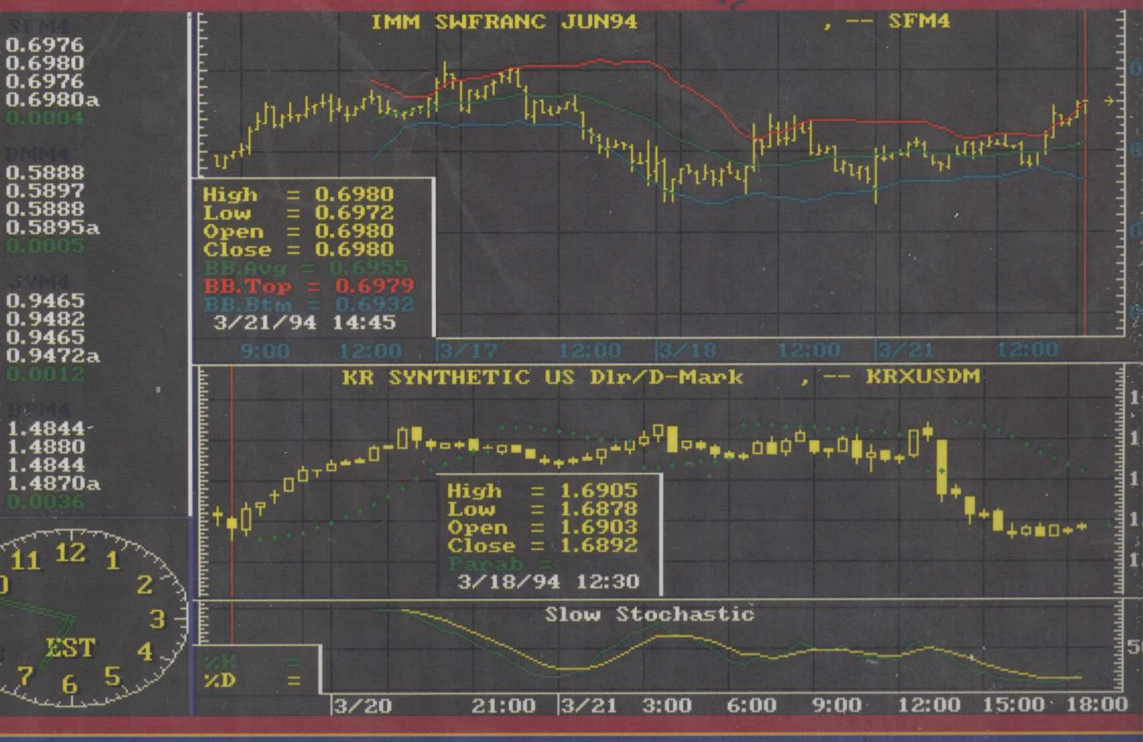
TRADING IN THE GLOBAL CURRENCY MARKETS



CORNELIUS LUCA

Trading in the Global Currency Markets

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Preface

Foreign exchange took off in earnest as recently as 1973, when currencies were finally allowed to float freely. Ostensibly a new industry, its origins can actually be traced to ancient times, when foreign coins started to be exchanged. Since stocks and bonds took several more millennia to come into existence, foreign exchange is, in fact, the oldest financial market.

Few financial instruments generate as much excitement and profitability. Traders from around the world enter positions for weeks, days, hours or only split seconds. The market can have explosive moves or steady flows. Money changes hands quickly, for a staggering daily average of $1 trillion. The foreign exchange profitability is legendary. George Soros' Quantum fund realized a profit in excess of U.S. $1 billion for a couple of days' work in September 1992. And Hans U. Hufschmid of Salomon Brothers, Inc. netted an income package of $28 million for 1993. Even by Wall Street standards, these numbers are heart stoppers.

It is impossible to envision a world without foreign exchange. Even the smallest transaction across borders triggers a currency exchange at one point or another. Whether importing or exporting raw materials, labor, manufactured goods or services, foreign exchange is an integral part of the transaction.

In addition to the corporate demand, currency trading provides a leading source of income for most financial institutions. In terms of profitability, commercial banks have steadily switched their focus from lending to foreign exchange. Along with investment banks, they set up sophisticated individual dealing rooms, somewhat resembling the NASA mission control rooms.

The latest newcomer to the markets, the hedge funds, rose to prominence in the early 1990s. Extremely aggressive, the hedge fund is able to concentrate billions of dollars into a single position, betting not only on the capacity of "reading" the market correctly, but also on its capability of "making" the market due to its sheer trade size.

Despite its high trading volume and its fundamental role, the foreign exchange market is rarely in the limelight. Since only a tiny fraction of the transactions are conducted on regulated exchanges, the currency markets are generally less visible and receive less media coverage.

There are no geographic, temporal or man-made boundaries to foreign exchange. This is a vibrant 24-hour market open to all eligible players. There are no official openings or closings, with the exception of the currency futures and the options on currency futures. Should the trading session not provide enough satisfaction, traders can deal after normal hours. And if there is a national holiday, players are generally able to find other markets open.

This book introduces you to all the significant aspects of foreign exchange in a practical manner, to best answer your typical questions, such as:

- Why do we trade currencies?
- Who are the players?
- What currencies do we trade?
- What makes them move?
- What instruments can we trade?
- How can we use them?
- How can we forecast currency behavior?
- How do we access the pertinent information?

The book is divided into six parts:

Part 1: Presents the basis of foreign exchange and the factors that contributed to the growth of the industry, from market developments to technological breakthroughs.

Part 2: Presents the historical developments in the market and how these elements have shaped the contemporary environment.

Part 3: Focuses on the mechanics of the market, the major players and markets, the risks pertinent to foreign exchange, corporate trading, methods of trading execution and dealing settlements.

Part 4: Analyzes foreign exchange instruments and provides comprehensive coverage of the major option strategies.

Part 5: Focuses on fundamental analysis, the economic indicators vital to the financial markets that may be disregarded in the currency markets, and the mind of the trader, for a point of view different at times from the typical theoretical expectation.

Part 6: Provides an exhaustive view on technical analysis, including an in-depth chart analysis comparing the major chart types, chart formations and oscillators, and a comprehensive discussion of candlestick and point and figure charts as they apply to foreign currencies only.

Leading experts in these fields have courteously contributed their significant knowledge and experience to this book. In addition to taking advantage of their level of sophistication, you will have the opportunity to learn and compare their financial services for your own use.

There are no miracle answers, of course—at least not in this book. In fact, I generally shy away from rules of thumb. The only solid answer I favor is, "It depends." What you will learn is what makes the market move and the traders tick.

You are presented with a comprehensive arsenal of trading weapons, many of them on the cutting edge of technology. You will answer yourself "on what it all depends." Based on these elements, you will be able to make your own choices, test them and ultimately use them for your own benefit.

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Chapter 1

What Is Foreign Exchange?

Foreign exchange is simultaneously a simple and complex notion, depending on the end-user. Despite the wide ranging points of view, they all have a common element. *Foreign exchange* is simply the mechanism which values foreign currencies in terms of another currency. An *exchange rate* is therefore the price of one currency in terms of another.

Why Foreign Exchange Occurs

Tourists around the world generate substantial foreign exchange flow. Whether the American tourists abroad in 1985 or the foreign tourists in the United States in the early 1990s, they all must convert their currencies to the local currencies to pay for traveling expenses. These small individual transactions generate important cash flow when compounded.

Investors around the world, large and small, are continuously hunting for investment opportunities. Whether in the equity markets, or real estate, or bank deposits, any international investment must, at one point or another, go through foreign exchange.

An American shopper may buy an American-made silk tie in an American boutique. Chances are that the silk was produced abroad. Even if an American buys an American car from an American dealer, if the car was assembled in Canada or Mexico, foreign exchange was executed.

The presence of foreign exchange in one or more stages of production is deeply ingrained, albeit not always obvious.

Global markets have become so competitive that corporations must continuously search the world for new markets and cheaper sources of raw materials and labor.

The degree of international integration generates interest rates adjustments, which in turn affect the foreign exchange rates.

Political changes are also major factors in foreign exchange. For instance, the fall of the Soviet Empire, despite its historic proportions, did not itself directly affect the foreign exchange market. However, a consequence of the fall, the German unification, generated a long term rally in the Deutsche mark, based on expectations of future economic might and short term high interest rates geared against inflation.

In terms of political or economic uncertainty, local currencies are quickly discarded in favor of safe-haven currencies, such as US dollars or Swiss francs. For instance, in the war-torn former Yugoslavia, where inflation rampages at incredulous rates of tens of million percent per year, the currencies of choice are US dollars and Deutsche marks.

In future chapters we will discuss in detail the major factors affecting the foreign exchange markets. For the time being, we must remember several of their general characteristics.The foreign exchange markets are:

1. sensitive to a large and continuously changing number of factors,
2. open to all players in the major currencies,
3. large and liquid in the major currencies,
4. concentrated on several currencies, and
5. extremely efficient relative to other financial markets.

Factors That Have Contributed to Foreign Exchange Volume Growth

The volume in foreign exchange has experienced a spectacular growth ever since currencies were allowed to float freely against each other. While the daily turnover in 1977 was US $5 billion, it increased to US $600 billion in 1987, to reach the US $1 trillion mark in September 1992 (see Figure 1.1).

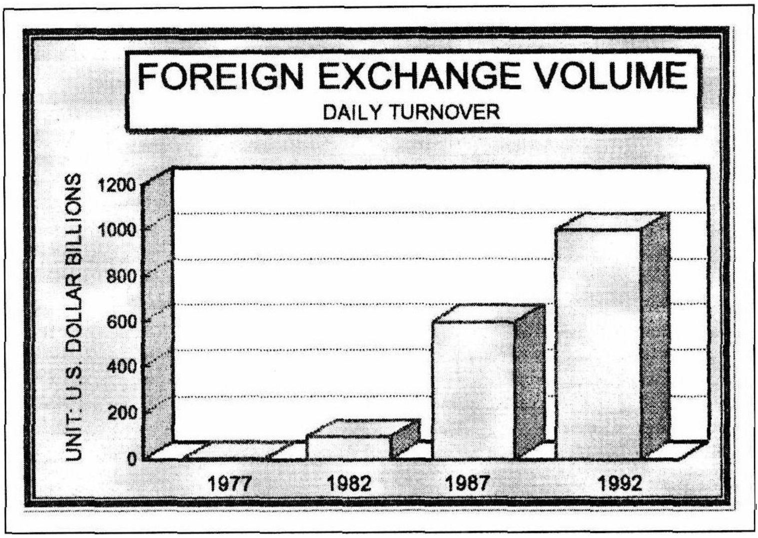

Figure 1.1. Since the currencies were allowed to float freely in 1973, the foreign exchange daily turnover was estimated to have reached the US $1 trillion mark by September 1992.

Volume in foreign exchange cannot be measured directly the way it is done in the stock market. Foreign exchange is generally conducted in a decentralized manner, with the notable exceptions of the currency futures and the options on currency futures. What is behind this spectacular growth?

Exchange Rates Volatility

During the last days of the fixed exchange rates system, few envisioned the volatility potential of the currency markets. People generally assumed that economic forces just needed occasional self adjutment in an otherwise quiet activity. Were they wrong. The unchecked increase of the US dollar in the 1980s had a destructive effect on the American exporters' international trade competitiveness. The US dollar's record highs were capped in September 1985 and the currency was sent into a two year nosedive, which trimmed 50 percent of its value (see Figure 1.2). The impact of the exchange rate activity on the international economy and trade is difficult to gauge.

For foreign exchange, currency volatility is a prime factor in the growth of volume. In fact, volatility is a *sine qua non* condition for trading. The only instrument which may be profitable under conditions of low volatility is currency options.