

forex Trading – How to Choose Currency Pairs

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Learn how to choose the right currency pair, which suits your Forex trading strategy. In this article, we provide considerations to help you decide on the best currency pair to trade.

- The currency market doesn't have hundreds of trading instruments like the stock market. However, with scores of currency pairs to choose from, currency traders must develop a system to choose which currency pairs are right for them to trade. In this article we will look at some of the things to consider when choosing a currency pair to trade.
- All currency pairs are derived from the concatenation of the currencies of separate countries or trading block. Therefore, to trade the Swiss Franc (CHF) against the Japanese Yen (JPY), you would trade the CHF/JPY. The most popular trading pairs are those that represent the largest economies and are derived from the following: US Dollar (USD), Japanese Yen (JPY), Euro (EUR), British Pound (GBP), Canadian Dollar (CAD), Australian Dollar (AUD), and Swiss Franc (CHF).
- **The Majors** - These are widely considered to be the “major” currency pairs: EUR/USD, USD/JPY, USD/CHF, USD/CAD, NZD/USD and GBP/USD.

Commodity Pairs - These pairs represent the largest commodity trading blocks for grains, crude oil and precious metals etc. The commodity pairs are: USD/CAD, AUD/USD, and NZD/USD. Trade commodity pairs if you have a knack for interpreting the possible impact world events may have on the prices of natural resources, and the economies that extract and produce them.

Crosses - A currency cross is one that does not include the U.S. dollar. Before currency crosses were created, an individual who wished to convert a sum of money into a different currency would be required to first convert that money into U.S dollars, and then convert it into the desired currency. Now, that conversion can be done directly. For example, someone in Europe can convert his or her currency to Japanese Yen, by referencing the EUR/JPY rate.

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The most popular currency crosses are: EUR/GBP, EUR/JPY and EUR/CHF. These derive their prices from the movement of other pairs, such as the majors and can be quite volatile. Choose one of these trading pairs if you don't want to trade the USD.

- **Correlations**

Currency correlation measures the extent to which one currency pair mimics the moves of other currency pairs. If two pairs tend to move in the same direction, they are positively correlated. If they tend to move in opposite directions, then they have an inverse correlation.

Traders need to be aware of these correlations, because being ignorant can cause you to overexpose your trading account. For example, entering a long trade on the EUR/USD and the NZD/USD, is, in essence, entering two short trades on the US dollar. There isn't anything inherently wrong with entering two trades involving one currency, but you must be aware of any double exposure.

Remember, diversification is the cornerstone of good money management. Research the correlation between the pairs you decide to trade, so you don't overexpose your trading account. www.Mataf.net has an excellent currency correlation table you might find useful for this purpose.

Volatility and Trading Range

Being aware of the daily trading range of a pair is essential, because it will help you to set appropriate stop loss and take profit targets. For those who like to see large moves, you can consider trading the GBP/USD, as it tends to average well over 200 pips on a daily basis. However, if you are new to forex, start with less volatile pairs, such as the EUR/USD or EUR/GBP.

Be advised, all currency pairs don't have the same pip value. As an example, a one-pip move in the EUR/GBP will translate into more money than would a similar move in the GBP/JPY.

Hedging

If trading highly correlated pairs can cause an overexposure, then the reverse is true; trading two similar currency pairs can provide hedging protection. Hedging is a trading strategy that seeks to offset the exposure to loss in one instrument, by entering an opposing trade on another instrument. For example, entering a long trade on the EUR/JPY and at the same time, a short trade on the CHF/JPY, would in essence be hedging against moves in the Japanese (Yen).

As a result of new regulations in the US, traders can't have a long and a short trade position consecutively, in the same trading account. However, traders may work around this rule by using a sub-account to enter an opposing trade on the same pair, or open an opposing trade with a pair that has an inverse correlation to the first.

- **Liquidity**

There are some pairs that have high levels of liquidity because of the size of the economies that they represent, i.e. the EUR/USD. As a starting point, one should look at the eight major pairs (EUR/USD, GBP/USD, USD/JPY etc) when choosing currency pairs to trade. More liquidity means tighter spreads, more predictability and more efficient trade execution.

Spreads

There is no doubt that liquidity affects the spreads that Forex brokers can present to their Forex clients. In some instances currency pairs have spreads below a pip, the EUR/USD and EUR/GBP are good examples, but this depends upon your broker.

- On this next page, we will look at a few more things to consider when choosing a currency pair to trade.
- Learn about interest payments and trading times when choosing Forex currency pairs/ Forex trading pairs.
- **Trading Times**

A large percentage of the trading volume that occurs happens because of commercial trades, travel activities and even equity and commodity market activities. It is not uncommon to see surges in trading activities once the commercial banks and other businesses start the trading day.

Therefore, it is a good idea to trade a particular pair at a time that corresponds to local business hours. For example, trade the EUR pairs between 2am and 1pm EST and Australian pairs between 6pm and 2am EST. Even though trading activities can be observed outside of these hours, the market moves are most decisive and predictable at these times. You might find it even more beneficial to trade when the market opening hours overlap, such as what happens between 8am – 1pm EST, when New York joins Europe in opening for business.

Interest Payment

One advantage of trading the Forex market is that traders are paid interest on their overnight trading positions. How much a trader makes in interest depends on the interest being paid by each country's central bank, and the Forex broker's policy on rollover fees.

The trading strategy that seeks to take advantage of the difference in the interest rates of currencies, is known as the carry trade. Generally speaking, traders find pairs that pay higher interest more attractive. For example, if the lending rate on the Swiss Franc is 3% and the Japanese Yen is 1%, then taking a long CHF/JPY trade will net 2%pa in interest income. The trader will pay around 2% pa if he enters a short trade instead. Choose currency pairs with large interest rates differences, if you also want to earn interest on your trades.

It must be stated; there is some risk in trading the carry trade. When the market is nervous, or is coming out of a growth period, the carry trade tends to move in the opposite direction, as traders become risk averse. Choose carry trade currencies when the difference in interest rates is high, and the world economy is bullish.

- **Summary**

The best currency pairs to trade are those that fit your Forex trading strategy, style and preference, but to choose the right currency pair, you must search for pairs that give clear trading

signals and chart patterns. In any case, you will need to consider the volatility, trading range, spreads and liquidity when choosing a Forex trading pair.

A trader can't flip a coin to choose a currency pair and expect the best results; he must make an informed decision. Focus on one currency pair (preferably one of the majors) to start and try to learn everything about it. As you become more proficient, you can add more trading pairs, but you must bear in mind the effects that a currency's correlation can have on your trading success. Also consider the spreads and volatility of each pair you decide to include in your trading portfolio; your choice can really affect your profitability.