

April 2006 • Strategies, News and Analysis for Forex Traders

CURRENCY TRADER



Volume 3, No. 4



BATTLE OF THE BUCKS

U.S. dollar vs. Canadian dollar

TOP CURRENCY TRADERS OF 2005

**HEDGING OVERSEAS INVESTMENTS
WITH THE DOLLAR INDEX**

CANDLESTICK REVERSAL PATTERNS

UNDERSTANDING FOREX SUPPLY AND DEMAND

YEN WATCH: JAPAN SET TO RAISE RATES?



Contributors6

Industry News

Japan signals intention to raise rates8

What does Japan's decision to abandon its zero interest-rate policy mean for the yen and other currencies?
By Currency Trader Staff

FXCM pulls plug on Refco negotiations8

Forex firm abandons acquisition — for now.

Forex brokerages take different routes to execution9

Which brokerage you use can have a big impact on how your forex trade is handled.

Global Markets

Dollar/Canada bounces off notable low10

Has the U.S./Canadian dollar rate established a significant low?
By Currency Trader staff

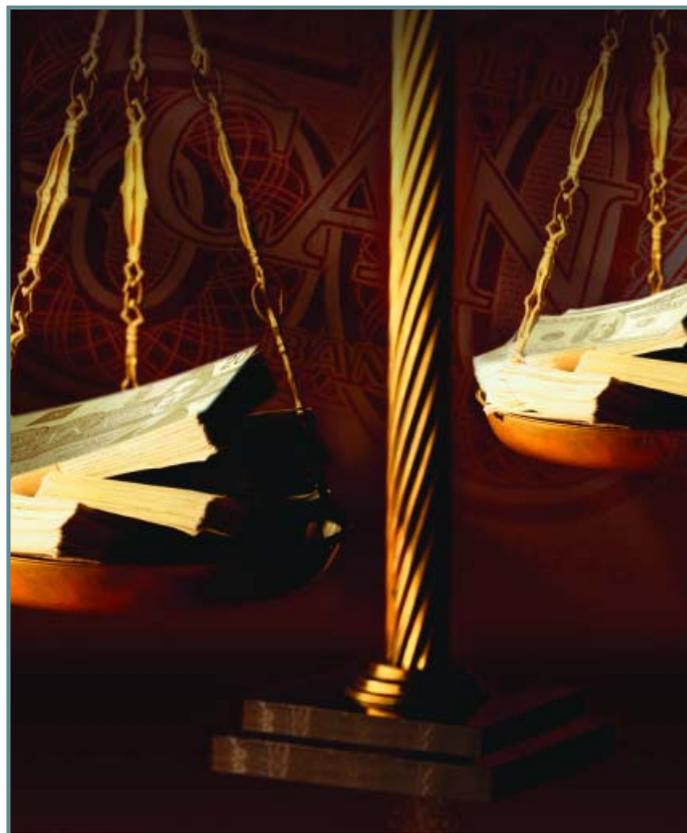
British pound waffles in a range12

What will happen to the British pound this year?
By Currency Trader staff

Spot Check:

Canadian dollar14

A look at what the stats say about the Canadian dollar's longer-term performance after months like March 2006.
By Currency Trader staff



On the Market

Top currency traders of 200518

A summary of last year's best-performing professional currency traders.
By Currency Trader staff

Big Picture

Supply and demand in the FX market20

Analyzing ongoing battle of bulls and bears in the currency market.
By Barbara Rockefeller

Advanced Concepts26

The index approach to currency risk management

Using dollar index futures to hedge non-dollar investments.
By Howard L. Simons

continued on p. 4



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The Technical Analyzer

Live Trading Signals Based On Technical Analysis

Technical Analysis Alerts Candlesticks

Alerts	Technical Analysis	Candlesticks																																																										
<table border="1"> <thead> <tr> <th>Ticker</th> <th>Time (GMT+1)</th> <th>Title</th> <th>MM20</th> <th>MM50</th> <th>MM20_50</th> <th>MACD_SL</th> <th>MACD_0</th> <th>Bollinger</th> <th>RSI70</th> <th>RSI80</th> <th>Volume</th> <th>Period</th> </tr> </thead> <tr> <td>JPY</td> <td>2006/02/15 17:33</td> <td>USD/JPY</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td>117.39</td> <td>1 day</td> </tr> </table>	Ticker	Time (GMT+1)	Title	MM20	MM50	MM20_50	MACD_SL	MACD_0	Bollinger	RSI70	RSI80	Volume	Period	JPY	2006/02/15 17:33	USD/JPY									117.39	1 day	<table border="1"> <thead> <tr> <th>Ticker</th> <th>Time (GMT+1)</th> <th>Title</th> <th>Candlestick</th> <th>Last</th> <th>Opinion</th> <th>Invalidation</th> <th>Period</th> </tr> </thead> <tr> <td>JPY</td> <td>2006/02/15 17:28</td> <td>USD/JPY</td> <td>Piercing line</td> <td>117.53</td> <td>+</td> <td>117.39</td> <td>1 day</td> </tr> </table>	Ticker	Time (GMT+1)	Title	Candlestick	Last	Opinion	Invalidation	Period	JPY	2006/02/15 17:28	USD/JPY	Piercing line	117.53	+	117.39	1 day	<table border="1"> <thead> <tr> <th>Ticker</th> <th>Time (GMT+1)</th> <th>Title</th> <th>ST</th> <th>Chg</th> <th>Mf</th> <th>Chg</th> <th>Last</th> </tr> </thead> <tr> <td>EUR</td> <td>2006/02/16 13:07</td> <td>EUR/USD intraday update: Buyzone expected</td> <td>+</td> <td>-</td> <td>+</td> <td>-</td> <td>1.187</td> </tr> </table>	Ticker	Time (GMT+1)	Title	ST	Chg	Mf	Chg	Last	EUR	2006/02/16 13:07	EUR/USD intraday update: Buyzone expected	+	-	+	-	1.187
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Currency Strategies32

Applying candlestick analysis to the dollar/yen

A look at different candlestick patterns that formed in the dollar/yen rate over the past year.
By Darrell Jobman

Currency System Analysis

The Trend Strength Crossover indicator36

Currency Futures39

Merc, China hook up on forex trading

The Chicago futures exchange will soon offer electronic trading access to forex products to Chinese institutions and investors.

The Business of Trading40

Spot forex taxation: The case for “60/40” treatment

Tips for tax treatment of spot FX contracts.
By Roger D. Lorence, LLM

Global News Briefs43

Economic news from around the world.

International

Market Summary44

Events/New Products46

Key Concepts47

Forex Trade Journal48

Low volatility readings indicate a potential price move.

Global Economic Calendar50

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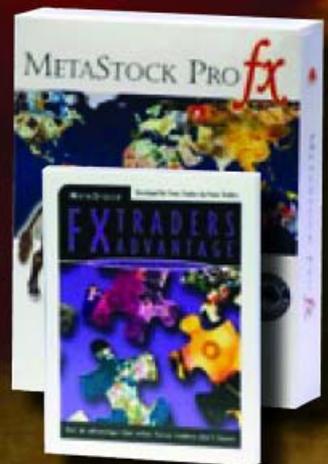
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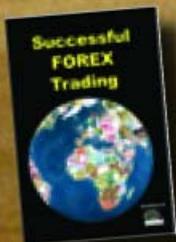
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No more easy money

Japan signals intention to raise rates

BY CURRENCY TRADER STAFF

At its March 9 meeting, the Bank of Japan (BOJ) voted to end its ultra-loose monetary policy, which has kept its overnight interest rates at zero percent for five years. While a hike in the actual rate will not likely occur until the third quarter, analysts say the BOJ has begun to end its so-called “quantitative easing” stance.

With incipient signs of inflation showing up in Japan’s core consumer price index for three consecutive months, BOJ policy makers have effectively begun to tighten monetary policy. The BOJ’s quantitative easing policy had the aim of increasing liquidity in the country’s commercial

Door still open a crack, though

FXCM pulls plug on Refco negotiations

On March 20, spot currency brokerage Forex Capital Markets (FXCM) announced it had ended negotiations with the creditors to acquire the assets of Refco F/X Associates, the unregulated currency trading arm of bankrupt clearing firm Refco.

Refco F/X Associates customers have been in limbo — unable to retrieve their frozen account funds — since Refco collapsed because of an accounting scandal on the heels of its successful IPO last year.

In November 2005 FXCM agreed to acquire Refco F/X Associates for approximately \$110 million through an auction process and subject to bankruptcy court approval. Although it won the auction in February 2006 (it was the only firm that made an actual bid), Refco’s creditors rejected FXCM’s bid as too low. After raising its bid to \$130 million, FXCM claimed in a press release that Refco has been “unresponsive to FXCM.”

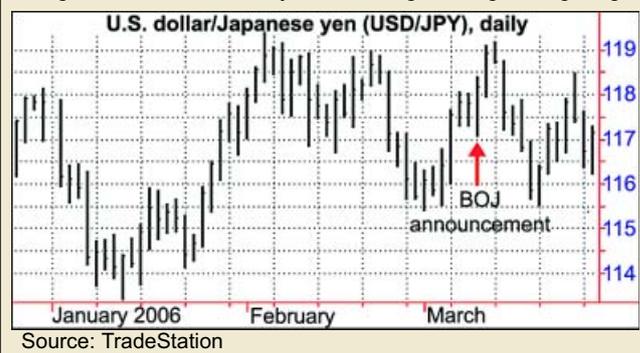
“While our hope remains to effect a transaction, the creditors’ demands remain unreasonable and their position inflexible,” the press release quotes FXCM Chief Executive Officer Drew Niv as saying. “They leave us no choice but to abandon negotiations at this time.”

Despite the fracture, FXCM’s announcement seems to leave open the possibility of future negotiations.

“We have done everything in our power to rescue the clients of Refco FX Associates,” Niv says. “From the very beginning our purpose has been to make their 17,000 clients whole. If successful, our efforts would have meant that every one of the 17,000 Refco F/X customers would have been paid back in full.”

FIGURE 1 — RANGE-BOUND YEN

The BOJ’s March 9 announcement that it would end its zero interest-rate policy resulted in a brief rally in the yen, but not enough to move the currency out of a longstanding trading range.



banking system, with a target at 30-35 trillion yen.

“Their plan is to gradually remove quantitative easing,” explains Naomi Fink, senior currency analyst at BNP Paribas, adding that this process could take from three to six months. “They are reducing [liquidity] to six trillion, which is viewed as normal demand for overnight cash in the market.”

But for now, most market watchers believe the BOJ will hold off on an actual rate hike until the third or fourth quarter of this year. BNP Paribas expects a .25 basis point hike in the third quarter, while Credit Suisse is anticipating a .25 basis point hike as early as October, with both firms seeing just one move this year.

“Not much is likely to happen for many months now,” says Clyde Wardle, currency strategist at HSBC.

Potential market impact

For years, global investment players have put on positions via the so-called “yen carry trade.” Basically, traders borrowed money in Japan at low rates and invested in other currencies around the world. Analysts say the carry trade has been utilized across virtually all types of financial assets and risk exists for a massive unwinding once those positions no longer become profitable.

In 2005, the dollar/yen pair (USD/JPY) posted a hefty rally from around 101.60 to 121.41 by December. Growing economic conditions and a rising rate environment in the U.S. were seen as key factors supporting that rally. Since early 2006, dollar/yen has shifted into a sideways consolidative type of environment (see Figure 1). The pair has been confined to roughly the 114-120 region for the past several months.

The bottom line is the removal of quantitative easing is essentially the beginning of a tightening of monetary policy, which should ultimately be a bullish factor for the yen.

However, Fink believes the dollar/yen will likely remain range-bound between the 115-121 zone for the remainder of the first half of the year.

Looking into the second half, Fink points to the potential for a slowing in U.S. and global growth. That could translate into a weaker appetite for Japanese players to invest abroad, which would weigh on dollar/yen. Fink forecasts a decline in dollar/yen in the third quarter below the recent support zone, with a target of 109 by year-end.

Forex brokerages take different routes to execution

As the interest in retail trading of foreign exchange continues to expand, so does the battle for brokerage firms attempting to capture those traders.

However, not every forex brokerage is alike. There are differences in the way they handle and execute trades, and each brokerage, obviously, touts their way as being the best.

Every forex firm has a trading desk, but how that desk functions and how it is staffed are very different. Ridgewood, N.J.-based FX Solutions has only two or three employees on a desk per shift because of the efficiency of their technology, according to head of trading Michael Cairns.

“As the company and the market evolved, huge foreign exchange desks weren’t a necessity,” he says. “I know other firms have 30-person desks, and my question is, why do you need that many people? We have a scalable platform. All our customers are going to be treated the same, whether they have \$500 or \$5 million.”

Drew Niv, CEO of FXCM, says his firm has a 40-person trading desk. He takes issue with firms that claim to act as forex “ECNs” — meaning, they simply match customer orders with other customer orders — because he believes that model creates accountability issues.

“Since we are the counter party to all of our customer’s transactions, if a customer feels he was cheated out of a trade — a stop was missed or something like that — he can complain directly to us because we were on the other side,” Niv says. “When you are using a third-party trading desk, there is no accountability.”

FXCM and FX Solutions are firms devoted exclusively to forex. Other firms that are primarily futures brokerages but have added forex trading capabilities often handle things differently.

XPRESSTRADE, a Chicago-based futures brokerage, has a trading desk staffed with salespersons versed in forex trading. However, when it comes to the actual execution of the trades, XPRESSTRADE routes its orders to a forex market maker.

“If we wanted to do forex here we could,” says Dan

O’Neil Jr., principal of XPRESSTRADE. “But our bread and butter is futures brokerage. Market making is a different game, so we wanted to leave that to a company [that specializes in that].”

Regardless, all firms agree they want to minimize the amount of human interaction that occurs in a trade.

“Any time a human gets involved, it calls into question the integrity of your system,” Cairns says. “The fact there is a human involved means you’re not sure of your actual pricing. To be successful, you have to be getting the ultimate price. If someone is touching that price or there is somebody in between you and getting that price, to me, that’s a problem.”

Niv says that while extraordinarily large trades — trades worth tens of millions of dollars — must be handled manually, the majority of the trades at FXCM are executed without any intervention from the trading desk.

“Because we do so many trades every day, it is not humanly possible for a desk of 40 people to execute them,” he says. “Our system is structured to be an internal matching engine. The dealers don’t have control over spreads. There is an independent feed that handles spreads.”

While Niv believes a smaller trading desk can lead to increased human interaction, Cairns counters that by saying smaller is better — if your system is good.

“We are totally confident in our price discovery,” Cairns says. “We have heard of some companies that are continually monitoring the rates and ticking them up or down manually because they are not certain of pricing. If you get a re-quote or the price moves, you have to question why somebody needs 30 people sitting on a trading desk.

“We manage our risk with scientific algorithms, so we are continually in the market offsetting risks. Our role for the trading desk is customer support. If somebody’s computer blows up, we can put on a trade for them, but we’re not touching our rates. We rely on our system. If you’re employing 30 traders, that money could be better spent making sure your systems are safe and secure.”





Dollar/Canada bounces off notable low

After reaching a nearly 15-year low, the U.S./Canadian dollar rate bounced sharply higher.

Has the market put in a bottom, or is this just another bounce to sucker in buyers?

BY CURRENCY TRADER STAFF

The U.S. dollar/Canadian dollar (USD/CAD) plunged to a nearly 15-year low at just under 1.13 in early March (Figure 1). But almost as soon as it did that, bullish forces seized control of the market and drove the pair as high as \$1.1650 as of mid-March.

Is it another bounce or a sign of a real trend change? Dollar/Canada has been in a massive downtrend for more than four years (Figure 2). Some market watchers and currency analysts are saying the \$1.13 level — which is as low as the Dollar/Canada rate has been since November 1991 — could be a formidable support zone for months to come.

Before looking at what's ahead for the Dollar/Canada, let's examine the fundamental factors that allowed the Canadian dollar to appreciate significantly vs. the U.S. dollar in recent months.

Canadian fundamentals: Riding the commodity wave

Rising worldwide commodity prices, rate hikes by the Bank of Canada (BOC), and increasing domestic demand have all helped support the Canadian dollar in recent months.

The Canadian dollar is considered to be one of the world's "commodity currencies," as it is a major exporter of a wide variety of commodities. Crude oil, natural gas, and coal comprise a large portion of Canadian commodity exports. But the country also exports agricultural products, including grains, wheat, and livestock. Additionally, the country is a large lumber exporter and produces and exports a number of metals including gold, silver, aluminum, and copper. (For a breakdown of the weighting of Canadian commodity exports, check

out the [Bank of Canada's Commodity Price Index](#)).

"Canada has seen a rising terms of trade, as commodities have soared the past couple of years," notes David Powell, currency analyst at Ideaglobal in New York.

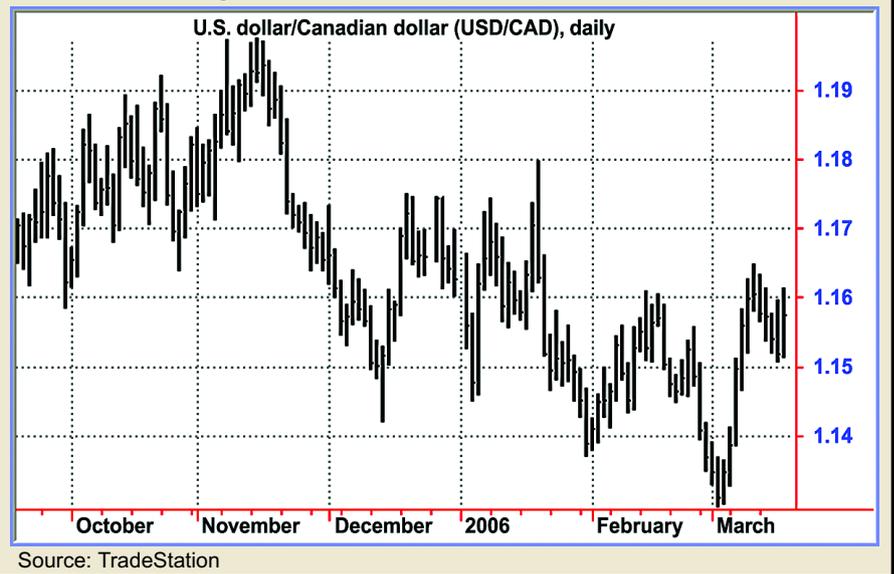
A look at the Reuters Jefferies CRB Index reveals a monumental bull move from the October 2001 low at 182.83 to the February 2006 peak at 364.28 (the index has retreated slightly into mid-March). The huge worldwide rally in commodities directly boosted Canada's economy and currency.

The BOC has also been hiking rates over the past couple of years, albeit at a slower rate than the U.S. Fed. Since September 2004, the BOC nudged its overnight call rate from 2.00 percent to 3.75 percent as of early March.

Finally, solid macroeconomic factors helped to support the Canadian currency in recent years.

FIGURE 1 — DAILY DOLLAR/CANADA

After dropping to a low of 1.1298 on March 2, dollar/Canada rallied sharply before consolidating around 1.15.



Economic data

The Canadian economy has been churning out respectable growth numbers. For 2005, gross domestic product (GDP) came in at 2.9 percent. That is just slightly below the Bank of Canada's 3.0 percent capacity target.

"The Canadian economy has been in very good shape the past couple of years," says Ideaglobal's Powell. "It's on track and right where they want it to be."

Charmaine Buskas, economist at Moody's Economy.com, agrees economic fundamentals are still very strong in Canada. Looking ahead to this year, Buskas has forecast a 3.2 percent GDP rate for Canada, while Ideaglobal expects a 3.1-percent reading.

Inflation data has been extremely well behaved in Canada, with the latest February Consumer Price Index core rate at 1.7 percent, below the BOC's 2.0-percent target.

Finally, in stark contrast to its neighbor to the south, Canada currently boasts a "twin surplus," in both its fiscal and current account readings. In 2005, Canada chalked up a \$30.2 billion (Canadian) surplus, vs. the U.S. 2005 \$804.9 billion current account deficit.

The end of the commodity boom?

While the Reuters Jefferies CRB Index remains quite firm into mid-March, crude oil prices have retreated modestly from 2005 highs. Front-month crude futures spiked to a high of \$70.85 per barrel in September 2005, but have recently been trading around \$60 to \$64 per barrel region.

Meanwhile, in early 2006 gold futures pushed above the \$500 mark for only the third time since the early 80s. A modest pullback has occurred since the yellow metal topped \$575, with the front-month futures dropping to 534 before rebounding to the \$555 area in mid-March.

Looking at the global cycle, Buskas says "the global commodity cycle is showing signs of fatigue, which could keep a lid on sustained major gains in the Canadian dollar. Demand is drying up — Canada's major resources cycle is slowing."

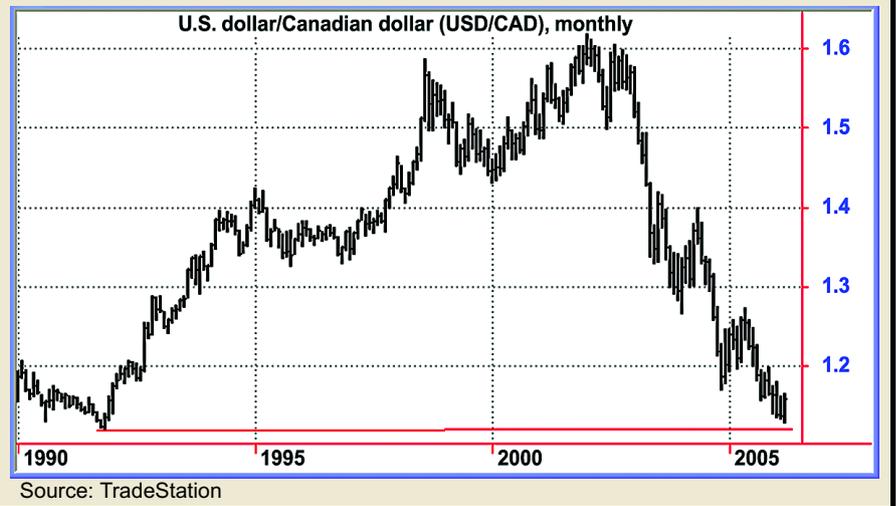
Buskas believes export activity will slow in lumber and the base metals, including copper and iron. A global commodity cycle, she explains, is generally a multi-year affair.

"Typically, a lot of base metals and

input commodities get bid up earlier in the cycle as they are needed to help build up the infrastructure," she explains. "The strength of the commodity cycle has been a blessing to the Canadian economy, but commodities are cyclical. It rais-

FIGURE 2 — WEEKLY DOLLAR/CANADA

The currency pair's recent low came close to matching a nearly 15-year low set in 1991.



es red flags because growth has been so dependent on commodities."

Monetary policy

Another critical piece of the currency outlook puzzle is future action by the BOC. Up until the March 7 BOC meeting, most currency watchers had been forecasting another interest-rate increase at the April 25 meeting. In the wake of new wording from the March 7 meeting, however, many now believe the BOC will keep the overnight call rate at 3.75 percent through the April meeting.

"Previously, the BOC had said that another tightening *would* be necessary, but on March 7 they basically said

continued on p. 13

U.S./CANADIAN DOLLAR AT A GLANCE

Average daily range (past 40 days): 0.0079							
Average weekly range (past 26 weeks): 0.0179							
52-week high/low: 1.2733/1.1297							
			U.S.		Canada		
Prevailing interest rates (%)			4.75		3.75		
Next central bank meetings			May 10		April 25		
GDP		Q4 2005*		Q3 2005		Q2 2005	
	USD	CAD	USD	CAD	USD	CAD	
	1.7	2.5	4.1	3.5	3.3	3.6	
*Estimate			All data as of April 3				



British pound waffles in a range

The British pound has traded in a fairly narrow range so far this year, but it could drop lower if support gives way.

BY CURRENCY TRADER STAFF

For those looking for a range-bound market to trade, the British pound just might fit the bill. For months now, the pound sterling has been bouncing back and forth within a fairly well-defined trading range between roughly 1.71 on the downside and 1.7625 on the upside. Regarding expectations for a breakout anytime soon, most market watchers said the equivalent of “don’t hold your breath.”

One of the key factors holding the sterling in a consolidation is the Bank of England’s (BOE) monetary policy outlook. With the overnight rate currently standing at 4.50 percent, the next move expected by the BOE later this year is a rate cut. But, for now, the Bank is seen as “on hold.”

“Because the BOE is on hold, there has been no real structural demand for sterling lately,” says Jamie Coleman, managing analyst at IFR-Forex Watch.

The steady monetary policy outlook from the BOE contrasts

sharply with other major central banks around the world, which are still perceived to be in a tightening mode. That includes the U.S. Fed, the ECB, and even the [Bank of Japan](#).

Looking at the chart

Figure 1 shows a weekly chart of the British pound. Since January, the currency has waffled between support at 1.7186 to 1.7230 on the downside and a push to a spike high at 1.79. However, better intervening resistance levels appear at 1.7625 and then 1.78. Most analysts contacted saw a bearish bias for the pound in the months ahead, with a test of major support at the 1.72 area likely.

Pointing to that level, Tim Mazanec, senior forex strategist at Investor’s Bank & Trust, says, “We’ve tested that multiple times. But I think that eventually gives way. It will be like a dam giving way and we could see significant losses.”

Bearish interest-rate outlook

One of the main fundamental factors pressuring the pound in the months ahead is a bearish interest-rate differential picture. Mazanec believes the U.S. Fed will remain aggressive in their monetary tightening, with room to hike rates toward 5.50 percent by year-end. That contrasts sharply with the BOE.

“[The BOE] cut rates once in 2005 and will be forced to cut rates potentially two times this year,” Mazanec says.

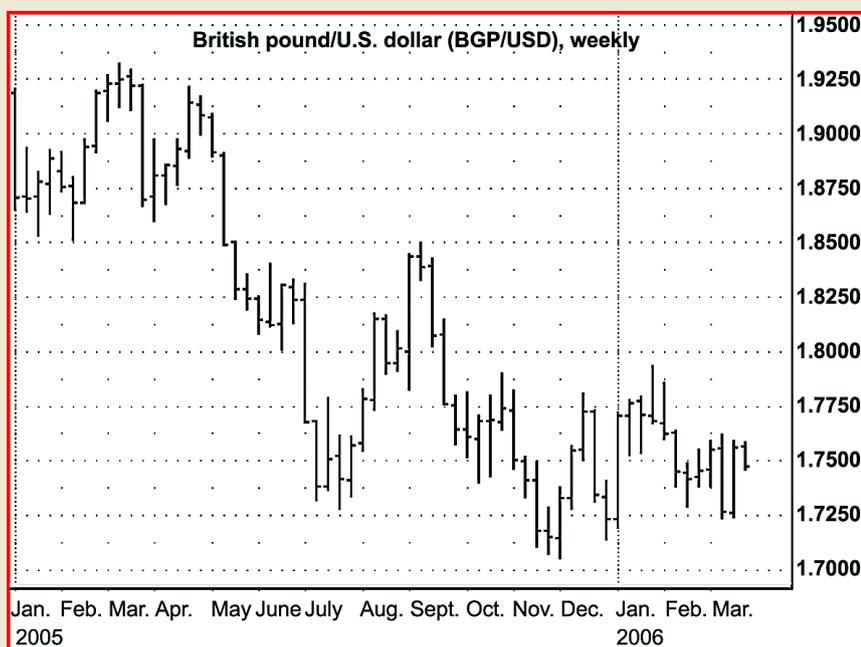
Sean Callow, senior currency strategist at Westpac Institutional Bank in Singapore agrees, but he is only predicting one rate cut.

“We expect the BOE to cut the repo rate 25 basis points in the third quarter,” he says.

Analysts agree a rate cut by the BOE will likely spell further weakness for the pound. Mazanec says a break of 1.72 would open the door for a bearish swing down toward the 1.65 area, a

FIGURE 1 — BRITISH POUND — RANGE-BOUND IN 2006

The British pound has traded between 1.7186 and 1.79 since the beginning of 2006.



Source: eSignal

BRITISH POUND/U.S. DOLLAR AT A GLANCE

Average daily range (past 40 days): .0014
Average weekly range (past 26 weeks): .0294
52-week high/low: 1.9217/1.7047

	UK		U.S.			
Prevailing interest rates (%)	4.5		4.75			
Next central bank meetings	April 6		May 10			
GDP	Q4 2005*		Q3 2005		Q2 2005	
	GBP	USD	GBP	USD	GBP	USD
	0.6	1.7	0.5	4.1	0.5	3.3

*Estimate

All data as of April 3

zone he expects to hit by the third quarter. On a 12-month outlook, he is calling for additional weakness to the 1.58 zone.

Callow's firm expects to see the pound at 1.72 three months out, with a 1.68 target in six months.

Analysts at Credit Suisse were also bearish. In the March 17 edition of *Global Economy This Week*, the firm wrote "with the BOE on the sidelines, the erosion in carry should keep overvalued sterling on the defensive." The analysts highlighted a 3-month target at 1.71 and a 12-month forecast at 1.65.

Economic data

For those trading the pound, Mark Smyth, currency analyst at XPRESSTRADE, suggests keeping a close eye on retail sales data and housing market numbers.

Looking at the latest UK economic news, February retail sales posted a rebound after lackluster January figures. In February, retail sales jumped 2.1 percent on a year-over-year basis. On the employment front, recent data suggests modest improvement. Total employment fell by less than 10,000 over the last three-month period, as seen in the January data. That compares favorably to the more than 50,000 drop in the previous month.

Callow forecast a 2.1-percent UK gross domestic product (GDP) number for 2006. He notes the housing market is a factor, which has shown recent strength.

"Prices boomed in 2001-2003, then cooled off sharply in late 2004-2005," he says. "But in recent months [prices] have been showing recovery."

"They've had relatively poor consumer demand in the last six to nine months," Coleman adds. "Their economy isn't doing badly, but it is not trending up like most of the global economies."

On the crosses

The euro/pound recently hit a new multi-month high, and analysts see room for the euro to continue strengthening against the pound.

"We see risks of further gains in euro/sterling as the ECB keeps tightening to 3.0 percent, producing an unusually narrow gap between the ECB and BOE benchmark rates," Callow says.

He and other economists saw potential for that cross to hit the 0.7000 level and even move beyond it in the weeks ahead.

Bottom line

"The pound is going to weaken," Mazanec says. "Traders could look at any rallies in the pound to sell them, [but] the so-called 'line in the sand' has been there for a couple of months now, so you need to be a little patient." ☺

Canadian dollar *continued from p. 11*

another tightening *might* be necessary," says Brian Dolan, director of research at Gain Capital.

Ideaglobal analysts believe the BOC will pause with their rate hikes in April, but that one more rate hike is likely before the end of 2006.

"Inflation has remained subdued," says Powell. "We do look for another rate hike before the end of 2006, but the timing is uncertain. The Bank is going to need to see further upticks in that core inflation rate. It will be very data-dependent."

"The interest-rate differential is not going to improve to the advantage of the Canadian dollar anytime soon," Dolan says.

That perception was a major factor putting the brakes of the downtrend in Dollar/Canada in March.

The strength of the Canadian dollar itself may be a factor that allows the BOC to slow its rate hike pace.

"A weak currency imports inflation, while a strong currency tends to shut the door on inflation," explains Dolan. Additionally, Dolan says a strong currency tends to slow

the export sector of the economy, which has the same impact of rate hikes.

The bottom line on the bottom

The March 2 bottom at \$1.1298 could be a significant low for the near to intermediate term for dollar/Canada, according to some analysts.

"There is room for another test of \$1.13, but \$1.10 is out of the question," says Buskas of near-term action for dollar/Canada.

Slowing BOC rate hikes, perhaps accompanied by slower demand for Canada's natural resources, could result in a pause for the multi-year dollar/Canada downtrend.

What should you do in the near term? Dolan suggests to continue to trade from a long dollar, short Canadian dollar bias. If a weekly close above \$1.1650 is achieved, he suggests to become more aggressive in buying dips. Initial chart resistance beyond there is implied at the \$1.1800 level, which is the 2006 high. ☺



Canadian dollar

March was a big month for the U.S./Canada dollar pair. What has happened in similar situations in the past?

BY CURRENCY TRADER STAFF

FIGURE 1 — THIRTY YEARS OF USD/CAD

Dollar/Canada made a nearly 15-month low at the beginning of March, then turned abruptly higher to close above the high of February. Notice that despite the downtrend of the past five years, the USD/CAD rate has, overall, moved up more than it has moved down.



Source: TradeStation

FIGURE 2 — DAILY PERSPECTIVE

Dollar/Canada turned down toward the end of March, which is not surprising given the force of the preceding rally.



Source: TradeStation

The U.S. dollar/Canadian dollar (USD/CAD) formed an outside month in March — a lower low and higher high than February — complemented by a higher close (Figure 1).

Outside months have formed in the USD/CAD 25 previous times since March 1976, and there is some evidence to suggest further upside movement — i.e., U.S. dollar strength vs. the Canadian buck — will follow.

“Dollar/Canada bounces off notable low” highlighted the fact

that the currency pair’s March low of 1.1298 occurred near the level of the late-1992 low (see the chart accompanying the story), which will certainly give reason for chart watchers and pundits to fan the flames of a potential upside move. Another factor is the U.S. Federal Reserve is still in rate-hike mode, having bumped up the benchmark Fed Funds rate on March 28; another increase is expected in May. Higher U.S. rates will make the American dollar more attractive.

Figure 2 shows the market reversed abruptly to the upside after establishing its low on March 2. The rally brought the pair as high as 1.1745 by March 29 before price plunged on March 30, and then rebounded on March 31. At that point the rate was still trading above the February high.

Analyzing other outside months in the USD/CAD rate over the past 30 years revealed a bullish tendency in the subsequent price action, although with any pattern analysis based on a small number of examples extracted from long-term data, the implications must be put in perspective.

Overall picture

After all outside months — regardless of whether they closed higher or lower than the previous month, or by how much — the results were mixed.

Table 1 shows how the USD/CAD performed the six months following all outside months. The average, median, maximum, and minimum moves are shown for the close of each subsequent month (M1, M2, M3, etc.), as well as for the largest up moves (LUM) and largest down moves (LDM) from the close of the outside month to the highs and lows of the six following months. The last two lines show the standard deviations of the various figures, as well as the percentage of times the market was above (>0) the closing price of the outside month.

The percentage of times the USD/CAD was higher or lower than the closing price of the outside month fluctuated from month to month, but had a slight bias toward the upside; the standard deviations indicate the wide probable ranges within which the values could fall, however.

The average returns at the closes of months three to six were negative, but the median returns were positive, which suggests a few large down moves skewed the average values disproportionately lower.

Finally, the average and median LUMs were generally larger than the LDMs at each interval, which implies there was more upside movement than downside movement.

continued on p. 16

TABLE 1 — DOLLAR/CANADA AFTER ALL OUTSIDE MONTHS, MARCH 1976 - MARCH 2006

Performance was mixed after outside months, but there was more of an upside bias than a downside bias. However, this is partially explained by the fact that the market as a whole had an upside bias over the past 30 years.

	M1	LUM	LDM	M2	LUM	LDM	M3	LUM	LDM
Avg	0.0063	0.0154	-0.0088	0.0051	0.0232	-0.0139	-0.0413	0.0278	-0.0178
Med	0.0015	0.0149	-0.0079	0.0039	0.0208	-0.0112	0.0017	0.0217	-0.0148
Max	0.0629	0.0703	0.0000	0.0526	0.0912	0.0000	0.0552	0.0912	0.0000
Min	-0.0260	0.0008	-0.0345	-0.0492	0.0008	-0.0492	-1.1389	0.0008	-0.0590
Std	0.0164	0.0146	0.0082	0.0256	0.0218	0.0113	0.2356	0.0239	0.0151
%>0	60.00%			52.00%			48.00%		
	M4	LUM	LDM	M5	LUM	LDM	M6	LUM	LDM
Avg	-0.0411	0.0312	-0.0187	-0.0400	0.0353	-0.0209	-0.0372	0.0386	-0.0247
Med	0.0042	0.0258	-0.0148	0.0012	0.0340	-0.0151	0.0195	0.0340	-0.0177
Max	0.0552	0.0912	0.0000	0.0618	0.0912	0.0000	0.0738	0.0912	0.0000
Min	-1.1389	0.0008	-0.0590	-1.1389	0.0008	-0.0680	-1.1389	0.0008	-0.0929
Std	0.2353	0.0257	0.0156	0.2367	0.0275	0.0183	0.2381	0.0295	0.0226
%>0	52.00%			48.00%			56.00%		

TABLE 2 — USD/CAD AFTER OUTSIDE MONTHS WITH HIGHER CLOSES

After outside months that closed higher, the USD/CAD rate was more consistent than after all outside months, but the upside bias was again tepid.

	M1	LUM	LDM	M2	LUM	LDM	M3	LUM	LDM
Avg	0.0041	0.0116	-0.0080	0.0069	0.0206	-0.0118	0.0097	0.0278	-0.0157
Med	0.0001	0.0078	-0.0092	0.0083	0.0158	-0.0105	0.0035	0.0209	-0.0133
Max	0.0210	0.0309	-0.0015	0.0440	0.0610	-0.0015	0.0552	0.0610	-0.0015
Min	-0.0077	0.0008	-0.0149	-0.0327	0.0008	-0.0327	-0.0403	0.0008	-0.0454
Std	0.0101	0.0099	0.0040	0.0237	0.0188	0.0085	0.0298	0.0226	0.0123
%>0	50.00%			50.00%			50.00%		
	M4	LUM	LDM	M5	LUM	LDM	M6	LUM	LDM
Avg	0.0048	0.0317	-0.0172	0.0038	0.0331	-0.0204	0.0078	0.0357	-0.0244
Med	-0.0022	0.0274	-0.0138	-0.0001	0.0331	-0.0151	0.0086	0.0331	-0.0157
Max	0.0552	0.0714	-0.0015	0.0610	0.0715	-0.0015	0.0738	0.0857	-0.0015
Min	-0.0296	0.0008	-0.0492	-0.0661	0.0008	-0.0680	-0.0783	0.0008	-0.0929
Std	0.0278	0.0260	0.0137	0.0378	0.0264	0.0191	0.0444	0.0302	0.0251
%>0	42.86%			50.00%			57.14%		



TABLE 3 — AFTER OUTSIDE MONTHS WITH CLOSE ABOVE PREVIOUS HIGH

The post-pattern performance was noticeably more bullish, but there were only nine examples on which to base conclusions.

	M1	LUM	LDM	M2	LUM	LDM	M3	LUM	LDM
Avg	0.0062	0.0119	-0.0071	0.0084	0.0226	-0.0111	0.0102	0.0318	-0.0150
Med	0.0048	0.0079	-0.0062	0.0180	0.0204	-0.0068	0.0134	0.0404	-0.0094
Max	0.0210	0.0309	-0.0015	0.0402	0.0610	-0.0015	0.0470	0.0610	-0.0015
Min	-0.0077	0.0008	-0.0149	-0.0327	0.0008	-0.0327	-0.0403	0.0008	-0.0454
Std	0.0107	0.0104	0.0048	0.0250	0.0193	0.0107	0.0329	0.0234	0.0154
%>0	66.67%			66.67%			55.56%		
	M4	LUM	LDM	M5	LUM	LDM	M6	LUM	LDM
Avg	0.0085	0.0361	-0.0158	0.0105	0.0384	-0.0166	0.0189	0.0409	-0.0189
Med	0.0137	0.0404	-0.0094	0.0208	0.0490	-0.0094	0.0208	0.0490	-0.0094
Max	0.0552	0.0652	-0.0015	0.0610	0.0652	-0.0015	0.0738	0.0776	-0.0015
Min	-0.0296	0.0008	-0.0492	-0.0339	0.0008	-0.0492	-0.0429	0.0008	-0.0492
Std	0.0298	0.0253	0.0163	0.0343	0.0255	0.0167	0.0408	0.0286	0.0194
%>0	55.56%			66.67%			66.67%		

Outside months that closed higher

Focusing on outside months that close above the previous month reduced the number of patterns to 14. Table 2 shows the results.

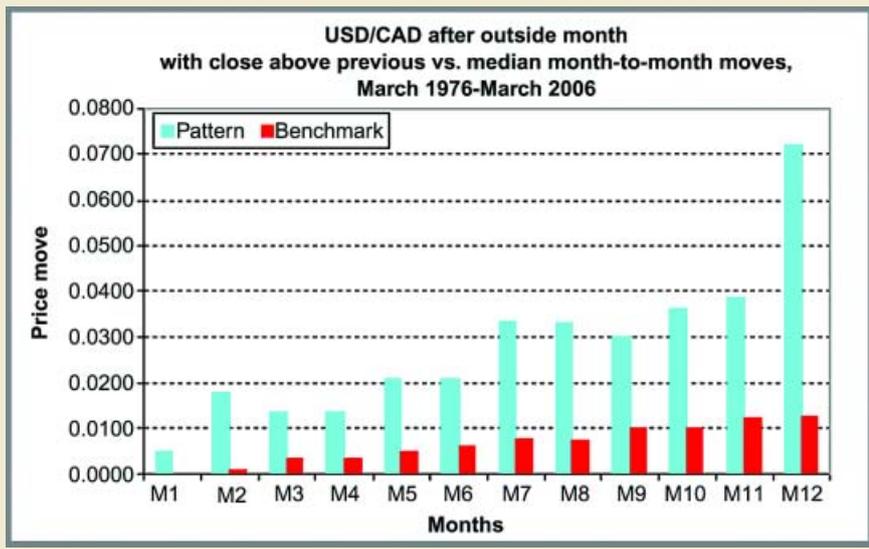
Interestingly, although probabilities for up moves are

the outside month to the close six months later (and was higher seven of nine times), and had gained a maximum of .0409 vs. moving down a maximum of -.0189.

Figure 3 compares median performance at the close of each of the 12 months after outside months that closed higher

FIGURE 3 — BETTER THAN AVERAGE

The USD/CAD rate had a small upside bias over the 30-year analysis window, but the gains after outside months that closed higher than the previous month were larger than the markets typical (median) gains.



than the previous month to the market's median moves for one-month, two-month, three-month, etc., periods during the analysis window. Despite the downtrend that has dominated the past five years, the price action over the entire 30-year analysis period had a minor upside bias.

The post-pattern price gains were consistently larger than the market's typical gains over all time periods. For example, after nine months (M9), the median USD/CAD close was .0300 higher than the close of the outside month. By comparison, the median close-to-close move for all nine-month periods from March 1976 to March 2006 was .0100.

One thing to keep in mind is that after any sharp move such as the March rally: Any market tends to retrace some of that move, even if the move is destined to continue in the long run. ☺



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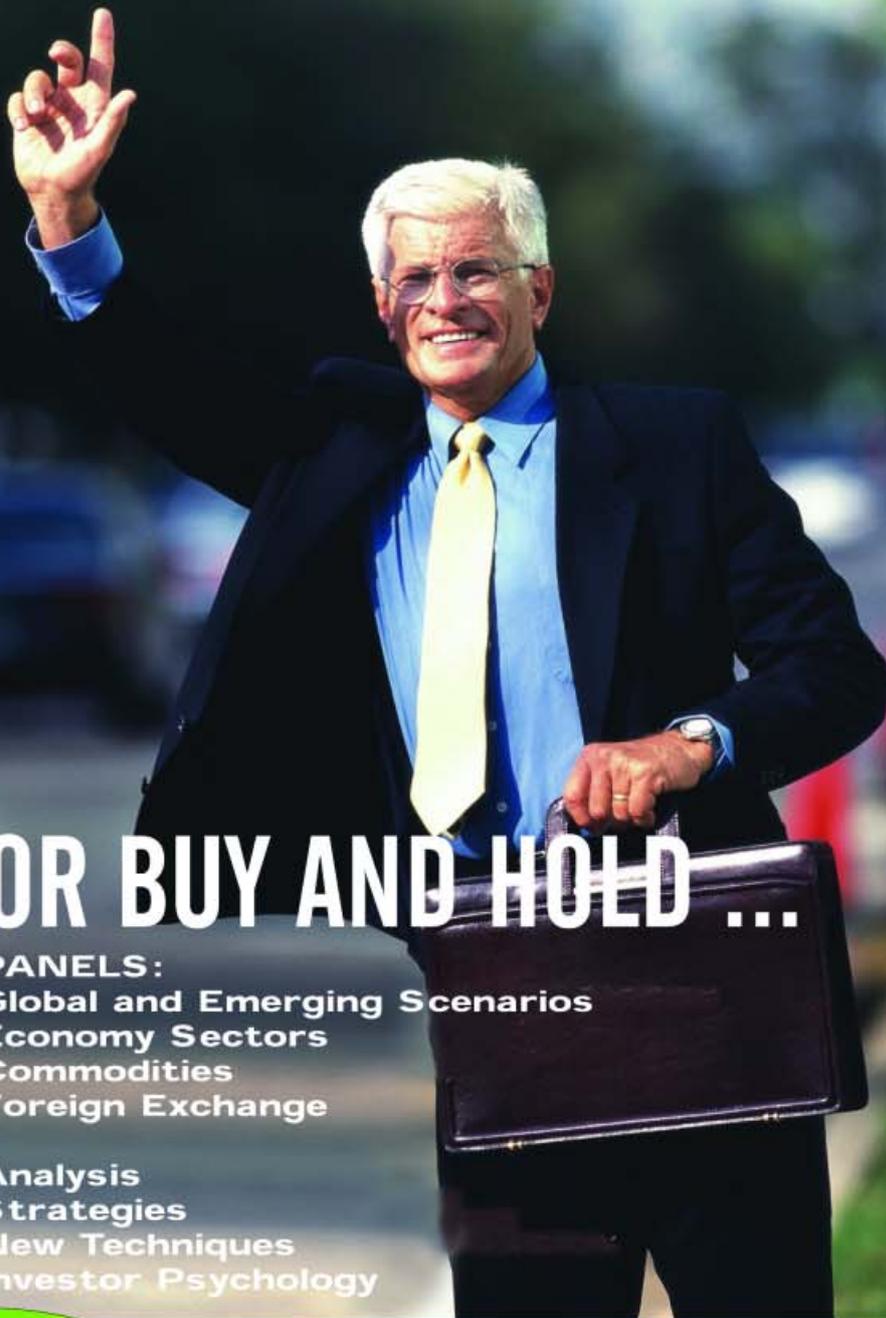
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Top currency traders of 2005

In a lackluster year for professional currency managers as a whole, several forex traders stood out from the bunch.

BY CURRENCY TRADER STAFF

Last year wasn't a great year for professional currency managers — in fact, it was their first down year since 1994 based on the Barclay Currency Trader Index — but that doesn't mean many traders weren't able to extract gains from the market. A few even managed to post some pretty remarkable numbers.

In an industry that includes traders managing a few hundred thousand dollars on a proprietary basis to those managing hundreds of millions of dollars, it's difficult to make apples-to-apples comparisons of all currency managers; trading hundreds of millions of dollars is a different breed of horse than managing a few million. Accordingly, we'll review the 2005 performance of two broad groups of currency managers — those managing less than \$50 million dollars and those managing \$50 million or more. It's not a perfect dividing line, but it provides some basis for putting the numbers in perspective.

Tables 1 and 2 show the top-five currency managers from each group ranked by [Barclay Trading Group, Ltd.](#) The funds under management range from \$1 million to more than a half-billion dollars. Comparing the two tables highlights some of the distinguishing characteristics of large and small currency managers.

First, the returns of the smaller money managers (\$1 million to \$49.9 million) were, overall, roughly twice the size of

those of the currency traders managing more than \$50 million. One probable reason for this is that smaller traders generally trade more aggressively because they are attempting to make a mark in the trading world so they can become bigger traders. On the other hand, bigger traders get more financial reward for maintaining lower-volatility, stable returns; the fewer customer withdrawals they have, the more money on which they earn interest.

Interestingly, though, the larger traders' drawdowns, while relatively low, were nonetheless larger on average than those of the smaller managers in Table 1. However, IKOS Partners currency fund had a triple-threat combination: the second-highest return for the year (19.85 percent), the second-lowest drawdown (1.5 percent), and the most money under management (\$502 million).

Three of the five funds in Table 2 are operated by traders interviewed in past issues of *Currency Trader*: Clarkson Jones of second-ranked Monarch Capital Management ("Clarkson Jones: Art, science, and forex," *Currency Trader*, December 2005); Mario Kelly and Darryl Swain of fifth-ranked Wallwood Consultants ("Wallwood Consultants practices what it preaches," *Currency Trader*, November 2005); and Peter Panholzer of top-returning DynexCorp Ltd. (+52.96), featured in the November 2004 issue of *Currency Trader* ("Peter Panholzer: Currency system architect").

Table 3 ranks the trading programs from Tables 1 and 2 according to their return/drawdown ratios — that is, their 2005 returns divided by their 2005 worst drawdowns. This measure, while hardly definitive, offers a quick way to gauge profits relative to the risk taken to achieve them.

Among the larger traders — those managing \$50 million or more — the rankings remained the same except the funds with the fourth- and fifth-highest returns switched places when ranked by return/drawdown.

The rankings of smaller currency fund managers changed much more. The fund with the fourth-highest return — Spot Forex Management — jumped to first place in the

TABLE 1 — 2005 TOP-5 CURRENCY TRADERS (\$50 MILLION OR MORE)

Ranked by return for 2005 (Jan. 1, 2005 — Dec. 31, 2005)					
Rank	Fund Name	2005 return	Funds (\$ mil.)	Start date	2005 worst drawdown
1	ACT Currency Partners AG	23.16%	\$50.0	Nov. 1994	1.3
2	IKOS Partners (Currency)	19.85%	\$502.2	May 1996	1.5
3	Hathersage (Long Term Currency)	12.69%	\$78.8	Aug. 1991	3.2
4	Appleton Capital (Appleton 25% Risk)	12.59%	\$131.3	Jan. 1995	12.0
5	DKR Capital (DKR Strat. Currency)	12.12%	\$119.0	Jan. 2002	5.9

Source: Barclay Trading Group, Ltd. (www.barclaygrp.com)

Past performance is not necessarily indicative of future results.

return/drawdown rankings, thanks to its miniscule 2005 maximum drawdown of 0.50 percent. The Dynex Corp. Percival fund, which had the highest 2005 return, moved down only one notch to No. 2. Previously fifth-ranked Wallwood Consultants moved up to No. 3.

The DynexCorp Percival program is based on the Market Sentiment Strategy developed by John Percival, according to Panholzer. Percival, who works in an advisory capacity with Panholzer, posted huge returns with the approach in the 80s and 90s. Panholzer says the Market Sentiment Strategy is longer term in nature compared to the “short-term trading fashion of the day,” and describes it as a moderate-leverage program that does not protect its positions with hard stops.

“It probably has the most impressive currency track record between 1989 and 1996, when John Percival’s funds under management at Chescor, London, UK, rose from \$100,000 to \$300 million, with an average annual return of 30 percent,” Panholzer says.

Percival is now retired in France and prefers to trade only for himself. He also publishes *Currency Bulletin* in conjunction with DynexCorp and Panholzer Advisory Corp., who offer the Market Sentiment Strategy exclusively to their clients.

The Percival fund’s discretionary trading principles were laid out in Percival’s out-of-print book *The Way of the Dollar*, which is available only in an online version to investors, according to Panholzer.

“It’s regarded by many as an ‘underground classic’ on currency trading,” he says.

Overall, Panholzer’s funds ended up 10 percent before fees, 6 percent after. Panholzer is optimistic about the immediate future of the forex market, believing a relatively sustained period of good performance could be at hand for currency managers.

“The most popular currency benchmarks, the Parker and Barclay indices, have been around for 20 years, and bad years occur cyclically almost exactly every five years,” he says. “Why they would pop up so

regularly every five years is still a mystery and invites interpretation. Given the amazing long-term regularity and reliability of annual returns over the past 20 years, it seems extremely opportune to exploit these cycles and invest *after* a bad year, expecting four good years to follow — *if* the pattern holds. This year may be the start of the next profitable five-year cycle.”

The May issue of Currency Trader will feature more of our conversation with Peter Panholzer.

TABLE 2 — 2005 TOP-5 CURRENCY TRADERS \$1 MIL. TO \$49.9 MIL.

Ranked by return for 2005 (Jan. 1, 2005 - Dec. 31, 2005)					
Rank	Fund Name	2005 return	Funds (\$ mil.)	Start date	2005 worst drawdown
1	DynexCorp Ltd. (Percival)	52.96%	\$1.0	Jan. 2005	2.3
2	Monarch Capital Mgmt.	44.14%	\$6.8	Nov. 2001	5.7
3	24 FX Management Ltd.	27.66%	\$10.6	Jan. 2001	4.4
4	Spot Forex Mgmt. (Copenhagen)	25.84%	\$10.0	Aug. 2003	0.5
5	Wallwood Consultants (Forex)	24.45%	\$12.7	Jan. 2001	1.4

Source: Barclay Trading Group, Ltd. (www.barclaygrp.com)

Past performance is not necessarily indicative of future results.

TABLE 3 — RETURN/DRAWDOWN RANK

Currency Traders (\$50 million or more)					
Rank	Fund Name	2005 return	2005 worst drawdown	Return/drawdown	Rank
1	ACT Currency Partners AG	23.16%	1.30%	17.82	1
2	IKOS Partners (Currency)	19.85%	1.50%	13.23	2
3	Hathersage (Long Term Currency)	12.69%	3.20%	3.97	3
5	DKR Capital (DKR Strat. Currency)	12.12%	5.90%	2.05	4
4	Appleton Capital (Appleton 25% Risk)	12.59%	12%	1.05	5

Currency Traders (\$1 million to \$49.99 million)					
Rank	Fund Name	2005 return	2005 worst drawdown	Return/drawdown	Rank
4	Spot Forex Mgmt. (Copenhagen)	25.84%	0.50%	51.68	1
1	DynexCorp Ltd. (Percival)	52.96%	2.30%	23.03	2
5	Wallwood Consultants (Forex)	24.45%	1.40%	17.46	3
2	Monarch Capital Mgmt.	44.14%	5.70%	7.74	4
3	24 FX Management Ltd.	27.66%	4.40%	6.29	5

Source: Barclay Trading Group, Ltd. (www.barclaygrp.com)

Past performance is not necessarily indicative of future results.



Supply and demand in the FX market

A recent scenario in the euro futures highlights why traders trying to push the market have such a vested interest in where the market closes each day.

BY BARBARA ROCKEFELLER

A peculiar thing happened on Feb. 17, the Friday before the three-day Presidents' Day weekend: An enormous supply of euros (EC) was offered on Globex, the electronic trading arm of the Chicago Mercantile Exchange (CME). Rumors began to fly around the spot forex market that someone was offering euro futures in size, by which spot traders meant "in the billions."

Is the story true? And if it's true, what does it mean?

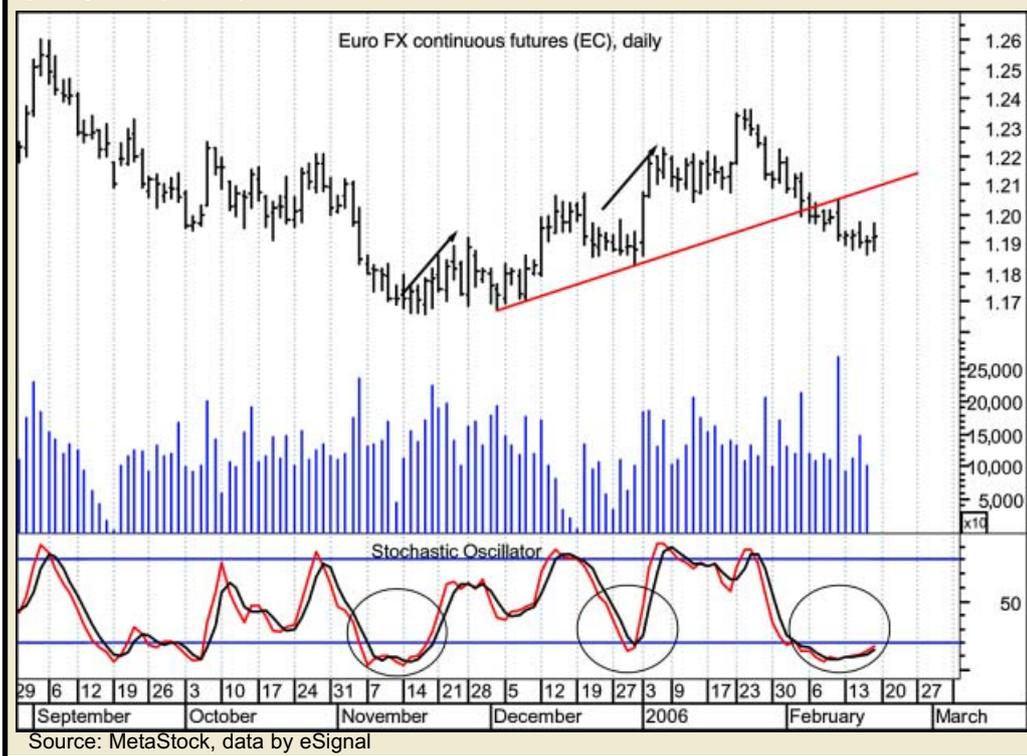
First, to trade billions on Globex seems kind of silly, at least initially. After all, each contract is worth €100,000, or \$119,250 as of the close on Feb. 17. To trade one billion dollars' worth, you'd need 8,385 contracts — in a market where 100 contracts is a large trade. Why not just trade in the deeper spot market?

One answer might be that a new market impulse does sometimes come from the futures markets precisely because oversized bids or offers are easily noticed. In the spot market, we have to deduce trade size from price, or rely on professional traders to reveal their interest and their customers' interest. The spot forex market is among the least transparent of all markets, in part because it's not in the interest of key participants to show their hands. The spot market is private and largely unregulated — which is why, when you want to send a message, Globex is Western Union.

The time and sales report on eSignal shows orders went from normal bid-offer amounts such as 150 x 40 (3 a.m.) and 120 x 85 (6:30 a.m.), to 411 x 3003 at 12:45 p.m., and then a few minutes later, 302 x

FIGURE 1 — THE EURO AND STOCHASTIC OSCILLATOR

When the euro was oversold in November and late December (circles), the euro subsequently rose (arrows).



Source: MetaStock, data by eSignal

9009 — an offer that qualifies for billion-dollar status. There also were a number of 3,000- and 6,000-contract offers.

It's difficult to read time and sales because every order is entered by the minute and second, and the report scrolls down hundreds of lines. Still, the massive amount of sell offers was detected within minutes and spread all over the market. The prevailing story was that the seller kept offering huge amounts and then pulling the offer to put in new ones as the price kept rising.

Somebody was offering the euro in size after it had fallen from 1.1958 at 10:40 a.m. to 1.1887 at 12:30 p.m., but had bottomed and was rising again. It didn't work, because the euro recovered to make a new daily high of 1.1966 at 1:20 p.m. before trailing off into a narrow range between 1.1940 and 1.1954 until the market closed.

However, the euro did not reach the highest high of two days before (1.1974), let alone the psychologically important round number of 1.2000. The recovery was not accompanied by huge bids in the hundreds and thousands of contracts, either, implying that in the absence of the enormous euro offers, the euro might have built up a head of steam and delivered an upside breakout by the end of the day — a *really* higher high. In fact, at the time of the greatest number of contracts offered (12:30-1:30 p.m.), the euro was rising, so the large offers could be viewed as a rear-guard action that (barely) kept the lid on the market.

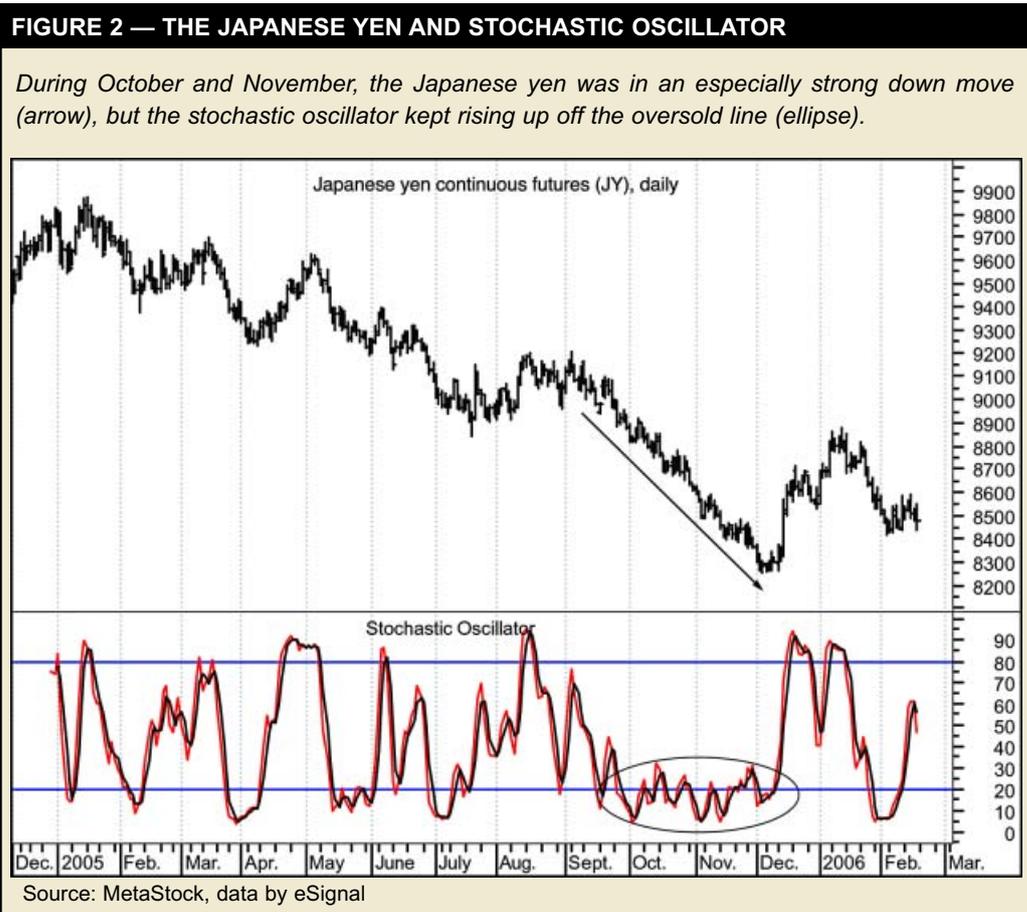
Who knows what the party doing the offering had in mind? Was he trying to prevent a higher high or a higher close? If so, the effort failed — Friday put in both, and failed to put in a lower low than the day before. That leads to the bigger question: How can we detect real supply and demand for a currency?

The daily supply-demand battle

It would be nice to be able to look at volume or the time and

sales numbers and feel confident they contain valid and valuable information, but in practice they are of little help. Seeing the huge euro offers on Friday, you might have wanted to jump on the euro-selling bandwagon, but depending on where you entered, chances are good you would have racked up a loss by the close.

Where the price closes relative to the open and to the high-low range is still the safe way to judge the balance of



supply and demand — what actually happened, rather than what some player *wanted* to happen. When the close is near the high, the bulls won that day, and when it's near the low, the bears won that day. If the close is exactly at the high or low, it was a rout. Because most people close out positions before the very end of the trading session, bulls or bears are sending a strong message to the market when they force the close to be at the exact high or low.

One of the objectives of strong bulls in forcing the close at the exact high or low is to influence certain technical indicators, especially if they can achieve a close in the top 30 percent of the bar over a series of days. Closes near the high

continued on p. 22



over three or five days suggest to all observers that sentiment is not only bullish, but growing more so. Market-leading bulls want to nudge the bar components to show not only direction, but momentum as well. Higher highs and higher closes accompanied by higher lows constitute an

gone as high as it is likely to go.

The opposite is true, too. When you have a lower low and subtract it from the lowest low over the past x days and then divide by the range, you get a lower number, one that approaches the “oversold” level. Figure 1 shows that when the euro was oversold in November and late December (circles), the euro subsequently rose (arrows). Then the euro was oversold again in February, and despite the price having broken the red support line to the downside, shouldn’t we expect it to rise?

Overall, the net effect of the stochastic oscillator is to disclose demand in a rising market and hide supply in a falling one. Therefore, when there is massive supply (as shown on Globex time and sales on Feb. 17) but it fails to move the oscillator downward, we should worry.

Or should we? If you reproduce Figure 1 using 60-minute bars instead of daily data, you see the stochastic oscillator at the overbought line — not rising up off the oversold line. The same is true of the 180-

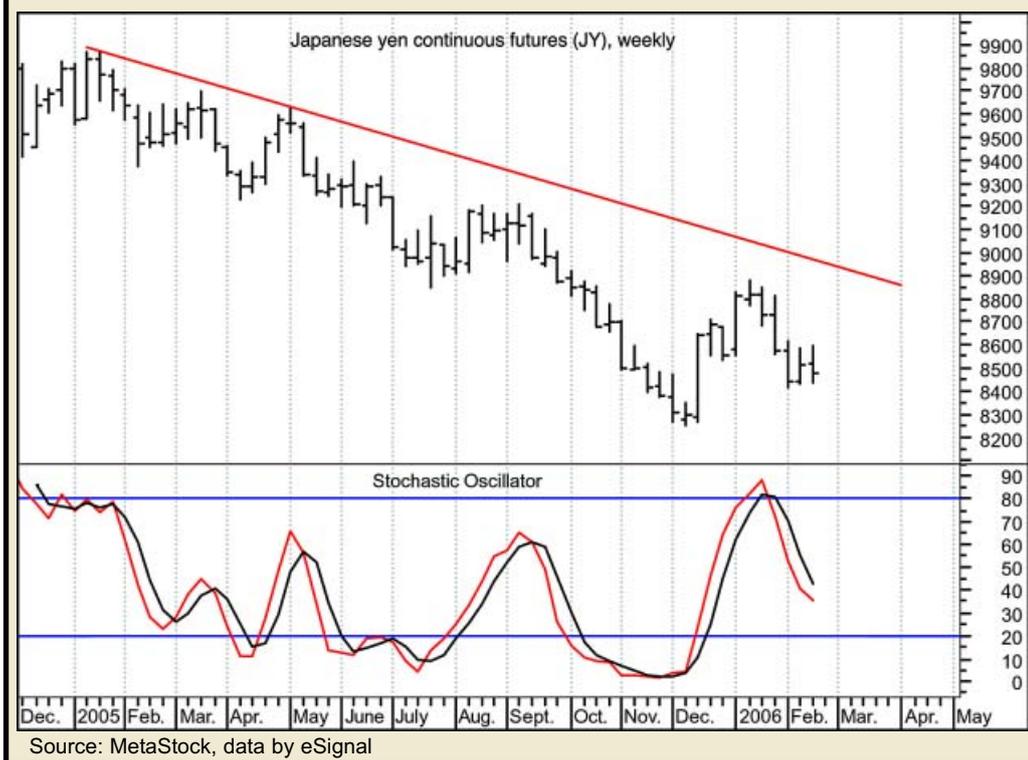
minute chart and the 360-minute chart. And that’s a real problem with the indicator — it’s not really a reversal indicator when a big trend is in force. It may be handy if you’re an intraday trader, but you shouldn’t count on it on a daily chart.

Consider the Japanese yen in Figure 2. From a peak in January 2005, it fell to a new low in December 2005, a move of over 1,600 points and a fat profit for anyone who could hold a short position through the entire period. No one would dispute this is a trend with a capital T.

If you had imagined the trend was ending each time the stochastic oscillator turned up, signaling an end to the oversold condition, you would have missed making a stupendous gain. During October and November, for example, the price was in an especially strong and continuous down move (arrow), but the stochastic oscillator kept rising up off the oversold line (ellipse). The stochastic oscillator was

FIGURE 3 — THE JAPANESE YEN AND STOCHASTIC OSCILLATOR

The stochastic was finally right about a crossover indicating a reversal move, which lasted six periods before indicating an overbought condition and resumption of the existing trend.

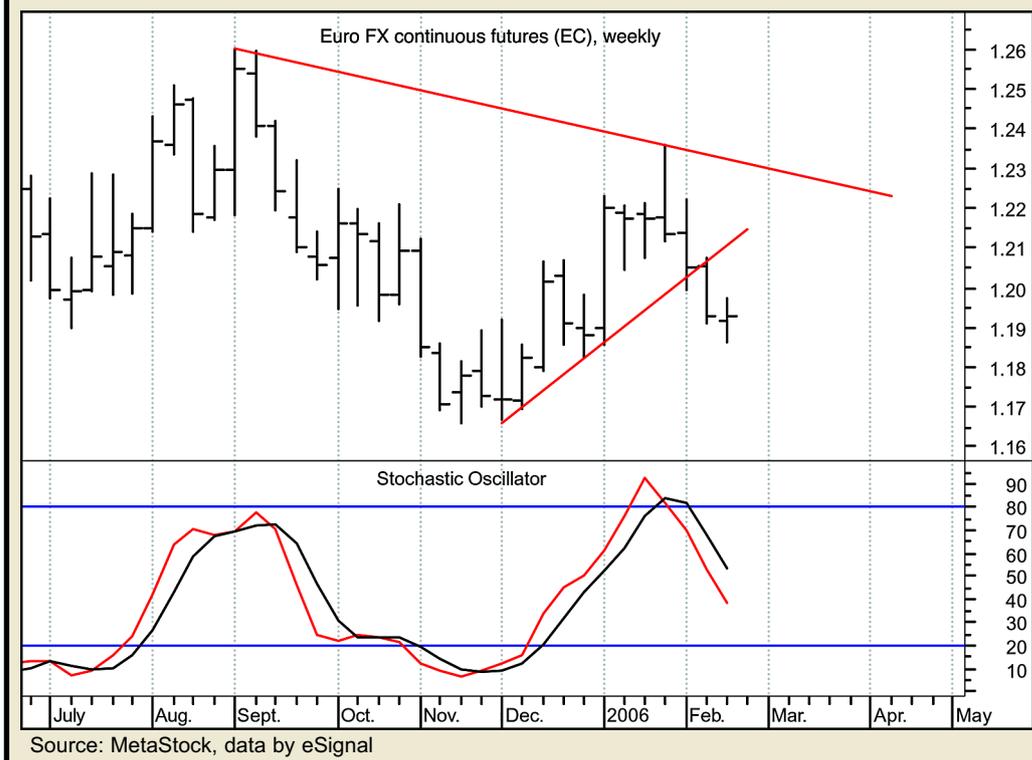


uptrend, but the key factor is the slope of the move — its steepness. The steeper the slope, the more chance the bull has of luring other traders into the market.

Many traders like to use the **stochastic oscillator** as a reflection of this kind of bar analysis. This indicator measures the distance between today’s close and the lowest low of the past x days, and divides that by the high-low range over the same x number of days. This ratio is multiplied by 100, making the indicator range between zero and 100, but more often, between 30 percent and 70 percent of the total possible range. When today’s close is higher than yesterday’s close, it’s farther away from the lowest low and thus a higher number, and when you divide that by the range, you still get a higher number. This denotes higher momentum, but at some point, the currency becomes “overbought,” meaning that relative to the normal range, it has

FIGURE 4 — THE EURO AND STOCHASTICS OSCILLATOR

On the weekly euro chart, the stochastic oscillator correctly identified a down move, an up move and another down move — all in the context of an overall year-long down move, although not one as consistent as the Japanese yen down move.



measuring only minor variations in the context of a major continuing trend.

This is mostly an arithmetic issue — the formula uses the high-low range over the past x days. When that is very small to begin with, any new high appears disproportionately bigger relative to the lowest low. You get a bottom in the indicator that is not a bottom in the price.

In fact, look at the same chart in a weekly format (Figure 3). On this chart, the stochastic was finally right about a crossover indicating a reversal move, which lasted six periods before indicating an overbought condition and resumption of the existing trend. If you were looking at a weekly chart, it would have delivered good guidance.

The same thing holds for the weekly euro chart (Figure 4). The stochastic oscillator correctly identified a down move, an up move and another down move — all in the context of an overall year-long down move, although not one as consistent as the Japanese yen down move.

Support and resistance

Another way to estimate true supply and demand is to look at support and resistance lines. We can say that fresh demand appears at support and new supply appears at resistance. The problem with support and resistance in forex is that these lines get broken all the time and you are continually re-drawing them. It's hard not to suspect sometimes that some participants are targeting support and resistance lines, especially on shorter time frame charts such as 15 and 60 minutes.

Then there is horizontal support and resistance, recently more popular than the sloping variety of support and resistance that connects a series of highs and lows. Horizontal support is a throwback to the "Darvas Box." Darvas was a successful trader in the 50s and 60s who observed that prices move in a series of sideways blocks, and once the top or bottom of a block is breached, you can expect a new high or low. Figure 5 shows such a series (blue horizontal lines).

A related concept is the pivot point, which draws a line through the median price. The median price is the high plus the low plus the close divided by three. When the close is under the median price, sellers offered a lot of supply that day. When the close is over the median price, demand was higher than supply. If you take a moving average of the median price and consistently buy when the close is over the median and sell when it's below the median, you have a moving average trading system that is more sensitive than the usual moving average using only the close. Figure 5 shows the median price (green line) and the five-day moving average of the median price (red line). Note that the close on the fateful billion-dollar supply day was higher than the median price.

All this makes it more understandable why some traders try to force the high or the low or the close to particular levels.

Some traders draw pivot-point charts with a horizontal support and resistance channel off each day's pivot point. Then they wait for a breach of the channel line. Breakouts of the channel are especially valuable at high and low points.

Figure 6 shows a pivot point channel in green drawn from the day of the latest lowest low, which happens to be the day before the billion-dollar day. The channel is constructed by taking the median value and multiplying by

continued on p. 24



two, and then subtracting the low (for resistance) and the high (for support). In this instance, the channel is bounded by support at 1.1870 and resistance at 1.1930. Note that the channel limits are not the same as a recent lowest low or a recent highest high, as in the Darvas box example or as cited by many traders. You may get a burst of buying or selling when the previous lowest low or previous highest high is breached, but the original impulse for the trade often comes from a breach of the less-obvious pivot point channel.

Weighing the evidence

As of late-February, it was impossible to know what the outcome would be. The daily stochastic oscillator indicated the euro “should” rise — but the intraday and weekly stochastics did not.

Standard support and resistance lines suggested the euro was still in downtrend, as did the Darvas approach, although a bottom may have been established.

Using a pivot point channel, a price over 1.1930 on the next trading day will probably draw buyers while a price under 1.1870 will inspire sellers — but it’s downright scary for a player to have offered a billion dollars worth of euros and not forced the close under the median. The failure of the euro seller implies the next trading days will see another piece of market lore fulfilled: “If you can’t sell it, buy it.” 🕒

FIGURE 5 — THE EURO, DARVAS BOXES, AND PIVOT POINTS

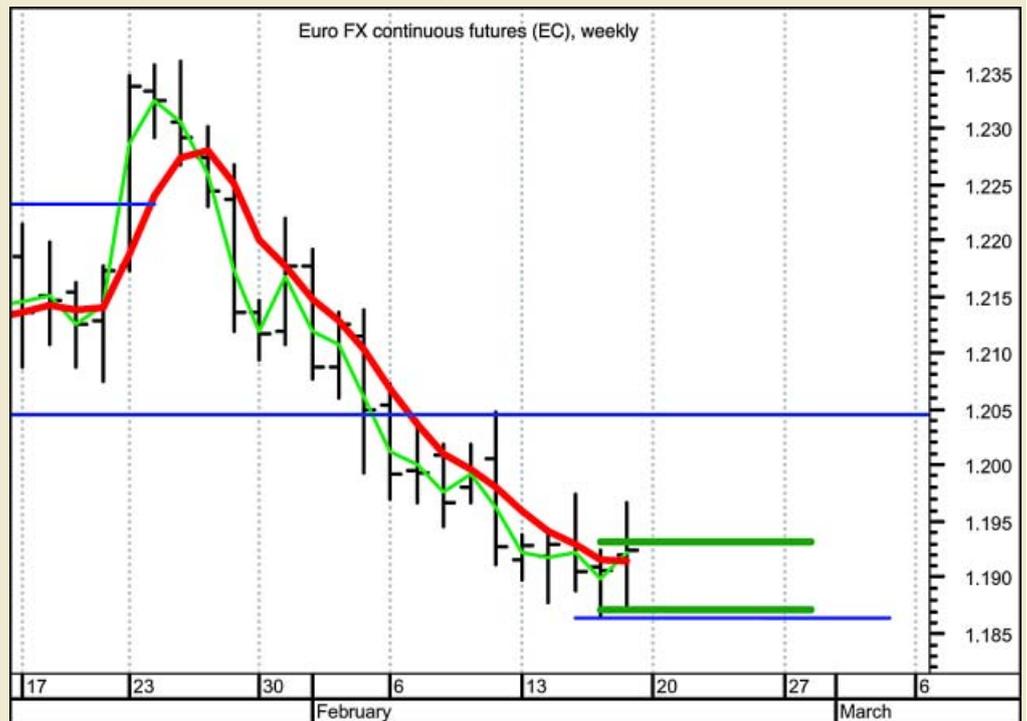
In this daily chart of the euro continuous futures, the median price is shown in green and the five-day moving average of the median price in red. Note that the close on the fateful billion-dollar supply day was higher than the median price.



Source: MetaStock, data by eSignal

FIGURE 6 — THE EURO AND PIVOT POINT CHANNEL

A pivot point channel in green is drawn from the day of the latest lowest low, which happens to be the day before the billion-dollar day.



Source: MetaStock, data by eSignal

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The index approach to currency risk management

Investors can often find superior returns overseas — as long as currency fluctuations don't negate their profits. The dollar index can be an effective tool for managing this risk in non-dollar portfolios.

BY HOWARD L. SIMONS

Would anyone be happier to see a single-currency world than global investment managers? Probably not. There is nothing more frustrating than seeing the hard work of individual asset selection and portfolio creation negated by currency fluctuations.

Like it or not, all investors are currency speculators. For example, Americans investing overseas in 2003-2004 benefited from dollar weakness, only to be harmed by dollar strength in 2005.

Worse, both portfolio managers and individual traders have to face the problem of which currency (or basket of currencies) to use if they decide to hedge their investments. A second and equally daunting question then comes into play: Should you hedge actively or passively — that is, should you try to trade or simply offset your initial currency exposure?

The annual returns of the Barclay Currency Traders Index are instructive in this regard (Figure 1). Like all hedge fund indices, this barometer has a massive “survivorship” bias. That is, the

FIGURE 1 — THE BARCLAY CURRENCY TRADERS INDEX

The compound annual rate of return (ROR) for the Barclay Currency Trader index has been 10.12 percent, with a Sharpe ratio of .41.

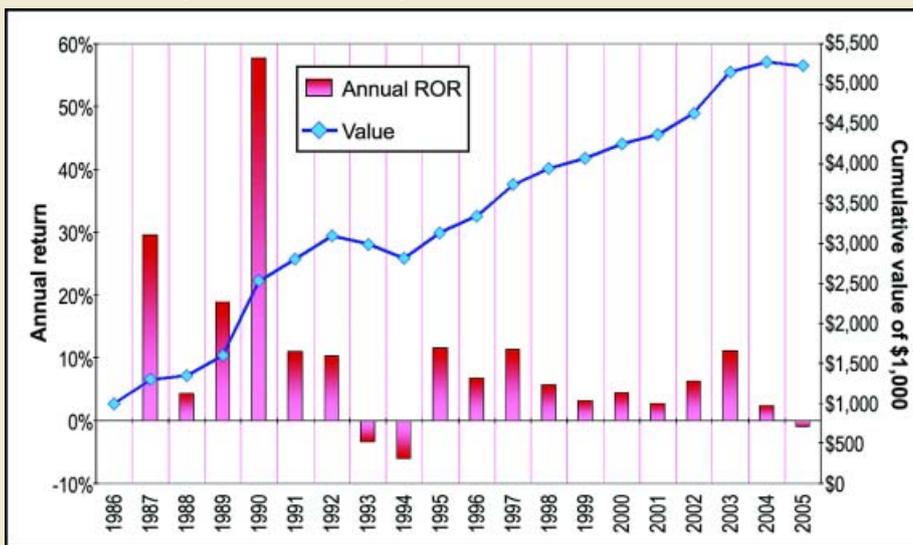


FIGURE 2 — CORRELATION OF DAILY RETURNS SINCE THE JANUARY 1999 INTRODUCTION OF THE EURO

This matrix shows the relatively low levels of correlation between the dollar index (DXY) and most of its six component currencies — the euro, Japanese yen, British pound, Canadian dollar, Swiss franc, and Swedish krona.

	DXY	EUR	JPY	GBP	CAD	CHF	SEK
Dollar index	1.000						
Euro	-0.940	1.000					
Japanese yen	-0.501	0.353	1.000				
British pound	-0.731	0.668	0.325	1.000			
Canadian dollar	-0.381	0.309	0.201	0.262	1.000		
Swiss franc	-0.900	0.931	0.376	0.659	0.280	1.000	
Swedish krona	-0.825	0.842	0.335	0.604	0.327	0.782	1.000

Source: Barclay Group

index sheds its laggards and retains its winners for each succeeding year, skewing the results in favor of the funds that survive or outperform rather than reflecting the performance of funds that blow out or underperform. (In fairness, the same can be said of stock indices.)

The compound annual rate of return (ROR) for the Currency Trader index has been 10.12 percent, with a *Sharpe ratio* of .41. (For comparison, the average annual returns for the Merrill Lynch 5-10 Year Treasury index and the S&P 500 were 7.54 percent and 11.46 percent, respectively, over this same period.) Because active management has a higher cost and greater variability of returns, we will turn our attention to a passive currency hedge management approach.

Which currency to use?

If anything can be learned from more than three decades of flexible exchange rates, it is that non-dollar cross-rates are as unpredictable as outright transactions against the U.S. dollar (USD). This is evident in Figure 2, which is a matrix showing the correlation of returns between the benchmark dollar index (DXY) and its six component currencies — the euro, Japanese yen, British pound, Canadian dollar, Swiss franc, and Swedish krona.

An investor holding a multiple-currency investment portfolio and seeking protection against a stronger dollar must choose a hedge instrument from a group of unsatisfying currencies. The euro (EUR), which comprises 57.6 percent of the DXY, clearly is the most negatively correlated against the USD, but at -0.94, the *tracking error* could be considerable.

The correlations drop off considerably after that: The Japanese yen (JPY) and Canadian dollar (CAD) have negative correlations of only -0.501 and -0.381, respectively. Within the correlation table for cross-rates, only the Swiss franc (CHF) and Swedish krona (SEK) have correlations greater than 0.8.

The Financial Accounting Standards Board's definition of

FIGURE 3 — THE EAFE HEDGED AND UNHEDGED

In USD terms, the EAFE index increased 232.2 percent over the period, while in local currency terms, its return was 234.0 percent. The hedged return — the EAFE index combined with a long dollar index position — was 245.2 percent.

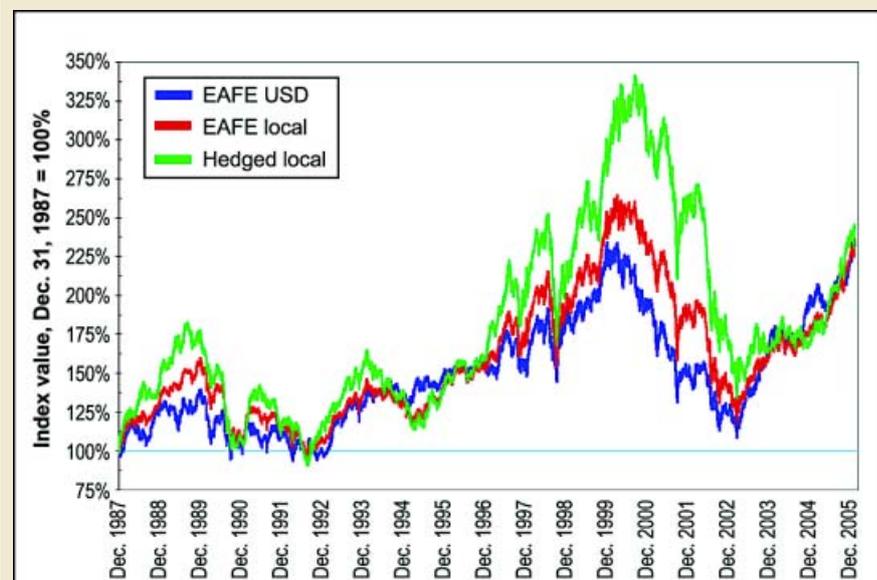
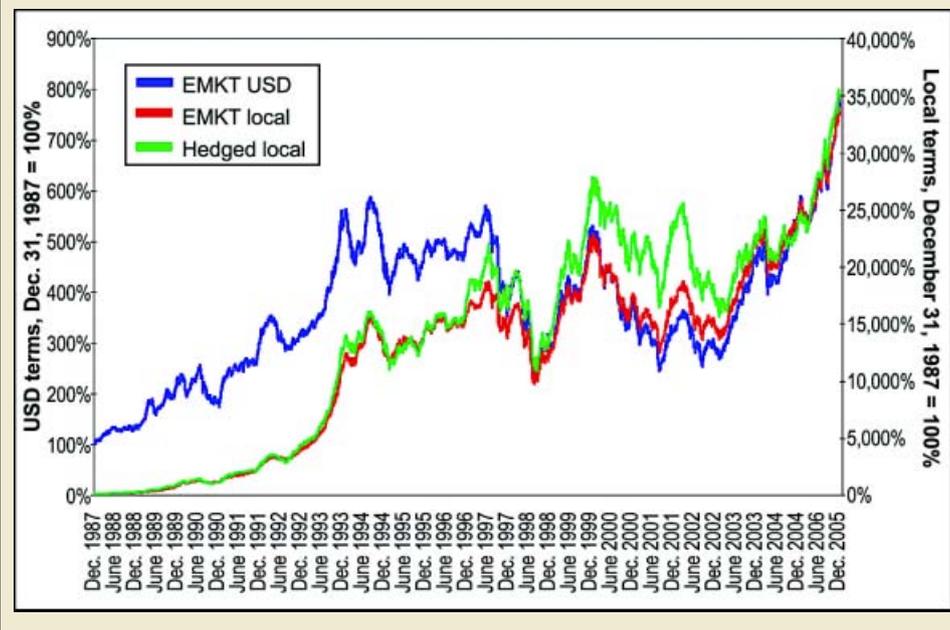


FIGURE 4 — THE EMKT HEDGED AND UNHEDGED

Although the six components of the dollar index do not represent any underlying emerging market asset, the dollar index performs well in converting the EMKT in local currency terms into USD terms.



a bona fide hedge requires an R^2 (percentage of variance explained) of 0.80 between instruments — which means the square-root of 0.80, or 0.894, is the number that must be exceeded in Figure 2. However, by applying this standard, only the EUR/DXY, CHF/DXY, and EUR/CHF pairs (highlighted in red) would qualify as bona fide hedges for one another.

Given the difficulty active currency traders have had in

continued on p. 28



FIGURE 5 — THE WORLD INDEX HEDGED AND UNHEDGED

As was the case with the other global indices, the MSCI World index (MXWD) hedged with a long position in dollar index futures provided superior results for dollar-based American investors.

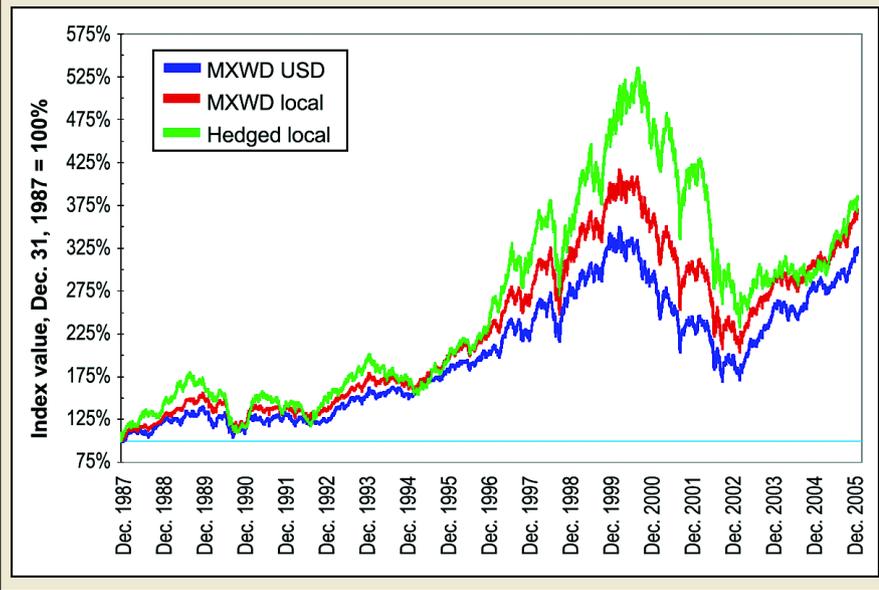
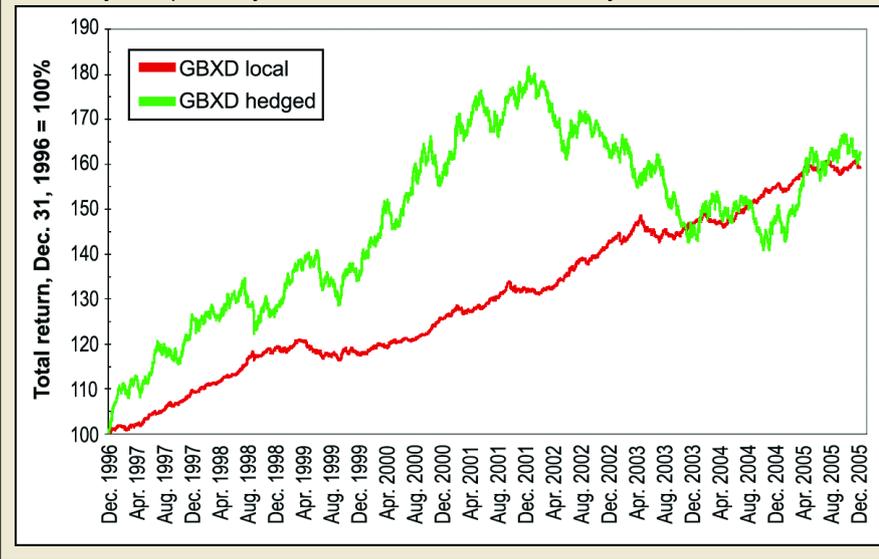


FIGURE 6 — THE GLOBAL BOND INDEX HEDGED AND UNHEDGED

The hedged Global Bond Index portfolio's outperformance during the late-90s USD rally dissipated by the end of 2003, but returned by late 2005.



beating standard financial benchmarks over time, why should we believe they could properly select the currencies to hedge a multi-currency bond or stock portfolio? A few missteps by the manager and currency volatility could turn — quite literally overnight — a superior portfolio into an underperformer.

Index hedging

Let's look at a few global investment indices (stated in both

USD and local currency terms) and see how their returns are affected by using two different dollar hedge instruments — the DXY and the Citigroup USD Flow-Weighted index (CFWI). Instead of reflecting the volume of physical trade between two countries, a flow-weighted index reflects the volume of financial flows, which can be many times as large. The failure of physical trade balances in explaining currency movements has been the impetus behind flow weighting.

The goal of the analysis is to determine which one produces the lowest tracking error in converting the local currency index back into USD terms.

Although the start date for the comparison is limited to the Jan. 4, 1999 introduction of the euro, an initial analysis of the dollar index's effectiveness as a hedge can be started in January 1988 using the Dollar Index futures (DX) traded at the New York Board of Trade. Using these futures also makes it possible to incorporate the interest-rate differentials between the U.S. and the DXY's component currencies.

The first market we can look at over the long-term sample is the Morgan Stanley International Europe, Australasia, and Far East (EAFE) index, a common benchmark for global fund managers. As shown in Figure 3, in USD terms the EAFE increased 232.2 percent over the period; its return in local currency terms was 234.0 percent. The hedged return — that is, the EAFE index combined with a long dollar index position — was 245.2 percent.

Figure 4 shows a similar comparison using the Morgan Stanley Emerging Market Free (EMKT) index. (A dual scale is needed to accommodate the effects of large-scale currency devaluations in many emerging markets over the analysis period.) Significantly, the six components of the dollar index do not represent any underlying emerging market asset, and yet the dollar index performs well in converting the EMKT in local currency terms into USD terms.

Figure 5 shows the final equity comparison, using the MSCI World index (MXWD). Once again, an equity index hedged with a long position in dollar index futures provided superior results for an American investor.

Bond market comparison

The ability of dollar index futures to hedge broad market indices is not limited to equity indices. Let's use the Merrill Lynch Global Broad Market ex USD as a fixed-income index. This index combines senior corporate, government, and supranational agency (World Bank, Asian Development Bank, etc.) bond issues and has a duration of slightly over six years. The index dates back to the end of 1996.

Because bonds represent a more direct currency play than stocks (equities' prospects can rise and fall because of currency fluctuations, while bond characteristics remain fixed), the hedged portfolio should have greater variance than the underlying index, and Figure 6 shows it does. The hedged portfolio's outperformance during the late 90s USD rally dissipated by the end of 2003, but returned by late 2005.

Index hedge comparison

Now let's compare the DXY to the CFWI as instruments for hedging. The CFWI begins with the January 1999 introduction of the euro and doesn't have futures contracts, so it is necessary to compare the two cash indices from that date forward.

Because hedging a non-dollar investment portfolio back into dollars involves borrowing non-dollar currencies and, in turn, lending dollar currencies, and as U.S. short-term interest rates have been off-cycle with the rest of the world since 1999, this is a serious detriment. These interest-rate differentials are real and will affect all derivatives used in portfolio hedges.

At first blush, Figure 7 suggests the two indices track each other reasonably closely (as if "reasonable" has anything to do with finance). However, statistics tell a better story. If we perform a regression analysis of the daily returns of the DXY against those of the CFWI, we get the following:

$$\text{DXY}_{\text{ret}} = -.00000102 + .975 * \text{CFWI}_{\text{ret}}$$

$$R^2 = .876$$

Not only is this R^2 ("percentage of variance explained")

FIGURE 7 — COMPARING TWO DOLLAR INDICES

The chart suggests the two dollar indices — DXY and CFWI — track each other fairly closely, but statistical analysis suggests they are more different than might be expected.

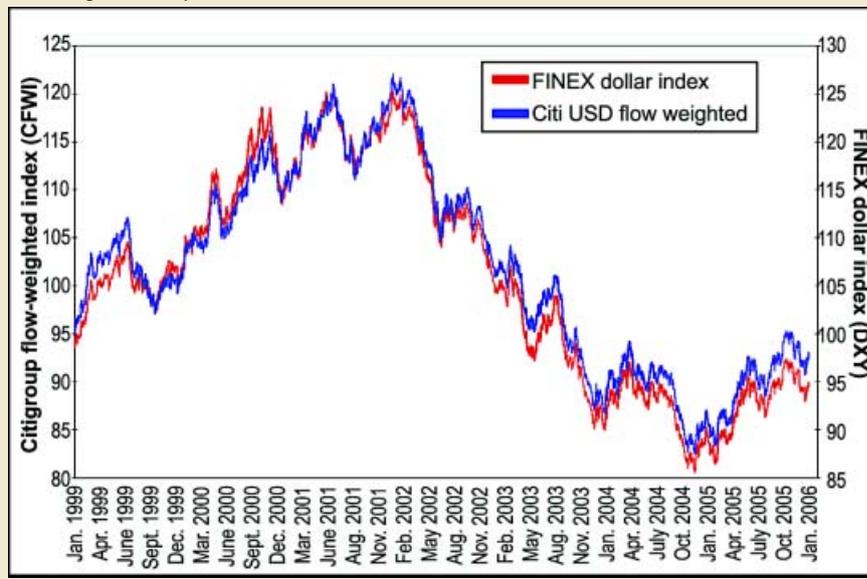
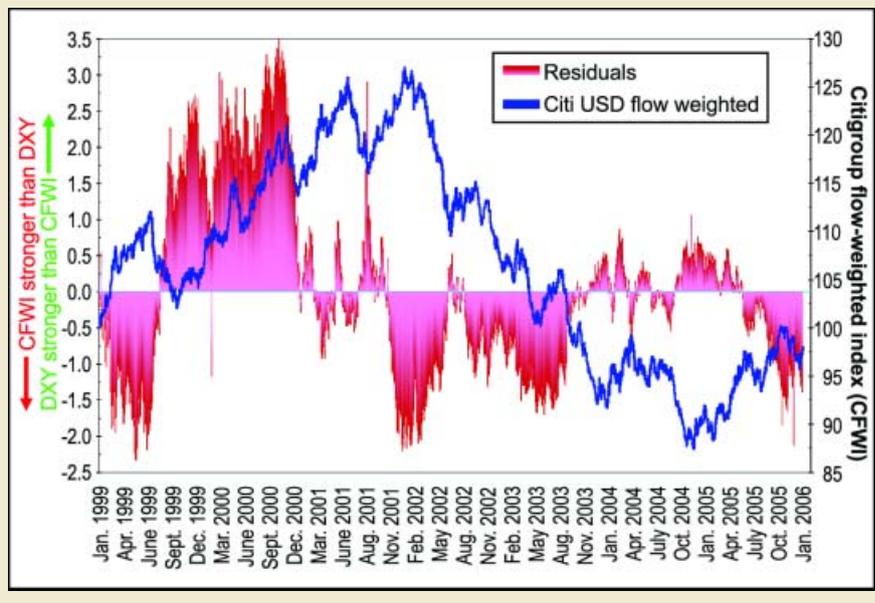


FIGURE 8 — WHERE THE DOLLAR INDICES MISMATCH

There were long periods, such as 2002-2004, when the DXY declined more rapidly than the CFWI. The CFWI rose faster than the DXY in the first half of 1999 and during 2005.



less than what we might expect (which is another way of saying the series are more different than we might expect), but the real story lies in the "residuals," or unexplained variance.

A glance at a comparative chart reveals long periods, such as 2002-2004, when the DXY declined more rapidly than the CFWI. The CFWI rose faster than the DXY in the first half of 1999 and during 2005. These long periods of out- and underperformance, or serial correlation, are highlighted in Figure 8. (For the statisticians reading this, the Durbin-

continued on p. 30



Watson statistic of the regression of the DXY and the CFWI is .027, a rather extreme example of serial correlation. The comparative hedge performance is irregular.)

A holder of non-dollar assets would have been better off with a DXY hedge during the second half of 1999 and throughout 2000, and then again in the first half of 2005, both periods of dollar strength. During the dollar decline from mid-2002 into mid-2003, the CFWI retained more strength; this probably is evidence that greater speculative DXY selling occurred than the flow fundamentals would have justified. Regardless, it is impossible to make a definitive statement on a full hedge-accounting basis whether the CFWI would have been a superior hedge once interest-rate differentials are included.

The dollar hedge tool

Given the information available, we can reach a single and quite valuable conclusion: Holders of non-dollar portfolios can hedge their returns back into USD with futures contracts on the passively constructed DXY and enhance their performance relative to their benchmarks.

Furthermore, this is true for three different measures of global equities on a consistent basis. It is also true for a non-USD bond index over the index's life. ☺

For information on the author see p. 6.

Related Reading

Other Howard Simons articles:

“The yen stands alone”

Currency Trader, March 2006.

The usual rules of the currency world haven't necessarily applied to the Japanese yen. Will that continue to be the case?

“Remember the forgotten currency”

Currency Trader, February 2006.

It's often labeled a “commodity currency,” but the Canadian dollar tends to be ruled by other factors. Here's a look at the factors impacting Canadian dollar movements.

“What drives the dollar index?”

Currency Trader, January 2006.

Market watchers often point to deficits and interest-rate differentials to explain the dollar's behavior, but analysis shows these factors might not be in the driver's seat after all.

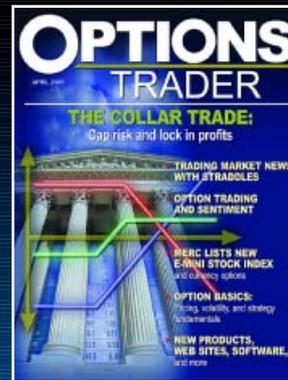
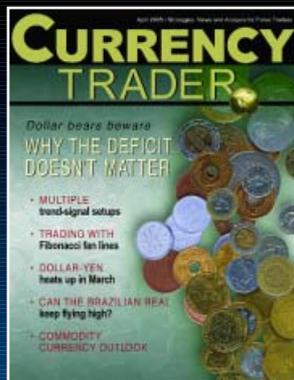
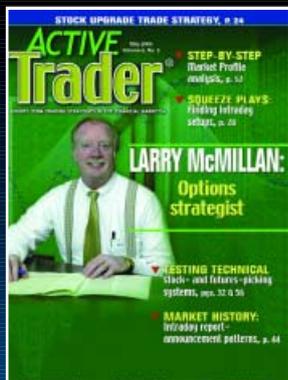
“The dollar index and ‘firm’ exchange rates”

Currency Trader, December 2005.

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Applying candlestick analysis to the dollar/yen

Candlestick patterns offer visual clues about the evolving balance of supply and demand in a market.

BY DARRELL JOBMAN

Candlestick charts are useful in assessing whether existing trends are sustainable or whether they are becoming overextended and vulnerable to a reversal. Their signals can also be used to help determine whether a direction change is more likely to be a complete reversal of a trend or a correction that implies the previous trend is more likely to reassert itself.

“It’s not that candlesticks offer new or different data than the traditional bar charts technicians have used for years —

they show the same open, high, low, and close prices — but they present the information in a more enlightening way, giving traders a better idea at a glance of market strength or weakness,” says Robert Colby, CMT, a consulting analyst at www.TradingEducation.com and author of *The Encyclopedia of Technical Market Indicators* (2002, McGraw Hill, Second Edition).

The U.S. dollar/Japanese yen (USD/JPY) pair illustrates how several candlestick patterns highlighted the market’s dynamics over the past year.

FIGURE 1 — DOLLAR/YEN, WEEKLY

The dollar/yen rate was dominated by an uptrend in 2005, but has more recently consolidated after pulling back from its high.



Source: TradeStation

Dollar/yen background

The recent history of the USD/JPY rate illustrates how candlestick analysis has been a useful tool during sharp swings in this currency’s direction.

The dollar/yen market is particularly sensitive to candlestick analysis, given Japan runs a substantial basic balance of payments surplus. Although short-term capital outflows tend to weaken the Japanese currency, any drop in these flows can result in rapid yen gains, reflecting an underlying over-supply of dollars in the market. There is the potential for extended dollar rallies punctuated by very sharp corrections.

The dollar remained under pressure in early 2005 as confidence in the U.S. currency remained very weak and the Bank of Japan (BOJ) intervened to curb yen gains toward the 100.00 level vs. the dollar (Figure 1). Over the course of the

year, however, the U.S. Federal Reserve increased interest rates at successive meetings of the Federal Open Market Committee (FOMC), while the BOJ left interest rates effectively at zero to combat deflationary pressure in the economy.

Although U.S. interest rates had been kept at 1.0 percent, the dollar was a clear target for short sellers (even with short-term Japanese interest rates at zero) because the yield was limited. The equation, however, continued to change gradually during 2005 as the interest-rate differential widened, with U.S. short-term rates rising to 4.25 percent by the end of the year.

The dollar became much less attractive as a global funding currency while there were increasing temptations to sell the yen (even with rates at zero) as the Japanese currency became the focus of attention as a global funding instrument. There were further outflows of capital into higher-yield instruments such as Uridashi bonds issued in New Zealand dollars.

Japanese economic data during the fourth quarter of 2005 was generally positive, with gains for production and employment and evidence of a slow emergence from deflation. The capital account data recorded strong inflows into Japanese equity markets, while evidence from speculative positions suggested an increasing short yen position.

The USD/JPY rate pushed to highs around 114.00 in the third quarter before weakening back to near 110.00 as the yen was boosted initially by the Chinese yuan revaluation in July. The dollar also hit short-term selling pressure after Hurricane Katrina hit the U.S. Gulf Coast in late August.

Candlestick basics

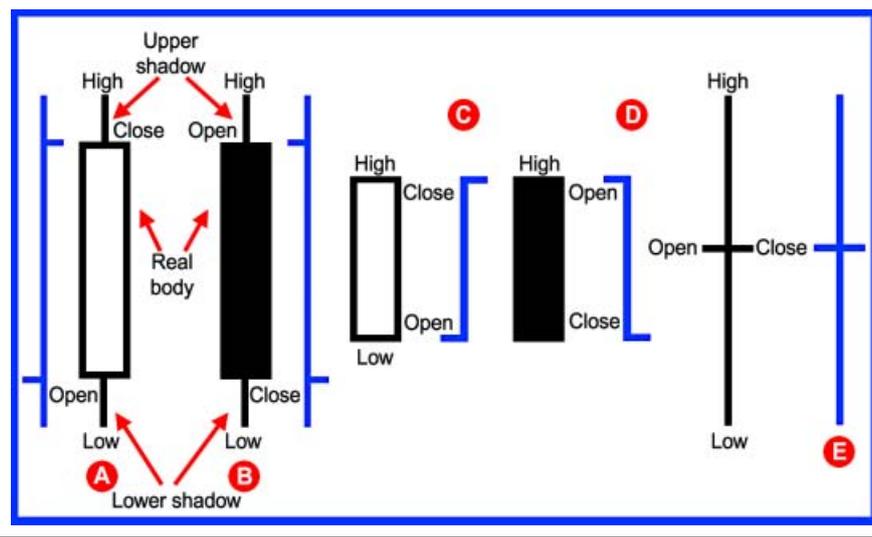
In Figure A, the trading period's high and low are represented by the highest and lowest points of the candlestick, while the session's open and close are represented by the top and bottom of the wider part of the candlestick.

The thin lines at the tops and bottoms are called shadows, and the wider parts are called real bodies. The candle is white (or hollow) if the close was above the open and black (or filled) if the close was below the open.

Candle A closed higher than the open and candle B closed below the open. Candle C closed above the open — the open was the low price of the day, and the close was the high price of the day. Candle D illustrates the opposite condition. Finally, candle E opened and closed at the same price; it is identical to its bar-chart equivalent.

FIGURE A — CANDLESTICKS

Different candlesticks appear alongside their bar-chart equivalents. Candles use the same price information as standard price bars, but display it in a different way.



Source: MTI Trend Trader

The dollar/yen recovered quickly, however, and pushed above the 115.00 level.

Yen losses vs. the dollar accelerated during the fourth quarter as widening interest-rate spreads encouraged further dollar buying, and the dollar/yen pushed above 120.00 by the beginning of December.

continued on p. 34



Daily candlestick signals were generally dollar bullish during November, but a closer look at the USD/JPY chart shows some warning signs. "Candlestick pattern summary" defines the patterns discussed in the following section.

Following the candles

Figure 2 is a daily candlestick chart of the dollar/yen from roughly November 2005 through February 2006. A "dark cloud cover" (1) marked one period of congestion in November. A little more than a week later "shooting stars" with long upper shadows (2) suggested the market was

the market's direction, potentially signaling a trend reversal.

Long upper shadows again suggested the market was attempting to push price higher but failing to hold the elevated levels reached during the day. It retreated by the close, forming a "spinning top" (4) and another shooting star (5). The shooting star was followed by a "gravestone doji" (an open and close at the low of the daily range) and another spinning top. The candlestick clues were mounting up that underlying market selling pressure was starting to increase.

Another bearish engulfing pattern (6) provided stronger evidence that sellers were starting to dominate the market.

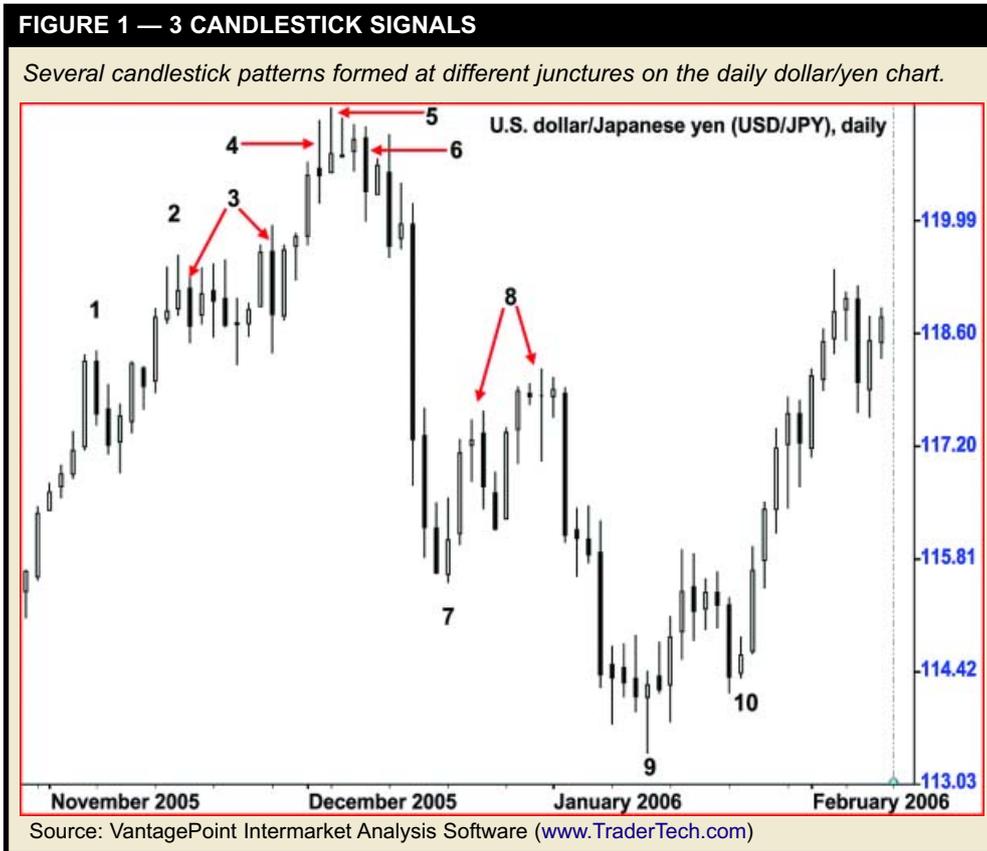
The dollar/yen did manage to close just above 120.00, but within the next week it had fallen rapidly to lows near 115.00.

A "piercing line" (7) on Dec. 19 started a bounce-back as the market opened lower than the previous close but then rallied to close well into the body of the previous candlestick, followed by another strong white candlestick. The dollar rallied back to 118.00 against the yen, but the rally attempt wasn't very convincing, as spinning tops and a doji (8) hinted the up move was probably a short-lived correction.

Moving into the first week of January 2006, the dollar/yen weakened sharply again with a low close at 113.50 as dollar confidence deteriorated. On Jan. 12 the market formed a "hammer" (9), which suggested dollar buyers were again starting to gain the upper hand. This was

supported by several strong white candlesticks and then a "bullish harami" (10), which is an inside day in Western technical analysis terms (the range of the entire day is within the body of the previous candlestick). From there the dollar was off on another run higher, waiting for the next candlestick pattern that might signal price direction.

With signs of improvement in the Japanese economy, the **BOJ in March eased its policy** on the amount of deposits commercial banks were required to hold, which should



beginning to reject higher levels.

A couple of long black candlesticks or "bearish engulfing patterns" (3) also indicated weakness: The market opened at or above the previous close, then closed below the previous day's high-low range as the candlestick body completely engulfed the previous candlestick body.

The dollar/yen survived this scare and rallied to highs above 121.00. From early December, however, the candlestick patterns started to issue more serious warnings about

encourage more lending and a gradual rise in interest rates from zero, potentially making the yen more attractive.

Although each candlestick has a story to tell about the price action during that period, and a succession of candlesticks can reveal the pattern of price direction and market momentum, candlesticks aren't perfect indicators. Like most aspects of technical analysis, they produce their share of false signals and fake-out moves. But if you keep in mind the candlestick pattern's position within the overall market action, candlestick charts can provide quick visual clues about trends and trend reversals. 📌

For information on the author see p. 6.

Related reading

“Detecting the professionals’ footprints: Lessons of the Chinese revaluation”

Currency Trader, August, 2005.

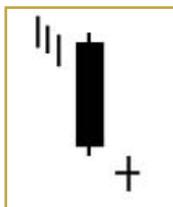
On paper, the Chinese renminbi revaluation is a historic event. But the market's initial reaction was fairly muted (if intriguing). Find out how things could play out in the forex market in the new world of Chinese forex participation.

“Intraday candlestick patterns for FX”

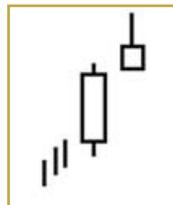
Currency Trader, January 2005.

This analysis of two candlestick patterns illustrates the process of defining trade risk, profit, and money management.

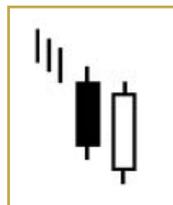
Candlestick pattern summary



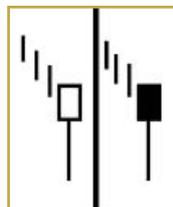
Doji: Prices at the open and close of the period are at the same level, indicating indecisiveness about price direction. The signal tends to be more dependable when it appears at a top than at a bottom.



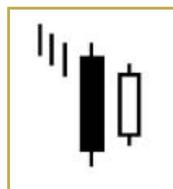
Shooting star: After an upward move, prices gap up from the previous close and rally higher from the open, but the market rejects the high prices and prices fall back to close near the open, depicted by a candle with a long upper shadow, a small real body at the lower end of the price range and little or no lower shadow. This suggests buying interest faded after an early spurt to higher levels and implies the end of a bullish run.



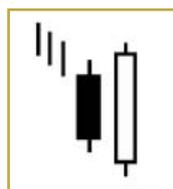
Piercing line and dark cloud cover: These reversal patterns are mirror images of one another and are close relatives of engulfing patterns, except that the current candle's body does not engulf the previous candle. Instead, the market has a gap opening, then moves sharply in the opposite direction and closes more than halfway through the previous candle's body.



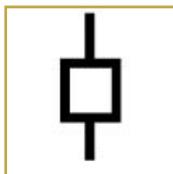
Hammer and Hanging Man: These two reversal patterns look very much alike, but their names and impact on prices depend on whether they occur at the end of a downtrend or an uptrend. The signal candlestick has a small real body and a long lower shadow, suggesting the previous trend is losing momentum. This pattern also requires confirmation by the next candle.



Harami: The harami is a reversal pattern following a trend. Rather than engulfing the previous candle, price action for the current candle is entirely within the range of the previous candle body. This pattern requires immediate follow-through for confirmation.



Engulfing patterns: Prices open below the previous close (bullish) or above the previous close (bearish) and then stage a strong turnaround, producing a candle body that totally engulfs the previous candle and suggesting a change in trend direction.



Spinning top: A spinning top is similar to a doji, but it has a real body – that is, the open and close are not the same – and shadows that are longer than its real body. The shade (white or black) of the real body is unimportant. Spinning tops indicate indecision, a stand-off of bullish and bearish forces. Several spinning tops together often mark a point of price trend change.

—Definitions from www.tradingeducation.com.



The Trend Strength Crossover indicator

Market: Currencies.

System concept: The Trend Strength indicator measures the trend by comparing price to simple moving averages (SMAs) of different lengths (10 days, 20 days, etc.) — an idea tested in the March issue of *Currency Trader*.

The Trend Strength Crossover indicator compares different moving average values to each other and counts the number of times various moving averages have crossed over each other.

During strong trends, SMAs of different lengths will align according to their look-back periods. In an uptrend, for example, a 10-day SMA will be above the 20-day SMA, which will be above the 30-day SMA, and so on. When the trend weakens, shorter-term SMAs change direction first and cross below longer-term SMAs. The further price drops, the greater the number of shorter-period SMAs that will cross below longer-term ones. The Trend Strength Crossover indicator is calculated by adding 1 when a shorter-term moving average crosses above a longer-term moving average and subtracting 1 when a shorter-term SMA crosses below a longer-term SMA.

During a strong trend, no SMAs cross above or below each other, so the indicator's value will be zero. Negative values over several days mean the trend is moving lower, while positive values over several days mean it's moving

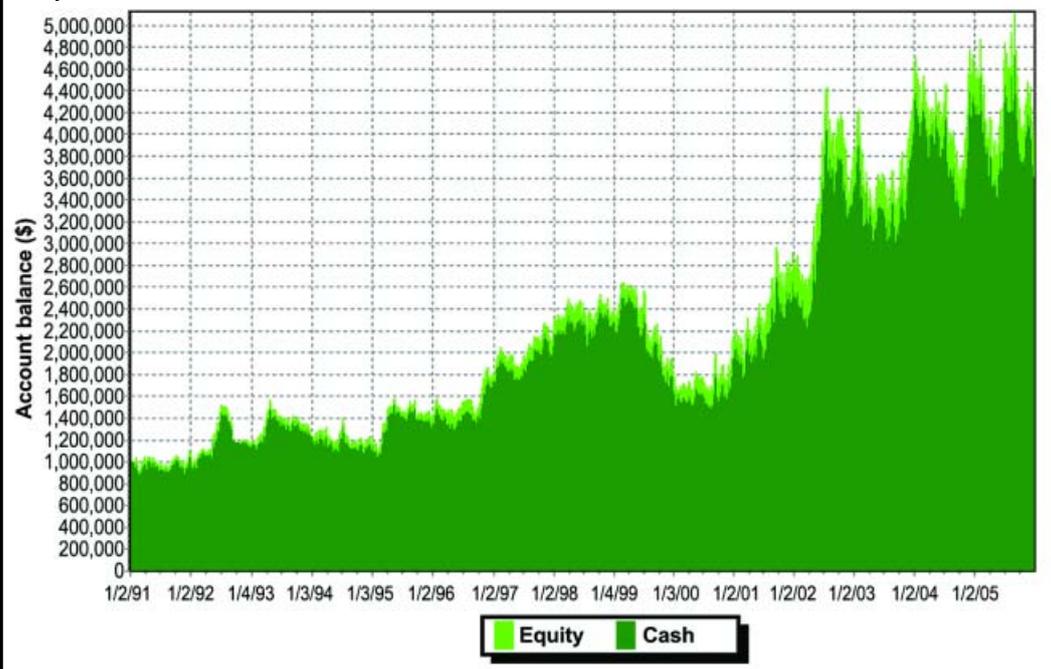
FIGURE 1 — SAMPLE TRADES

The Trend Strength Crossover indicator caught a large uptrend in the euro starting in March 2002. However, the system was whipsawed as the euro traded sideways in the second half of 2002.



FIGURE 2 — EQUITY CURVE

System equity rose during the 15-year test, but the system was quite volatile during the last six years.



higher. The indicator's daily values don't generate trade signals; values are summed over the past 20 days.

The indicator is used to trigger trend-following trades. The system goes long when the 20-day sum crosses above zero and sells short when the 20-day sum crosses below zero. The Trend Strength Crossover indicator uses 10 SMAs ranging from 10 to 100 days in steps of 10. (Visit Wealth-

Lab.com and search for "TrendStrength" for more details.)

Figure 1 shows a trade in euro futures (EC). All 10 SMAs are plotted with price in the lower window; the Trend Strength Crossover indicator's daily value (histogram) and 20-day sum (blue line) are in the upper window. The system went long on March 8, 2002 because several shorter-term SMAs crossed above longer-term ones, causing the 20-day sum to cross above zero.

More shorter-term SMAs crossed above their longer-term

counterparts in the following months, pushing the indicator above 20. The uptrend continued from May to July and all SMAs eventually aligned in ascending order (the 10-day SMA above 20-day SMA, the 20-day SMA above the 30-day SMA, and so on). This alignment caused the indicator's 20-day sum to drop to zero in July. At this point, the uptrend stopped. Several short-term SMAs fell below longer-term ones and the Trend Strength Crossover indicator dropped

continued on p. 38

STRATEGY SUMMARY			
	Long + Short	Long Only	Short Only
Starting capital (\$)	1,000,000.00	1,000,000.00	1,000,000.00
Ending capital (\$)	3,948,275.70	3,642,883.50	1,305,392.20
Net profit (\$)	2,948,275.70	2,642,883.50	305,392.20
Net profit (%)	294.83	264.29	30.54
Annualized gain (%)	9.59	9.00	1.79
Exposure (%)	7.10	4.00	6.42
Number of trades	370	185	185
Avg profit/loss (\$)	7,968.31	14,285.86	1,650.77
Avg profit/loss (%)	0.39	0.44	0.35
Avg bars held	31.88	30.36	33.40
Winning trades	146	69	77
Winning %	39.46	37.30	41.62
Gross profit (\$)	13,425,065.08	8,113,172.17	5,311,892.92
Avg profit (\$)	91,952.50	117,582.21	68,985.62
Avg profit (%)	3.81	4.40	3.28
Avg bars held	52.01	51.61	52.38
Max consecutive	5	6	7
Losing trades	224	116	108
Losing %	60.54	62.70	58.38
Gross loss (\$)	-10,476,789.39	-5,470,288.67	-5,006,500.72
Avg loss (\$)	-46,771.38	-47,157.66	-46,356.49
Avg loss (%)	-1.84	-1.92	-1.75
Avg bars held	18.76	17.72	19.87
Max consecutive	9	21	14
Max drawdown (\$)	-1,242,627.25	-1,702,929.50	-2,573,645.75
Max drawdown (%)	-40.80	-61.69	-93.72
Max drawdown date	5/1/2003	12/28/2005	4/22/2005
Wealth-Lab score	79.94	86.23	1.75
Profit factor	1.28	1.48	1.06
Recovery factor	2.37	1.55	0.12
Payoff ratio	2.08	2.29	1.88
Sharpe ratio	0.52	0.45	0.25
Ulcer index	16.24	21.38	34.80
Wealth-Lab error term	8.21	16.83	22.49
Wealth-Lab reward ratio	1.17	0.53	0.08
Luck coefficient	4.99	3.87	5.79
Pessimistic rate of return	1.16	1.10	1.08
Equity drop ratio	0.45	0.69	5.65

LEGEND: Starting capital — Equity at the beginning of the simulation period • Ending capital — Equity at the end of the simulation period • Net profit — Profit at end of test period, less commission • Net profit % — Profit at end of test period in percent of starting equity • Annualized gain % — Compounded annual growth rate • Exposure — The area of the equity curve exposed to long or short positions, as opposed to cash • Number of trades — The total number of round-trip trades plus open positions • Avg profit/loss — The average profit/loss per trade in dollars • Avg profit/loss % — The average percentage profit/loss per trade • Avg bars held — The average number of bars held per trade • Winning trades — The total number of winning trades • Winning % — The percentage of winning trades • Gross profit — The total profit generated by the winning trades, minus commissions and slippage • Avg profit — The average profit per winning trade • Avg profit % — The average percentage profit per winning trade • Avg bars held — The average number of bars held per winning trade • Max consecutive — The maximum number of consecutive winners • Losing trades — The total number of losing trades • Losing % — The percentage of losing trades • Gross loss — The total loss generated by the losing trades, minus commissions and slippage • Avg loss — The average loss per losing trade • Avg loss % — The average percentage loss per losing trade • Avg bars held — The average number of bars held per losing trade • Max consecutive — The maximum number of consecutive losers • Max drawdown — Largest decline in equity in dollars • Max drawdown % — Largest percentage decline in equity • Max drawdown date — Date on which the max drawdown was realized • Wealth-Lab score — An overall measure of profitability, exposure (efficiency), and risk • Profit factor — Gross profit divided by gross loss • Recovery factor — Net profit divided by max. drawdown • Payoff ratio — Average profit of winning trades divided by average loss of losing trades • Sharpe ratio — Annualized average return divided by the annualized standard deviation of returns • Ulcer index — A measure of the portfolio's overall volatility • Wealth-Lab error term — The average of the absolute values of all percentage distances along the equity curve from its linear regression line • Wealth-Lab reward ratio — Annual percentage return divided by the Wealth-Lab error term • Luck coefficient — The percentage profit of the largest winning trade divided by the average percentage profit of all winning trades • Pessimistic rate of return — A statistical adjustment of the wins to losses ratio that estimates the worst-expected return from previous results • Equity drop ratio — The standard deviation of all drops in the equity curve — measured from each equity low to the previous equity high — divided into the annualized return.

Currency System Analysis strategies are tested on a portfolio basis (unless otherwise noted) using Wealth-Lab Inc.'s testing platform. If you have a system you'd like to see tested, please send the trading and money-management rules to editorial@currencytradermag.com.
 Disclaimer: Currency System Analysis is intended for educational purposes only to provide a perspective on different market concepts. It is not meant to recommend or promote any trading system or approach. Traders are advised to do their own research and testing to determine the validity of a trading idea. Past performance does not guarantee future results; historical testing may not reflect a system's behavior in real-time trading.



FIGURE 3 — DRAWDOWN CURVE

The system's maximum drawdown reached 40.8 percent in 2000, which would be difficult for most traders to withstand.

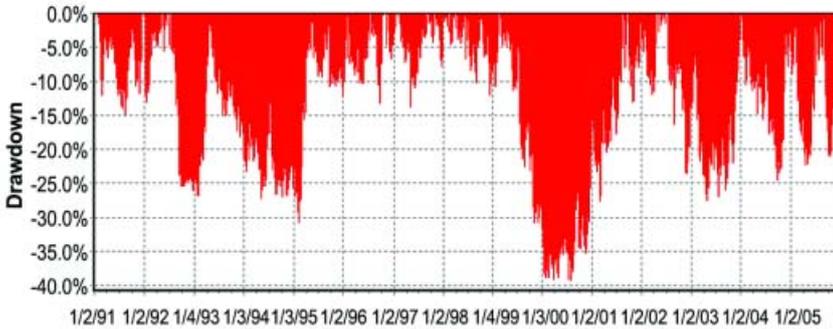
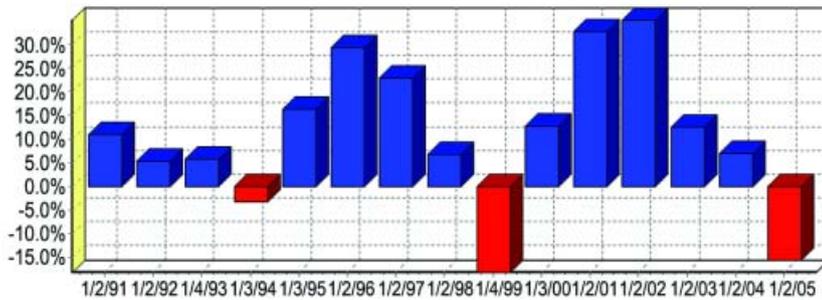


FIGURE 4 — ANNUAL PERFORMANCE

The system gained at least 10 percent in eight of 15 years with only three losing years.



below zero. The system exited on Aug. 2 with an 11-point gain.

However, the euro didn't move in a clear direction in the following months, and the indicator crossed zero several times, producing "whipsaw" losses on Oct. 17, Oct. 21, and Nov. 1.

Rules:

1. **Go long** and **exit short** next day at market if the Trend Strength Crossover indicator's 20-day sum rises above zero.
2. **Stop-loss:** Exit with a loss on a move above three times the 10-day **average true range** (ATR).
3. **Go short** and **exit long** next day at market if the Trend Strength Crossover indicator's 20-day sum drops below zero.
4. **Stop-loss:** Exit with a loss on a move above three times the 10-day average true range (ATR).

Test period: January 1991 to December 2005.

Test data: The system was tested on the following currency futures portfolio: British pound (BP), euro (EC), Japanese yen (JY), and Swiss franc (SF). Data source: Pinnacle Data Corp. (www.pinnacledata.com).

Starting equity: \$1,000,000. Deduct \$20 commission per round-trip trade per contract. Apply two ticks of slippage per stop order.

Money management: Risk a maximum of three percent of account equity per trade. The number of contracts is calculated using the entry price, the stop-loss level, and the dollar value of a one-point move.

For example, assume the system goes long at 100 in a contract in which a one-point move has a value of \$1,250. The stop-loss is \$98. To determine the trade's dollar risk, multiply the point value (\$1,250) by the difference between the entry price and the stop-loss level (\$100 - \$98 = \$2). A single contract's dollar risk is \$2,500. The system can risk \$30,000 for this trade, so it buys 12 contracts (\$30,000/\$2,500).

Test results: The equity curve (Figure 2) shows increases with low drawdowns until the beginning of 1999. Volatility increased at that point and the system's maximum drawdowns hit 40 percent (Figure 3). However, the system gained 9.59 percent annually, despite large losses in 1999 and 2005.

Figure 4's annual returns show the system generated large profits in most years. The system gained at least 10 percent in eight of the test period's 15 years. However, the system's **Sharpe ratio** is only 0.52 because of the large drawdowns.

Similar to other trend-following systems, this one has a low percentage of winners (39 percent) and holds them an average 52 days, while the losers are held only 18 days. The average profit per trade is 0.39 percent (\$7,968), which suggests the system is hardy enough to withstand higher slippage and commission costs.

The system generated 370 trades over the test period; more trades would be helpful in gauging the system's robustness in various market conditions. Its exposure (7.1 percent) is quite low, so you could consider increasing the position size to improve profits. However, risk and drawdown will increase too.

Bottom line: The Trend Strength Crossover indicator helped detect major trends. This test used 10 SMAs ranging from 10 to 100 days, but it is advisable to experiment with a different number of SMAs and other look-back periods. The system's volatility is high but its exposure is low, so consider investing the remaining equity in a different, uncorrelated strategy to flatten the equity curve.

—José Cruset of Wealth-Lab



No great wall here

Merc, China hook up on forex trading

The Chicago Mercantile Exchange (CME) and the China Foreign Exchange Trade System & National Interbank Funding Center (CFETS), China's foreign exchange and bond market, announced in March a multi-year agreement through which Chinese financial institutions and investors will have access to the CME's forex futures and options through the exchange's Globex electronic trading network. Interest rate products were also included in the agreement.

CFETS, also known as the National Interbank Funding Center, is part of the People's Bank of China central bank and is the country's only foreign exchange and interbank money market. Through the agreement, CFETS will become a CME clearing member and provide access for China-based investors who will be trading CME products. The terms of the agreement are subject to final approval by CFETS' and CME's governing bodies and regulatory agencies within China and the U.S.

In a CME press release, CFETS President Xie Duo said, "On CFETS' path to accomplishing further developments in China's interbank foreign exchange market, providing valid channels of new products for our member institutions is important for our success in the future. Our cooperation with CME provides a great opportunity for us to learn current experiences and practices associated with developing and deepening international financial markets."

CFETS currently calculates and officially publishes key

benchmark rates, such as the renminbi (yuan) benchmark exchange rate and the CHIBOR money-market rate in China. The agreement, which encompasses electronically traded forex and interest rate futures and options, will be marketed jointly by CFETS and the CME.

"Access to CME's global interest rate and FX futures and options contracts will provide Chinese institutions and investors with a new range of foreign currency denominated investment and risk management tools that complement CFETS' product offerings," said CME CEO Craig Donohue in the press release.

Currency managers off to shaky '06 start

The largest professional currency fund traders are following 2005's sub-par performance with negative returns in the early part of 2006, according to the [Barclay Trading Group's](#) index of currency managers.

Barclay's BTOP FX Index, which tracks the 50 largest forex-based commodity trading advisors (CTAs), was down 2.3 percent on the year as of March 28, and up only fractionally on the month.

To read about last year's top-performing currency managers, see "[Top currency traders of 2005.](#)"

CURRENCY FUTURES SNAPSHOT as of 3/27/06

The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields.

Contract	Pit sym	Elec sym	Exch	Vol	OI	10-day move	% rank	20-day move	% rank	60-day move	% rank	Volatility ratio/% rank
Eurocurrency	EC	6E	CME	120.8	123.9	0.31%	11%	1.74%	42%	1.63%	67%	.48 / 57%
Japanese yen	JY	6J	CME	64.1	154.1	1.76%	82%	0.49%	21%	1.19%	63%	.33 / 50%
British pound	BP	6B	CME	51.5	74.4	0.82%	75%	0.53%	23%	2.02%	98%	.38 / 48%
Swiss franc	SF	6S	CME	38.0	92.4	0.06%	0%	1.70%	50%	0.72%	51%	.57 / 67%
Canadian dollar	CD	6C	CME	34.3	92.0	-1.08%	46%	-2.31%	100%	-0.27%	56%	.39 / 42%
Australian dollar	AD	6A	CME	22.3	49.8	-3.89%	100%	-4.44%	100%	-3.16%	83%	1.08 / 100%
Mexican peso	MP	6M	CME	10.7	62.4	-1.86%	50%	-4.85%	100%	-1.41%	46%	.76 / 92%
U.S. dollar index	DX		NYBOT	5.3	24.5	-0.49%	33%	-1.00%	42%	-1.49%	66%	.45 / 63%
Euro / Japanese yen	EJ		NYBOT	2.0	19.3	-1.37%	67%	1.23%	48%	0.46%	10%	.34 / 20%
Euro / Swiss franc	RZ		NYBOT	0.7	9.8	0.31%	9%	0.02%	0%	0.90%	62%	.49 / 37%

Note: Average volume and open interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity is based on pit-traded contracts.

LEGEND:

Sym: Ticker symbol.

Vol: 30-day average daily volume, in thousands.

OI: 30-day open interest, in thousands.

10-day move: The percentage price move from the close 10 days ago to today's close.

20-day move: The percentage price move from the close 20 days ago to today's close.

60-day move: The percentage price move from the close 60 days ago to today's close.

The "% rank" fields for each time window (10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the % rank for 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the % rank field shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, the % rank field shows how the most

recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100% means the current reading is larger than all the past readings, while a reading of 0% means the current reading is lower than the previous readings. These figures provide perspective for determining how relatively large or small the most recent price move is compared to past price moves.

Volatility ratio/% rank: The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The % rank is the percentile rank of the volatility ratio over the past 60 days.

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Spot forex taxation: The case for “60/40” treatment

Tax rules for FX traders are cloudy, but don't let that stop you from pursuing the best tax treatment for spot forex contracts.

BY ROGER D. LORENCE, LLM

The rules for federal income taxation of foreign exchange trading are light years behind the developments in the marketplace. The Internal Revenue Code is stuck in 1984, when foreign exchange trading was a vastly different, and much smaller, world.

Back then, nearly all foreign exchange trading was conducted between banks (or other financial institutions) or through regulated futures contracts. Spot foreign exchange trading at the retail level hardly existed in 1984; today, it is one of the biggest (by dollar value) markets.

The tax treatment of spot forex trades is (surprise) just a mess. The nominees for best tax treatment of a spot forex contract are:

1. All gains or losses are always ordinary and open positions at year-end are marked-to-market.
2. All gains or losses are always ordinary and open positions at year-end are not marked-to-market.
3. All gains or losses are ordinary and open positions are marked-to-market, but the taxpayer may make a valid, timely election to treat them as “60/40” transactions (60 percent of gains or losses is long-term and 40 percent is short-term).

While we wait for the awards presenter (Internal Revenue Service Office of Chief Counsel) to open the envelope, you should be aware that because of positions the IRS has taken recently on other types of currency trading, the last nominee may be the most reasonable choice.

The marketplace

A spot forex contract is one that settles no later than two business days later than the day the “contract” is entered into, and the overwhelmingly majority are settled on a daily basis. Positions are rolled over from one day's settlement to the next. Although a position in a particular currency can be held for a long time (theoretically, indefinitely as long as there is cash in the account to support the position) — technically the contracts are settled in the spot market.

The definition of spot contract is vital for tax and regulatory purposes. The spot forex market is not overseen by any U.S. regulator. The Commodity Futures Trading Commission's (CFTC) position is that it does not have the authority to regulate the spot forex market — hence, there is no effective regulation of the traders and advisers. *Forex brokers*, however, are regulated by the

CFTC as Futures Commission Merchants (FCMs; similar to broker-dealers in securities) or they are banks or other financial institutions regulated by a banking regulator.

As a result, what regulation that exists in this market is imposed by the FCMs because they have their own risks. For example, if a spot forex trader wants to manage trading accounts for others, the resulting relationship (adviser-client) is not directly regulated by anyone. Rather, the forex broker, as an FCM or bank, is required to give the client the appropriate written disclosures, which are similar to those that would be furnished by the adviser if he were a Commodity Trading Adviser (CTA) regulated by the CFTC. As a result, from a regulatory standpoint, the spot forex adviser is in a unique regulatory spot — not effectively reg-

Foreign exchange trading at the retail level hardly existed in 1984; today, it is one of the biggest (by dollar value) areas in all of commodities and securities trading.

ulated by anyone, apart from state law rules governing the duties of anyone who manages other people's money.

The tax rules

The Internal Revenue Code contains two main sections governing the treatment of forex trading: Sections 988 and 1256. They were drafted at different times by different congressional staffers, and they fail to cross-reference each other effectively.

Section 1256 — No model of clarity

Section 1256 provides for special treatment of qualifying contracts, termed "Section 1256 contracts." Gain or loss is 60-percent long term and 40-percent short term, regardless of the trader's holding period for the contract. At current rates, this is a 23-percent federal rate, as opposed to a 35-percent federal rate for net gains from short-term trading or from ordinary income (such as wages and interest).

You have to factor in your own state (and local, if applicable) income tax rates. (State and local usually tax all income at the same rate, but there are divergences from the general rule.) If you are lucky enough to be a tax resident of Nevada, you will have a 23-percent maximum effective tax rate; if you live in New York City, it's around 35 percent. Regardless, the 12-percent savings at the federal tax level can count for a lot if you are a successful trader.

Section 1256 states that Section 1256 contracts include "foreign currency contracts." There are three requirements:

1. Contracts in foreign currency for which there are also positions traded through regulated futures contracts must require delivery or cash settlement;
2. The contract is traded in the interbank market;
3. The contract is entered into "at arm's length" at a price determined by reference to the interbank market price.

What does Congress mean by arm's length? Prices are determined to be at arm's length if they are based on the prices that would be paid in a transaction between unrelated parties, neither of whom is under a compulsion to act. For example, prices are determined at arm's length if they are based on prices posted by a large, reputable financial institution for similar transactions. As you can see, requirement three is the easiest to satisfy because all spot forex contracts are entered into at arm's length.

The first requirement is satisfied for all of the major currencies and many lesser currencies. For all of the currencies that are traded in the spot forex market, there is usually at least one regulated futures contract for that currency.

So, the second requirement has to be considered. The issue is whether the statute can be interpreted in a way that does justice to the intent — there is an active market for these contracts, so pricing can be determined objectively. This requirement was imposed by Congress because it was fighting tax shelters using manipulated forex contract prices. If objective pricing is the requirement, then the huge amount of trading in the spot forex market would certainly generate the type of objective prices the statute insists upon.

A notice about a recent type of foreign currency tax shelters issued by the IRS in 2003 seems to indicate that the interbank market requirement should not be taken literally. The IRS's interpretation of the law is that the taxpayer's actual contract does not have to be entered into in the interbank market, but only that similar contracts are traded in the interbank market. Given the gigantic size and diversity of contracts in the interbank market, it is safe to conclude that any contract entered into the retail spot forex market has an equivalent contract traded in the interbank market.

The IRS has yet to rule on the tax treatment of spot forex contracts under Section 1256. However, given the IRS's very broad reading of the statute in the 2003 notice, some tax practitioners have taken the view that the statute's reach extends to the spot forex contract, as long as requirement one (that there has to be at least one regulated futures contract for that same currency) is met. The IRS has indicated that they have this question under review and may issue guidance on it. However, in most cases the wheels of the Internal Revenue Service grind exceedingly slowly. Until then, it appears that a spot forex contract should be treated as a Section 1256 contract.

Section 988 — No model of clarity, either

For the purposes of this discussion, assume a spot forex contract in a currency for which there is at least one regulated futures contract qualifies as a Section 1256 contract. Next, we analyze Section 988, which deals exclusively with the tax treatment of foreign exchange contracts. Section 988 provides a general rule (laced with exceptions) that income or loss from foreign currency contracts is ordinary. Section 988 has specific rules for Section 1256 forex contracts that are either regulated futures contracts or regulated options (that is, forex options listed on CFTC regulated exchanges). These retain their 60/40 treatment unless the taxpayer affirmatively elects out. This specific exception does not apply to spot forex contracts.

However, another rule in Section 988 provides that a taxpayer may elect out of ordinary treatment for "a forward contract, a futures contract, or option" if they are forex contracts. (The reference to futures is regarding futures traded

continued on p. 42



on non-U.S. exchanges, as U.S. regulated futures are covered by the rule discussed immediately above.) This election is supposed to be made for each contract, which is obviously impossible in today's active forex trading world. In practice, an election is made in the taxpayer's books and records, covering all future spot forex contracts traded by the taxpayer, until the election is revoked by the taxpayer (through a notation in the books and records).

The issue is whether a spot forex contract is similar enough to forwards, futures, and options to afford the same tax treatment. The IRS's 2003 notice has been interpreted by some tax practitioners as authorizing a very broad view of the statute's scope, presumably allowing economically similar contracts to receive the same tax treatment. It is hard to differentiate a forward that settles in one week from a spot contract that settles in two days. Nonetheless, they would arguably be given very different tax treatment (35-percent rate vs. 23-percent rate for net gains).

Guidance

The IRS has not issued any guidance on this issue, although informally IRS lawyers have spoken of the need for more consistent tax treatment of economically similar contracts, whether securities or commodities. The issue for any spot forex trader is whether there is sufficient authority to treat spot forex contracts (for which there is a regulated futures in that currency) as 60/40 contracts, provided the taxpayer has made a valid election to opt out of the normal Section 988 treatment of forex as ordinary.

Especially important is whether to make the Section 988 election, and if so, when, how and for how long. It is clear that the statutory rules are a hopeless antique (Ronald Reagan was in his first term of office when Section 988 was enacted). Modernization of those rules may be appropriate, but until that occurs, take these guidelines into consideration. Ⓛ

For information on the author see p. 6.

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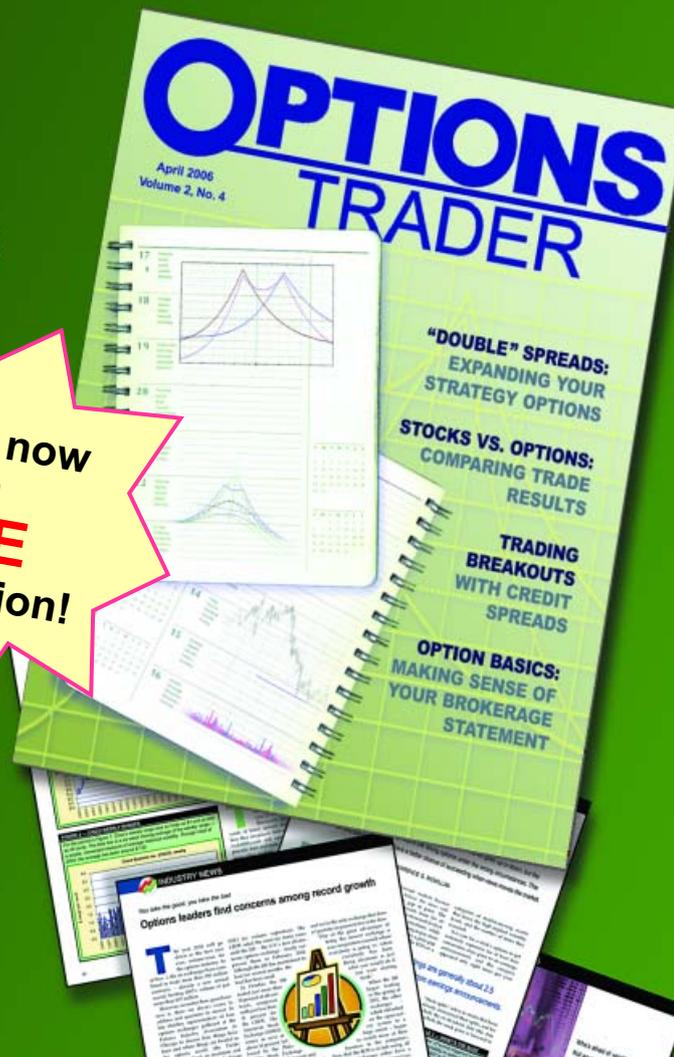
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EUROPE

▼ **French unemployment** remained stable at 9.6 percent in February, down 0.5 percent compared to its February 2005 rate. In March, French labor unions and students held regular protests against newly proposed work laws that would make it easier for employers to fire workers under the age of 26 without cause.

GDP growth in France decreased in 2005 compared to the previous year because of declines in manufacturing growth, especially in the auto industry, and drops in agricultural production, according to the INSEE. INSEE expects an annualized GDP growth of slightly more than 2 percent in the first half of 2006.

▼ **German unemployment rate** increased 0.1 percent to 12.2 percent, a 0.4-percent drop compared to February 2004.

According to Germany's Federal Statistical Office, **Germany's CPI** grew 2.1 percent in February over the same month a year earlier, as prices continued to rise for mineral oil products. Also, the country's **PPI** rose 5.9 percent from February 2005, posting its largest annual rate of change since a 6.4-percent gain in June 1982. The PPI increased 0.7 percent from January.

▼ **UK's jobless rate** increased 0.1 percent on the previous three-month period and rose 0.3 percent on the same period a year ago, according to preliminary estimates.

ASIA & THE SOUTH PACIFIC

▼ **Japan's jobless rate** grew 0.1 percent to 4.5 percent in January, the same rate as January 2005. The country's current account surplus shrank 7.6 percent in January, based on a year-to-year comparison.

▼ **Australia's Q4 2005 GDP** rose 0.5 percent from the previous quarter and 2.7 percent compared to Q4 2004. "Following the fall in GDP in Q4 2000, there have been 20

consecutive quarters of growth," noted the Australian Bureau of Statistics.

The country's CPI increased 0.5 percent over the previous quarter and 2.8 percent year-to-year.

The Australian jobless rate dropped 0.1 percent to 5.2 percent in February, but the rate was 0.1 percent higher compared to the same month in 2005.

▼ **Hong Kong's unemployment rate** remained steady in February at 5.2 percent, according to preliminary data.

AMERICAS

▼ **Argentina's Q4 2005 GDP** grew at a 21.5-percent rate compared to Q4 2004. The country's **unemployment rate** dropped 1 percent in February from January, 2 percent lower than February 2005.

▼ **Brazil's Q4 2005 GDP** increased 0.8 percent from the previous quarter, 1.4 percent higher than Q4 2004. The country's January unemployment rate increased 0.9 percent from December 2005, but was 1 percent lower than January 2005.

▼ **Canada's economy grew at a 2-percent rate in Q4 2005** — a 7.1-percent rise on the same quarter in 2004. The GDP for the entire year increased 2.9 percent, almost equal to the same figure for 2004. According to Statistics Canada, "[2]005 was the year of the consumer, as the 4.0-percent jump in personal expenditure on goods and services was the main contributor to overall growth in real GDP."

Canada's jobless rate in February fell to 6.4 percent, equaling the 30-year low reached in November 2005. Employment statistics showed an increase in employment in western Canada, strength in the youth labor market, more hiring in trade, and a continued upward employment trend in construction.

AFRICA

▼ **South Africa's economy** grew 3.3 percent over the previous quarter. Estimated annual GDP increased 4.9 percent, which was 0.4 percent higher than the 2004 growth rate.

**Unemployment rates refer to Q4 2005 or February 2006 numbers, unless otherwise stated.*

GLOBAL INTEREST RATES

Country	Interest rate	Rate	Last change	Sept. 2005	April 2005
U.S.	Fed Funds Rate	4.75	.25 (March 06)	3.75	2.75
Japan	Overnight call rate	0	--	0	0
Eurozone	Refi rate	2.5	.25 (March 06)	2	2
England	Repo rate	4.5	.25 (Aug. 05)	4.5	4.75
Canada	Overnight funding rate	3.75	.25 (March 06)	2.75	2.5
Switzerland	3-month Swiss Libor	1.25	.25 (March 06)	0.75	0.75
Australia	Cash rate	5.5	.25 (March 05)	5.5	5.5
New Zealand	Cash rate	7.25	.25 (Dec. 05)	6.75	6.75
Brazil	Selic rate	16.5	.75 (March 06)	19.5	19.5
Korea	Overnight call rate	4	.25 (Feb. 06)	3.25	3.25
Taiwan	Discount rate	2.25	.125 (Dec. 05)	2.125	1.875
India	Reverse repo rate	5.5	.25 (Jan. 05)	5	5
South Africa	Repurchase rate	7	0.5 (May 05)	7	7.5



FOREX (vs. U.S. DOLLAR)

Rank*	Country	Currency	Current price vs. U.S. dollar	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous rank
1		Swedish krona	0.12876	1.95%	2.35%	0.36%	0.145	0.1206	16
2		Euro	1.20408	1.34%	1.41%	0.00%	1.3123	1.1638	14
3		Russian rouble	0.03591	1.21%	3.37%	2.25%	0.03618	0.03447	8
4		Thai baht	0.02573	0.94%	4.93%	5.80%	0.02614	0.02362	5
5		Swiss franc	0.76313	0.48%	0.11%	-1.37%	0.8516	0.7525	15
6		Singapore dollar	0.61732	0.20%	2.80%	4.00%	0.62	0.5858	4
7		Hong Kong dollar	0.1289	0.00%	-0.08%	0.00%	0.1291	0.128	3
8		British pound	1.74283	-0.19%	0.50%	-1.62%	1.9216	1.7048	12
9		Indian rupee	0.02251	-0.31%	1.44%	-1.40%	0.02317	0.02152	6
10		Brazilian real	0.46539	-0.47%	7.43%	5.32%	0.4763	0.3635	1
11		Japanese yen	0.008517	-0.49%	-1.03%	-4.15%	0.00959	0.00824	9
12		Taiwanese dollar	0.0306	-0.75%	1.90%	1.53%	0.03225	0.02955	10
13		Canadian dollar	0.85686	-1.63%	-0.16%	0.43%	0.885	0.7851	2
14		South African rand	0.16096	-2.45%	1.74%	2.33%	0.1685	0.1427	7
15		Australian dollar	0.70895	-4.18%	-2.75%	-6.34%	0.784	0.7059	11
16		New Zealand dollar	0.60893	-8.20%	-9.73%	-11.53%	0.7376	0.6074	13

As of March 26 *based on one-month gain/loss

GLOBAL BOND RATES

Rank	Country	Rate	March 26	1-month	3-month	6-month	Previous
1	UK	Short sterling	95.37	-0.06%	-0.23%	-0.21%	3
2	U.S.	10-year T-note	107.155	-0.10%	-1.86%	-2.69%	4
3	Australia	3-year bonds	94.645	-0.14%	-0.12%	-0.08%	1
4	Japan	Government Bond	133.74	-1.43%	-2.14%	-3.44%	5
5	Germany	BUND	118.23	-1.77%	-2.85%	-3.70%	2

NON-U.S. DOLLAR FOREX CROSS RATES

Rank	Currency pair	Symbol	March 26	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	Real / Aussie \$	BRL/AUD	0.65735	3.88%	10.72%	12.52%	0.6573	0.4736	2
2	Franc / Canada \$	CHF/CAD	0.89136	2.15%	0.25%	-1.76%	1.0543	0.8646	20
3	Euro / Yen	EUR/JPY	141.42	1.84%	2.49%	4.38%	143.605	130.6	16
4	Real / Canada \$	BRL/CAD	0.54359	1.17%	7.83%	4.90%	0.5517	0.4451	4
5	Franc / Yen	CHF/JPY	89.68004	0.97%	1.15%	2.95%	93.14	85.1568	19
6	Franc / Pound	CHF/GBP	0.43803	0.67%	-0.43%	0.42%	0.4474	0.4289	18
7	Pound / Yen	GBP/JPY	204.759	0.30%	1.59%	2.67%	213.03	192.62	14
8	Real / Yen	BRL/JPY	54.68775	0.01%	8.79%	9.92%	55.8704	38.8672	3
9	Real / Pound	BRL/GBP	0.26718	-0.27%	7.13%	7.09%	0.2721	0.1954	8
10	Franc / Euro	CHF/EUR	0.634	-0.84%	-1.29%	-1.40%	0.6542	0.6334	15
11	Canada \$ / Yen	CAD/JPY	100.69	-1.15%	0.89%	4.82%	104.635	83.2354	9
12	Canada \$ / Pound	CAD/GBP	0.49193	-1.44%	-0.66%	2.12%	0.5041	0.4162	7
13	Pound / Euro	GBP/EUR	1.44867	-1.50%	-0.90%	-1.60%	1.5124	1.4102	10
14	Real / Euro	BRL/EUR	0.38682	-1.80%	6.18%	5.37%	0.3976	0.2819	1
15	Aussie \$ / Canada \$	AUD/CAD	0.82808	-2.59%	-2.60%	-6.71%	0.9837	0.8281	17
16	Canada \$ / Euro	CAD/EUR	0.71221	-2.93%	-1.55%	0.50%	0.739	0.6163	5
17	Aussie \$ / Yen	AUD/JPY	83.33283	-3.67%	-1.65%	-2.20%	91.34	80.63	13
18	Aussie \$ / Pound	AUD/GBP	0.40701	-4.01%	-3.25%	-4.75%	0.4398	0.4022	12
19	Aussie \$ / Franc	AUD/CHF	0.9297	-4.65%	-2.85%	-5.00%	0.9945	0.9107	6
20	Aussie \$ / Euro	AUD/EUR	0.58946	-5.41%	-4.06%	-6.24%	0.6424	0.5876	11

GLOBAL STOCK INDICES

Rank	Country	Index	March 26	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	India	BSE 30	10,950.3	7.35%	20.52%	29.15%	11,017.25	6,118.42	2
2	Australia	All ordinaries	5,001.6	3.14%	7.08%	9.56%	5,011.40	3,886.00	12
3	UK	FTSE 100	6,036.3	3.00%	7.88%	10.69%	6,044.00	4,773.70	7
4	France	CAC 40	5,218.71	2.85%	9.69%	14.27%	5,226.37	3,882.42	4
5	Japan	Nikkei 225	16,560.87	2.85%	2.81%	23.66%	16,777.37	10,770.58	10
6	Singapore	Straits Times	2,497.31	1.78%	7.26%	7.76%	2,517.13	2,107.67	5
7	Germany	Xetra Dax	5,973.14	1.74%	10.22%	19.51%	5,977.06	4,157.51	1
8	Italy	MIBTel	29,503	1.59%	9.91%	10.45%	29,780.00	23,450.00	3
9	Mexico	IPC	19,339.3	1.25%	8.79%	22.67%	19,675.66	11,727.51	14
10	Canada	S&P/TSX composite	11,947.61	1.16%	6.15%	9.57%	12,119.71	9,246.28	13
11	Switzerland	Swiss Market	8,045.1	1.14%	7.30%	17.41%	8,108.30	5,820.00	6
12	U.S.	S&P 500	1,302.95	1.05%	2.70%	7.18%	1,310.88	1,136.15	11
13	Hong Kong	Hang Seng	15,716.46	-0.88%	3.51%	2.89%	15,999.31	13,337.44	8
14	Brazil	Bovespa	37,577	-2.68%	12.85%	20.67%	39,395.00	23,680.00	9
15	Egypt	CMA	2,197.49	-7.73%	0.40%	11.66%	2,653.25	1,559.37	15

ACCOUNT BALANCE

Rank	Country	2005	Ratio*	2004	2006 ⁺	Rank	Country	2005	Ratio*	2004	2006 ⁺
1	Hong Kong	17.808	10.3	16.119	18.678	9	UK	-40.981	-1.9	-42.086	-40.118
2	Taiwan	14.369	4.3	18.606	16.26	10	Spain	-69.382	-6.2	-55.266	-80.067
3	Japan	153.101	3.3	172.07	140.484	11	U.S.	-759.018	-6.1	-668.082	-805.179
4	Germany	121.064	4.3	103.828	121.937	12	New Zealand	-7.946	-7.4	-6.141	-8.34
5	Canada	16.689	1.5	22.159	19.529	13	Australia	-38.765	-5.7	-39.797	-35.419
6	Denmark	4.797	1.9	6.001	5.468						
7	France	-27.253	-1.3	-8.396	-31.022						
8	Italy	-29.877	-1.7	-14.963	-24.394						

Totals in billions of U.S. dollars
**Account balance in percent of GDP + Estimate*
Source: International Monetary Fund, World Economic Outlook Database, September 2005



EVENTS

Event: Operations Conference for Securities, Brokerage & Trust

Date: April 2-4

Location: Omni Orlando Resort at ChampionsGate, Orlando, Fla.

To Register: www.fwfinancial.org

Event: American Association of Professional Technical Analysts' Second Annual Conference

Date: April 20-23

Location: Caribe Royale Resort, Orlando, Fla.

For more information: www.aapta.us

Event: National Association of Active Investment Managers (NAAIM) Annual Conference

Date: April 30-May 3

Location: The Ritz Carlton, Phoenix, Ariz.

For more information: E-mail Susan Truesdale at naaim@mindspring.com or call (888) 261-0787

Event: The Wealth Expo

For more information: www.thewealthexpo.com

Date: May 4-6

Location: Atlanta, Ga.

Date: Sept. 7-9

Location: Dallas, Texas

Event: optionsXpress Inaugural optionsXpo

Date: May 4-5 (pre-events on May 3)

Location: Sheraton Chicago Hotel & Towers

For more information: www.optionsxpo.com

Event: First Annual FXCM Currency Trading Expo

Date: June 3-4

Location: Hilton Hotel, West 53rd Street and Avenue of the Americas, New York, N.Y.

For more information:

www.fxcm.com/trade-show-page.jsp

Event: The Traders Expo Ft. Lauderdale

Date: June 7-10

Location: Broward County Convention Center, Ft. Lauderdale, Fla.

For more information: Call (800) 970-4355 or visit www.tradersexpo.com

Event: Expo Trader Brazil 2006

Third Annual International Traders Conference

Date: June 7-8

Location: São Paulo, Brazil

For more information: Call +55 21 2232 5133 or visit www.traderbrasil.com

Event: Hedge Fund Trading

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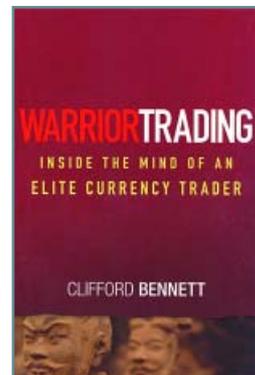


NEW PRODUCTS

Warrior Trading: Inside the Mind of an Elite Currency Trader

By Clifford Bennett
Wiley & Sons, 2006
Hardback, 172 pages
\$45

Bennett classifies warrior traders as an "elite group who consistently amass immense fortunes." He discusses the economic concepts, philosophies, and characteristics that make warrior traders fierce competitors. The three-part book covers subjects such as emotional price action, market positioning, and global economic forces accompanied by a few charts.



Note: Books listings are summarized from the material provided by publishers. They are not reviews or endorsements.



Correlation coefficient: Sometimes referred to simply as correlation, correlation coefficient is the degree of similarity between two variables. In the markets, correlation is typically used to measure how close the relationship is between two price series (e.g., two distinct stocks or markets), between an individual stock (or trading fund) and an index, and so on.

Correlation coefficients range between -1.00 and +1.00, with +1.00 representing perfect positive correlation (two variables moving precisely in tandem); and -1.00 representing perfect negative correlation (two variables moving exactly opposite to one another). A correlation coefficient of zero means the two variables have no discernible relation.

The site <http://davidmlane.com/hyperstat/index.html> offers relatively easy-to-digest definitions of this and other statistical terms.

Sharpe ratio: The Sharpe ratio was developed by Professor William Sharpe who won the Nobel Prize in Economics in 1990. The ratio measures risk-adjusted returns by subtracting the risk-free rate (usually represented by U.S. Government bonds) from the investment's performance and then dividing the result by its standard deviation. The higher the ratio, the larger the performance for a given amount of risk.

The formula is:

Performance - risk-free investment rate / standard deviation

Stochastic oscillator: A technical tool designed to highlight shorter-term momentum and "overbought" and "oversold" levels (points at which a price move has, theoretically at least temporarily exhausted itself and is ripe for a correction or reversal).

Calculation: The stochastic oscillator consists of two lines: %K and a moving average of %K called %D. The basic stochastic calculation compares the most recent close to the price range (high of the range - low of the range) over a particular period.

For example, a 10-day stochastic calculation (%K) would be the difference between today's close and the lowest low of the last 10 days divided by the difference between the highest high and the lowest low of the last 10 days; the result is multiplied by 100. The formula is:

$$\%K = 100 * \{(C_t - L_n) / (H_n - L_n)\}$$

C_t is today's closing price

H_n is the highest price of the most recent n days (the default value is five days)

L_n is the lowest price of the most recent n days

The second line, %D, is a three-period simple moving average of %K. The resulting indicator fluctuates between 0 and 100.

Fast vs. slow: The formula above is sometimes referred to as "fast" stochastics. Because it is very volatile, an additionally smoothed version of the indicator — where the original %D line becomes a new %K line and a three-period average of this line becomes the new %D line — is more commonly used (and referred to as "slow" stochastics, or simply "stochastics").

Any of the parameters — either the number of periods used in the basic calculation or the length of the moving averages used to smooth the %K and %D lines — can be adjusted to make the indicator more or less sensitive to price action.

Horizontal lines are used to mark overbought and oversold stochastic readings. These levels are discretionary; readings of 80 and 20 or 70 and 30 are common, but different market conditions and indicator lengths will dictate different levels.

Related reading: "Indicator Insight: Stochastics," *Active Trader*, August 2000, page 82.

Tracking error: How tightly a synthetic index matches an actual index. It is generally calculated as the square root of the sum of the squares of the differences between the synthetic index and the actual index, divided by the index itself. It's expressed as a percentage or as basis points.

True range (TR): A measure of price movement that accounts for the gaps that occur between price bars. This calculation provides a more accurate reflection of the size of a price move over a given period than the standard range calculation, which is simply the high of a price bar minus the low of a price bar. The true range calculation was developed by Welles Wilder and discussed in his book *New Concepts in Technical Trading Systems* (Trend Research, 1978).

True range can be calculated on any time frame or price bar — five-minute, hourly, daily, weekly, etc. The following discussion uses daily price bars for simplicity.

True range is the greatest (absolute) distance of the following:

1. Today's high and today's low.
2. Today's high and yesterday's close.
3. Today's low and yesterday's close.

Average true range (ATR) is simply a moving average of the true range over a certain time period. For example, the five-day ATR would be the average of the true range calculations over the last five days.



Low volatility readings indicate a potential price move.

TRADE

Date: Wednesday, March 1.

Entry: Long the euro/U.S. dollar rate (EUR/USD) at 1.1916.

Reason(s) for trade/setup: The EUR/USD rate had reached a significantly low-volatility condition at the beginning of March: On Feb. 28, the 10-day move in the euro currency futures (see the April 2006 *Active Trader* Futures Snapshot) had a percentile rank of 0, meaning the most recent 10-day move was smaller than the previous twenty 10-day moves, and the market's "volatility rank" had reached 2 percent. These statistics meant price action was exceptionally stagnant, which implied the chances of a volatility increase were good.

Initial stop: 1.1764, .0061 below the Feb. 27 low.

Initial target: 1.2100.

RESULT

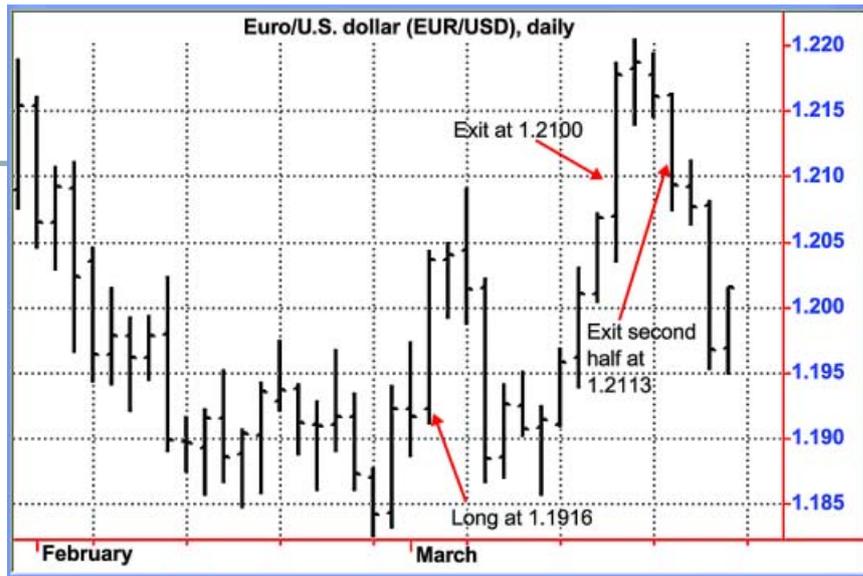
Exit: 1.2100 (first half); 1.2113 (second half).

Profit/loss: .0184, or 1.5 percent (first half); .0197, or 1.6 percent (second half).

Reason for exit: Initial target reached (first half); trailing stop hit (second half).

Trade executed according to plan? Yes.

Outcome: On March 6, the market rallied just nine ticks shy of the initial profit target — to 1.2091 — before reversing sharply intraday to close the U.S. session around 1.2000. We weren't watching the market at the time, or we might



Source: TradeStation

have exited when it showed weakness after virtually fulfilling the target.

Also, we were tempted to exit later in the day because of the formation of an outside bar with a lower close. However, the analysis in "Trading the euro inside-out" (*Currency Trader*, September 2005) showed that over the past 10 years, the EUR/USD has tended to move higher after such bars. With a 100-tick profit in hand at this point, we decided to wait to see what the next day would bring.

The next day brought disaster, in a word. The pair plummeted to a low of 1.1868, although it rebounded on March 8 to 1.1941.

The market finally hit the initial profit target on March 16. We exited half the position and moved the stop up to 1.2036 (.0022 below the day's low) with market trading above 1.2160. We then decided to move forward trailing a stop below the previous day's low.

This year has been rough on many of our trades so far, as most major currency pairs have been mired in trading ranges and follow-through has been minimal. Positions have started out profitable, but quickly withered.

Accordingly, it seemed as if it might have been a good idea to take this into consideration when the market rallied to 1.2091. The market did, after all, experience a volatility kick that appeared to peak on March 7; unfortunately, price didn't move in the desired direction. Fortunately, the trade stayed alive long enough to profit when price moved back up. 📌

TRADE SUMMARY

Date	Currency	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Trade length
3/1/06	EUR/USD	1.1916	1.1764	1.21	1.21	1.21	3/16/06	0.0184 (1.5%)	0.0289	-0.0058	11 days
						1.2113	3/21/06	0.0197 (1.6%)			14 days

Legend: IRR — initial reward/risk ratio (initial target amount/initial stop amount); LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade); MTM: marked-to-market — open profit or loss at a given time.

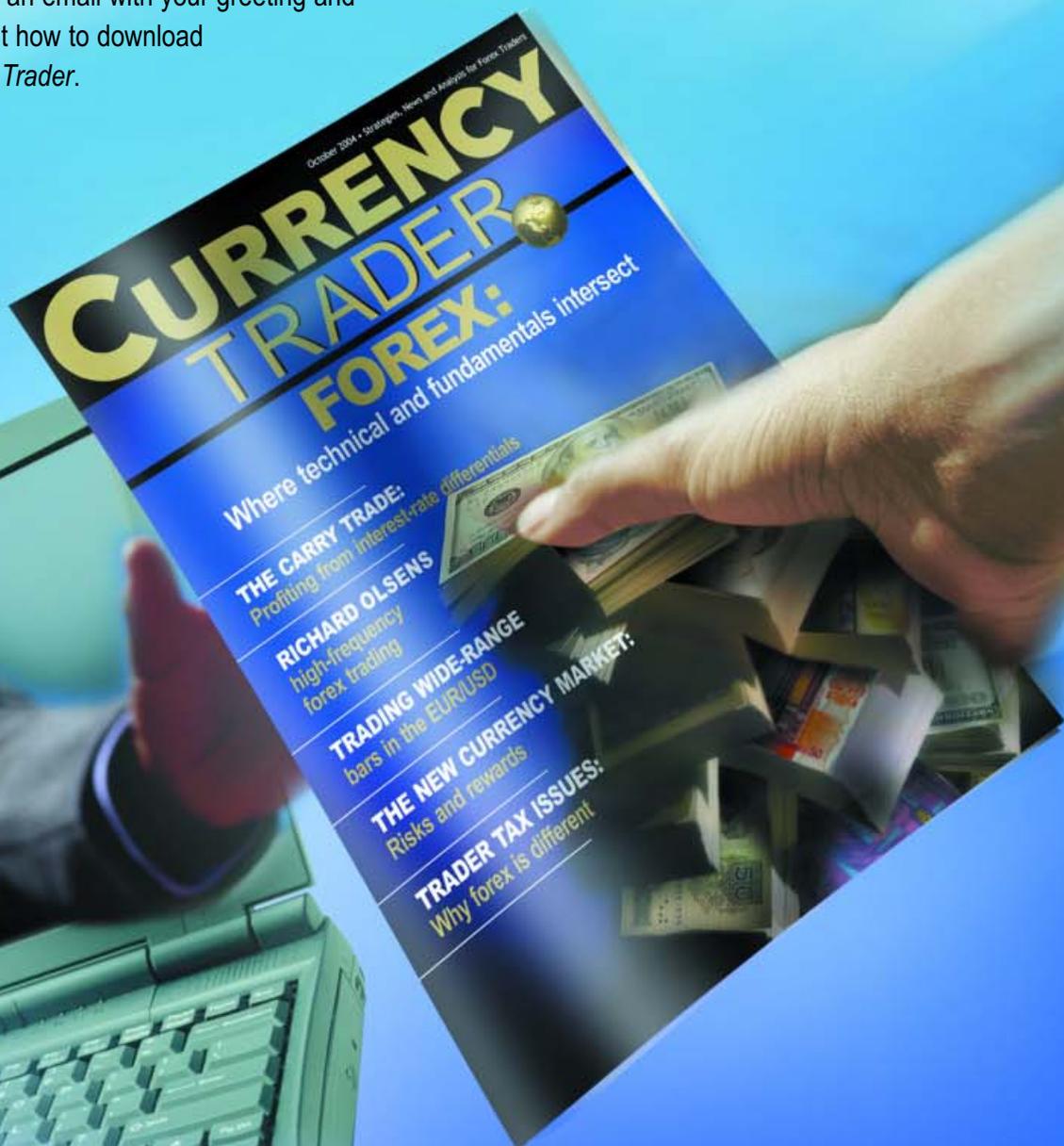
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3 U.S.: ISM report on business Japan: Account balances Australia: Index of commodity prices	4 Japan: Monetary base Australia: Reserve bank meeting	5 Great Britain: Monetary policy committee meeting	6 ECB: Governing council meeting Great Britain: Monetary policy committee meeting Germany: Orders received and manufacturing turnover	7 U.S.: Unemployment; wholesale inventories Germany: Production index; foreign trade; bankruptcies Australia: Official reserve prices	
10 Japan: Bank of Japan monetary policy meeting	11 Japan: Bank of Japan monetary policy meeting	12 U.S.: Trade balance Japan: Balance of payments Germany: CPI Italy: Balance of payments	13 U.S.: Retail sales Japan: Corporate goods price index Canada: Manufacturing survey	14 Japan: Monetary survey	15
17	18 U.S.: PPI	19 U.S.: CPI Germany: PPI Canada: Leading indicators	20 U.S.: Leading indicators ECB: Governing council meeting Canada: CPI	21 Canada: Wholesale trade; retail trade	22
24 Great Britain: Capital issues	25 Japan: Corporate service price index Canada: Interest rate announcement	26 U.S.: Durable goods Canada: Employment	27 Germany: Unemployment New Zealand: Reserve bank meeting	28 U.S.: GDP Japan: Bank of Japan monetary policy meeting Canada: GDP Australia: International reserves and foreign currency liquidity Italy: International reserves and foreign currency liquidity	
1 U.S.: ISM report on business Japan: Account balances	2 Australia: Reserve bank meeting Japan: Monetary base Germany: Retail turnover	3 Great Britain: Monetary policy committee meeting	4 ECB: Governing council meeting Great Britain: Monetary policy committee meeting	5 U.S.: Unemployment Germany: Bankruptcies Australia: Statement on monetary policy	6

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