Strategies, analysis, and news for FX traders

CURRENCY TRADER

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THE CARRY TRADE DOWN UNDER:
Aussie and kiwi dollars on a roll p. 8

TIME/VOLUME FX SETUP
p. 20

INSIDE A YEN
inside-day pattern
p. 26

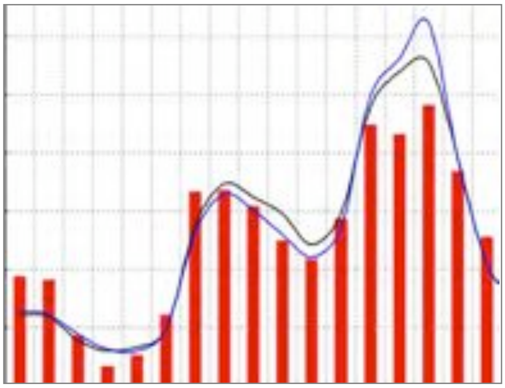
THE DOLLAR FIX
p. 16

CURRENCY FAIR VALUE:
Analyzing purchasing power parity p. 30

TOO-TIGHT STOP
p. 43

CONTENTS

continued on p. 4



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For all subscriber services:
www.currencytradermag.com

Editor-in-chief: Mark Etzkorn
metzkorn@currencytradermag.com

Managing editor: Molly Goad
mgoad@currencytradermag.com

Contributing writer: Chris Peters
cpeters@currencytradermag.com

Contributing editor:
Howard Simons

Contributing writers:
Barbara Rockefeller, Marc Chandler

Editorial assistant and webmaster: Kesha Green
kgreen@currencytradermag.com

Art director: Laura Coyle
lcoyle@currencytradermag.com

President: Phil Dorman
pdorman@currencytradermag.com

Publisher,
Ad sales East Coast and Midwest:
Bob Dorman
bdorman@currencytradermag.com

Ad sales
West Coast and Southwest only:
Allison Chee
achee@currencytradermag.com

Classified ad sales: Mark Seger
seger@currencytradermag.com

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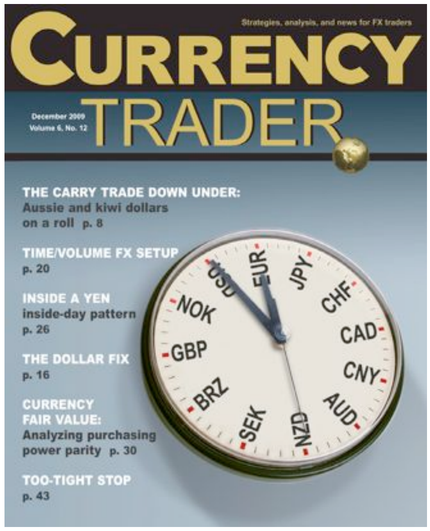


▼ **Howard Simons** is president of Rosewood Trading Inc. and a strategist for Bianco Research. He writes and speaks frequently on a wide range of economic and financial market issues.

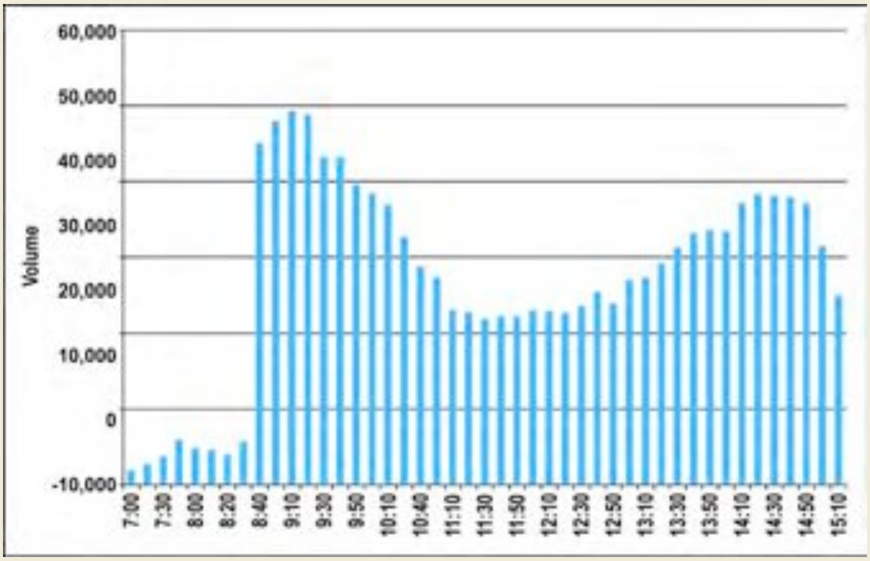
▼ **Caspar Marney** started his trading career on the foreign exchange desk at HSBC in London. He then moved to SBC (which later merged to become UBS), as head of technical analysis. He has been a regular commentator on financial television. He also ran a global proprietary trading team and became one of the bank's most successful traders. Since then, his company has managed funds for some of the world's leading investment banks and financial institutions. He also holds a distinction in the Society of Technical Analysts Diploma and has been their guest speaker. Further details are available at www.marneycapital.com.

▼ **Barbara Rockefeller** (www.rts-forex.com) is an international economist with a focus on foreign exchange. She has worked as a forecaster, trader, and consultant at Citibank and other financial institutions, and currently publishes two daily reports on foreign exchange. Rockefeller is the author of *Technical Analysis for Dummies* (For Dummies, 2004), *24/7 Trading Around the Clock, Around the World* (John Wiley & Sons, 2000), *The Global Trader* (John Wiley & Sons, 2001), and *How to Invest Internationally*, published in Japan in 1999. A book tentatively titled *How to Trade FX* is in the works. Rockefeller is on the board of directors of a large European hedge fund.

Exploiting currencies
with time and volume

FIGURE 1 — E-MINI S&P FUTURES

In the futures market, intraday time-volume characteristics tend to follow clear patterns, as illustrated by this three-month average of 10-minute bar volume in the E-Mini S&P 500 contract.



The forex "volume profile" has implications for short-term traders seeking the optimal time to place trades.

BY CASPAR MARNEY

Although there is a great deal of research and analysis in the futures markets about trading opportunities using time and volume, little comparable research exists in the foreign exchange market.

The reason time and volume dominate so much discussion of futures trading systems is almost certainly because their behavior in these markets is predictable, and therefore exploitable. Figure 1 shows the volume distribution of a typical futures market, the E-Mini S&P 500 contract (ES) traded on the Chicago Mercantile Exchange, over a three-month period. Although individual days can show huge variance because of specific economic data releases or news, over time this is an incredibly stable profile.

One of the primary reasons time and volume have not been as widely exploited in the currency market is likely because traditionally, it has been almost impossible to get accurate volume information because the foreign exchange market has no central exchange; the market is fragmented among various banks, brokers, and electronic communications networks (ECNs).

Nonetheless, you can accurately determine currency pair volume profiles by sampling the market. This data can then be incorporated in a trading strategy to maximize its potential.

TABLE 1 — THE 12 CURRENCY PAIRS

Analyzing the trading activity in 12 currency pairs showed that regardless of a pair's native trading session, volume was greatest when the three largest forex centers — London, Europe, and the U.S. — were open at the same time.

Pair	Symbol
Aussie dollar/U.S. dollar	AUD/USD
Euro/Swiss franc	EUR/CHF
Euro/British pound	EUR/GBP
Euro/Japanese yen	EUR/JPY
Euro/Swedish krona	EUR/SEK
Euro/U.S. dollar	EUR/USD
British pound/Japanese yen	GBP/JPY
British pound/U.S. dollar	GBP/USD
New Zealand dollar/U.S. dollar	NZD/USD
U.S. dollar/Canadian dollar	USD/CAD
U.S. dollar/Swiss franc	USD/CHF
U.S. dollar/Japanese yen	USD/JPY

Determining forex volume profiles

The advent of currency ECNs has made accurate forex time and volume data much more readily available. Data from the EBS currency ECN, which the firm reports is used daily by

continued on p. 22

Trading FX through Managed Accounts

By Betsy Waters, Global Director of dbFX.com

For investors who believe trading forex is the right way to diversify their portfolios but feel that self-directed trading is not the correct approach for them, an alternative is to have a managed account. A managed account is an investment account that is owned by an individual investor, for whom the trading decisions are made by a professional money manager.

Trading platforms such as dbFX.com, the online margin forex trading platform from Deutsche Bank, have become increasingly sophisticated, introducing managed account programs which not only allow managers to trade on behalf of clients, but provide the systems to handle all administrative details around account opening and fund transfer –effectively providing all the back office and administrative requirements needed as part of any manager / client relationship, whilst allowing clients full transparency of the trading activity and P&L of their account.

So how does it actually work and what are the benefits?

There are numerous benefits to investors trading through a managed account:

- control over the funds going into and out of your account
- liquidity to your funds with no lock up periods, you can withdraw your funds at any time
- visibility over every trade done in your account on your behalf
- choose the professional manager who will trade on your behalf and who meets your investment objectives
- transparency of any fees you pay to the manager for his professional services

Once an investor has decided that the managed account option meets the requirements and objectives of their investment, the most important decision they will make is how to choose the right professional forex manager.

So how do you go about finding the right professional forex manager?

A good start is to obtain referrals from other investors or your financial adviser. Make sure that either the advice or referrals relate to a manager's service that should meet your needs, rather than just comparing performance.

Once you have identified a manager, robust due diligence is important and there are a number of questions you should ask before employing them to run your account: What is the full range of services they provide? How much input do I have to the trading strategy? Are they regulated and if so by which regulator? What is their track record? Do you understand the fee structure and is it transparent?

An honest heart to heart discussion with your professional manager is an important next step to ensure your investment goals are aligned with the trading strategy your professional manager will implement. You should review your personal risk and return goals in relation to the manager's strategy and style, and ensure that you are not committing more funds than you can afford to lose. Ensuring that the manager's trading style matches your personal investment philosophy will be crucial to the success of your account.

Let us now assume that you have chosen a manager, determined your risk and return profile and agreed on a trading strategy. Far from being the end of the road this should be the beginning of an engaged relationship with the professional manager trading forex through your account. You should regularly monitor the trades and your position on the dbFX trading platform and talk to your manager regularly for updates on your funds performance, be clear of his and your objectives, and don't be afraid to ask questions if you don't understand anything.

Trading forex through a managed account with dbFX.com offers the best of both worlds – you have diversified your portfolio and you also have the expertise of a professional manager and an experienced client services team at dbFX with the peace of mind of knowing that you have full control over your account. ■

2,800 traders in more than 50 countries, provides a great representative sample of the global spot forex market and will be used throughout this article. You can get access to EBS data through their Data Mine product.

Figure 2 shows the volume distributions (as percentages of total daily volume) for 12 currency pairs from August to October 2009 in London time. Table 1 lists the pairs.

According to the Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, which was last published by the Bank for International Settlements (BIS) in 2007, London, Europe, and New York are the three largest foreign exchange trading centers. It follows that the highest volume occurs during the few hours when all these centers are active, even for currencies such as the Australian (AUD) and New Zealand (NZD) dollars, which are not native to these time zones.

Figure 3 shows the aggregated volume profile for the same currencies and time period in Figure 2. As was the case in the E-Mini S&P futures market, the chart has a distinct volume pattern. The overlapping opens and closes throughout the forex trading day give the profile its unique but stable distribution, with evident peaks as each trading center opens.

The three distinct peaks correspond to the openings of the Asian, European/London, and U.S. forex sessions, with the largest volume occurring during the few hours when all three are open at the same time. Volume tails off steeply as Europe and London close (17:00), and a final decline occurs as the U.S. closes (22:00); the cycle commences again with the next day's Asian-session opening.

Over time there is little variation in this relationship, which is also highly correlated to the average hourly price ranges of these currencies throughout the day. Figure 4 plots the two together, with the ranges shown as a percentage of the maximum hourly range. A second

continued on p. 24

FIGURE 2 — EBS VOLUME (%) ANALYSIS BY CURRENCY PAIR

Despite the wide range of currency pairs and native trading sessions, their volume profiles are very similar.

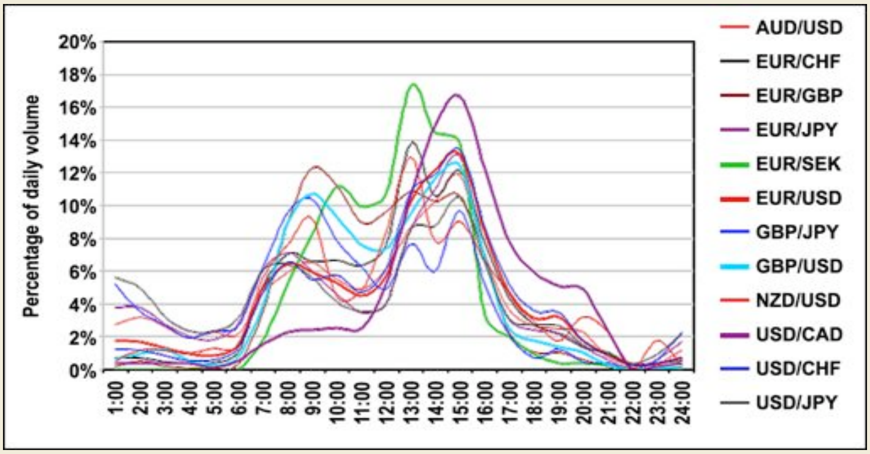


FIGURE 3 — COMBINED VOLUME PROFILE (AUG.-OCT. 2009)

The combined volume profiles of the currencies in Figure 2 produce a distinct pattern, with evident peaks as the Asian, European/London, and U.S. forex sessions began.

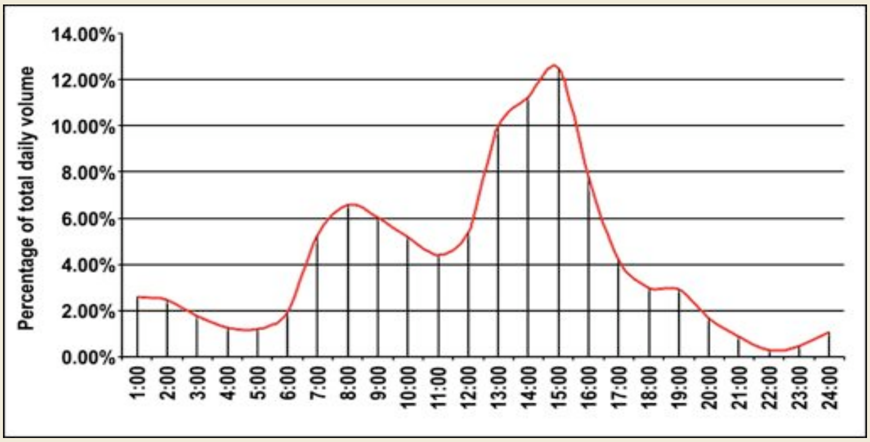


FIGURE 4 — AVERAGE HOURLY RANGES VS. AVERAGE HOURLY VOLUMES

The volume profile is highly correlated to volatility, shown here as hourly trading ranges (red bars). A second volume distribution (black line) from an entirely different time window is very similar to the first distribution.

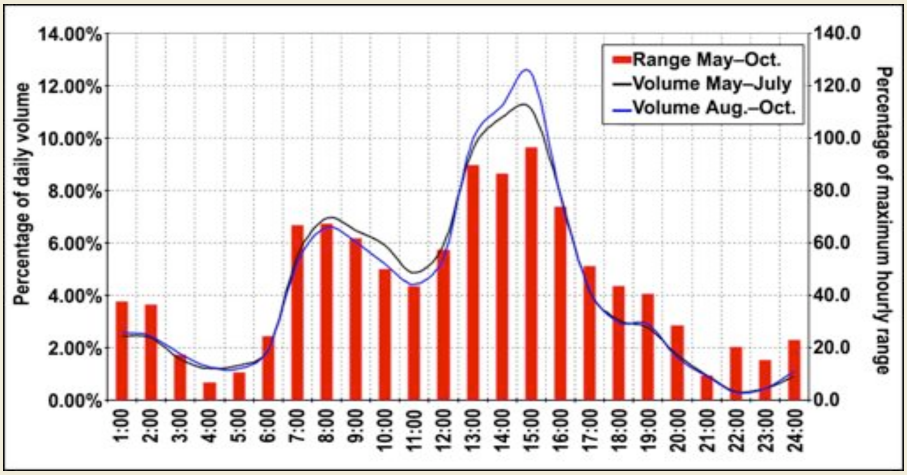


FIGURE 5 — STRATEGY RESULTS (2003-2009)

Results in the EUR/JPY (top), GBP/CHF (middle), and USD/CAD (bottom) were uniformly positive, although there were some significant drawdowns.

volume distribution graph from a different time period (May to July 2009) highlights the correlation between time of day, volume, and ranges, as well as how stable these relationships are over time.

Many studies have been conducted to demonstrate how volume confirms a price move, and this analysis supports that case. It also shows the biggest ranges and highest volume occur at the same time — specifically, during the London afternoon.

This information, in turn, implies several potential trading opportunities, including the fact that any breakout strategy should have a higher chance of success if trades are executed when both the volume and expected ranges are the greatest.

Testing a breakout strategy

Although optimization can play an important role in researching trading strategies, rules based on market behavior are likely to be more robust than those derived from optimization. The basic trading premise in this case is that a move to a new high or low during the London afternoon might be significant. This theory can be tested by applying a simple breakout trading strategy. All times are London time.

Volume is lowest after the New York close (10 p.m.), then it starts to steadily increase as each trading center opens the next day. The strategy looks to trade a breakout of the highest high or lowest low that is established since the New York close.

The highest volume of the day occurs between the hours of 1 p.m. and 4 p.m. and this is always likely to remain the case, as it represents the hours of the day when the three largest trading centers of Europe, London and the U.S. are all active.

Knowing volume is an important factor in confirming a trend, if a market made a new high or low during this period, then it might be significant and this theory can be tested by applying a simple trading strategy.

The rules to test are:

1. **Go long** between 1 p.m. and 4 p.m. if price trades above the highest high since the New York close (set at 10 p.m. the previous day); or,
2. **Go short** between 1 p.m. and 4 p.m. if price trades below the lowest low since the New York close.
3. **Hold the position** until a trading signal occurs in the opposite direction.

This relatively simple rule produced robust results, which were consistent when run both in and out of sample on a wide range of currency pairs, across all of the time zones. Figure 5 shows the equity curves for three currency pairs — the Euro/Japanese yen (EUR/JPY), British pound/Swiss franc (GBP/CHF), and U.S. dollar/Canadian dollar (USD/CAD) from June 1993 to June 2009, tested on 10-minute bars. In each case the initial account size and position size were set to 100,000, and profits and losses were converted back to the base currency (Euros, pounds, and U.S. dollars). Slippage and rolls were not included, and no stop-loss was used.

In each pair, the rule was profitable over the long run, although it did produce significant drawdowns in some of the individual currency pairs, as well as long spans between new equity highs. However, when implemented across a wide range of currency pairs, the results become increasingly significant. It is also a rule that can be used to compliment other trading strategies, to enhance their performance.

Also, the incorporation of position sizing and risk control rules has the potential to improve performance. Additional tests (not shown) using volatility-adjusted position-sizing and stop-loss rules extracted even more benefits from the strategy.

Currency commonality

Although individual currency pairs may have unique characteristics, there are evidently a number of common volume and range characteristics related to the time of day.

Although the foreign exchange market doesn't have a central exchange or fixed open and close times, it is still possible to determine its volume profile. This tendency is not only logical — following the volume peaks as the major centers open and close — it also mirrors the size of currency pair volatility (trading ranges) throughout the trading day.

The research also demonstrates these relationships and market behavior are stable over time and across currency pairs, making them very exploitable.

For information on the author *see p. 6.*

EVENTS

Event: TradeStation Futures Symposium
Date: Dec. 10-12
Location: Naples, Fla.
For more information: Visit www.tradestation.com/strategy

Event: Oxford Club's 2nd Annual Caribbean Wealth Cruise
Date: Jan. 23-30
Location: Crystal Symphony, Miami to Aruba
For more information: Go to www.moneyshow.com/events/Investment_Cruises.asp

Event: International Traders Expo
Date: Feb. 13-16
Location: Marriott Marquis Hotel, New York, N.Y.
For more information: www.tradersexpo.com

Event: 26th Annual Risk Management Conference
Date: March 7-9
Location: The Ritz-Carlton Golf Resort, Naples, Fla.
For more information: Visit www.cboe.com/rmc

Event: 35th Annual International Futures Industry Conference
Date: March 10-13
Location: Boca Raton Resort & Club, Fla.
For more information: Go to www.futuresindustry.org

Event: The 17th Forbes Cruise for Investors
Date: March 18-30
Location: Crystal Symphony, Sydney to Auckland
For more information: Go to www.moneyshow.com/events/Investment_Cruises.asp

Event: The World MoneyShow Vancouver 2010
Date: April 6-8
Location: Hyatt Regency Vancouver
For more information: Go to www.moneyshow.com/events/World_MoneyShows.asp

Event: FIA/FOA International Derivatives Expo
Date: June 8-9
Location: The Brewery, Chiswell Street, London
For more information: Go to www.idw.org.uk

Event: Los Angeles Traders Expo
Date: June 9-12
Location: Pasadena Convention Center, Los Angeles
For more information: Go to www.moneyshow.com/caot/?scode=013721

Event: The Forex & Options Expo Las Vegas 2010
Date: Sept. 12-14
Location: Caesars Palace
For more information: Go to www.moneyshow.com