THE DEFINITIVE GUIDE TO BUILDING A

WINNING FOREX TRADING SYSTEM

Part 1: Market Types & Setups

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The secrets to success are not really secrets at all.

Those traders who have succeeded have developed a winning formula that can be copied and taught. In *The Definitive Guide to Building a Winning Forex Trading System*, I harness my learnings from the careful study and application of the principles of top traders and share them with you.

Armed with this knowledge, your Forex trading success or failure truly is up to you.

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FOREWORD BY SEAN LEE OF FOREXTELL AND FXWW

When Sam Eder told me he was going to write an eBook on Forex system development, I must admit I was intrigued. Sam is one of the new breed of young trader, forged in the fires of retail trading, instead of on an interbank dealing desk like I was. When I received my copy of *The Definitive Guide to a Winning Forex Trading System*, I was pleasantly surprised at how well it captures the important elements of building a successful system...which most traders tend to miss. In fact some of my ex-bank colleagues could very well do with reading this eBook too!

Like every profession, there are basics that need to be mastered before one can excel. Most trades start out with technical school and apprenticeship programs, while most white-collar jobs begin with a university degree. Trading is different in that there is no school (except the hard knocks variety!) These days, most traders are self-taught. However, learning the foundations of trading is essential to success.

What can be taught are entry strategies, exit strategies and money management principles. Not only can the entry/exit points and money management strategies be learned, they can also be translated into simple trading systems.

There is no single strategy that guarantees perfect entry and exit levels, but there are strategies that work better in different markets. If you can devise a series of strategies for different market types, and then recognise the type of market you are dealing in, you will be a long way towards becoming a gun trader.

Thanks to *The Definitive Guide to a Winning Forex Trading System*, you can kickstart this educational process at your own pace. Get to know yourself and what makes you tick, and build systems that reflect the type of person you are. I highly recommend you take your time and go through this guide in detail.

About Sean: Sean has been an FX trader since 1986 when he began in the interbank market. Nowadays he leads the way in improving market access, services and information for the aspirational retail trader. His FXWW business manages allocation programs for the new breed of FX professional as well as providing unbeatable market coverage through his chat-rooms on Reuters Messenger. He is also Managing Editor of Forextell and aims to provide plenty of good trading ideas from professional traders (in an entertaining format).

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INTRODUCTION: WHY I CHOSE TO WRITE THIS EBOOK

This eBook was not planned, rather it evolved.

I have dedicated my last eight years as a Forex trader to studying the principles of the world's top traders. In particular, I have an interest in how they build their trading systems.

What I have come to realise is that the market is not random. Rather, it has structure, and patterns based on the collective psychology of the market participants repeat time and time again. And it depends on the quality of the systems that the trader employs as to how well they can harness these patterns to generate profit.

When I was asked to write about these topics on the AxiTrader blog, the positive response from readers was overwhelming. Here is a selection of comments I received from the first couple of posts:

> *Thanks for the very enlightening information"*

> *Once again thanks heaps for a very informative post. I have learnt far more and gained a far better insight into the world of FX trading from your post than all the other training tools I have been using."*

> *Excellent pieces"*

> *Thank you for sending this information. It is extremely informative and I am looking at starting a whole new system of trading based on your post...Keep up the good work."*

> *I found the blog quite interesting and educational. The tips for trading techniques to suit the different market types was the best part for me."*

> *Thanks for the "Heads up"...It is so easy to get involved in the detail, that you can't see the wood for the trees! Thanks."*

As I wrote more posts, the feedback continued to roll in and the idea germinated to collect the articles on system development together in an eBook. So here it is, *The Definitive Guide to Building a Winning Forex Trading System*, which contains updated versions of some of my best work, along with a ton of new material that is exclusively available here.

In the Guide, we will cover everything from market types through to position sizing, and, importantly, how to trade your system mistake-free.

Once you have read through the material, please get in touch and let me know your thoughts.

Stay disciplined in your trading,

SAM EDER
Author & Forex Trader

(**Note:** I am not talking about Forex robot systems in this guide. Personally I am a robot-free zone, and The Definitive Guide to Building a Winning Forex Trading System is for use by traders who wish to use their discretion to outperform the markets – not that mechanical traders won't benefit from this material too.)

We have all done it.

Embarked on the quest to find the Holy Grail of Forex trading – a system that produces consistent results, week in, week out, with a limited drawdown and a nice upward-sloping equity curve.

But there is a problem with the Holy Grail approach to system development that means the search leaves us more frustrated than enlightened. If you can understand the problem, then you will have one of the keys to a winning Forex trading system firmly within your grasp.

The problem is the failure to understand market types.

Market types – the first key to building a winning Forex trading system

> ***"Expecting the same system to work in all market types is the definition of insanity."***
> *– Van K. Tharp*

Market type refers to the different stages or states that a market flows through.

The market type concept was made popular by trading coach and psychologist Van K. Tharp in his books and courses. Tharp believes that while it is insanity to expect a system to work in all conditions, if you can define the market type then it is relatively easy to design a system that provides an edge in that specific market.

Think about it.

If you are in a sideways volatile market, should you be running your buy dips in a trend system? Or: how many traders get blown out of the water trying to buy and hold a strong bear?

While there are up to 25 different market types according to Tharp, there are six that should be of primary consideration when trading Forex.

1. Bull normal
2. Bull volatile
3. Bear normal
4. Bear volatile
5. Sideways quiet
6. Sideways volatile

You can see market types in action if you study a price chart for a moment. You will notice that each currency pair is in constant flux. Sometimes it is trending nicely; at other times it coils into a tight range, or is choppy and volatile.

The core problem with most Forex systems

The core problem with most Forex systems (and incidentally why most Forex robots tend to fail in time) is that they are only designed for use on one or two market types. If you instead shift your focus to identifying market types and then applying a system to that market type, you might find your Forex trading becomes more fruitful.

How to identify the market type

Market types are not so difficult to identify. Normally it's just a matter of looking at a chart.

If the market is going up quietly then it is a bull normal market type. If it's going down it's a bear normal. If it's in rapid descent or rapid ascent it's a volatile market. If the price is oscillating between two support and resistance levels then it's a sideways market. If the sideways range is wide then it's sideways volatile, if it's tight then the market type is sideways quiet.

The trick is remaining aware. Be centred enough that you can do the following:

1. Notice the current market type
2. Notice when that market type has changed.

There is a very useful tool you can use to help identify the market type – Bollinger Bands.

Bollinger Bands

The technique here is quite simple.

Bring up a chart and apply the Bollinger Bands. Bollinger Bands are a volatility-based indicator. When they contract it is a sign that the market type is normal or quiet; when they expand it is a sign that the market type is more volatile. 1

You can also use the Bollinger Band to determine direction. If the price is bouncing off either side of the band, then the market is sideways; if it is trending in the direction of the Bollinger Band, then you likely have either a bull or bear market type.

Look at the following EUR/NZD 30-minute chart and tell me what market types you can identify. 2

How did you go? 3

In the chart above, you can see the Bollinger Bands contract into a sideways quiet, followed by a breakout to a bear normal, into a bear volatile. The next part is a bit harder to classify but it could be bull volatile or sideways volatile. Next it moves into a sideways volatile followed by a sideways quiet and finally what I would call a strong bull.

Now that you can identify market types, is there anything else you notice on the chart? Can you spot the transitions?

The secret sauce – market type transitions

Markets are like the ocean.

The primeval forces of human emotion drive the ebb and flow of the price, just as the wild and unpredictable forces of Mother Nature drive the tides.

Like the ocean, the market transitions from calm to restless.

A stormy night clears into a sunny day. Choppy foam settles into a peaceful blue-green glaze...or morphs into a squally and dangerous tempest.

Just as sideways volatile settles into sideways quiet and then transitions into a strong bull.

There is an edge if you understand market types, but there is a greater edge if you understand the *probability* of what the next market type will be. If you know that historically more often than not a bull volatile ends in a bear volatile, then you can plan accordingly. Similarly if you understand that a sideways quiet usually results in a breakout to a bull or bear, then you could develop a system to capitalise on this knowledge.

Trading is a statistical game and knowing probabilities is important.

Market types across timeframes

Some of you may be wondering which chart timeframe you should be looking at to determine the market type.

The fact is that all charts will display all market types. Really it comes down to preference.

The lower the timeframe, the more agile you need to be in adjusting to changes – and the more likely you will get fake-outs, so be wary. Higher timeframes give you more time to adjust to changing conditions and your trading efficiency (trading without mistakes) will be higher.

Importantly, a higher timeframe is often the set-up for a lower timeframe. For example, once you determine the market type on the weekly charts, you can slide down to the daily or hourly charts to snipe for an entry.

Personally I like to define market direction on the weekly or daily charts and then move to a lower timeframe like the 15-minute chart for an entry. Shorter-term market types seem to show up pretty clearly on the 15-minute chart so it could be a good place to start.

As a tip, you might notice the market changes type at certain times of day. Knowing this can be very valuable for your trading. You might not want to take a range trading position on the London open, for example.

Manage your stops based on market type

If you know that a bull volatile typically turns into a sideways or bear volatile, then you can adjust your stop types based on that information.

For example, you might switch to using a Parabolic SAR indicator with a steep gradient that keeps your stop nice and tight in a volatile market, or perhaps you limit your risk to one or two times your initial stop.

Having an appropriate exit system that is intelligently adjusted depending on market type is a good way to keep hold of your profits on a trade.

Systems for each market type

At the start of this chapter, I mentioned that trying to develop a system that works in all market types is the metaphorical search for the Forex Holy Grail. Instead you could look to build a system that works well in each market type and switch between them as the market type changes.

Is it a lot of work? Yes it is. But is it worth is? Definitely.

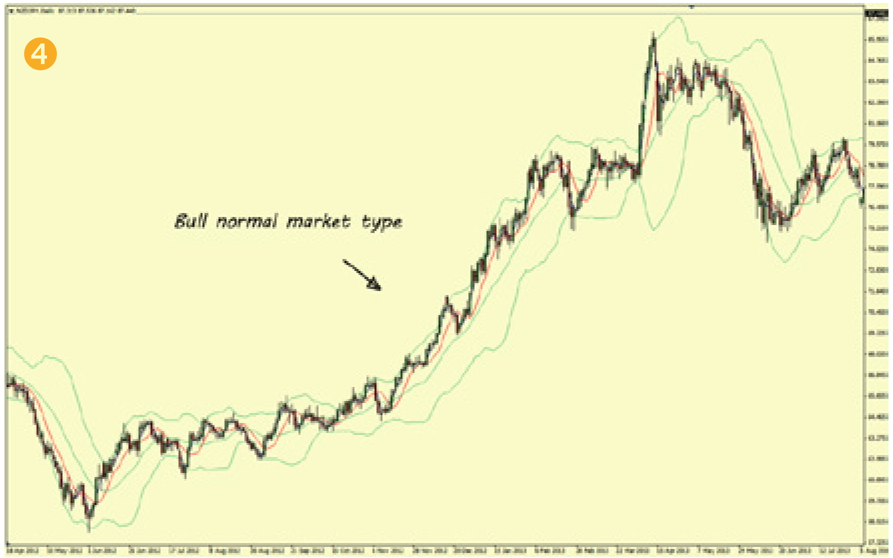
Here are a few rough concepts for systems that tend to work in each market type.

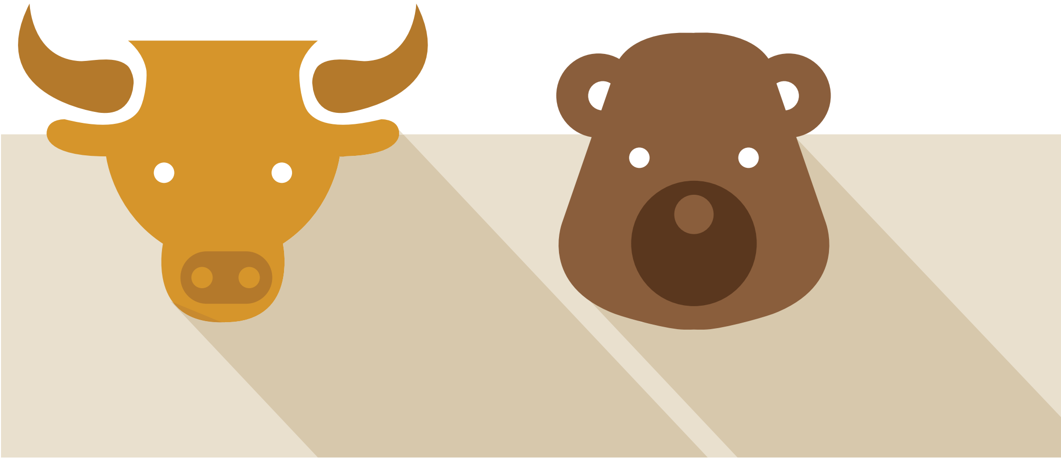
Bull normal – buy and hold

In a bull normal market type you can simply buy and hold with a trailing stop-loss. As long as the market type does not change this can be a pretty successful system.

TIP! Watch for a change to a volatile market. You might find that that the bull market is coming to an end and it's a good time to tighten your stop.

Here is an example on the NZD/JPY on a daily chart. Notice the long bullish candles and widening Bollinger Bands at the top of the chart, signalling a move to a more volatile market type. Here would be a good time to tighten your stop. 4





Bull volatile – long swing trading

Bull volatile markets are suited to a more active trading style. Profit targets are the order of the day in this market type. Look for a pull back, a reversal, and then find a logical profit-taking objective on the long side. You may want to consider dropping to a lower timeframe to improve the risk/reward on the entry.

Here is a bull market that has turned volatile on the AUD/JPY 30-minute chart. See how a buy and hold approach would have struggled while profit targets would have helped you capture the majority of each swing. 5

Bear normal – sell and hold

Bear normal markets are the opposite of bull normal markets. Sell short and hold with a trailing stop to help capture the majority of the move. The 2013/14 fall in the AUD from 1.06 cents to 88 cents is a good example of this market type in action. 6

Often sideways quiet markets result in a strong breakout and trend. Instead of trading the sideways quiet you can stalk the shift to a new market type by trading breakouts.

A breakout system is not for the faint-hearted.

You will face fake-out and false breakout and then need to have the psychology to hold on for the big wins. But a breakout system that is executed with efficiency is perhaps one of the most powerful systems in the Forex market, where trends can last a long time. You can see the breakout from a sideways quiet market below on this 4-hour chart of the USD/HKD. 8

➡ Bear volatile – short swing trading

In currencies, the bear volatile is the opposite of the bull volatile (this is not so true if you are trading stocks). Try a short swing trading approach with a profit target that gives you a good risk to reward on your trade. 7

➡ Sideways quiet – breakout

There are two ways (at least!) to trade a sideways quiet market. You can move to a lower timeframe and use a band trading system (like in the sideways volatile section below). This approach can be very lucrative if the currency pair stays in this market type for some time. There will be lots of 2:1 and 3:1 risk/reward trades you can pick off in a row.

Sideways volatile – band trading

Sideways volatile markets can be targeted with a band trading approach.

In the below example on the CHF/JPY 30-minute chart, I have replaced the Bollinger Bands with moving average envelopes and customised the settings to the timeframe and currency pair. With envelopes you want the majority of action (90% or so) to be contained within the Bands. Once the price touches an outer band, look for a reversal off a support and resistance level to give you a nice risk/reward on your trade. 9

Don't throw the baby out with the bath water

If you have a good system that works *sometimes*, don't give up on it.

Instead identify the market types where the system performs and **trade those market types only**.

It's like playing golf.

You pull a different club out of the bag for each different scenario you face. You would never use a putter to hit a tee shot, or a driver when you are stuck in sand.

The same applies to trading. Build a toolkit of systems that perform well in different conditions and *use them as appropriate, depending on the market type*.

The hunt for the Holy Grail

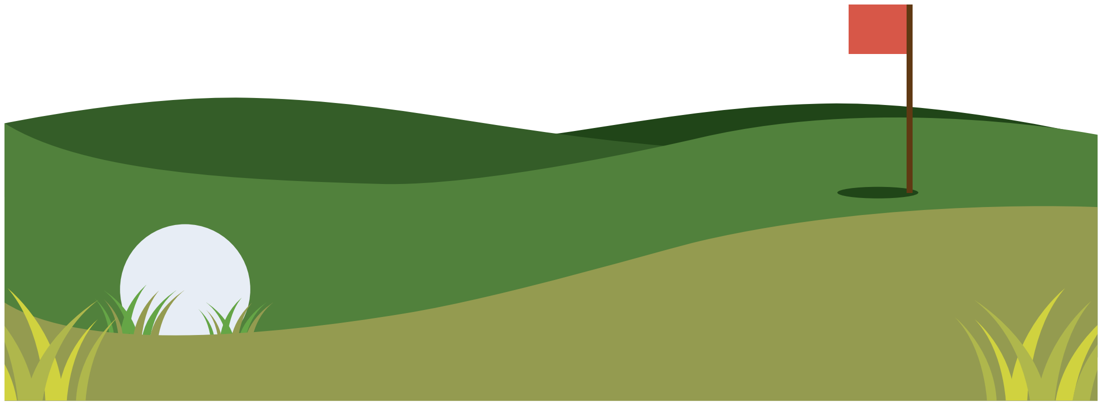
Van K. Tharp still believes in Holy Grail systems.

But his definition is different. To Tharp, the Holy Grail is a system that performs exceptionally well in a particular market type. Think of it this way. If you know that you are able to meet your trading objectives for a system operating in a certain market type, then all you need to do is hunt for the market type you wish to trade.

Imagine if you were a golf player who excels at putting and could only play on the putting green – *and still win golf tournaments.*

In trading, you can take this approach.

You make the rules of the game so **if you only want to trade one market condition, you can.**



“Although the cheetah is the fastest animal in the world and can catch any animal on the plains, it will wait until it is absolutely sure it can catch its prey. It may hide in the bush for a week, waiting for just the right moment. It will wait for a baby antelope, and not just any baby antelope, but preferably one that is also sick or lame; only then, when there is no chance it can lose its prey, does it attack. That to me is the epitome of professional trading.”
– Mark Weinstein

Do you remember when you first got into trading?

Set-ups are among the first things to enchant the wide-eyed new entrant to the world of Forex. Those glittering charts with all their indicators that promise to give you a glimpse of the future...and all the profit that portends.

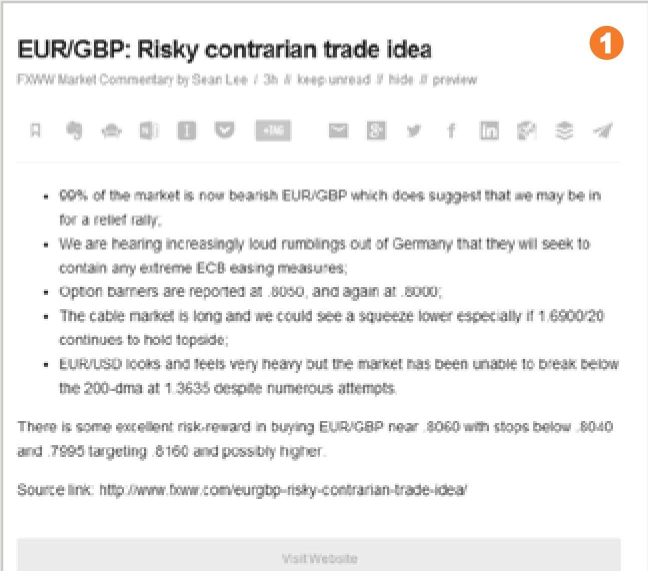
There are five primary types of set-ups:

1. Technical set-ups
2. News-based set-ups
3. Big picture fundamental set-ups
4. Sentiment set-ups
5. Expert set-ups

These set-ups can be used on their own or combined to create high probability, low risk/ high reward trade ideas.

But be careful...

The essence of a good trading plan is simplicity. Pick and choose only the best set-ups that suit your trading personality. Doing more than that is a recipe for disaster as conflicting set-ups cause confusion, indecision and mistakes.



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EUR/GBP: Risky contrarian trade idea

FXWW Market Commentary by Sean Lee / 3h // keep unread // hide // preview

- 90% of the market is now bearish EUR/GBP which does suggest that we may be in for a relief rally;
- We are hearing increasingly loud rumblings out of Germany that they will seek to contain any extreme ECB easing measures;
- Option barriers are reported at .8050, and again at .8000;
- The cable market is long and we could see a squeeze lower especially if 1.6900/20 continues to hold topside;
- EUR/USD looks and feels very heavy but the market has been unable to break below the 200-dma at 1.3635 despite numerous attempts.

There is some excellent risk-reward in buying EUR/GBP near .8060 with stops below .8040 and .7995 targeting .8160 and possibly higher.

Source link: http://www.fxww.com/eurgbp-risky-contrarian-trade-idea/

Visit Website

So you can get an idea of what a good set-up looks like, I have borrowed an example from Sean Lee, the founder of FXWW and Forextell. 1

You can see how Sean combines a fundamental directional bias with technical factors to generate an idea for a trade.

A set-up is not a buy signal

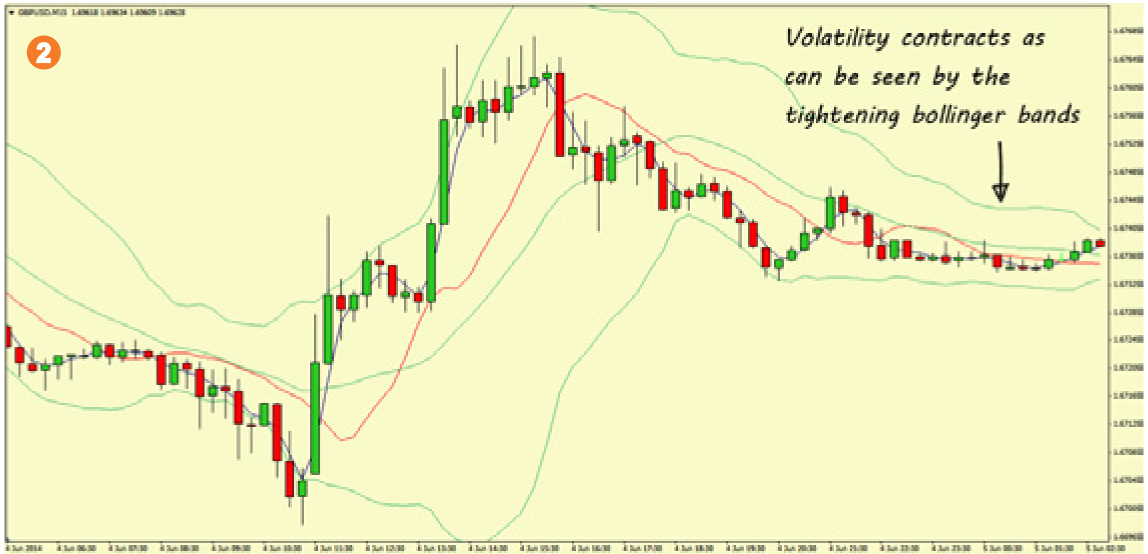
Great traders stalk their trades like the cheetah lies in wait for the antelope.

The set-up is the scenario that occurs before the trade is executed. It is not the trade itself.

Once the set-up conditions arise, you don't necessarily enter straight away. You want to time your entry with precision to increase the risk/reward on the trade.

To continue with the cheetah analogy, once the cheetah chooses its prey using patience (the set-up), it still needs to execute the kill (the entry). For this, it has a specific routine involving stealth, speed and strength. The cheetah moves low in the grass using the small rises of the land to disguise its approach. This is followed by a terrifying burst of speed to get close enough to pounce on its prey. Then the cheetah closes in, using raw strength and skill to target the prey's vulnerable areas with its powerful jaw and sharp claws.

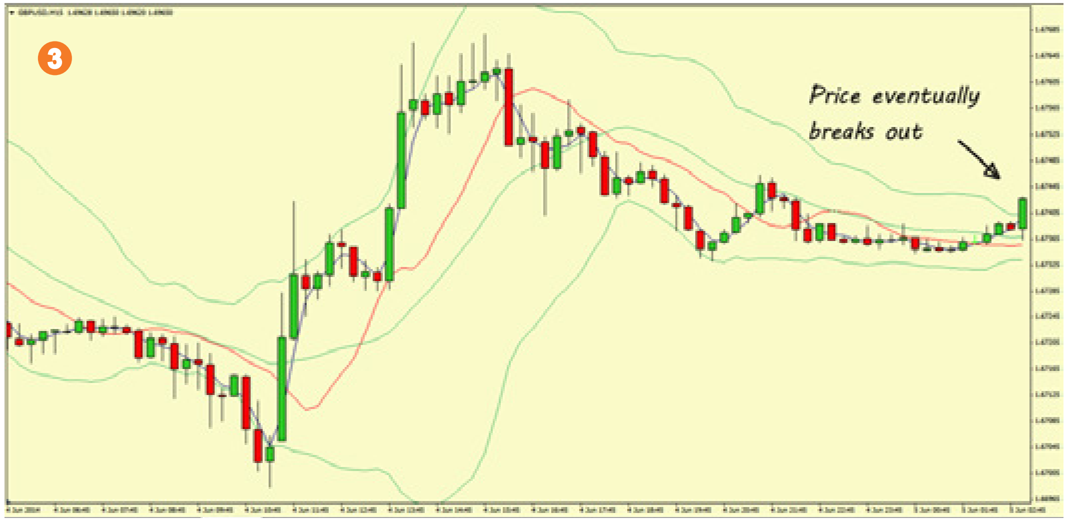
I'll illustrate with an example using a simple volatility contraction set-up on the GBP/USD with a breakout entry. You can see how volatility contracts on the right-hand side of the chart, which is our set-up. 2



We then wait until we get our specific entry signal before we place the actual trade, which in this case is a breakout buy signalled by a close of the 15-minute candle above the Bollinger Band. 3

And the result of our patience is a trade that returns three to four times our risk depending on our exit system. 4

As a trader you have set-ups that alert you to a good trade, but you still need to time your specific entry to maximise the potential profit.



How to think about your set-up

"Luck is what happens when preparation meets opportunity."
– Seneca (Roman philosopher)

Once you find a good set-up, it is helpful to have a framework for thinking about how you are going to best exploit it.

Consider as your framework:

- What are 2–4 options of that can come out of this set-up?
- How am I going to make money out of this set-up?
- Where are my potential entry points?
- Where are my potential profit targets?
- What could happen after I enter my trade?
- Where can I re-enter if I get stopped out?
- Where can I scale into the trade?

Let's use our GBP/USD example again to go through this step by step.

In this case, our main set-up is a low volatility sideways market type.

What are 2–4 options that can come out of this?

What options do I have for a sideways market? Typically it could either breakout or stay within the range.

How am I going to make money out of this?

In this example, I think the best risk/reward trade opportunity is the breakout, so I will ignore the range trade for the moment.

Where are my potential entry points?

A close above or below the Bollinger Band on the 15-minute charts would be a suitable entry on this set-up.

Where are my potential exit points?

As I believe that prices tend to move towards the clusters of stops at the highs and lows (represented by the red lines on the chart below), I see these as potential profit areas.

I could place my stop on the lower Bollinger Band, meaning that I have a risk/reward of at least 3:1 on the trade.

I would also look to apply the complex exits approach in chapter 5 to the trade. 5

What could happen after I enter my trade?

Once I enter into the trade, there are four things I think could happen:

1. The breakout continues and a trend forms
2. The breakout fails and goes down and hits my stop-loss

3. There is strong reversal signal
4. The strong reversal signal fails and the breakout continues.

I should consider how to handle each option and note it down if it is not already in my trading plan.

Where can I re-enter if I get stopped out?

If I do get stopped out, then I would look to re-enter in either direction if I get a similar signal.

Where can I scale into the trade?

If I get a reversal failure, I will scale into the position on a close over the reversal candle.

If a strong trend develops from a breakout, then that is a new set-up that allows me to add another position, in the direction of the trade. (I would then need to ask myself the same set of questions about the new set-up.)

Selecting your system's currency pairs is part of your set-up

It's my bet that you have been told to keep it simple and stick to the major currency pairs such as EUR/USD or GBP/USD.

While this may be true for some of you, the smarter trader might decide to trade the cross rates instead. Don't be shy in exploring the full spectrum of currency pairs that are on offer to see what is going to best suit your system. The cross rates often now have spreads that are very close to the majors, and because less people specialise in them, you may find you develop a nice edge by choosing to focus on them.

The art of the chart – some damn good technical set-ups

"The 10-day exponential moving average (EMA) is my favourite indicator to determine the major trend. I call this 'red light, green light' because it is imperative in trading to remain on the correct side of moving average to give yourself the best probability of success. When you are trading above the 10-day, you have the green light, the market is in positive mode and you should be thinking buy. Conversely, trading below the average is a red light. The market is in a negative mode and you should be thinking sell."
– Marty Schwartz

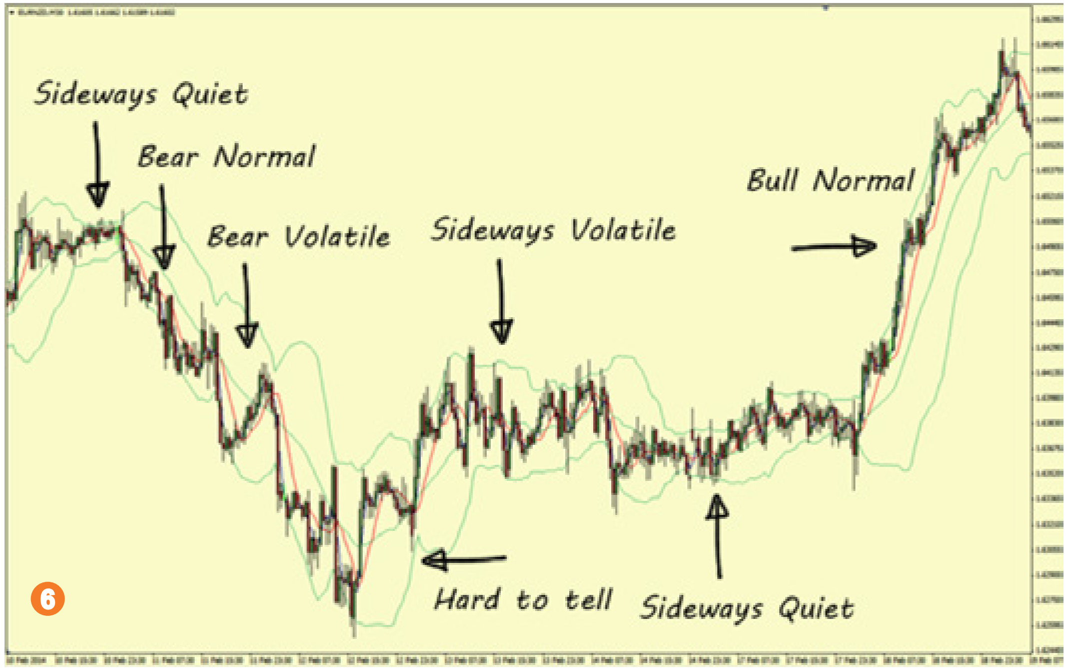
Some of the simplest and best set-ups are derived from the art of technical analysis.

Your primary guide should always be price. Ignoring what the price is telling you is the nautical equivalent of ignoring a rocky outcrop because it is not marked on your ship's chart. Don't ignore the evidence in front of your eyes.

But there are hundreds of set-ups that you can potentially use, so let's help you simplify by selecting a few of the most useful.

Know your market type

Market types (see chapter 1) make excellent set-ups. You should be aware of the market type you are in before you trade. In addition, consider using the transition from one market type to the next as the set-up. 6



Use a trend filter to befriend the trend

Forex system development is about trial and error. You can make systematic changes step by step, which will improve your results over time. A trend filter is a set-up that can be used in this way.

You simply apply a trend-following indicator to a chart and never trade against it, like Marty Schwartz with his 10-day EMA. If the price is above the indicator you never go short; if it is below the indicator then you never buy. 7

You can test the effectiveness of a trend filter by back-testing, either manually by looking on the charts or, if you have the skills, by programming a back-test. Personally I like manual testing as it can give you insights you can't glean from a computerised back-test (though the same could be said for the reverse).

Marty Schwartz's 10-period EMA on a daily chart

Some useful trend filters

10-day Exponential Moving Average	You would never trade against the 10-day EMA. In this case your entry would be on a lower timeframe.
Displaced moving average. Try a 25-period moving average displaced by 5 periods for short-term trends or on a higher timeframe for long-term trends.	I came across this indicator through Joe DiNapoli who recommends displaying moving averages to avoid whipsaws experienced by the typical moving average.
Displaced moving average. Try a 200 x 5 period moving average on your entry timeframe.	A variation of the 25 x 5 above for use on the main timeframe you use for the trade.
MACD – Normal settings of 12/26/9	You can use this on both your entry timeframe and on a higher timeframe.
MACD – Settings of 70/200/70	Use this on the main timeframe you use for the trade.

Let's look at an example of how a trend filter works using the 70/200/70 MACD. In this example, I am operating a simple support and resistance trading system that sells on resistance in a downtrend and buys on support in an uptrend. The exit is on the opposite support/resistance level. Each winning trade has a 3:1 risk/reward ratio. 8

By trading with the trend filter there are five wins and three losses, but the winners are three times bigger than the losers, returning twelve times the amount risked over eight trades.

Note this is an idealised example. With any trend filter you can experience periods of whipsaws as markets consolidate before a new trend forms.

Chart patterns, trend lines, and support and resistance levels make excellent set-ups

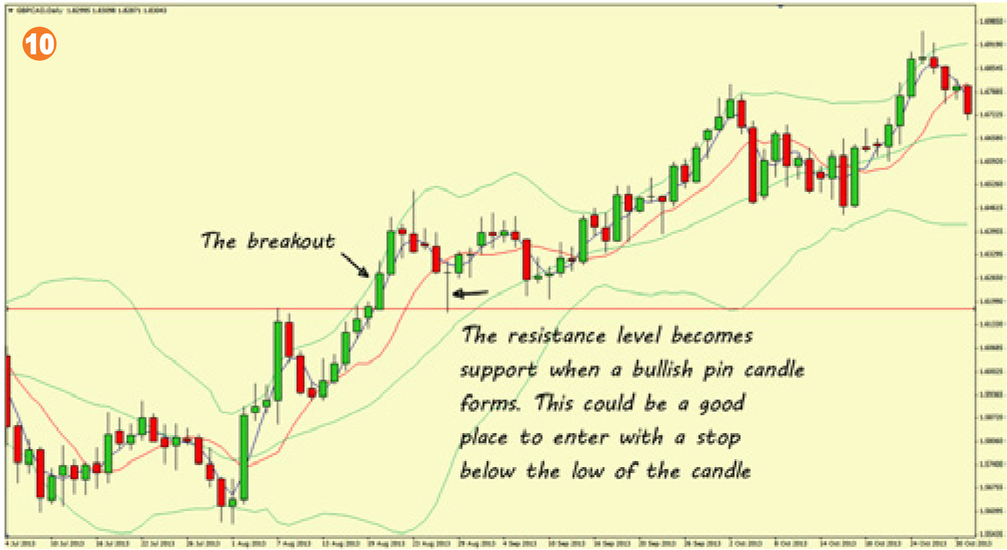
Maybe you're an avid chartist, with a comprehensive knowledge of charting that you don't want to go to waste.

Never fear – your carefully drawn triangles, wedges and Fibonacci levels can serve as perfect set-ups.

The distinction here is that when you use a chart pattern as a set-up, it is not your entry. Once you see a likely pattern, you then move to a lower timeframe to improve the risk/reward on the trade. For example, on the GBP/CAD trade we have a resistance level on the weekly chart that has held six times before the breakout finally comes. 9

After the breakout, rather than rushing to enter the market, you move to a shorter timeframe to improve the risk/reward on the trade. (10)

You can see that not only do you improve the risk/reward on the trade by using the resistance level as a set-up instead of an entry, but also you could have potentially avoided several failed breakouts.



Some damn good news-based set-ups

Some people are attracted to Forex trading for the buzz of it.

You can spot them a mile away.

They have itchy trigger fingers, they trade big because it gives them a rush, and they tend to lose. Forex trading is not the place to get your thrills. That part of your psyche needs to be put aside when you trade. Needless to say, this type of trader is attracted to the thrill of the news announcement. The promise of quick profits is hard for the gambler inside to resist.

And this presents opportunity.

Where there is a lack of discipline and emotion in the markets, there is profit potential for the prepared and patient trader. For you to take advantage of this opportunity, you will need a thorough knowledge of news set-ups. Here are some important ones.

	How has price has reacted to this news event in the past?	You can get this information from a service such as Autochartist's event impact analysis tool.
	What have previous news results been like?	Do they come in as expected or is there a typically a variance? How does the market typically react if numbers come in over or under? You can see past results in any decent Forex economic calendar.
	How important is the event?	Some events move the market more than others. Again, you can find this in an economic calendar.
	How long do the moves typically last?	The reaction to events can be fleeting or can last for months. Try to know how long you can expect the move to last.
	What are analysts' predictions?	You could read your favourite sources of expert commentary about what to expect from the news event. Try **www.forextell.com**.
	Do you think what the market expects has been priced in?	Harder to gauge, but see if you can glean from market sentiment, analysts' commentary or chatter if the market is overly long or short and likely to get caught out.
	Is there news divergence?	A powerful set-up can occur if the price reacts the opposite to how it should. For example, if there is negative news and the price reacts positively then it could be a good set-up for a buy.
	If it is an interest rate announcement, what do the Central Bank minutes say?	Some traders read the Central Bank minutes to get an insight into their directional bias.

When two trades diverge

Trading the news presents you with a clear choice. Do you enter your trade

- Before; or
- After?

This decision will influence how you use the news as a set-up.

If you are placing your trade prior to the event, then it is *your prediction of what is actually about to occur* that is the set-up. If you are waiting for the news result to come out, either for a technical move or for the news result to become apparent, then this is actually your set-up.

Some damn good fundamental set-ups

In effect most fundamental information is a set-up. Here are two very important fundamental set-ups you could consider before each trade, particularly if you are holding long-term positions.

Interest rates

The interest rate differential between countries is one of the best predicators of currency movements.

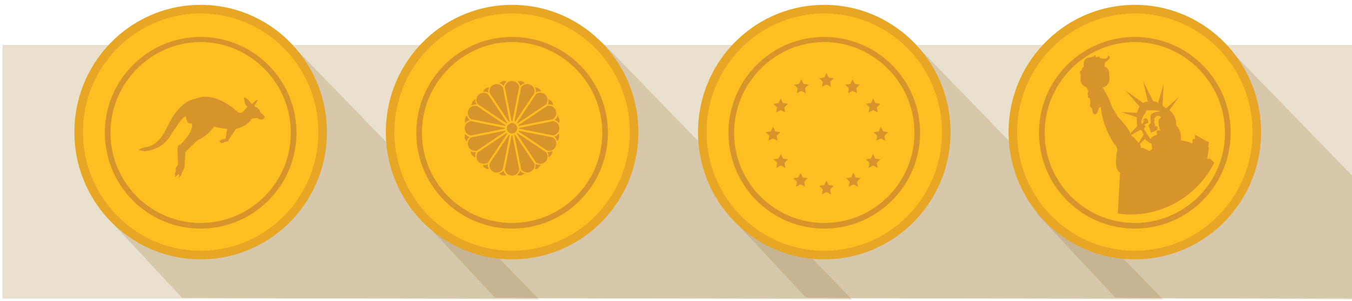
Currency trading can be seen to be a form of leveraged fixed interest trading. So if a currency pair has a higher rate, then it can be an attractive long-term buy. When there is demand, there tends to be price increases.

In addition, they have a very real impact on your account balance. If you are buying the currency pair with the lower interest rate, you are likely to have the interest charge subtracted from your account each day.

Chris Lori, a popular American trader, takes this set-up very seriously. He recommends trading only the AUD/JPY and only buying AUD so that he is always earning interest on his trades.

There is an example of interest rates at work on the following chart. Here you can see the correlation between the spread on German and US bonds, versus the price of the EUR/USD. 11

Source: Forexlive.com



Central bank bias

It used to be all about interest rates, but after 2008 central banks across several major developed nations dropped interest rates to close to zero.

Their main tool became quantitative easing, where (essentially) they would inject cash into the economy in exchange for toxic debt. This bias towards easing had a telling impact on the movements of currency pairs. Thus currency traders tune in to the easing or tightening proclivity of central bankers to get an idea of the direction they want to trade. You can see the impact quantitative easing has on the movement of currency pair on the following chart of the EUR/USD. 12

So take note of directional biases caused by fundamentals as they can make very good set-ups for longer term trades.

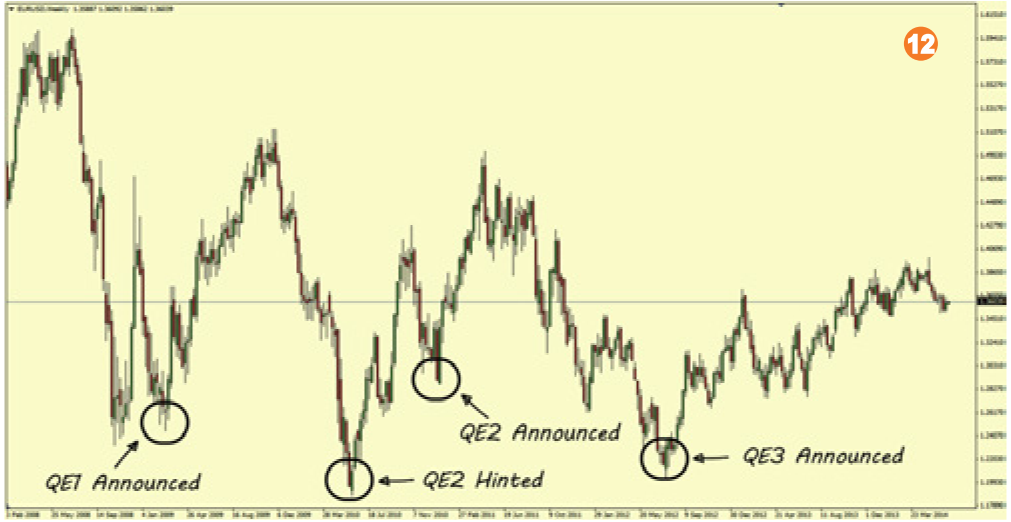
Some damn good expert set-ups

Trade ideas dominate Forex websites and for the uninitiated it can be hard to sort the wheat from the chaff.

But if you do find an expert source of information about the Forex pairs you are tracking, it can give you a built-in edge. The experience and connections of those in the industry are not easy for us retail traders to emulate and their trade ideas can prove well worth tracking.

You should not go all in on the "hot tip" of an expert. You should treat an expert's trade idea like you would any other set-up. It is simply a component to be added into your complete Forex trading system.

Why not follow these ideas in full? Because you have your own unique objectives, psychology and



motivations, which if not considered will lead to trading failure.

What will you do if the experts you are following:

- Experiences a drawdown
- Trades a timeframe that does not suit you, or
- Doesn't give you a place to put a stop-loss?

And they certainly won't have a position-sizing model designed to fit you.

If you don't treat their ideas as your own in an integrated manner, then over time the incongruences will pile up and you will make mistakes that harm your trading account.

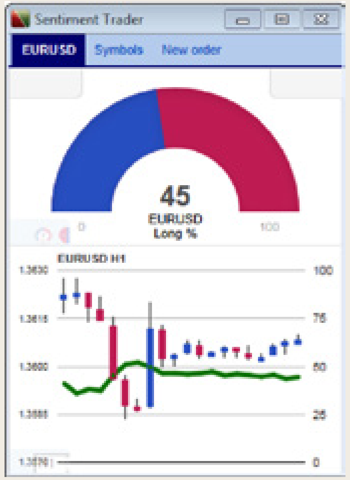
Some more damn good set-ups

Set-ups abound. Wherever you can find a Forex trader you can find a new set-up.

In fact entire books have been written on one or two set-ups alone. Here are a few more set-ups that you should know about.

(Please note that just because I did not include these above does not mean they are any less useful or important. It all depends on the trader and the edge they are seeking to find.)

See which ones suit you and your trading style. Avoid the temptation to overcomplicate. You must have a specific reason for adding a set-up into your plan, and then you should rigorously test it like a scientist tests a hypothesis.

Time of day/ session	The time of day and the session you are trading in can have a big influence on the outcome of your trade.
Divergence	Lookout for indicators that are signalling a change in trend before the price reverses.
Size of the candle	Large candles can signal an important event has happened that may create a change in the trend.
Information about the order flow	Information about where orders and stops are sitting in the markets can be excellent set-ups.
Options barriers	If market participants are looking to either protect their options from execution or make sure that an option is executed, then their actions could move the market.
Sentiment indicators	Sentiment trading is a relatively new innovation in the Forex market. By knowing which way the "herd" is positioned, you can choose to either follow or fade the trend. 

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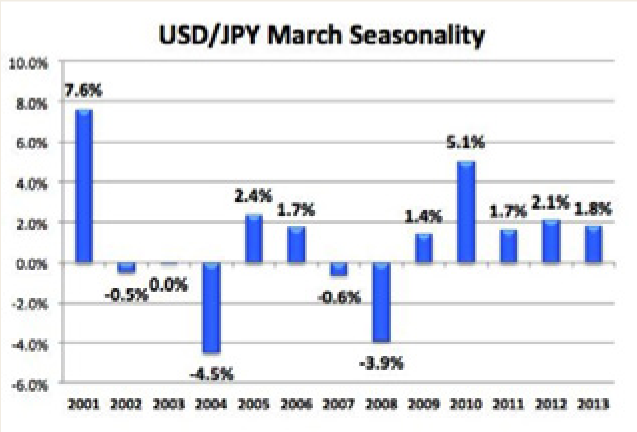
(Table continued)

Correlations	Correlations between currency pairs can be important leading indicators across multiple timeframes.
Upcoming news events	If you assess the events that you have on the horizon for the coming week, you can get a sense of what can move the market and where.
Why a pattern is formed	If a pattern is formed because of a news event or not.
Seasonality	Historically currency pairs may have performed differently based on the time of the year. You can see an example in this chart where for the last 5 years USD/JPY has been strong in March. (chart courtesy of Kathy Lien) 
Environmental or geopolitical events	Such as 9/11, the Japanese tsunami or Russian troops in the Crimea in 2013 can heavily influence the direction of currency pairs.
Corporate buyers	A large corporate purchasing currency (perhaps due to a merger and acquisition) can be a powerful set-up.

Here's what to do next

Smart traders know that the search for the perfect combination of set-ups is a *chimera*.

As you develop your Forex trading strategy, you will be tempted to spend the lion's share of your time in this area.

But don't be so easily seduced.

I suggest you choose:

1. A market type
2. A trend filter

Then choose one other set-up from those listed above (or one of your own that you already like).

And simply move on. Go and work on other aspects of your system or your position sizing. You can then experiment with the set-up as a variable as you make changes down the track.

Ready to practise what you learned in Part One?

Open a Demo account and practise in a real-time, risk-free trading environment. The Demo account only uses virtual funds and is 100% free. Or open a Live account and start trading the markets.

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Coming up in Part Two...

We'll go over some of the simple entry and re-entry methods to the market, as well as exit strategies and the all-important stop losses.

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