HOW TO FIND OPPORTUNITY IN FAST-MOVING MARKETS

HARNESSING MARKET VOLATILITY

One of the benefits of trading forex is the opportunity to find profit potential in both rising and falling markets.

Since the market can go up or down at a moment's notice, volatility can work to your advantage—if you know how to use it. We'll show you some technical and fundamental analysis that can help you harness market volatility, as well as some risk management techniques that can help you capture potential profit and limit losses.

An example of market volatility

The following table illustrates the percentage change of different instruments since October 2007 and July 2008. **Oil prices plummeted more than 50 percent** in that time frame while the **EUR/USD, GBP/JPY and USD/JPY fell approximately 20 percent.** The daily trading ranges increased significantly as few hundred point swings in the Dow became the norm. The same was true for currencies where the average daily range expanded significantly. The average true range for many currency pairs doubled in that period.

PAIR	OCTOBER 1, 2007	CHANGE	JULY 1, 2008	CHANGE	OCTO-BER 23, 2008
EUR/USD	1.4282	-10%	1.5827	-19%	1.2820
GBP/USD	2.0495	-21%	2.0000	-19%	1.6105
USD/JPY	106.39	-9%	123.29	-21%	97.32
DJIA	14116	-39%	11408	-25%	8545
SP500	1549	-42%	1285	-30%	897
FTSE	6467	-37%	5626	-28%	4046
DAX	7922	-44%	6395	-30%	4456
NIKKEI	16773	-50%	13515	-37%	8461
ASX	6568	-39%	5232	-24%	3974
OIL	82.0	-18%	143.3	-53%	68
GOLD	747.4	-6%	948.3	-26%	705
VIX	18.44	272%	25.14	173%	68.61

20% change

>50% change

To increase the probability of successful trades, traders must understand whether the market is in trend or range. Common technical indicators that can help traders delineate between the two different market conditions include Bollinger Bands and ADX.

BOLLINGER BANDS

Range Trading Zone

Buy Zone

Sell Zone

ACTUAL SCREENSHOT Source: GFT

BOLLINGER BANDS ARE GREAT TOOLS TO USE TO HELP DETERMINE WHEN A CURRENCY PAIR ENTERS OR EXITS A TREND. FOR THOSE TRADERS WHO LIKE TO PICK TOPS AND BOTTOMS, A GOOD WAY TO DO SO IS TO WAIT FOR THE CURRENCY PAIR TO EXIT THE BUY OR SELL ZONES.

Basically, Bollinger Bands plot standard deviations above and below a moving average. They are typically used to determine volatility, but you also can use Bollinger Bands to help gauge trends. In the chart above, we plotted a standard Bollinger Band using the settings **20,2** (which means 2 standard deviations away from the 20-day moving average) and then added a set of **20,1** (1 standard deviation away from the 20-day moving average). This helps us to create our **Buy Zone** and **Sell Zone**.

The **Buy Zone** is the zone between the upper Bollinger Band of 2 standard deviations and the upper Bollinger Band of 1 standard deviation. The **Sell Zone** is the zone between the lower Bollinger Band of 2 standard deviations and the lower Bollinger Band of 1 standard deviation. If the currency pair closes below the **Buy Zone** or above the **Sell Zone**, we say that it has entered the **Range Trading Zone**.

AVERAGE DIRECTIONAL INDEX (ADX)

Shaded sections were inserted to represent the times when ADX crossed the 30 mark.

Strong Trend

Range Trading

AS A RULE OF THUMB, IF THE ADX IS GREATER THAN 30, A TREND IS STRONG. IF ADX IS BELOW 20, A TREND IS WEAK. IN A STRONG TREND, WE WANT TO SEE THE ADX SLOPING UPWARDS.

The **Average Directional Index (ADX)** is a classic measure of a trend's strength. Unlike Bollinger Bands and Moving Averages, which can help define the direction of the trend, **the ADX simply measures whether the trend is strong or weak**. The index is displayed on a scale of 0 to 100 as an oscillator in a separate box below the price chart.

In this example, the ADX crossed above the 30 mark when the currency pair was trading at 1.52. Over the next month, the currency pair gained strength at a relatively rapid pace, hitting a high above 1.60. When the ADX crossed back below the 30 mark, the currency pair ended up range trading for the next few months before breaking lower.

AVERAGE TRUE RANGE (ATR)

YOU CAN SEE THAT IN THIS 12 MONTH PERIOD, THE ATR FOR USD/JPY RARELY WENT OVER 1.40. IN SEPTEMBER, NOT ONLY DID THE ATR BREAK ABOVE THAT LEVEL, BUT IT REACHED AS HIGH AS 2.5. THE ATR HAD DOUBLED FOR THIS PAIR.

The **Average True Range (ATR)** index **measures the volatility of a currency pair over a given period of time**. The **true range** is the greatest of the following:

Current HIGH minus current LOW

Current HIGH minus previous CLOSE

Current LOW minus previous CLOSE

The standard ATR setting is 14, so it calculates the average of the **true range** over the past 14 periods.

In the USD/JPY chart above, you can see that over a 12 month period, the ATR for USD/JPY rarely went over 1.40. Then, not only did the ATR break above that level, but it reached as high as 2.5. This indicates that the average trading range for the currency pair more than doubled! Therefore, for technically oriented traders, stops may need to be adjusted accordingly.

SHORT-TERM VS. LONG-TERM TRADING

In looking at the ATR of many currency pairs, traders may realize that the daily range is wide for some pairs that long-term trading is very difficult. The trend may be clear, but a reasonable and logical stop may not.

IT MAY BE MORE BENEFICIAL TO LOOK FOR SHORTER-TERM TRADING OPPORTUNITIES IN THE DIRECTION OF THE TREND.

As indicated earlier, Bollinger Bands and ADX are useful tools to help gauge whether the market is in trend or range.

COMMON TRADING PATTERN

Triangles

Price Channels

Head and Shoulders

Buy

IN TODAY'S TRADING ENVIRONMENT, THERE ARE SEVERAL PATTERNS THAT CAN BE HELPFUL FOR SHORT TERM TRADERS.

Given the strength of the moves in the market, breakout patterns may be particularly fruitful on both a continuation and reversal basis.

TRIANGLES

TRIANGLE PATTERNS USUALLY DEVELOP IN TRENDING MARKETS IN THE FORM OF A CONSOLIDATION AREA.

The continuation pattern is formed when a series of candles place lower highs and higher lows, developing a triangular shape. We can see this in the 1-hour EUR/USD chart.

PRICE CHANNELS

PRICE CHANNELS OCCUR WHEN THE PRICE ACTION FORMS BETWEEN TWO PARALLEL TREND LINES.

When a breakout occurs, prices will often retrace and use one of the trend lines as support/resistance. As seen on the chart above, typically the more times these parallel trend lines are touched during the formation, the stronger the pattern becomes and the more powerful a breakout if any of the channel walls are broken.

HEAD AND SHOULDERS

Shoulder

Head

THE HEAD AND SHOULDERS PATTERN OCCURS AT THE END OF A PREVIOUS UP/ DOWN TREND AND IS USUALLY CONSIDERED TO BE A REVERSAL PATTERN.

It consists of a left shoulder, head, and right shoulder. The neck line is the base of this pattern and is the support/resistance level where the rallies from shoulder to head fail. Though the pattern can occur in either direction, we will describe the one occurring after an up-trend.

In the chart above, the left shoulder is part of the continuation from the previous trend, which makes a small retracement and then continues higher. The head develops as price action creates a higher high, then retraces once again. The right shoulder develops when the retracement from the head is reversed but fails to form a higher high. Price action should soon break lower through the neckline to confirm the reversal pattern.

THE ROLE OF FUNDAMENTAL ANALYSIS

While technical analysis is extremely important to determining ranges or trends in volatile markets, you should also understand the fundamental forces driving the markets. Major and minor economic announcements, not to mention political turmoil, can have profound impacts on a country's currency, both in the short and long terms.

TROPICAL STORM WANDA UPGRADED TO HURRICANE LEVEL IN THE ATLANTIC

FED RESERVE CHAIRMAN TESTIFIES BEFORE CONGRESS

EUROZONE CONSUMER PRICE INDEX (CPI) RELEASED

IN ESSENCE, FUNDAMENTAL ANALYSIS IS THE STUDY OF THE POLITICAL, SOCIAL AND ECONOMIC FORCES THAT DRIVE THE SUPPLY AND DEMAND TRENDS OF A PARTICULAR CURRENCY.

Traders can use this information to attempt to determine whether current or potential future conditions may drive the value of a nation's currency up or down.

Many traders prefer to combine technical and fundamental analysis to help determine the proper market conditions for trading. Because most economic announcements are regularly scheduled, it is often easy to anticipate times when the market may be more volatile. While some traders choose to attempt to trade on news announcements, others prefer to stay out of the market due to the market's unpredictable reactions.

YOU CAN FIND A SCHEDULE OF THESE ECONOMIC ANNOUNCEMENTS BY DOWNLOADING GFT'S ECONOMIC CALENDAR.

OUR DERIVATIVE MARKET STRATEGIST, DAVID MORRISON AND OUR DIRECTORS OF CURRENCY RESEARCH, KATHY LIEN AND BORIS SCHLOSSBERG OFFER FUNDAMENTAL AND TECHNICAL COMMENTARY ON GFTUK.COM.

IN ORDER TO MAKE THE MOST OF VOLATILITY, DON'T FORGET ABOUT...

ORDER TYPES

Use order types to manage risk and protect potential profit.

AUTOMATIC TRAILING STOP

Trails your position at a preset distance as the market moves.

LIMIT

Specifies that a trade must be executed at a specific price or better.

PARENT & CONTINGENT (P&C)

Allows you to easily place a trade, including stops and limits, in just one step.

ORDER CANCELS ORDER (OCO)

Both a stop and a limit order— when one order is executed, the other is canceled.

SETTING PROPER STOP LEVELS

A trader has to avoid the trap of "bleeding to death from a thousand small cuts." A narrow stop can cause more damage to your account balance if it's frequently triggered. Make sure to consider:

The volatility of the underlying currency pair.

The duration of the trade (intra-day, daily, weekly).

Any significant support or resistance points on the chart.

A TRADING PLAN

Create and follow your trading plan. Here some sample questions to get you started:

1 Will I trade only one specific currency pair or many?

2 Will I trade on a daily basis or hold my positions for days or longer?

3 What will be my maximum risk per trade?

4 If I trade on a daily basis, how many consecutive losses will I tolerate before stopping for the day?

5 Will I generate signals using technical analysis or fundamental analysis?

6 What will be the specific rules of my setup? (For example: I will enter a long trade when the price crosses the 20-period simple moving average on a five-minute chart.)

7 Will I use fixed-point stops or chart-based stops to control my risk?

8 Will I have one profit target or will I scale out of my position?

REMEMBER, ALL TRADERS INCUR LOSSES FROM TIME TO TIME.

The most successful traders stick to their strategies and employ the technical, fundamental and risk-management tools at their disposal to try to ensure that their potential profits outweigh their losses.