eurotrader

Introduction to Financial Markets

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INTRODUCTION

"Investment in knowledge pays the best interest."

Benjamin Franklin

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What is Forex?

Forex, short for foreign exchange, is a **decentralized global market** where all of the world's currencies trade.

Each forex trade involves two currencies because you're betting on the **value of one currency against another**. In the EUR/USD, the most traded currency pair in the world, the Euro is the base currency and the US Dollar is the quoted currency. If the price of the EUR/USD pair is 1.12 it means that 1 euro is equal to 1 dollar and 12 cents. If, for example, the number increases, this means that the Euro is getting stronger in relation to the Dollar.

As the market is open 24 hours a day, five and a half days a week, it's become **extremely liquid** over time. Trades can be closed within minutes of opening, as well as be held for months. And due to the size of the market, even players as large as banks can't easily manipulate the prices. They are driven only by supply and demand. All of that has led Forex to becoming the favorite place for many traders.

What's a Commodity?

A commodity is a **raw material** used in commerce. Commonly traded products are gold, oil, natural gas, silver, copper, coffee, and wheat.

The fundamental principle is that all commodities of the same grade are **interchangeable** with other products of the same category regardless of who produced it.

Investors buy and sell commodities through **futures contracts**. The minimum quantity is defined by the exchange, for example, one oil contract might include 50 barrels. The trade also determines what grades of oil can be used to satisfy the contract. All oil that fits the requirements will be sold for the same price, no matter who produced it.

What’s an Index?

Traders need to monitor the condition of the market. As it is too complicated to track every single security in the market or even in a market sector, financial specialists have started to **combine individually traded stocks** into indexes. For example, British Petroleum is quoted separately but is also included in the Oil and Gas Index.

Each index is calculated in a slightly different way, but its value represents a **weighted average** of the current values of its component stocks.

For instance, the Dow Jones Industrial Average has stocks from 30 of the most significant companies in the US. Meanwhile, the S&P 500 index comprises of 500 of the most widely traded companies in the US. As the S&P 500 is more diverse, it can give a **better representation** of the condition of the US stock market as a whole.

Besides Dow Jones and S&P 500, some **widely traded indices** are:
- The FTSE100 (London)
- The DAX30 (Frankfurt)
- The Hang Seng (Hong Kong)
- The Nikkei 225 (Tokyo)
- The Shanghai Composite (Shanghai)

What’s a Share?

Shares, also known as stocks, are the **unit of investment** in individual companies. When a company is listed on an exchange, it issues a fixed number of shares that represent the value of a certain percentage of the company. Each of those shares has a nominal value, but after the launch, they start being traded at the market price. It will increase or decrease depending on the demand, which in turn is driven by the attractiveness of the company to the investors.

Some **widely traded stocks** are:

- Apple
- Google
- Amazon
- Facebook
- Alibaba
- Tesla

What's a CFD?

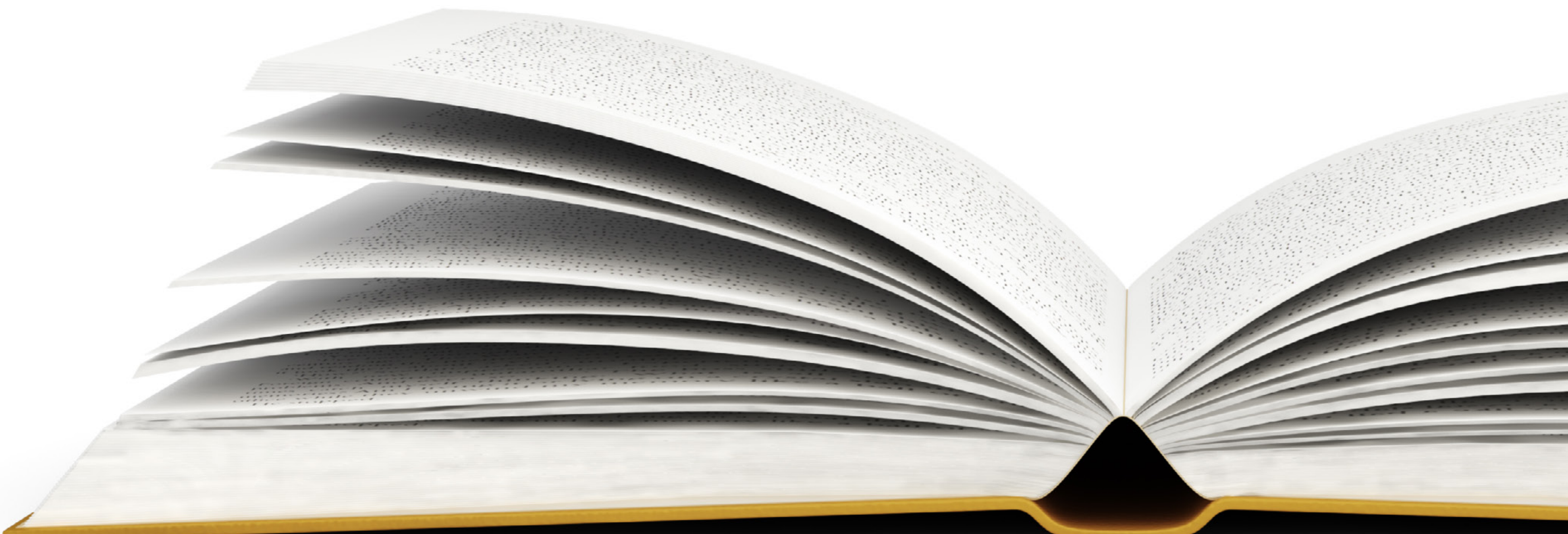
A contract for difference, known as CFD, enables traders to speculate on the rising and falling prices **without owning** the underlying asset. This is possible through a contract between a client and a broker that does not involve an actual forex, stock or commodity exchange. There are several significant advantages that have led to CFDs becoming immensely popular in the recent years.

CFDs offer **higher leverage** than traditional trading, which means greater potential profits from smaller investments. Of course, increased leverage can also bring bigger losses.

CFD trading also allows assets to be **shorted at any time**, while certain markets either prohibit shorting or have different margin requirements compared to long positions. This is possible because with CFDs there is no additional cost for the broker.

The negative side of CFD trading is having to pay the **spread** which discards the potential to profit from minor price movements.

TERMINOLOGY



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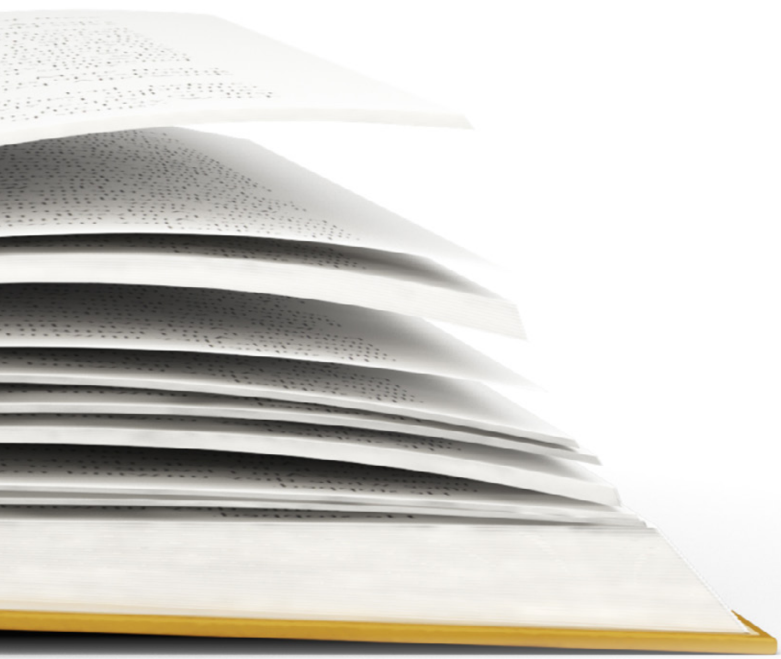


Pips, Points, and Ticks

Pip, point, and tick are terms used to describe **price changes.**

A **point** represents the **smallest price change to the left** of the decimal point. An investor might describe a stock price increase from $70 to $73 as a three-point movement.

A **tick** is the **smallest price change to the right** side of the decimal point. Markets have different tick sizes: it could be 0.1, 0.01, or even 0.25, as with the S&P 500 E-Mini. In that case, a point equals 4 ticks.

A **pip** usually refers to the **fourth decimal place** of a price. If the EUR/USD pair moves from 1.1205 to 1.1206, that is a one-pip movement. However, sometimes the term could also be used for any smallest possible price change, regardless of the decimal place, precisely like the tick. The difference being that the pip term is largely used in the Forex market, while the tick — in the futures market.

Balance and Equity

The **balance** represents the outcome of a trader's **closed positions**, be it a profit or a loss. The **equity** is what the traders would see in the balance if they were to close all their **open positions** at this moment.

So as long as an investor has ongoing trades, the balance **does not represent** the actual amount of your funds. Even if they have a significant balance, they could have much less equity if there are open positions with substantial losses.

For example, if a trader has deposited $500 and opened a position that's gotten them a loss of $100, they would see the balance of $500, but the equity of $400.

Bull and Bear Market

A **bull market** is when prices are **rising** or are expected to rise. Bull markets are associated with investor expectations that strong results are to continue.

When investors are pessimistic and expect prices to **decline**, it is referred to as a **bear market**.

The names are assumed to have originated from the way the animals attack. A bull places its head down and **points the horns up**, while the bear raises its hands and **presses the pray down** to the ground.

Lots

When investors purchase and sell financial instruments, they generally do so in **batches** rather than single instances. These batches are called lots.

The **lot size differs** depending on the market and the security you're trading. The common sizes for currency pairs, for example, are 100,000 for a standard lot, 10,000 for a mini lot, and 1,000 for a micro lot. But the sizes could very well differ even for two instruments of the same market: Gold could sell by lots of 2 units each, while a Silver lot would consist of 100 units.

Bid and Ask Prices

The price at which a security is **sold** for is called the **bid price**, also known as the sell price. The **ask price** is how much one can **buy** a security for. Thus it is often called the buy price.

Sometimes the bid and ask prices are equal, but usually, there's a small difference called **spread**. The spread goes to the market maker as compensation for the risk.

For a liquid instrument, it is easy for the market maker to turn around and buy/sell to someone else, so the spread is small. For less liquid securities, however, the spread has to be more substantial to **compensate** for the risk of potentially having to carry the instrument for some time, during which the price could go into the wrong direction.

Short and Long Positions

When a trader **buys** a security expecting for the price to rise, it's called a **long position**. They will be able to sell it later for a higher price and pocket the difference. For example, an investor who buys 10 shares of Google is said to have gone long 10 shares.

But sometimes a trader expects a stock or a currency to depreciate. Then they would bet against the market and **sell** the security now to repurchase it later at a lower price. That's called **shorting**, and you don't need to own a security to sell it. For example, if a stock is worth $50 and an investor opens a sell position for one share, once the price goes down to $40, they will profit $10.

Stop Loss and Take Profit

A **stop loss** order closes a position if the security reaches a certain price. Essentially it stops losses from mounting up if the price goes in an unfavorable direction. No matter how confident a trader is, it is recommended to set a stop loss order to each position just in case.

However, even if a position is profitable, an investor might not want to risk the price turning the other way, so they set a **take profit** order. This way the position would be liquidated upon reaching a certain profit.

With these options, a trader does not need to continually monitor the charts as the positions will **close automatically** when specified.

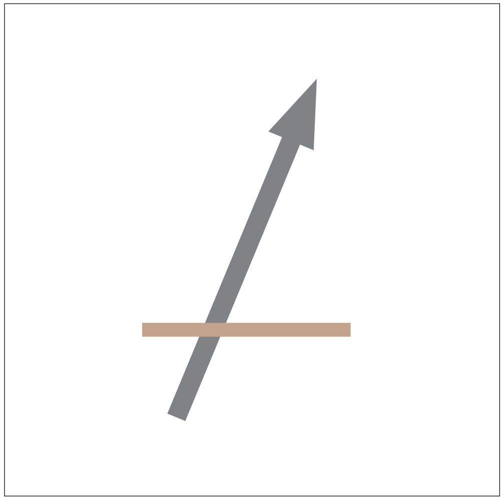
Pending Orders

A pending order, also known as an entry order, is placed when a trader wants a position to be opened when a security reaches a **certain price**.

For example, if the EUR/USD currency pair gains 20 pips, you might expect the price to continue rising. You can either monitor the chart and open a position manually, or place a pending order which will execute only if the price will indeed increase by 20 pips.

If the security price never reaches the target, the order will never be executed. It will **expire** sometime later so that it doesn't trigger a position unexpectedly when the price happens to reach the target, but the market situation has changed.

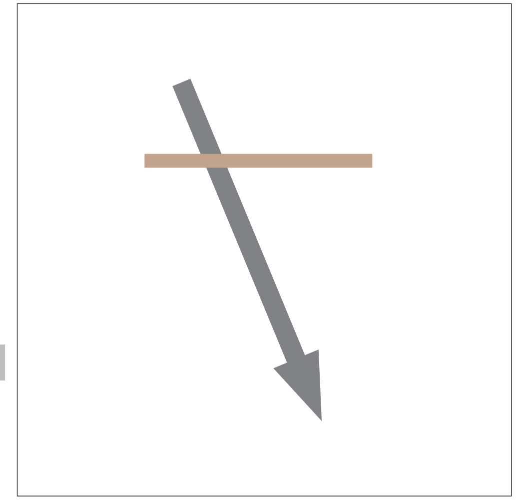
Pending Orders

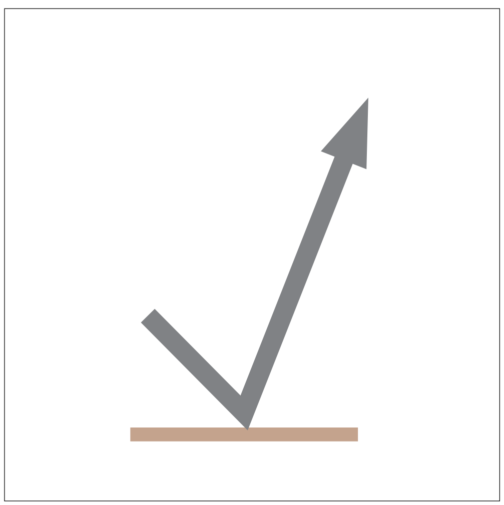


There are four types of pending order.

Buy Stop is selected when a trader anticipates the current uptrend to continue rising, therefore the entry point is placed above the current price.

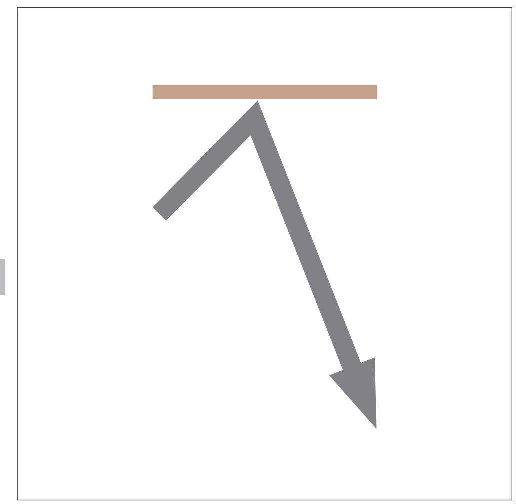
Sell Stop, on the other hand, is placed below the price during a continuing downtrend.





With **Buy Limit**, the market is currently declining, but the investor expects it to bounce back, thus an entry point is created below the current price.

Sell Limit anticipates the uptrend to reverse into a downtrend, therefore the trigger price is placed above the price.



Leverage and Margin

Since fluctuations in price changes are small most of the time, a common trader would not benefit much by investing solely their own money. So brokers provide a way to open positions for **larger amounts** than the trader has in the balance. It's called **leverage**.

For example, if an investor has deposited $100 and the broker provides leverage with a ratio of 200 to 1, the investor can open a position for as much as $20,000. The $100 of their own money would be called the **margin**.

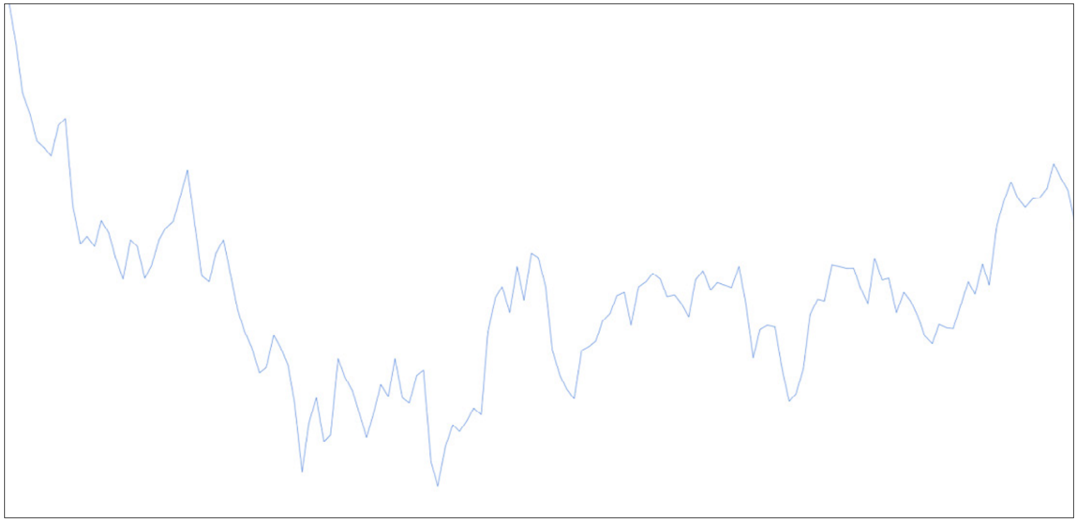
It is important to remember that leverage could increase not only the trader's profits but also their losses.

Chart Types

There are several types of charts a trader can use for analysis. We'll show you the most popular ones and to make things simpler, all the examples will use the same trading session.

Line Chart

A Line chart has a single line connecting all the closing prices. It doesn't offer much detail, but a Line chart is good for observing long-term trends and picking out patterns like Head & Shoulders and Triangles.



Bar Chart

A Bar chart shows the closing prices, the opening prices, and the highs and lows of a security.

Chart Types

Candlestick Chart

Candlestick charts show the same information as bar charts except for each candlestick having an enlarged region between the opening and the closing prices. It's called the body of a candlestick and it makes it easier to spot bar patterns.

Point and Figure Chart

A Point and Figure chart has a series of X's and O's. Each X represents an increase in the price and O shows a decline. Whenever the market reverses, a new column is drawn. That's why a trader never sees X and O in the same column. This chart is mostly used for long-term trends, like the line chart.

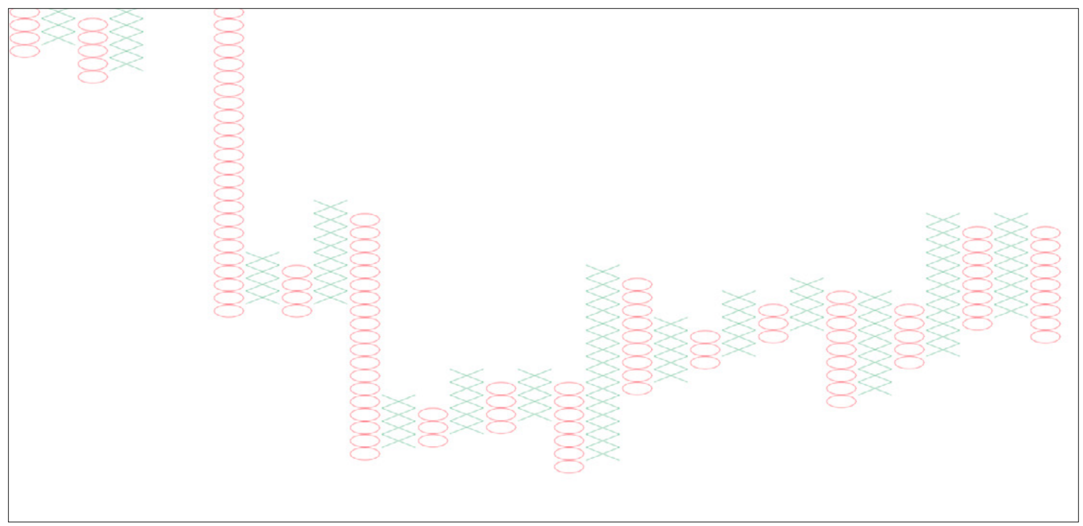
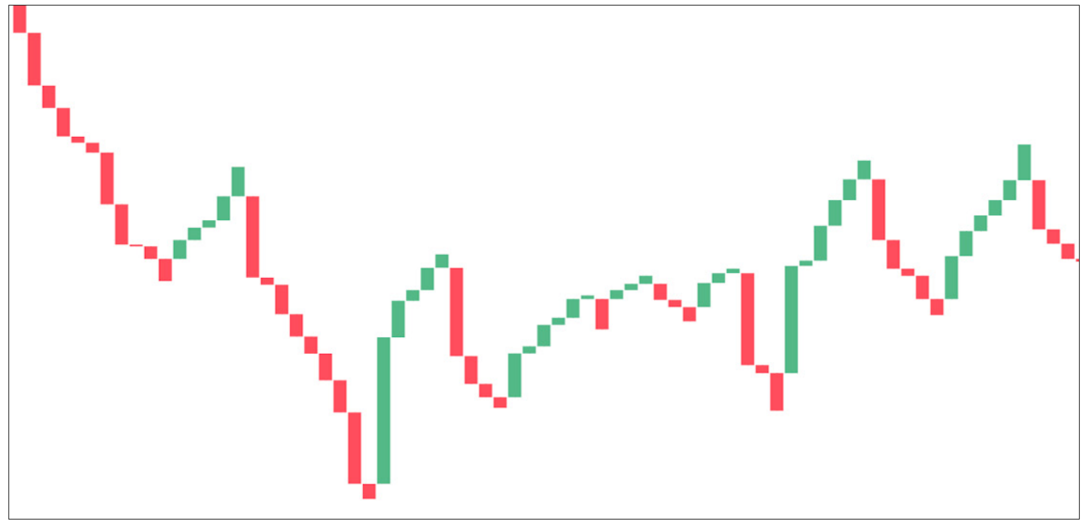
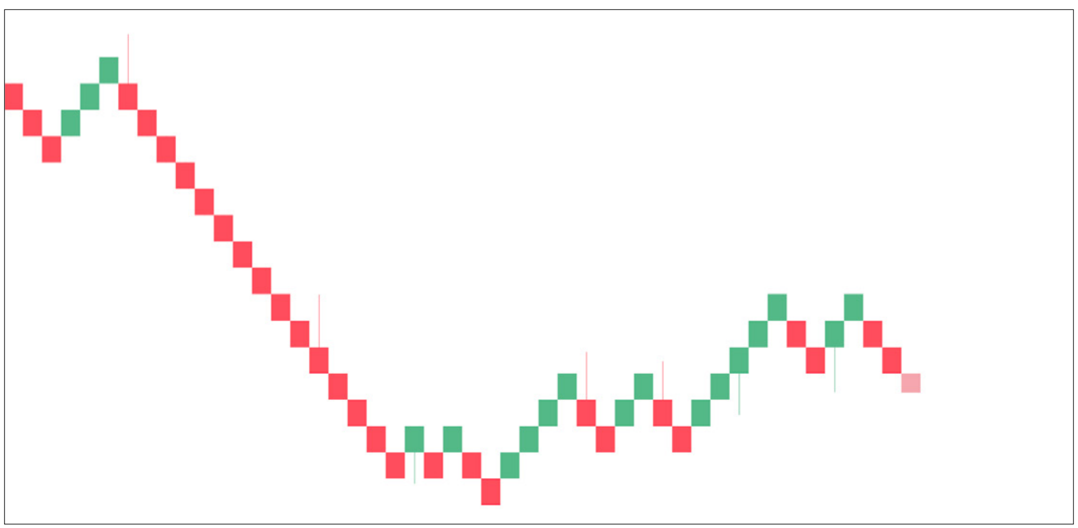


Chart Types

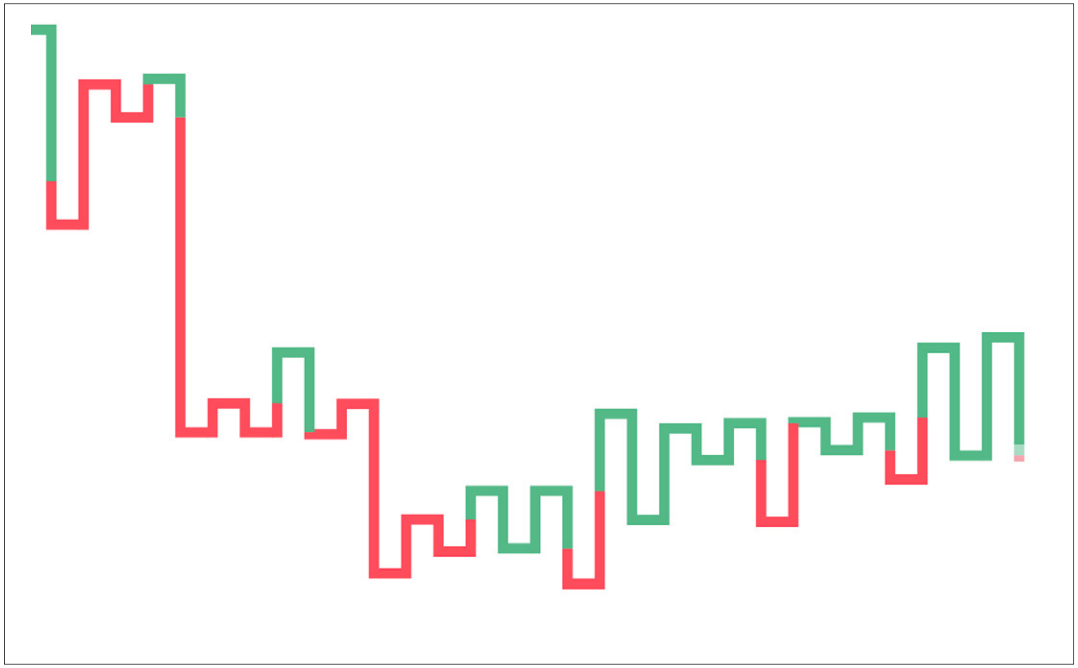
Three-Line Break Chart
In a Three-Line Break chart, a new line in the same direction is drawn when the closing price is beyond the closing price of the previous line. A reverse occurs when the closing price is beyond not one, but the last three lines in the opposite direction. This type of chart works well for the trend line and the support and resistance analysis.





Renko Chart
The Renko chart comes from the Japanese word for "brick." Each new brick appears when the price moves more than the brick size away from the previous brick. Since a Renko chart does not display the exact price action, it isn't fit for the bar pattern analysis. But since it strips away all the noise in the form of smaller price movements, it is excellent for observing trends.

Chart Types



Kagi Chart

A Kagi chart line changes direction when the price reaches a predefined reversal amount, which is usually set at 4%. The thickness of the line increases when the price goes beyond the previous vertical line. Often thin and thick lines are replaced with lines of different colors.

WORST MISTAKES TRADERS MAKE

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Trading Emotionally

Most people are fearful when they have a winning trade. They think if they do not close it today, the trade is going to turn around and either break even, or become a loser. That **fear** causes investors to stop their gainers too early.

However, people are very **hopeful** with their losing trades. Every time they look at the chart, they expect it to turn around in the near future. Often, traders buy more to average down the cost and break even sooner.

What an investor should do is be **hopeful** that their profitable positions can get even better. On the other hand, with unprofitable positions, investors need to be **fearful** of them getting even worse.

Averaging Down

Averaging down means **increasing the size of a losing position**. It brings the average investment price down so that an investor can break even sooner.

Even though it could work a few times, eventually, averaging down will result in a **large loss** because an investor will either lose patience and close the position, or they will experience a margin call.

Money aside, keeping, let alone reinvesting, in losing positions wastes **time** that could be spent on looking for better trading possibilities.

Trading Without Risk Control

Some people will enter trades without any **risk management strategy**. But if a trader opens enough positions, some of them are going to be wrong.

Even if an investor generally uses stop-loss orders, on long-term positions, they might set them well outside a **safe zone**. Sometimes traders even make a mistake of moving a stop-loss order further, just before it is supposed to be triggered, because they firmly believe a reversal is imminent.

Setting stop-loss orders at safe levels and sticking to them while trades are ongoing is **crucial** for successful trading.

Not Following a Plan

Novice investors often do not have a **trading plan** before opening a position. Even if they do, they tend to disregard that plan midway through if the trade is not going as they hoped it would. This, of course, almost always results in a loss.

More experienced investors do not get into a trade without a plan. They know how much they are going to invest, when to enter the market, and when to leave it, be that with a profit or a loss.

THANK YOU FOR CHOOSING OUR SERVICE.

WE WISH YOU SUCCESSFUL TRADING!