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Boris Schlossberg shows how to exploit the 'stop hunters' in the Forex markets using a simple, mechanical method that only requires a price chart and one indicator

Stop Hunting with the Big Players

Foreign exchange is the most leveraged financial market in the world. In equities, standard margin is set at 2 to 1, which means that a trader must put up at least $50 cash to control $100 worth of stock. In options, the leverage increases to 10 to 1 with $10 controlling $100. In the futures markets, the leverage factor is increased to 20 to 1. For example, in a Dow Jones futures e-mini contract, a trader only needs $2,500 to control $50,000 worth of the index.

However, none of these markets approach the borrowing intensity of the Forex market where the default leverage at most dealers is set at 100 to 1 and can to as high as 200 to 1. This ratio means that a mere $50 in trading capital can control up to $10,000 worth of a currency.

Why is this important? First and foremost, the high degree of leverage can make Forex trading either extremely lucrative or extraordinarily dangerous, depending upon which side of the trade you are on. In Forex, retail traders can literally double their accounts overnight or lose it all in a matter of hours if they employ the full margin at their disposal. Most professional traders limit their leverage to no more than 10 to 1 and never assume such enormous risk. Regardless of whether they trade on 200 to 1 leverage or 2 to 1 leverage, almost everyone in the Forex markets uses stops.

Stops are Key

Precisely because the Forex market is so leveraged, most market players understand that stops are critical to their long-term survival. The notion of 'waiting a loser out,' as some equity investors might do, simply does not exist for most Forex traders. Trading without stops in the currency market means that sooner rather than later, the trader will face forced liquidation in the form of a margin call. With the exception of a few long-term investors who may trade on a 100% cash basis, the overwhelming majority of Forex market participants are speculators. Therefore, they simply do not have the luxury of nursing a losing trade for too long because their positions are highly leveraged.

Because of this unusual duality of the Forex market (high leverage and almost universal use of stops), 'stop hunting' is a very common practice. Although it may have negative connotations to some readers, stop hunting is a legitimate form of trading. It is nothing more than the art of flushing the losing players out of the market.

In Forex-speak, they are known as 'weak longs' or 'weak shorts.' Much like a strong poker player who may take out less capable opponents by raising stakes and 'buying the pot,' large speculative players (like investment banks, hedge funds and money center banks) like to gun stops in the hope of generating further directional momentum. In fact, the practice is so common in the Forex markets that any trader unaware of these price dynamics will probably suffer unnecessary losses.

Because the human mind naturally seeks order, most resting

Figure 1 : EUR/US - Charts courtesy of Fxtrek by Intellicharts

stop orders are clustered around numbers ending in "00." For example, if the EUR/USD pair was trading at 1.3970 and rising in value, most stops would reside within one or two points of the 1.4000 price point rather than, say, 1.4017. This one fact provides valuable knowledge because it clearly indicates that most retail traders should place their stops at less crowded and more unusual locations.

However, the possibility of profit from this unique dynamic of the currency market is more interesting. The fact that the Forex market is so stop driven offers the possibility for several opportunistic setups for short-term traders. In her book, *Day Trading the Currency Market* (2005), Kathy Lien describes one such setup that is based on fading the "00" level. The approach discussed here is based on the opposite notion of joining the short-term momentum.

Taking Advantage of 'The Hunt'

'Stop hunting with the big specs' is an exceedingly simple setup, requiring nothing more than a price chart and one indicator. Here is the setup in a nutshell. On a one-hour chart, mark lines 15 points on either side of the round number. For example, if the EUR/USD is approaching the 1.4000 figure, the trader marks off 1.3985 and 1.4015 on the chart. This 30-point area is known as the 'trade zone,' much like the 20-yard line on the football field is known as the 'red zone.' Both monikers communicate the same idea that the participants have a high probability of scoring once they enter that area.

The idea behind this setup is straightforward. Once price approaches the round-number level, speculators try to target the stops clustered in that region. Because Forex is a decentralized market, no one knows the exact number of stops located at any particular "00" level, but traders hope that the size is large enough to trigger further liquidation of positions. This causes a cascade of stop orders that will push price farther in that direction than it would move under normal conditions.

In the case of a long setup, if price in the EUR/USD were climbing toward 1.4000, the trader would enter long the pair with two units as soon as it crossed the threshold at 1.3985. The stop on the trade would be 15 points lower than the entry because this is strictly a momentum trade. If prices do not immediately follow through, chances are the setup failed.

The profit target on the first unit would be the amount of initial risk or approximately 1.4000. The trader would also move the stop on the second unit to breakeven to lock in profit. The target on the second unit would be at two times initial risk or 1.4015, allowing the trader to exit on a momentum burst.

Aside from watching these key chart levels, there is only one other rule that a trader must follow in order to optimize the probability of success. Because this setup is basically a derivative of momentum trading, it should be traded only in the direction of the larger trend. There are numerous ways to ascertain trend direction using technical analysis, but the 200-period simple

Figure 2 : USD/JPY- Charts courtesy of Fxtrek by Intellicharts

moving average (SMA) on the hourly charts may be particularly effective in this case. By using a longer-term average on short-term charts, you can stay on the right side of the price action without being subject to near-term whipsaw moves.

Note that on September 18, 2007, the EUR/USD is trading well above its 200-period simple moving average. This indicates that the pair is in a strong uptrend (Figure 1). As price approaches the 1.3900 level to the upside, the trader would initiate a long the moment price crosses the 1.3885 level, putting a stop 15 points below the entry at 1.3870. In this particular example, the upside momentum is extremely strong as traders gun stops at the 1.3900 level within the hour. The exit for the first half of the trade is at 1.3900 for a 15-point profit and the second half is exited at 1.3915 generating 45 points of reward for only 30 points of risk.

The example illustrated in Figure 2 takes place on October 5, 2007, but this time it is in the USD/JPY. The 'trade zone' setup generates several opportunities for profit over a short period of time as key stop cluster areas are probed over and over. In this case, the pair trades well above its 200-period simple moving average and the trader would only look to take long setups. At 4pm EST, the pair trades through the 116.85 level, triggering a long entry. In the next hour, the longs are able to push the pair through the 117.15 stop cluster level and the trader would sell both units for a combined 45-point profit.

The longs cannot sustain the buying momentum but the pair never trades below 116.85. The trader could enter once again on the 7pm EST close of 116.95, keeping a 15-point stop. Only two hours later, prices once again rally through 117.15 and the trader makes a profit on the second trade. Thus, multiple profit targets are hit as buying momentum overwhelms the shorts and they are forced to cover their positions, creating a cascade of stops that steadily push prices higher.

Conclusion

The 'stop hunt with the big specs' is one of the simplest and most efficient Forex setups available to short-term traders. It requires nothing more than focus and a basic understanding of currency market dynamics. Instead of being victims of stop hunting expeditions, retail traders can finally turn the tables and join the move with the big players, banking short-term profits in the process.

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