



## The Rules for Turning Patterns Into Profit

# The 10 Essentials of Forex Trading

### THE SUMMARY IN BRIEF

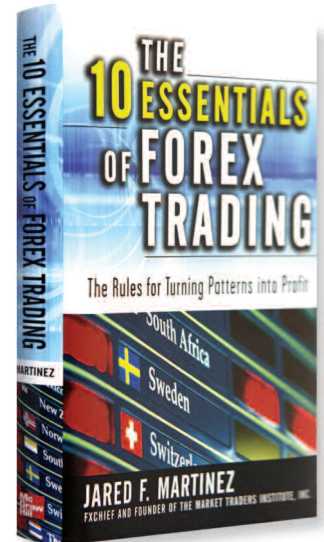
In *The 10 Essentials of Forex Trading*, currency trading expert Jared Martinez shows how to use charting methods to effectively relate market movements to trading patterns. Though written primarily for traders, there are lessons within Martinez's mentoring approach to Forex trading for anyone in quest of personal and financial success. Martinez pronounces that success will be determined by how confident you feel, what you think and how you respond when bad things happen. In his words, "In any financial or business endeavor, success starts in your head, is fueled by your heart and the results are driven by your actions."

To trade the Forex market, you must come to the trading table well prepared with skills that include knowing how to choose and use the right trading tools, how to trade in buy and sell zones, and how to identify trends and trendlines. You will also need to be prepared for what the market demands the most — change and discipline.

Martinez introduces the tools and mind-set necessary to reap personal and financial reward. By following his rules for turning patterns into profit, no matter what your level of trading experience is, you can develop the skills you need to become a consistently successful foreign currency trader.

### IN THIS SUMMARY, YOU WILL LEARN:

- The importance of developing a solid personal and trading constitution.
- How to use Japanese candlesticks to discern the sign language of the market.
- How to create entry and exit strategies.
- How to forecast and trade a sideways movement in the market.
- The importance of trends: finding and using them to your advantage.
- How to become a confident, competent and profitable trader.



by Jared F. Martinez

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# THE COMPLETE SUMMARY: THE 10 ESSENTIALS OF FOREX TRADING

by Jared F. Martinez

**The authors:** Jared F. Martinez is the founder and CEO of Market Traders Institute Inc., where his primary focus is to teach novice investors as well as experienced traders how to effectively take advantage of the markets.

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## Introduction

Forex, or the foreign exchange market, offers incredible financial opportunity for those who are ready for the adventure, but it can be disastrous and financially devastating for those who are unprepared.

No one can become successful at trading without first establishing his or her personal constitution. It is this aspect of yourself that either destroys you or allows you to succeed in life and that includes Forex.

What the market demands most is change and discipline. If you cannot find the courage to change and then remain disciplined to that change, you will be unable to develop a trading strategy that aligns with your personality and your perception of life.

The “holy grail” is knowing when to get in the market and why, and *when to get out and why*. If you can learn the when and the why, you will be able to make market movements work for you.

If you are going to be successful at trading, you will need to acquire a trading strategy that is easy to execute, easy to understand, easy to obey and that works for you consistently.

Remember that man was not created just to get by; he was created to reach his highest potential. ●

## So You Want to Trade Forex?

The first step to successful trading is to ensure that you are not bringing your bad habits to the trading table. Creating your personal constitution is like acquiring the best helmet possible to protect your most important asset — your mind. Your mind is the epicenter of your body and the control tower of your destiny.

• **Are you more honest than dishonest?** Telling the truth is critical; it prevents future trading missteps.

• **Are you a promise keeper or a promise breaker?** If you are not a promise keeper, you will bring this bad habit to the trading table and you will not follow the rules as you trade.

• **Are you a rule maker or a rule breaker?** Being successful at trading requires that you follow certain rules. Otherwise, you will be driven by your emotions and will be caught up in chasing the market, changing your mind and breaking every rule in the book in the spirit of trying to save yourself.

• **Are you a good or a bad listener?** The greatest reward comes to those who develop the art of hearing what is not said. As the market moves, it “tells” a story. You cannot find success in trading by disrupting the flow of the market’s conversation.

• **Do you think before you speak or speak before you think?** As a trader, you must engage in conversation with the market, and your response can be either ignorant or intelligent. If you insist on speaking before you think, the market will allow you to prove your ignorance.

• **Do you think before you act or act before you think?** You will need to get in the habit of thinking of all the details potentially involved in a trade. You will need to have checklists. You will need to get in the habit of creating a trading plan and maintaining the discipline of trading your plan. That habit forces you to think before you act, avoiding impulsive, emotional actions that generate unsuccessful trades. The market has no remorse for ignorance and impulsive action.

• **Do you manage your emotions or do your emotions manage you?** When it is time to trade, the more you rely on your emotions, the more money you will lose. Successful traders manage their emotions; unsuccessful traders let their emotions manage them.



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- **Are you responsive or reactive?** When it comes to any crisis, you owe it to yourself to respond logically, not emotionally. Reactive trading will cause you to lose all your money, whereas responsive trading will allow you to think through your next move and take advantage of the next opportunity that knocks.

- **Is your ego more constructive or destructive?** The market will teach the destructive ego the true definition of humility. The constructive ego, through humility, will in the end fight to be happy rather than right.

- **Are you more positive about life or more negative?** If you want to become a successful trader, you will have to purge your negative attitude and adopt a positive mind-set.

- **Do you fear your mistakes or do you embrace them and learn from them?** You must pay attention to your mistakes and embrace them with a positive attitude.

- **Do you focus on what you have or on what you have lost?** All traders lose money and make money as they trade. Successful traders spend no time worrying or thinking about their losses; they stay focused on the next opportunity.

- **Are you a goal setter or a goal quitter?** Traders who set goals and persist until they succeed reach their pot of gold: executing trades correctly 100 percent of the time and consistently making more money than they lose.

Developing a solid personal and trading constitution is the first step toward successful trading on Forex. What good are technical skills without courage? What good are trading rules if you are a rule breaker? Why learn to take advantage of new trading opportunities if you cannot let go of your past mistakes and failures? ●

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### Introduction to the Forex

Forex is an acronym for *foreign exchange*, a market where people exchange the currency of one country for the currency of another in order to do business internationally. Forex is also called the *cash market* or *spot inter-bank market* (trading on the spot, at whatever the price is at that moment).

Prior to 1994, the Forex retail market for small individual speculative traders — those looking to make a profit on price movement and not looking to hold onto any currency long term — was not available. In the late 1990s, retail market-maker brokers were allowed to offer individual traders the opportunity to participate in the Forex market as we know it today.

Forex is considered the largest financial market in the world. More than \$1.5 trillion is traded daily on the Forex, exceeding the daily combined activity of all the other financial markets.

Although Forex trading is commission free, there still is cost involved. That cost is called the spread, which is what you get charged to access the Forex market. The spread is the difference between the buy price and the sell price of a specific currency.

There are spreads between all currency pairs traded, and they average 3 to 6 price interest points, or pips, on the major world currencies (the U.S. dollar [USD], the British pound [GBP], the Japanese yen [JPY], the European euro [EUR] and the Swiss franc [CHF]). The value of a pip averages around \$10. Currencies from small countries are called *off-brand currencies* and can have spreads of as much as 500 to 1,000 pips.

A trader's financial reward is measured in pips, which are then converted to dollars. Most traders on the Forex trade with leverage, borrowing a broker's money to trade. You acquire leverage by posting a bond or deposit with a Forex broker who then allows you to trade using the broker's money. There are typically two types of lots: a \$100,000 unit is called a *regular lot*, and a \$10,000 unit is called a *mini-lot*.

#### There are four types of orders:

- **Market orders:** to enter or exit at the current market price,
- **Limit orders:** to enter or exit the market at a predetermined price,
- **Stop orders:** similar to limit orders, they turn into market orders when the market reaches the predetermined price. A stop order is when you place a buy order above the current market price or when you place a sell order below the current market price.
- **OCO orders:** (one cancels the other order) to cancel exposure after either your stop or limit has been filled and you have been taken out of the market.

Understanding all successful trading procedures and rules before you trade is essential. You must practice them over and over again until they become unconscious practices. ●

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### Self-Empowerment via Trading

You must be taught to use the best tools available. The most important thing about a trading system is that it must be simple and easy to use. It must be able to find the current market direction, have a consistent

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entry strategy, and have two very clear exit strategies — one for protecting against major losses and one for capturing profits.

Indicators and oscillators (which are nothing more than mathematical equations for monitoring price movement against time displayed via lines on a chart) are one way to determine market direction. Using trading indicators eliminates a lot of guessing and allows you to develop a trading strategy that works consistently within a time frame that suits your personality.

Most traders make their money during trends and lose it when the market gets turbulent or begins to go sideways.

Use indicators to make your exit decisions. Keep your exit strategy simple, and trade using smaller time frames: as a beginner, perhaps 30-minute, 15-minute or 10-minute time frames. Your aim should be to establish the habit of winning more than you are losing. After that, you will be able to move to a larger time frame to capture more pips, and you can start learning more advanced exit strategies.

A confused mind is going to take you down a path of financial destruction. Stay clear from using too many indicators or complicated indicators. Keep it simple! ●

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### Trading Japanese Candlesticks

There are three types of charts traders can refer to: a line chart, a bar chart and a candlestick chart. Until recently, bar charts dominated, but now even the world's top traders are using Japanese candlestick charts.

Japanese candlesticks communicate via certain formations the future potential moves of the market. This visual language indicates clear buy and sell signals, communicating to the trader when it is time to enter a market or get out. Candlesticks monitor price movement against time, providing traders with four key pieces of information for a specific time period: the opening price, the closing price, the highest price reached and the lowest price reached.

A *high* is defined as a level where the market ceases to rally and turns in the opposite direction. A high can be considered a new level of resistance, or a higher price level achieved by the bulls that was interrupted and reversed by the bears.

A *low* is defined as a level where the market ceases to drop. A low can be considered as a new level of support, or a lower price level that was achieved by the bears and then interrupted and reversed by the bulls.

Learning how to identify and trade candlestick formations can be extremely useful in identifying potential coming patterns. However, you should not trade these candlestick patterns on their merits alone. Success is increased if you have more than one educated reason to enter the market. ●

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### The Financial Game of Support and Resistance

Forex trading is a game played on a daily basis by two teams, or two types of investors on opposite sides of a trade. The bulls want the market to go up. The bears want the market to go down. The two sides are in constant, unrelenting battle, fighting for control of the trading territory. Like any game, there are objectives, rules and penalties. Each side is trying to get ahead by scoring points, following the rules of the game. You must obey the rules if you are planning to succeed in trading.

Bulls and bears fight aggressively to make the market go their way. There must be someone buying and someone selling simultaneously. In other words, one trader must be a bull going long and one must be a bear going short. Both are adamant about their positions, despite the fact that they are relying on extremely accurate information, often from the same sources. What is amazing is they are adamant about the market going in opposite directions.

Bulls and bears enter the market buying or selling in hopes that more bulls or bears will enter after them — creating a greater rally or greater dip.

#### Resistance and Support

As bulls and bears make new highs and lows, levels of support and resistance are registered. *Support* occurs when traders begin buying, supporting a price as it is falling. Conversely, *resistance* occurs when traders feel prices are getting too high or expensive, and they resist buying at that price.

As traders support a currency at a certain price, a new low is created, and when they resist buying, a new high is created. Buyers want prices to go lower so they can get a better deal, and sellers want prices to go higher to enable greater profits.

Resistance occurs when the bulls move the market to a new high and the bears jump in aggressively selling, attracting more sellers than buyers, interrupting the rally, and creating a retracement or pullback from the high. The new high becomes a new level of resistance, defined

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as a price level where bears start selling enough to interrupt and reverse a rally.

Support occurs when bears move the market to a new low and the bulls jump in aggressively, buying to support the price and attracting more buyers than sellers. That increased buying interrupts the dip and creates a pullback from that low. The new low becomes a new level of support, which is where bulls start buying enough to interrupt and reverse a dip.

Most successful traders are more focused and more comfortable trading midway of a price swing, rather than going to extreme lows and highs in pursuit of profit. Knowing where the projected highs or lows will be will allow you as a trader to know when it is time to get in and out of the market.

The major levels of resistance are the targets the bulls will be aiming for if they are in control or if they take back control from the bears, establishing a new high. Then there is typically a pullback, because traders that take short positions most of the time place their protective stop-loss orders near the last highs; so when the bulls hit that area, there are a lot of buy-stop orders and a lot of selling. Bulls succumb temporarily, bears start to gain a little and a pullback takes place. Bulls will step in and support a price near a past level of support or near an uptrend line.

If the past level of resistance is penetrated and the uptrend is going to stay in place, the bulls will step in and start buying heavily near the last low. The first level of support becomes a great area to go long in the market. ●

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### Learning to Short the Market

Bears want to take the market to lower levels, enabling them to sell high and buy low. This is called *shorting the market*, or *going short*. To avoid making losses, it is important to know how to identify those potential targets the bears are aiming for — the major levels of support — if they want to take control from the bulls. This happens when the market reaches a past level of support and establishes a new low. Then there is typically a pullback, because traders that take long positions most of the time place their protective stop-loss orders near or at the last lows, meaning that when the bears hit that price point, there are a lot of sell-stop orders and a tremendous amount of buying taking place. Bears succumb temporarily and bulls start to gain a little territory, and a pullback and a small rally takes place. Prices will continue to rally until the bears

step in and start selling again near a past level of resistance or near a downtrend line.

If the past level of support is penetrated and the downtrend is going to hold, the bears will step in and start selling heavily near the last level of resistance. The first level of resistance becomes a great area to go short in the market.

As bulls and bears continually play this game, bulls try to make higher highs and bears try to make lower lows. As the market moves up, many times past resistance can become future support and becomes a great place to buy. As the market moves down, many times past support can become future resistance and becomes a great place to sell.

Trading is a game. The way to learn how to win at this game is to work at it. ●

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### Trends and Trend Lines

As the market moves, it will move in only one of three directions: up, down or sideways. When it moves in any direction, it waves.

#### Spotting an Uptrend

If the market is going to move up or trend up on any time frame, it will wave up, creating higher highs and then wave back down, creating higher lows. At some point the trend will end, but until it ends, most successful traders try to take advantage of the move and take the ride up until it bends or ends.

As the market trends in any direction, it moves at different speeds. Most trends travel at a 45-degree angle as they move; that trend line is called the *outer trend*. When a trend moves at a slower pace, a long-term trend line is created. When a trend moves faster, it creates what is called an aggressive trend, or the *inner trend line*.

If any current trend is going to stay in place, once it retraces back to a trend line, the market will bounce in the direction of the previous trend, and the trend line will act as an obstacle that will change the direction of the current movement. In other words, correctly drawn trend lines can project future levels of potential support in an uptrend and future levels of resistance in a downtrend.

Successful traders constantly monitor all uptrend lines on all time frames. Outer trend lines represent the overall movement on the chart for that time frame, and the inner trend line represents the most recent movement.

Uptrend lines act as future levels of support. They are like a floor, and when the market hits the floor, it usually bounces back up.

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If the inner trend line is broken, the market usually moves to the outer trend line. If the market breaks the outer trend line, the market will predominantly move to the long-term trend line and bounce back up from there. If the long-term trend line is broken, as a rule there will be a major reversal.

### Finding Downtrend Lines

In a downtrend, the market reacts the same way as in an uptrend, but in the opposite direction. That means all the rules are the same, but in the opposite direction. Instead of the market making higher highs and higher lows as it trends up, it makes lower lows and lower highs as it trends down. The market bounces down on a downtrend line, creating a level of resistance.

Downtrend lines act as ceilings for the market and are future projected levels of resistance. If the inner downtrend line is broken, the market usually moves to the outer downtrend line and bounces back down from there. If the market breaks the outer downtrend line, the market will generally move to the long-term downtrend line and bounce back from down there. If the long-term line is broken, as a rule there will be a major reversal.

### Trading Channels

As a trend moves, it likes to move inside a trading channel, which is described as the market moving at an up or down angle inside two trend lines that create somewhat of a channel. The trend lines of the trading channels act as both resistance and support. Trading channels can shift.

The value of trend lines is that using them as part of your trading system and in conjunction with other indicators increases your chances of success. This is because of convergence. Where there are several things taking place at a single price point, having several indicators could confirm and support trading decisions. Trend lines are just another little piece of the puzzle that indicate a continued move. The key is to always look for that convergence, along with a trend line bounce in the direction of a trend. ●

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## Buy and Sell Zones

Trend lines divide buy zones from sell zones. When the market is trading above any trend line, it is in the buy zone and traders are looking for the best location to buy the market. When the market is below the trend line, traders are looking for the best location to short the market. When a trend line is broken, a trader may want to reverse position.

When the market breaks the uptrend line and enters into the sell zone, always take the time to check the angle of the trend line. The backside of the uptrend line will now act as resistance. Should the market begin to rally again, it will need to break through the backside of that trend line or resistance. If the backside of the trend line is lower than the last high, there is an 80 percent chance of a continued dip and a trend reversal. If the backside of the trend line is higher than the last high, there is an 80 percent chance of a continued rally.

The strongest sign of a reversal, or that the uptrend is dead, is when the market retraces back to the latest level of major support.

The buy zone works exactly the same as the sell zone, but in the opposite direction. When the market breaks the downtrend line and enters into the buy zone, always take the time to check the angle of the trend line. The backside of the downtrend line will now act as support. Should the market begin to dip again, it will need to break through the backside of that trend line of support. If the backside of the trend line is higher than the last low, there is an 80 percent chance of a reversal and a new rally. If it is lower, there is an 80 percent chance of a continued dip.

The strongest sign of a reversal, or that the downturn trend is dead, is when the market retraces back to the latest level of major resistance.

Knowing about buy and sell zones can significantly aid your trading success; however, not all trend-line breaks offer trading opportunities. Not all trends are clear, and not all buy and sell zones are clear. If the market does not look clear to you, stay out. ●

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## Fundamental Analysis

The news that comes out about a country, good or bad, is called a *fundamental announcement*. Countries and companies both have fundamental announcements, which have similar effects on the value of a country's currency as on a company's share price. When investors get nervous and want to move their money from one country to another, they create a buying frenzy around the currency they are acquiring, driving the value up and creating a selling frenzy around the currency they're selling, which drives the value of that currency down. If the masses start selling more than buying — stock or currency — the prices will be driven down.

In the currency market or on the Forex, each country has approximately 20 major fundamental announcements annually for investors to monitor. Most economic reports

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are created monthly, quarterly or yearly, but some are created weekly.

*Trading days* are days when there are no fundamental announcements. Currency charts typically move 60 to 90 pips, depending on the currency.

*Trending days* are fundamental announcement days, when the market will generally take off in a direction after the announcement and move 120 to 240 pips within the first five hours, incurring a major price change.

Novice traders prefer trading days as the market is typically more predictable. Expert traders, however, prefer trending days over trading days because they can make more money in less time.

## World Economies

There are three major world economies and time zones that traders monitor: 1) the Asian market; 2) the European market; 3) the U.S. market. The sun doesn't set on the financial markets of the world. Somewhere in this world, a financial market is open during any given 24-hour period.

Tracking down the fundamental announcements before you trade is critical. Make it a habit to see if there are any major fundamental announcements about to take place that may create volatility. ●

## Consolidating, Bracketing, Accumulation or Sideways Movement

The market can only move up, down or sideways, which is commonly referred to as *consolidation*. Believe it or not, the market consolidates 50 to 60 percent of the time and trends the remainder of the time. You really need to trade two different trading systems: one that spots trends and allows you to take advantage of them, and one that spots consolidations and allows you to take advantage of them.

### Consolidation Factors

There are two primary reasons why a market starts to consolidate, accumulate, bracket or go sideways. The first is when the world is waiting for a fundamental announcement and traders stop trading in anticipation; the market begins to consolidate in a tight trading range. The second reason the market may consolidate could be due to a country intervening and wanting its currency to trade within a certain trading range for economic reasons.

## U.S. Fundamental Announcements

Fundamental announcements have an effect on every country's currency in some way, either immediately or soon after. The following fundamentals are announced in the United States:

- **Purchasing Managers Index**, indicating an expanding or contracting factory sector
- **Consumer Confidence Index**, monitoring consumers' attitudes and expectations regarding economic conditions
- **Consumer Price Index**, also known as the cost-of-living index, measuring changes in consumer prices
- **Durable Goods Orders**, a government index reflecting strength in demand for U.S. manufactured goods
- **Employment Situation**, listing non-farm payroll jobs, the unemployment rate, average hourly wages, and the length of the average workweek
- **Non-farm Payroll Indicator**, the greater the increase in employment figures, the faster the economy will grow
- **Existing Home Sales**, measuring the selling rate of pre-owned homes
- **Gross Domestic Product**, measuring the performance of the U.S. economy by measuring its production output
- **New Home Sales**, measuring new home sales and considered indicative of consumer spending generally
- **National Manufacturing Activities**, as reported by the Philadelphia Fed
- **Producer Price Index**, indicating the underlying inflation trend
- **Retail Sales**, considered to be the timeliest indicator of broad consumer spending patterns
- **Balance of Trade**, measuring the difference between imports and exports of U.S. goods and services

There are three trading strategies to use when the markets are consolidating, accumulating or bracketing.

### Strategy 1

During periods of consolidation, traders will look to sell at resistance or near the highs. When prices get close to resistance, most traders turn to smaller time frames and look for confirming bearish Japanese candlestick formations near the highs and then short the market after the bearish formation appears. The bearish

candlestick formation gives confirmation that the market is about to U-turn. They then turn back to a larger time frame and look to find support on the other side of the consolidation trading range, taking the ride back down to support.

When prices get close to another level of support, once again traders will look to confirm their decision to buy and look for bullish Japanese candlestick formations near a level of support or a prominent low. They will enter going long after the bullish formation appears.

Once you find consolidation, it is hard to get hurt — as long as you have the patience to wait for the bearish candlestick formation to appear near the level of resistance and a bullish candlestick formation to appear near a level of support.

### Strategy 2

This strategy will work provided your broker will allow you to trade this way. The *straddle* was designed for trading in tight trading ranges in anticipation of a fundamental announcement. It is very important that there is a fundamental announcement to be released and the market range is between 20 and 60 pips. In order to trade a straddle effectively, the market needs to create a tight level of consolidation before the announcement, which, in turn, will provide a straddle opportunity.

### Strategy 3

Should you spot consolidation, rule No. 1 is to check to see if there is a fundamental announcement in the near future. If there are no fundamental announcements, then go ahead and trade in the direction of the current trend. ●

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## Bull and Bear Traps

After consolidation has formed and there are no fundamental announcements, *bull traps* are false breakouts to the south of that consolidation, doing nothing more than fulfilling the natural numerical sequence of the market.

*Bear traps* are the opposite of bull traps. After consolidation has formed and there are no fundamental announcements, bear traps are false breakouts to the north.

Currencies may aggressively react to fundamental announcements or they may not. Successful and educated traders respond, rather than react, to those announcements. They are well prepared and ready to switch from being a bull to becoming a bear at the drop of a hat. ●

## Learning the Rules of Equity Management

As you learn to trade, never forget rule No. 1: *Protect yourself at all times* — this is vital to your financial survival. Protecting yourself as you trade is called placing a protective stop-loss order in the market at the same time that you execute the trade. Protecting yourself as you trade involves quantifying how much you are willing to lose ahead of time before you enter the trade and how much you will be able to emotionally and financially survive without that loss affecting your life and your financial security.

Trading without a protective stop-loss order ignores the potential damage the market can do to you. Events that move the markets 500 pips in a direction don't happen every day, but surprise fundamental announcements happen all the time.

The rule of survival at trading is never to risk more than 5 percent of your equity on any given trade. Do not stay focused only on the potential gain. You need to stay focused on the potential risk when making any trade. The reason you need to risk only a certain percentage of your trading margin is so that you have staying power in the market.

There is no need to ever sell the farm for any given trade. Your habit of success must be that for every dollar you risk, you must plan to make 1.5 times the return.

Savvy investors have one major focus: the preservation of their initial capital. They already know the price they had to pay to get that money. They are not driven by greed, and they don't want to re-earn the principal again. They first look at risk, then at the consequences of taxes and lastly at the potential of returns. ●

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## The Final Analysis

The only difference between successful traders and unsuccessful traders is that the unsuccessful ones don't know what they are doing and keep losing money in a desperate attempt to get it all back.

Successful traders know exactly what happens when they lose money and how to put it in perspective. They don't desperately chase the market, trying to make up for past losses. They don't waste any time dwelling on the past, rather; they stay focused on what future trading opportunities exist — and that is what makes them successful. ●