INTERVIEW

Talking Forex Patterns And Probabilities

FXEducator's Ed Ponsi

As an experienced professional trader, Ed Ponsi, the president of FXEducator.com, has advised hedge funds, institutional traders, and individuals of all levels of skill and experience. He has made numerous appearances on CNBC, CNN, BBC, Fox, and ForexTV, and his dynamic and humorous style sets him apart from the suit & tie crowd. In addition, Ponsi is the author of Forex Patterns And Probabilities*, a top-selling book on currency trading.*

STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan and Staff Writer Bruce Faber interviewed Ponsi via telephone on June 8, 2009.

Ed, how did you get started in trading?

My first exposure to trading was with a summer job I held at the Philadelphia exchange (PHLX). It was a clerical job, not on the floor, but it was perfect for a teenager. The trading floor of the PHLX was right down the hall. I didn't know anything about the markets or trading, but I was close enough that I caught the trading bug. I started reading everything I could get my hands on about the subject. The first book I read was *How To Buy Stocks* by Louis Engel.

Later, I worked as a musician at night and I owned a business that allowed me to finish work very early during the day, so I had time to trade during market hours. I started trading stocks in the afternoon during the NASDAQ bubble of the 1990s — trading tech stocks out of my basement on an old COMPAQ using a 14.4K dial-up modem, strictly Level 1. I also had a Quotrek, one of those pre-PDA portable quote devices they used to advertise on CNBC. So I'd point this device toward the sky, looking for the radio signal that carried the quotes. I remember running down the boardwalk in a beach town in New Jersey, trying to find a pay phone so I could buy 3Com! I was clueless.

The market was very forgiving then — you could buy the wrong stock at the wrong time and it would still go up, so trading was easy, provided you weren't short. I built up a track record and parlayed that into an entry-level trading job at a Wall Street boutique firm. I think they hired me because I was willing to travel 100 miles to get to work every day. That was when I really learned how to trade.

JG: What attracted you to the forex markets specifically?

I was working as a trader in New York, and someone I used to trade with started trading forex. When he told me about the liquidity, the leverage, and the other advantages of currency trading, I didn't believe him. Even now, when I talk to stock traders about the advantages of forex, they seem to have a hard time grasping that I'm using 100:1 leverage and collecting interest on the trade at the same time. They are used to paying for everything, including leverage.

The other attraction was the strong trending nature of forex. I was already a trend trader in the stock market, and it only seemed natural that I should take that style and apply it to the market known for long trends.

JG: How do you collect interest using 100:1 leverage?

Stock traders commonly use 2:1, 4:1, and sometimes 10:1 intraday daytrading buying power. Meanwhile, currency traders use 100:1 leverage. Most stock traders consider that to be an insane

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amount of leverage, but it's an apples and oranges comparison. If you take for example something like the most liquid currency pair out there, euro/US dollar, it literally moves on average less than two pennies a day. We had to create a whole new subset called *pips*, which are really almost 1/100th of a penny. So currency traders can make or lose money on a move of a tiny fraction of a penny. If you try to trade currencies without leverage, it would be like trying to trade a stock that only moved a penny a day even if you considered the big rallies. In an entire *decade* the euro went from \$0.85 to \$1.60. That is literally \$0.75 in a decade.

JG: How is trading the forex markets different from trading equities?

There are a couple of major differences. When I traded stocks, I was a pure technical trader. I never paid much attention to fundamental analysis because it seemed so disconnected from the technicals. By the time a company reports its previous quarter's earnings, that information is ancient history. Buying stocks on fundamentals is risky because you'll never know if you're missing a key piece of information, or if your information is outdated; it's all rear-view mirror stuff. Meanwhile, the chart is telling you everything that you don't know about the stock.

But in the currency market, fundamental analysis can and does work. I'm still a technical trader, but I look for situations where the technicals and the fundamentals are in harmony. With stocks the two are disconnected, but in forex they are like two sides of the same coin.

What variables or factors should we pay attention to when trading the forex markets?

Time frames are essential. When I started trading forex, I used the same time frames that I'd used to trade stocks for years. I had trouble initially, so I tried everything I could think of. Then after a while I tried using the same stock trading techniques on longer time frames for forex. That's when it began to fall into place for me.

In addition, forex is a news-driven market. I wouldn't recommend trading forex without at least one newswire. Forex is driven by an ever-unfolding series of events, many of which occur at specified times, like a speech from a central bank official or an economic report. If you understand what to expect from a speech or an economic report, you can anticipate the market's reaction or, better still, react to the market's overreaction to the news.

JG: When you say short and longer term, what time periods are you looking at?

When I was trading stocks, I was using the 15-minute charts, five-minute charts, and even the one-minute charts. I tried to do the same thing on forex, but here are the problems you're going to encounter on most platforms: First, the spreads are wider on currencies than they are on most stocks, and second, you cannot buy the bid and sell the offer. So you are going to have to pay that spread over and over again. If you are trading on a five-minute chart on the forex, get ready to pay a lot of spreads. That's a problem. The thing is, even if the techniques make sense in the short term and the long term, that spread will kill you in the short term. So let's make the playing field bigger. The stops need to be wide, and the targets should be wider. No matter what time frame you are trading in, the spread remains the same. That makes the spread less of a detriment in longer time frames because it becomes a smaller percentage of the overall playing field.

BF: So what's the answer?

Make the playing field bigger. On a bigger playing field, targets are wider, stops are wider, time frames are longer, everything is bigger, but the spread stays the same. If the guy who is trying to make 10 pips is paying a two- or three-pip spread, he is giving 20% to 30% to the house, win or lose. That is just not going to work over the long term, and yet that is what most people are trying to do. They are trying to play a game where they have the deck stacked against them. They don't even realize it. They haven't looked at the math and exclaimed, "Gosh, I'm giving up 20% of my target to the spread!" It's like flipping a coin and whether it comes up heads or tails, you still have to give 20% to the house. That is going to be very hard to overcome. But if you are only giving up 2% to the house, and you are using good techniques and you are collecting interest; that *is* surmountable.

I would say 90% of the people who try to trade forex want to do it exactly that way. I call them "Johnny Two Pips." They want to make five or 10 pips on a trade and they are willing to give up two- or three-pip spreads. It seems like a good idea, but if you think about it, it is a terrible one. That is probably why so many people have trouble trading forex, or trading anything, for that matter.

JG: Why is it important to know your fundamentals when you're trading forex?

In the equity markets, big players go to great lengths to hide their intentions; they use all kinds of tactics, like breaking their orders into small pieces, trading through electronic communication networks (ECNs), using iceberg orders†, bluffing — there is an incredible amount of nonsense going on. It's like a big poker game, and everyone is holding their cards close to their vests.

But in the forex market, you have central banks telling the world what they plan to do. For example, the Swiss National Bank has made it clear that they want a weaker currency, and they've acted on that by selling Swiss francs. So instead of hiding their intentions, they want traders to help them. They figure if we know that *they're* selling the Swiss franc, then *we'll* sell it too. It's not charity; it's a means to an end.

Stocks are relatively easy to manipulate, but moving a currency can be very difficult, and the SNB is trying to enlist traders to help. It's an easy trade once you look at the chart, and you can see they are trying to keep EUR/CHF above a certain specific level. If you understand the SNB, then you know they don't intervene against the USD; they do it against the euro. The closer I buy EUR/CHF to that level, the less risk I'm taking. It's likely that the Swiss central bank will prevent it from breaking below that level; they've got my back. That kind of stuff doesn't happen in the stock market, but it's not uncommon in forex.

JG: But there must be some pitfalls a trader would have to look at if he or she were trading forex. What are they?

The biggest pitfall for me is the lack of accurate volume statistics. When I traded stocks I used volume as a key part of my analysis, because I always believed that moves occurring on high volume had more significance. But we just don't have accurate, up-to-the-minute volume figures in forex because there's so much of it.

Another problem is that each forex broker has his or her own little fiefdom; there is only one counterparty on each platform. I would love to see all the big forex brokers, like Gain, FXCM, Interbank FX, and the rest all on one platform. It would be like a Level 2 platform where you see Goldman and you see Morgan Stanley, and the rest of the market makers, all in one place. It's like their own little kingdom.

BF: Like their own little world.

They own the casino. I'm not saying it's rigged or that they do bad things, but there *is* potential for abuse. We are seeing a lot of new regulation coming in with the NFA and the CFTC, most of which is really good. I'd like to see more. I'd love to see all these brokers put on one platform at some point. The brokers would not like it, though, because the way it is now, they get to keep the entire spread. But if we could get all these different brokers onto one platform, it would be wonderful for traders.

JG: Speaking of these new regulations, there was a recent one you mentioned. It's called hedging rules. What can you tell me about them?

Most of the new rules are good. They are getting rid of a lot of the marginal players, who are dropping off the playing field due to the new capitalization rules. Regarding the new hedging rule, the concern is that some traders are going long and short the same currency pair at the same time. They are essentially paying two spreads to go flat. I am sure there are people out there doing that. By taking that away, you have also taken away the ability of a trader to say, "I think euro/USD is going to go up for the next hour, but I think it is going down for the next month, so I want to go long for the next hour, and short for the next month."

That is a mistake. Some of the new regulations are good, but not the hedging rules. But they are right in that there are a lot of people who are simply playing the spread twice so they can go flat, which is silly. But it is like the pattern daytrader (PDT) rule for stock traders. The regulators mean well, but isn't this a free market? If I want to go long euro/USD for the next hour and short for the next month and have both trades open at once, I should be able to do that because it's not as though I have 10,000 currency pairs to choose from the way a stock trader does. I have maybe a dozen or so good currency pairs to trade. So I think that rule is a mistake.

JG: You said that fundamentals are really important when trading forex, and you mentioned that if you understand the central bank, you have some idea about price behavior. How does someone go about understanding the central banks?

You need to pay attention to about eight central banks. The beautiful thing is that for the most part, they are not trying to hide their intentions; they are actually trying to signal them. If you read the news media like the *Financial Times*, what you'll discover is that they are very transparent. They try to avoid shocking the market. They often want to let you know ahead of time what they are planning to do.

BF: What's an example?

In the last year, we have had the Australian central bank push the Australian dollar up. Now we have the Swiss National Bank saying they are going to push the Swiss franc down. So from the very start you know there is this huge buyer or this huge seller in the market. To me, that is just wonderful. These central banks are not attempting to make money from speculation; that is not their goal. That might be *my* goal. They are telling the markets, "Listen, we are going to push this currency higher, so if you want to go along for the ride, you'll make some money and you will make it easier for us to push this currency higher." The shorts get out of the way if they know there is a big buyer, and that makes it easier for the central bank to move the exchange rate. So instead of going against traders, they are trying to enlist us by signaling their intentions. This is a huge advantage to the trader. Pay attention to the comments coming out of central banks, and you will see that often they tell you ahead of time what they are going to do. It is a beautiful thing.

JG: Unlike company announcements.

Right. Let's say that second-quarter earnings are going to be coming out in July, and the second quarter consists of April, May, and June. So in July they are going to tell you about how the company performed in April. Well, that's ancient history and doesn't do me any good now. Maybe the fundamentals are saying the stock should go up, but the chart says the stock is going down on heavy volume. I don't know *why* the stock is going down, but somebody knows something I don't. That is the way I approach stocks. I don't care about the fundamentals if I am trading stocks because I know that I don't know everything that's going on. But I know that someone else *does* know, and he is leaving big footprints, so I am just going to follow in those footsteps.

As far as currencies go, there are no footprints. We don't see the volume. On the other hand, there are tremendous numbers of players. We are talking about an estimated liquidity of $3.2 trillion a day. The liquidity is huge because there are an awful lot of people in this market who are not in it to make money through speculation. General Electric needs to buy stuff from a company in Japan, so they need the yen. They have to pay people in *this* country. But in the stock market, it seems like just about everyone is chasing a profit. Meanwhile, there are an awful lot of people in the currency market who are just facilitating business, and they are providing liquidity in the process.

JG: Are there any indicators you favor for trading the forex market?

I'm kind of "old school" in the sense that I don't want the indicators to prevent me from seeing what is going on with the price; people forget that most indicators are just a derivative of the price. A moving average is nothing but an average of prices; the relative strength index (RSI) is comparing the current price to recent prices. You could say that price is the ultimate indicator. In addition to price, the indicators I use the most are exponential moving averages (EMAs), average true range, the RSI, candlestick patterns, support and resistance, and Fibonacci retracement levels.

JG: How do you decide when to enter a trade? What about exiting a trade?

I'm a trend trader at heart. The first thing I look for is a strong trend on a long-term chart. I might enter the trade on a short-term chart, but the trend itself is always determined by the long term, the daily or weekly chart.

If I find a nice trend, I'm only looking to enter in the direction of that trend — I don't fight against it. We have a tendency to say, "It's already gone up so much, maybe I should short it." I'm not part of the reversion to the mean crowd. I had that habit at one point, but after I examined what I was doing and what was working for me, I stopped fighting the trends and went with them.

So I enter with the trend, but not at an extreme point. I'm always looking for the pullback. I tend to use support and resistance levels for exits, but in some cases I'll just trail a stop manually and let the stop take me out.

JG: What indicators do you use to determine if a trend is continuing or reversing?

It's been my experience that there is no magic indicator that tells you when a trend is going to end. If I'm buying pullbacks in an uptrend, or shorting rallies in a downtrend, I know I could be wrong. If I'm wrong, I figure it's okay to lose, as long as I don't get creamed — always limit the losses. But if I'm right, I might try to pyramid the trade into a monster.

BF: What's the bottom line?

If you never allow yourself to get hurt when you're wrong, and you occasionally knock one out of the park when you're right, you don't have to know if the trend is ending. And that is a good thing because there is no way to know for sure.

JG: Do you use different indicators for currencies that are trending vs. those that are consolidating?

Absolutely. For example, I only use moving averages when I'm in a trending situation. I put a lot less emphasis on support and resistance if the market is trending, because it's easier to break those levels if the currency pair has a head of steam.

On the other hand, for my style of trading, moving averages are useless if the market is not trending. In a case like that, I'm putting more emphasis on support and resistance, and Fibonacci as well. I'm a big believer in varying my technique based on the current situation; I don't believe there is such a thing as a one-size-fits-all approach.

JG: The US dollar has been very volatile. Do you think another currency could replace the US dollar as the world's reserve currency?

Whatever you do, don't ask our Treasury Secretary about that! Timothy Geithner's comment that a replacement of the dollar as the world's reserve currency "deserves consideration" is one of the most bizarre official comments in a year that can only be described as surreal. Geithner is a smart guy, and when I parsed the language he used, it seemed genuine and well thought out — in other words, this was no slip of the tongue. It revealed his true thoughts on the subject. He really does believe that the idea deserves consideration.

Many believe the euro or the Chinese yuan will replace the US dollar as the world's reserve currency, but I believe the reserve currency will be supplanted by a supranational currency. The most likely choice would be Special Drawing Rights (SDRs), which the International Monetary Fund (IMF) created to be used as an international reserve currency. This is what Geithner was referring to when he shook the markets with his comments back in March.

People in the US seem to think the dollar has some sort of entitlement to be the world's reserve currency, but they forget that it wasn't always so. The British pound was the world's reserve currency prior to the dollar, and the day will come when the USD is no longer the world's reserve currency.

In my opinion, the reserve currency debate is about more than money. It is a question of economic power and influence: Will the United States remain a powerful and influential nation in the future? The US should try to maintain the dollar's status as the world's reserve currency for as long as possible.

BF: Some of the pundits in the currency/financial field seem to think that the dollar is in real trouble. You also seem to believe that one day the dollar is not going to be the reserve currency. Do you think that these SDRs might be backed with precious metals in order to get all the fiat currencies back in line again?

Nah. That would be a great idea, but think of all the power you'd have if you could just snap your fingers and create money out of thin air. That is very powerful, and if you go to a hard currency, you are giving up all that power. So it doesn't seem likely. Special Drawing Rights are not backed by anything of intrinsic value. World governments can snap their fingers and create more currency, which is happening now. There is so much power involved in being able to say, "Okay! We are going to put in some more zeroes on the end of our bank account/balance sheet." I just cannot see anyone with that kind of power wanting to give it up.

BF: Years ago, I read a book called **Black Obelisk** ***by Erich Maria Remarque, which was an eye-opening story about the hyperinflation of the Weimar Republic. Ever since then, long before I knew anything about stocks and currencies, it has been in my mind as I watched inflation devouring the dollar. Now, with the downward spiral of the dollar and the coming spike of inflation, those trillions may be hiding in the bank right now, but inflation is coming sooner rather than later.***

You are right. It's definitely coming.

BF: To me, it is looking like the Weimar Republic all over again. The more of those zeroes you were talking about that you add on at the end, the less the paper is worth.

The amazing thing is that this happens all through history. Look at Germany in the 1920s. Look at Zimbabwe today,

where they actually have a one-hundred trillion-dollar bill. You can barely buy a loaf of bread with it. On TV I saw a guy in Zimbabwe selling food from a truck and everyone was waving paper at him. I thought it was money, but it was gasoline coupons. Their money is worthless, but at least this coupon buys gasoline. So in a sense the gasoline coupon becomes the currency. It almost breaks down into a barter system. Nobody wants the money. Nobody wants the paper.

This kind of thing leads to social unrest; suppose you were a businessman in Zimbabwe and saved up a million dollars. Today, that million dollars won't even buy you a can of Coke. Think of the huge problems that something like this creates. I cannot believe that is the best we can come up with right now. We can't decide to go down this road when we have all these examples all through history, saying, "No! Don't do this! This is a really bad idea!"

BF: In the history of the world in the game of money, the score for fiat currencies is zero.

You can go back to the Roman Empire and their use of coins. They found it so tempting to put less and less gold and silver in the coins. We are just going to have to keep making the same mistakes over and over again. And it already happened here in the US in the 1780s. Back then, the currency was called continentals, and it became worthless paper. History keeps repeating itself if we don't learn from it. The people I really fear for are those on fixed incomes, because the government will be losing real wealth. People will make more money, but those with fixed incomes will be losing wealth. I love to watch when Ron Paul gets hold of [Federal Reserve chairman] Ben Bernanke on Capitol Hill to get him to justify his policies. It's like a deer in the headlights. Bernanke has no answer. But it doesn't matter because people just don't get it. We have to sound the alarm and say, "Everybody, wake up!"

BF: You play into that with your trading in the forex, right?

Yes. If I am short the dollar, then even though I know my dollars won't be worth as much, I can take solace in the idea that I will have more of them. I'm just trying to break even. If you own real estate or stocks and bonds valued in US dollars and those dollars are shrinking, you can hedge your portfolio by shorting the US dollar. That's what you should do if you think the dollar is going to fall, and I do. I am really big on the Australian dollar and have been for a while. The Canadian dollar looks good. They haven't indulged in any quantitative easing yet. I look at it in terms of which countries are not going to start up the printing presses. Those are the ones that will probably outperform over the next few years.

JG: Do you still trade frequently, or do you focus on the education part of trading?

I've been trading for about 15 years, and I never got involved in any type of education until about four or five years ago. When I started trading, I was extremely active. At one point I was a pure Level 2 daytrader, averaging a quarter-million shares a day, a thousand at a time. That is 125 round trips per day on average. Now, of course, that doesn't work any more. I don't think you can make money doing that particular style of trading. The market is different now.

The longer I'm in this, the more long-term oriented I become. Starting around 2002–03, I started trading off of daily charts for the first time. Starting around 2006–07, I started trading off of weekly charts for the first time. It seems as though I hold positions longer because in forex, the trends are so big and they play out over such a long period of time. So if I start jumping in and out of trades, I feel like I'm cutting myself short. You are not paid on the amount of activity you create, or the amount of commissions that you generate. You are paid on the quality of the trades. I really think that one good trade is better than dozens of mediocre ones.

Any last words for our readers?

Always look at the big picture. I have been holding an aussie position for about two months now, and I hope I'm still in it two months from now. I hope it goes on and on, because if I am still in it that means it's still going strong. That one trade could do more for me than day after day of 125 round trips a day and it is a lot less labor-intensive. Plus, there is positive carry on that aussie dollar trade. There is interest collected on it every day, whether it goes up or down. That, to me, is the way to go.

JG and BF: Thanks for your time, Ed.

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