

Foreign exchange moves to centre stage for CFDs

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It would come as little surprise to contracts for difference aficionados to learn recent research shows that currencies are the most popular CFD.

The Investment Trends *2011 Australia CFD Report* has foreign exchange comprising 27 per cent of all trades in the year to May 2011. CFDs over Australian blue-chip shares, which made up the largest proportion of trades a year before, made up just 21 per cent of trades.

It is well known that the Australian dollar and US dollar pair features heavily in the CFD market, but what is more interesting is why. Even if the long-term upward trend of the Australian dollar to its US counterpart is taken out of the equation, traders have realised that currencies tend to trend "better" than shares. By contrast, sharemarkets (which were so volatile in August) tend to "gap" more.

Another popular currency pair is the US dollar and the euro, both of which have been under pressure.

Sharemarkets react with breathtaking speed to news events, whereas currencies, while volatile, tend to be more solid on financial and economic data.

Investment Trends found that the number of CFD traders rose only marginally over the year, from 39,000 to 41,000 in the 12 months to May. This is far less than the corresponding period a year earlier (32,000 to 39,000). Since the big breaks in the market in recent weeks, there is anecdotal evidence that volumes, and applications for new accounts, have increased.

However, the present volatility would be daunting for first-time investors.

Investment Trends principal Mark Johnston says high levels of volatility are the cause of the slowing in CFD take-up, as well as "heightened regulatory and media discussion of the risks involved in leveraged trading".

"While few people stopped trading CFDs as a result of this discussion, the number contemplating their first CFD trade has fallen," Johnston says.

The research also indicates that Australian traders are becoming more sophisticated, and perhaps more cautious, with a corresponding growth in the use of stop losses and guaranteed stop losses to reduce trading risk.

Michael McCarthy, chief market strategist at CMC Markets, says traders are becoming more sophisticated and agrees – as the research shows – that foreign exchange markets have moved to centre stage.

As volatility in the markets has increased, investment timescales have decreased, he says. "Clients are taking much shorter term positions now," McCarthy says.

"They're tending to trade intraday, rather than holding positions for several days."

What the research doesn't say is that charting is becoming the savvy trader's tool of trade. Some people trade on 15-minute increments, McCarthy says, and in some cases are charting movements on a minute-by-minute basis.

The challenge for platform providers is to be able to accommodate this trend, he adds. The modern CFD platform has to have the capability to allow those analysing markets to configure charts for any timeframe they wish.

"That's not to say they are trading every minute, but many traders are analysing the market on a minute-by-minute basis," McCarthy says. Pairs trading has become de rigueur. Market commentators say that with a growing concentration on the relative fortunes of two shares comes the corresponding interest in correlation analysis. This used to be the province of big investment houses, but it is now commonplace for traders to explain pairs in terms of numerical parameters (plus one equals full convergence, minus one equals total divergence).

Classic examples of this are the US dollar and the Australian dollar, as well as gold and silver. Traders are also pairing companies.

Peter Esho, chief market analyst at City Index, says he sees a proliferation in foreign exchange and commodities trading, much of which has little to do with the markets themselves. "More people are taking short positions – and more people are trading pairs in a sideways market," Esho says.

People have begun to realise that one company's misfortunes may be to another's advantage, Esho explains. Traders are asking about the points that gold and silver converge and possibly diverge at, and the reasons behind it.

"It is now about trading between two entities rather than taking a market position."

The Australian Financial Review

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Foreign exchange is fast becoming the trade of choice for CFD players. **Photo: AP**

CFDs or shares?

- Foreign exchange comprised 27 per cent of all CFD trades in the year to May 2011.
- Currencies tend to trend better than shares, which have a tendency to "gap" more.
- Sharemarkets tend to react swiftly to market news, while currencies move more sedately and on more solid financial data.

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