheer volume of currency traders and the amount of money exchanged, price movements can happen very quickly, making currency trading not only the largest financial market in the world, but also one of the most volatile.

This makes it essential that you take steps to manage your risk.

Discuss and agree a trading strategy with your Personal Broker which matches your appetite for risk and investment goals. Be clear on what you are prepared to risk and keep your Broker informed of any changes to your financial circumstances.

Ease yourself in

Trade with reduced minimum sizes for an initial period until you become more familiar with market movements and volatility. Adjust your positions according to your risk tolerance.

Stop Losses - Knowing your limit

To limit losses there is the opportunity to choose 'stop loss' limits. This automatically closes your position when it reaches a price limit of your choice. Although there are some circumstances in which a 'stop loss' limit is ineffective - for example, where there are rapid price movements, or market closure. Stop loss limits cannot therefore always protect you from losses.

Limiting your Leverage

The higher the leverage, the faster you gain profit or loss. If you lose, it may be because of over leveraging - meaning you chose a leverage level with a risk too high to reasonably manage. While trading with smaller investments is an attractive option for avoiding over-leveraging, it also reduces your potential profit. You should carefully select your leverage according to your account volume, appetite for risk and financial circumstances. It's important to calculate your order sizes with enough trade capital available to outlast unexpected market movements.

Hedging

As FOREX allow you to short sell and therefore profit from falling currency prices, a hedging strategy is often implemented. Direct hedging is when you place a trade that buys a currency pair and then at the same time you can place a trade to sell the same pair. While the net profit is zero while you have both trades open, you can make more money without incurring additional risk if you time the market just right.

The way a simple forex hedge protects you is that it allows you to trade the opposite direction of your initial trade without having to close that initial trade. The advantage of using the hedge is that you can keep your trade on the market and make money with a second trade that makes profit as the market moves against your first position. When you suspect the market is going to reverse and go back in your initial trades favor, you can set a stop on the hedging trade, or just close it. Whether hedging is a suitable strategy for your portfolio will depend on your personal circumstances.

Hedging can be a bigger part of your trading plan if done carefully. It should only be used by if you are experienced in and understand market swings and timing. Playing with hedging without adequate trading experience could be a disaster for your account.

Managing your Risk

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Equitrade Capital employs a range of risk management techniques during the life-cycle of a trade to help protect your position

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Who Trades Leveraged Forex?

If you already actively trade the financial markets, adding leveraged forex to your portfolio is an alternative way to take advantage of price movements, without having to buy the underlying asset.

The risks involved mean that leveraged forex trading isn't suitable for everyone, but it generally attracts:

- Share, commodity and index traders looking to diversify their portfolios
- People with an interest in currency markets and the factors that affect their volatility
- Those looking to earn larger returns on their investment capital, through leverage

Make efficient use of your capital with leveraged trading, and get exposure in the markets for only a small proportion of the notional price of your trades.

- Take a position with a fraction of the capital needed for the equivalent cash trade
- Leaves the remainder of your capital free for a range of positions
- You can back markets to fall, as well as rise
- It's tax-efficient – spread betting is tax-free – CFDs are tax deductible.

Tax laws are subject to change and depend on individual circumstances. Tax law may differ in a jurisdiction other than the UK.

The Benefits of leveraged Forex Trading