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Using the Crosses

Finding the right pair to trade should be of utmost importance to all individual traders. Opportunity cost is a real cost for most traders and funds committed to any one position are funds that cannot be used in other (possibly more profitable?) trades. Since in FX every pair is in one way or another connected to the others, traders who adopt a dollar-centric view risk missing promising trades and not understanding the real potential some opportunities offer. Although most of the dealing is done through direct dollar buying/selling, one should constantly keep an eye on the crosses in order to gauge a currency's true strength/weakness,[1] which in the end will tell you which pair is best to trade.

A very reasonable way to trade equities is to trade from big to small. For example, through your analysis you determine that the stock market in general should rise, but knowing that you have limited funds, you need to choose your stocks carefully. It would therefore be advisable to look at sector-specific indices and find the most promising of the bunch. From there, you would look within the index and find the most attractive company(s) in which to invest directly. This "big-to-small" thinking is very solid and should be applied to FX.

Even if not trading them directly, cross movements should never be overlooked, since the movements of the crosses can often hide the footsteps of large players choosing to position themselves in a stealthy manner rather than through one of the majors. If someone is looking to load up on euros, for example, they may try to fly under the radar by buying euros against Swiss francs, sterling, yen, or other more obscure crosses. These are bets on broad-based euro strength (for fundamental reasons) spread out over a number of currencies (a basket) rather than taking a direct dollar negative position.

The crosses can also prove incredibly important to swing or momentum traders, since they can be used as forecasting tools and show you which currency is leading

[1] I personally do not like to use the USD Index (USDX) to gage the USD's broad strength/weakness, since the basket is heavily euro-weighted and essentially makes the index a mirror of the EURUSD.

the pack. Traders that overlook the importance of the crosses are often stuck with positions that do not move, while the rest of the market takes off in their desired direction.

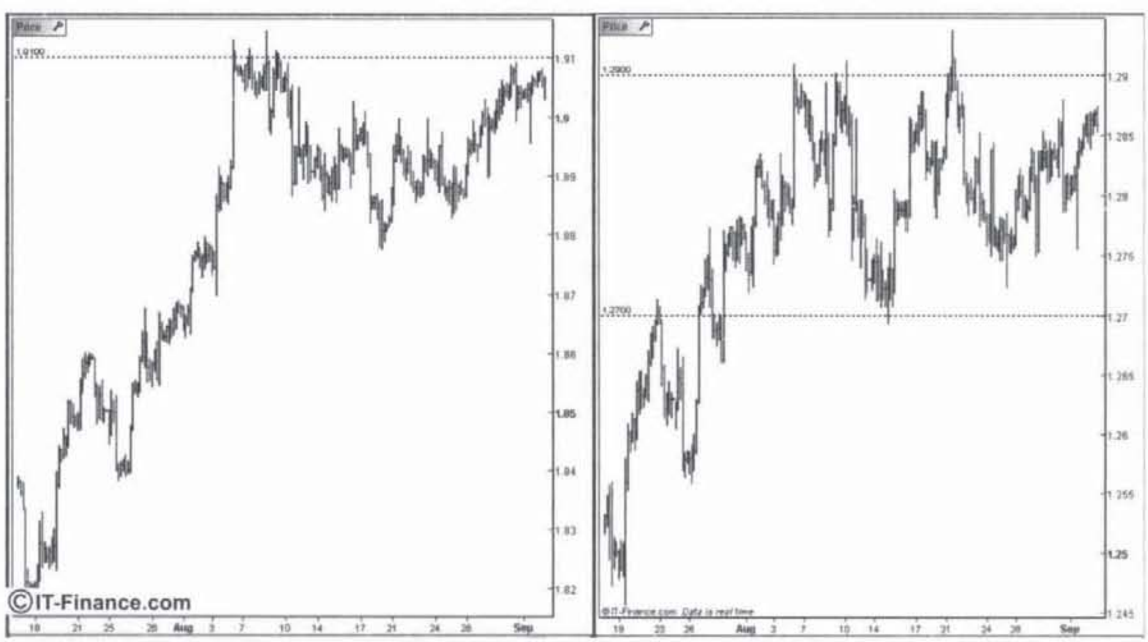
PRESSURE VALVES

If the dollar is rallying against everything, but cable does not seem to be moving much, then one look at its crosses will show you where the selling pressure is being absorbed. Maybe sterling is rallying strongly against the euro or against the yen; in the end it does not matter. All that matters is that your cable short is barely in the black, and probably poised to bounce back strongly when the demand for dollars is exhausted.

With limited funds you always want to pick the pair that will move the most, but how exactly do you come to a reasonable conclusion? That is where the crosses come in.

Cross movements either work to amplify the move or minimize the effects. If the euro is dropping against the dollar, for example, but rising against the pound, the net effect will be to limit the size of the EURUSD fall. When this cross is rising, it is telling us that the euro is outperforming the pound, and vice versa.

Look at an example below of using the crosses. You are certain that the next few days will be a period of dollar strength (for whatever reason), but faced with



Which one to trade? We turn to the crosses for help.

It is reasonable to assume that EURGBP will bounce from the area of strong support.

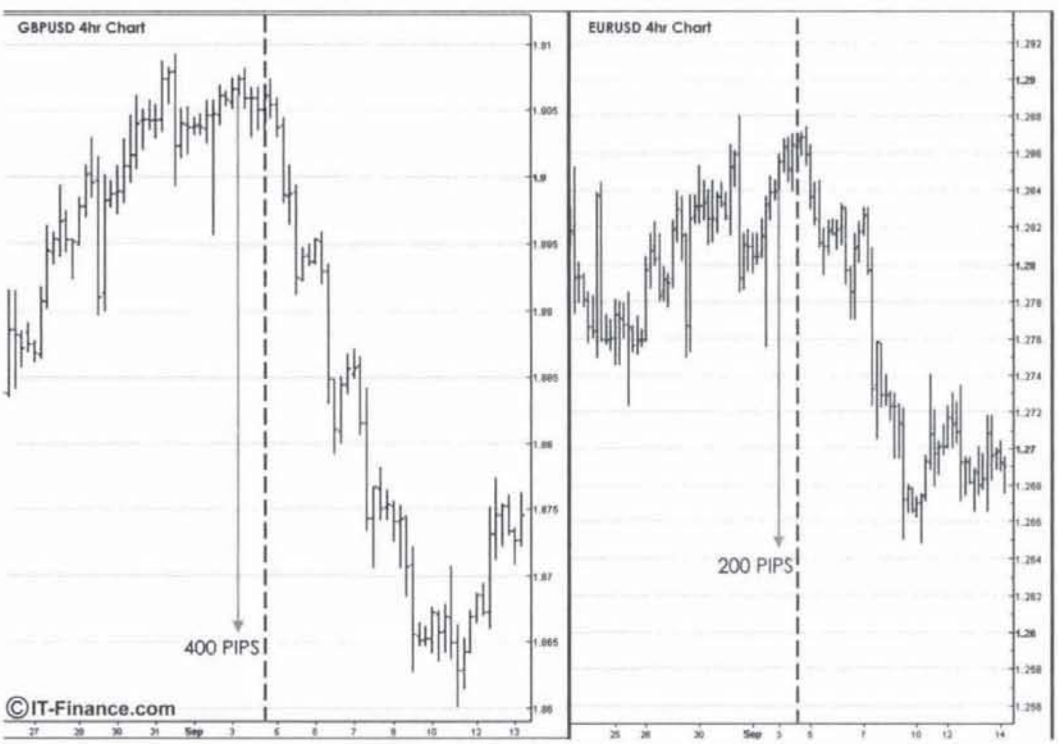
limited resources you cannot take a broad-based USD bet. You only have enough ammunition to trade one pair, and decide to either short the euro or cable. The question then becomes, which one?

By looking at the EURGBP chart above, we notice that its sharp fall has it testing the area of strong support near .6720. Chart patterns and oversold technical readings means that we can reasonably assume that this area of support will hold and that the cross may stage a brief rebound. Of course we can either anticipate this move or wait for the price action to confirm our thoughts. Either way, a rising EURGBP means that sterling is likely to be the weaker of the two.

Any EURUSD selling pressure (euro sells) is likely to be offset somewhat by the rebounding cross (euro buys), while GBPUSD sales (sterling sales) will only be amplified by the cross sales (sterling sales). Since EURGBP is likely to bounce, it would therefore make sense to short cable instead of euro.

In the aftermath, we can see that EURGBP did indeed bounce as expected (see below), and the added selling pressure on sterling caused GBPUSD to drop nearly 200 pips more than EURUSD! If at the very beginning we had instead chosen to randomly pick one of the two pairs to short, we may have missed out on a great trade.

EURGBP bounces at least temporarily from its support.

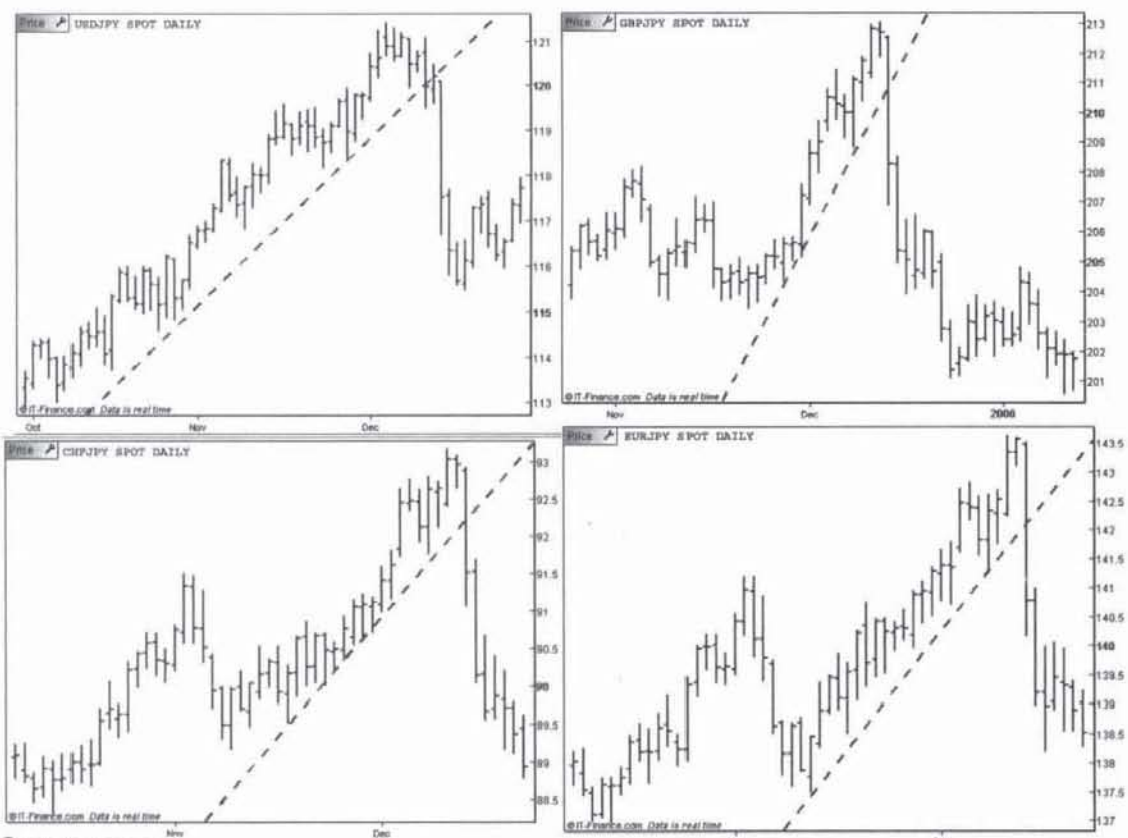


The difference in picking the right pair can prove significant!

Every trader should have currency pages set up within their charting software that focus on these key crosses:

EURO	**STERLING**	**YEN**	**SWISSY**
EURUSD	GBPUSD	USDJPY	USDCHF
EURCHF	GBPCHF	EURJPY	EURCHF
EURJPY	GBPJPY	GBPJPY	GBPCHF
EURGBP	EURGBP	CHFJPY	CHFJPY

Looking at the cross charts in a daily and 4 hour time frame will instantly give you an idea of the relative strength of a currency and show you who is leading the pack in the near term.



Looking at a yen page, we can instantly see that the yen strengthened across the board, confirming the yen as the primary driver. If some of the charts were dropping and some were rising, on the other hand, this would indicate that the market was concentrating on another currency.