
# UNDERSTANDING FINANCIAL MARKETS

## A GUIDE TO TRADING IN TIMES OF ECONOMIC UNCERTAINTY

AVATRADE
TRADE WITH CONFIDENCE

Understanding Financial Markets: A guide to trading in times of economic uncertainty



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# FOREWORD

The past year has been an interesting one for the financial markets – not least due to the COVID-19 pandemic – and we at AvaTrade have seen a huge increase in demand for online trading.

It's not hard to see why. Financial markets are going through a period of remarkable volatility. Prices are moving frequently and significantly, and with this comes myriad opportunities for traders to engage in the markets. The greater the price spikes, the greater the potential for a trader (along with enhanced risks too). In April 2020, for instance, the price of futures contracts for West Texas Intermediate (WTI) crude oil fell below US$0 per barrel – representing one of the biggest price shocks of all time – following a glut in supply that meant buyers had nowhere to store new barrels. Anyone with the presence of mind to short the market (perhaps recognising the drop in consumer energy and fuel demand) stood to make a substantial profit.

In the stock market, meanwhile, the share prices of companies across the spectrum have gone on something of a carousel, as both government and company policy announcements around the pandemic have triggered rapid and significant changes in fortune – and with them, strong market reactions. Most prominently, stocks crashed following the global outbreak of coronavirus in March 2020, but rallied immediately after as hopes for a swift resolution mounted. The pandemic has also given rise to a new class of assets, known as "stay at home" stocks, populated primarily by digital businesses that cater to people working remotely or in lockdown. Shares in Amazon, Microsoft and Alibaba have all jumped significantly, while Zoom stocks grew by almost 750% between January and mid-October 2020.

Against this backdrop of bustling market activity, interest rates on regular savings accounts are falling through the floor as central banks look to stimulate economic activity and discourage the population from hoarding cash. This too generates fresh impetus for people to invest their money and look to capitalise on the many price changes in today's markets.

But trading is not just a compelling undertaking in today's climate because it stands to help you build wealth. It also offers rewards on a personal level. It is a chance to develop a new and interesting skill – one that challenges you in new ways and brings you into closer contact with the workings of the wider business world.

Of course, if you're planning on broaching the world of trading, understanding the markets and how to navigate them is a necessity. Trading opens the door to great opportunities, but it also entails risks. Understanding how to manage these and making well thought-out, rational decisions is central to a positive trading experience.

And that's exactly why we have put together this guide. By providing you with a foundation-level understanding of the market, we are equipping you with the basic knowledge required to enter this often mysterious and complex, but in equal parts exciting and fascinating, world. In turn, we walk you through the different players and markets that populate it, providing you with invaluable ideas on how to trade safely and protect your investments.

**Dáire Ferguson, CEO, AvaTrade**

# 1 WHY TRADE AND HOW CAN YOU GET STARTED?

The practice of buying and selling financial instruments is something that has long been associated with a certain breed of specialist, found on Wall Street or in other financial centres around the world. The boldness, the expertise and certainly the profits of these characters have always captured the imagination, but their world has previously seemed remote and dangerous.

But this is changing. Trading is no longer the preserve of the city elite. Today, technology has evolved to the point where anyone on the street can open a trading account with as little as £100, enabling them to trade a wide range of financial instruments.

At the same time, as we have bedded into a new way of life, the risk-reward profile of trading has changed dramatically. Highly volatile financial markets are offering impressive opportunities. Meanwhile, traditional vehicles for saving money offer increasingly dismal returns, with the Bank of England (BoE) having sounded out lenders on the prospect of a 0.00001% base rate in October 2020 and the European Central Bank (ECB) having operated with negative interest rates for several years. In this context, the decision to invest rather than save entails a very different equation from a few years ago, when saving offered reasonable returns and more stable markets offered less in the way of explosive profits.

Certainly, there is a strong financial case to be made for trading, which offers much better returns than other types of investment. There is also a more emotive case. Simply put, trading is interesting and enjoyable. It's a chance to learn a new skill - and if you read the rest of this guide, you will be well on your way in this respect.

# 1.1. FINDING A PLATFORM

If you're ready to give trading a go, your first job is to choose a provider. This is an important job and shouldn't be neglected, as getting this right will make the trading experience both easier and safer. There are a few elements to consider.

Security is probably the most important. Make sure you work with a regulated broker to ensure your money is in safe hands. In general, the more a broker is regulated (they can hold licences across many jurisdictions), the more likely they are to be a reliable counterparty (see section 3.3.1 for more details).

You should also think about what you want to trade. If you have a specific market in mind, make sure your broker has a platform that does it. Certainly, you won't be able to trade every asset, using every tool, with every broker. Depending on what your priorities are, brokers can be better suited to your needs based on what they offer. Some, for instance, offer outside-the-box options to traders – such as enhanced risk management tools – that can add a different dimension to your trading, helping you take up sophisticated positions without making the associated calculations. AvaTrade, for instance, offers a tool called AvaProtect™ (discussed in section 3.3.3) that allows traders to buy protection against any loss incurred on a trade for a pre-determined period of time. This kind of tool can help you take bolder positions with greater confidence, making trading both more accessible and more enjoyable.

If you have no strong views on specific tools and functionality, one of the key priorities will be convenience and ease of use. Having all trading options, activities, markets and advice in one place (generally a mobile or web app) can make a big difference to the trading experience – especially for users who are new to the activity.

Good brokers will also be keen to keep you informed and making decisions based on the latest knowledge and insights. Ongoing educational support and live market updates can be useful tools, providing important insights into current trends and perspective that may influence trading decisions. This won't be critical to your decision when selecting a broker, but a strong offering here may help tip the scales.

Most quality brokers will offer the option to create a demo account, which will enable you to test their services before fully committing. The benefits here are three-fold: first, you will get a feel for the platform and its features, and whether they are suited to your needs. Second, for those new to trading, it will enable you to test some market trades before having to put down any capital. Third, for those with slightly more experience, you will have the opportunity to check different strategies without risking real money.

**QUESTIONS TO ANSWER BEFORE COMMITTING TO A BROKER:**

- WHERE ARE THEY REGULATED?
- HOW ESTABLISHED ARE THEY IN THE MARKET?
- HAVE YOU TESTED THE PLATFORM AND DOES IT SUIT YOUR NEEDS?
- WHAT RISK MANAGEMENT TOOLS ARE ON OFFER?
- WHAT TRADING PLATFORMS ARE ON OFFER?
- WHAT INSTRUMENTS ARE AVAILABLE?
- WHERE IS YOUR MONEY HELD?

## 1.2. TYPES OF TRADING

There are two main ways you can trade financial assets. The first, and most commonly thought of, is to purchase assets outright, where, for instance, if you buy a futures contract for 5,000 bushels of soybeans, you can expect to take delivery of 5,000 bushels of soybeans unless you sell that contract before it matures. This is more of a longer-term activity and is known as investing.

The second is to purchase what are known as contracts for difference (CFDs). These see traders purchase a contract that, by agreement with the broker, tracks the value of a chosen real-life asset, without the buyer actually owning the asset itself, meaning the trader simply receives a profit or a loss based on the price movement of the asset, rather than taking physical delivery. With CFDs, there is no need to find storage space for 5,000 bushels of soybeans.

This means a user can trade against the same price movements undergone by the asset with much greater flexibility – and with a lower cost barrier to entry. For instance, gold is typically traded in troy ounces, with one troy ounce costing between US$1,200 and US$2,000 over the last few years. Using CFDs, there is no need to buy a whole troy ounce, however, since you will not be purchasing the underlying asset – only trading against its price.

It's not only commodities that can be traded via CFDs – currencies, shares, indices futures, commodity futures, cryptocurrencies and exchange traded funds can all be traded in this way. This makes it a simple way to gain exposure to a huge range of assets.

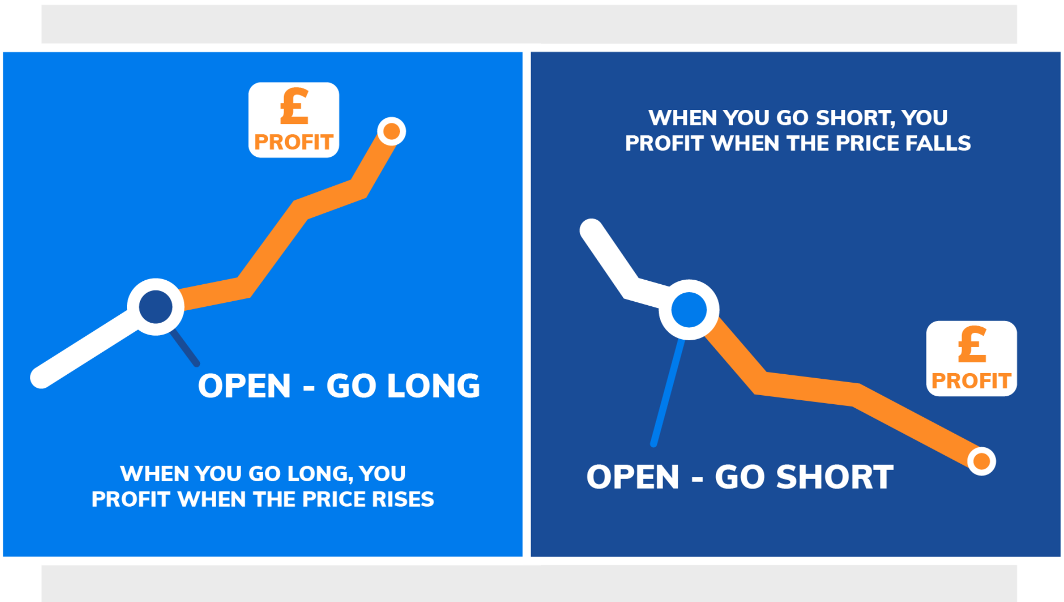
### FEATURES OF CFD TRADING

## 1.2.1. Benefits and advantages of trading CFDs

CFDs are based on using leverage. This is a powerful tool, which reduces the amount of money required to purchase and trade a financial asset. It is almost like briefly borrowing money from your broker. A 10:1 leverage, for instance, means multiplying your transaction value by 10 and would mean paying only a 10% margin on the asset rather than outright purchasing and owning it in full. The benefit of CFDs is that, despite paying only a small portion of the asset value, the profit made on any market movement will be the same as if the investor owned the full asset, meaning a lot of money can be made from a comparatively small investment. The flipside to this is that the risk is also as high as if you owned the full asset and so the potential losses are equally high – see section 3 later on Risk.

There are also different types of CFD trades that can be carried out. Typically, when you purchase an asset outright, you are taking a "long position", whereby you are invested in its value increasing for the period that you own it. The same can, of course, work with CFDs. Yet, thanks to the nature of CFDs – whereby contracts are linked to the asset price, rather than deeds to the asset itself – you can just as easily take a "short position", which allows you to profit from the asset decreasing in value. You can simply select the "sell" option on an online CFD broker's trading platform to position yourself well for markets you expect to head downwards. These "short positions" typically come with the option of a much shorter lifespan, including minute-to-minute.

USING CFDS TO BENEFIT FROM MARKET MOVES IN EITHER DIRECTION



# 2 HOW DO FINANCIAL MARKETS WORK?

Before delving into the world of trading, it is important to be aware of how different markets work and the specific nuances of trading assets within these, as well as how to evaluate them.

## 2.1 ASSET CLASSES

In the previous section, we outlined the differences between outright purchasing assets and trading CFDs. One of the great advantages of CFDs is that they give you access to a wide range of different markets without many of the complications that come with them, but it's still important to understand what these markets are and how they differ. Below, we outline the major markets and their key characteristics.

### 2.1.1. Foreign Exchange

The foreign exchange market – also known as the "FX" or "forex" market – is the largest and most liquid financial market in the world, with over US$5trn traded every day. Forex trading was historically considered to be exclusive to central banks and international businesses, but is now available to retail traders via a trading broker, meaning it is accessible to traders hailing from all backgrounds and levels of experience.

FX presents a potentially lucrative opportunity for traders to net handsome profits from relatively little investment. This is because the market is highly sensitive to news triggers, resulting in small but regular fluctuations in major currency pairs on a daily basis. As a result, traders typically use leverage to maximise the value of these opportunities.

An important feature for those investing in this market is that it is open 24 hours a day (five days a week) due to the fact it is spread across four different time zones – with the market opening in Sydney and closing in New York. This means that those wanting a greater level of control over their trades have the flexibility to move money around over an extended period.

## 2.1.2. Stocks

Purchasing assets on the stock market gives investors the opportunity to own a certain percentage share of a company publicly listed on a stock exchange, such as the London Stock Exchange (LSE) or the New York Stock Exchange (NYSE). Companies listed on an exchange will have undergone an initial public offering (IPO) that enables them to raise capital through the sale of shares in their company. These shares are then either held by investors (in anticipation of dividends and price appreciation) or traded on an exchange, such as the London Stock Exchange, in search of a profit. The benefit of purchasing shares is that the value of a share in a company will increase in parallel with its growth, and stocks can be sold on for profit. As a general rule, investments of this type are longer-term than FX trades, with stocks seeing fewer small intra-day price changes, for example. However, they have the potential to rise and fall dramatically in line with their performances, as well as in response to broader market disruption, such as a sudden drop in demand.

Stocks can also be traded as CFDs, as described in Section 1, which enable you to trade based on the price of the underlying asset and have the added option of being able to go both long and short (though long positions on stock CFDs don't entitle the trader to a dividend). This means you can trade in falling markets too.

What's more, traders also have the option to trade on the cumulative values of stocks via stock indices (singular: index). Baskets of similar stocks are often grouped together in indices to track the overall performance of an economy or sector, with the value calculated as a weighted average of the respective companies' share prices. Well-known indices include the Dow Jones Industrial Average, the FTSE 100, and the DAX 30, which represent the largest companies trading on the American stock exchanges (the New York Stock Exchange and NASDAQ), London Stock Exchange and Frankfurt Stock Exchange respectively.

Indices are not assets in themselves, but traders can still gain exposure to them via CFDs or certain exchange traded funds (ETFs) – specially created investment vehicles made up of a basket of assets and designed to track the price movements of an index.

## 2.1.3. Commodities

Commodities trading is the buying and selling of raw items of consumption in the worldwide economy. This can include anything from oil, to basic food products (such as coffee or wheat), to precious metals (such as gold and silver). As a rule, commodities fall under one of two main categories: hard and soft. Hard commodities are naturally occurring resources that are mined or extracted from the earth, such as gold, copper or oil. Soft commodities include livestock or agricultural produce which must be cultivated.

Similar to stocks, commodities are bought and sold on an exchange, and can also be purchased as CFDs. Volatility is generally lower in this market, since it is largely driven by supply and demand, but significant fluctuations in price can and do occur and are generally difficult, if not impossible, to predict. Herd mentality among traders all analysing similar data, as well as broader geopolitical, macroeconomic and even extreme weather events (typically cutting supply), can all feed into price fluctuations.

As such, commodities are generally considered a risky investment. However, during periods of high market volatility, commodities generally move in opposition to stocks and are therefore seen as a more secure investment when the stock market is in turmoil. Gold, in particular, is looked upon as a “safe haven” investment and is particularly attractive during such periods, where it consistently holds its value – and often increases it. As such, it can be a useful tool in helping investors mitigate their exposure to losses.

## 2.1.4. Bonds

Bonds enable governments and corporates to raise money by issuing debt to investors. The issuers of these bonds pay interest to the investors (known as bond-holders) throughout the lifetime of the bond, before repaying the principal amount at the end of its term. As a result, the return on a bond is fixed, but market conditions can fluctuate causing the price of bonds to rise and fall. In particular, the value of a bond is inversely correlated to interest rates. When interest rates go up, bond prices go down (because investors can get a better return for the same risk elsewhere) and vice versa. Since interest rates are the main driver of bond pricing, and changes in interest rate are relatively infrequent (at least by the standards of market drivers), bonds are generally seen as safe investments. The flipside to this is that they are unlikely to yield big profits. As with other markets, traders can speculate on bond price movements by trading CFDs.

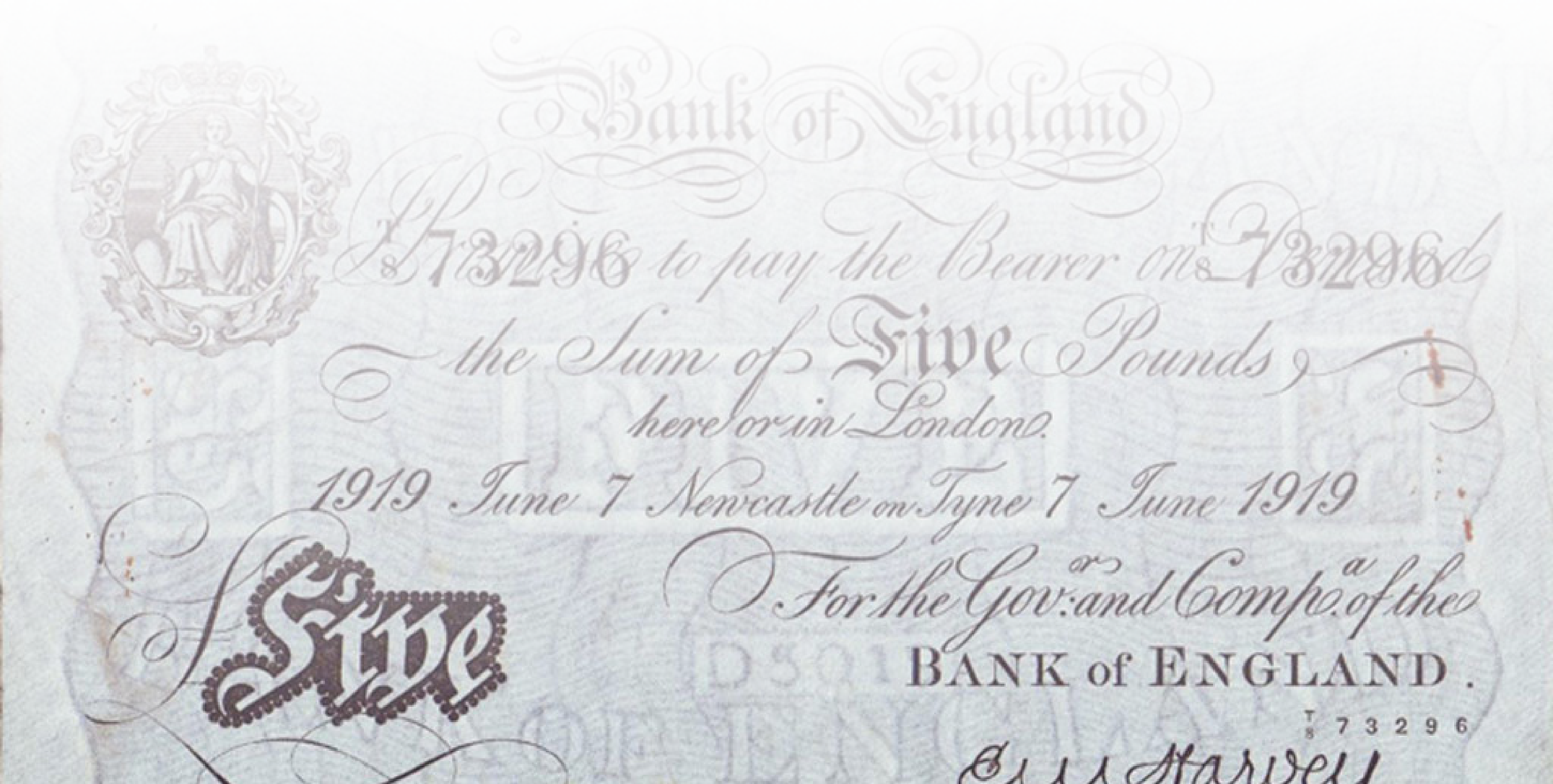
## 2.1.5. Cryptocurrency*

Cryptocurrencies are digital "coins" that can be virtually transferred. Unlike traditional transactions, which are handled by banks, cryptocurrency is transferred via blockchain or similar digital ledger technology (DLT). Cryptocurrency can be traded either by the outright purchase of the digital currency on an exchange, from which you can profit if its value increases, or through CFDs, which enable you to profit off a predicted change in value.

The cryptocurrency market is well known for its volatility, characterised by frequent and often large changes in price, which can be prompted by anything from new market regulation to negative news, such as cyber attacks. This makes for exciting possibilities and potentially huge profit margins. However, it also means there is the potential for significant losses, which we outline in the following section.

Like gold, cryptocurrency Bitcoin is becoming increasingly regarded as a safe haven asset due to its resilience amidst financial turmoil. Indeed, despite the volatility it sometimes sees, it has been the best-performing asset of the past 10 years, and as the market continues to mature, demand is expected to rise further.

* Please note that crypto trading is not available to UK Retail clients



# 2.2. EVALUATING ASSETS

## 2.2.1. Fundamental vs. technical analysis

Fundamental and technical analysis are techniques used by investors to determine the risk and potential of an investment.

Fundamental analysis looks at the intrinsic value of a stock – what its value would be if the company weren't listed and trading on an exchange – and compares this to the price at which it is trading. As part of this process, traders look at a company's earnings, expenses, assets and liabilities to determine whether the asset is trading at a premium or a discount. This approach can also include reviewing foreseeable market events that are set to affect the price and seeing if these are priced in.

Technical analysis, on the other hand, uses historical data on an asset's pricing and volume trends to identify the stock's supply and demand dynamics in order to predict the likely resulting market movements.

When it comes to deciding which method works best in a given instance, it is most useful to determine whether your investment will be long or short term. Indeed, technical analysis, which looks at supply and demand, lends itself better to short-term investments while fundamental analysis is more useful in indicating what a stock may be valued at years into the future.

Learn more about how to carry out fundamental and technical analysis.

## 2.2.2 Charting

Trading charts are commonly used to analyse an asset's data and identify trends. There are varying levels of detail included in different charts:

**Line charts** are the most basic form of chart, and likely the one beginners will start out with. They represent closing prices over a defined period of time, but do not give detail on trading range.

**Bar charts** are made up of a series of vertical lines, with each representing the highs and lows of a trading period and also both the opening and closing prices – each represented by a horizontal, shorter line, or a “dash” on the bar.

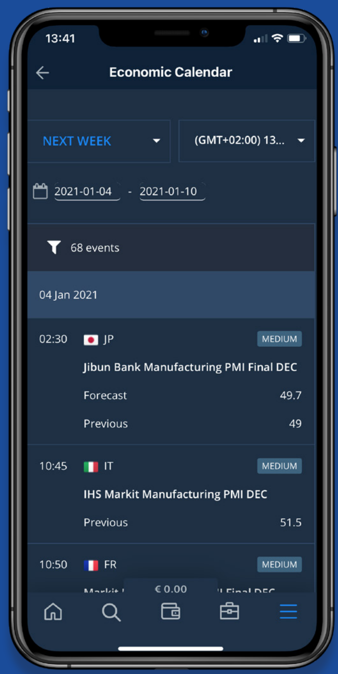
**Candlestick charts** are usually reserved for expert traders. They are similar to bar charts, but more detailed. The body of the candle uses different colours to represent the market movement of the time period, and at the top and bottom of each candle, long, thin lines represent the high and low ranges. Charts are used to identify trends and are particularly useful in technical analysis.

### 2.2.3 Economic calendar

Economic calendars can help you keep track of routine financial events, such as productivity figures, employment numbers and central-bank policy announcements, which may stimulate a movement in the value of an asset. For more skilled traders, these can be used to anticipate events and trades can be planned in accordance.

Many online brokers and independent websites offer online economic calendars you can use to plan your own trades.

AvaTrade's is available here.




# 3 RISK

Understanding the markets in which you are trading is incredibly important to both optimising profit and managing risk and loss. While trading can be incredibly lucrative, it can often be difficult to judge which way the market will move – especially when executing shorter-term trades, where unknown factors can cause unexpected movements. Being aware of the risks is vital to avoid unnecessary losses and to optimise the trading experience.

## 3.1. COUNTERPARTY RISK

While it may not seem important, the legitimacy of the broker you decide to trade with can go a long way to minimising the risks associated with trading. As discussed, when purchasing a CFD, you are buying a contract with a broker and not the actual asset. As such, you must be sure that your broker can – and will – make good on the value of that contract. In order to minimise this risk, it is important to identify a reputable and stable broker.

# 3.2 TRADING RISK

## 3.2.1 Volatility

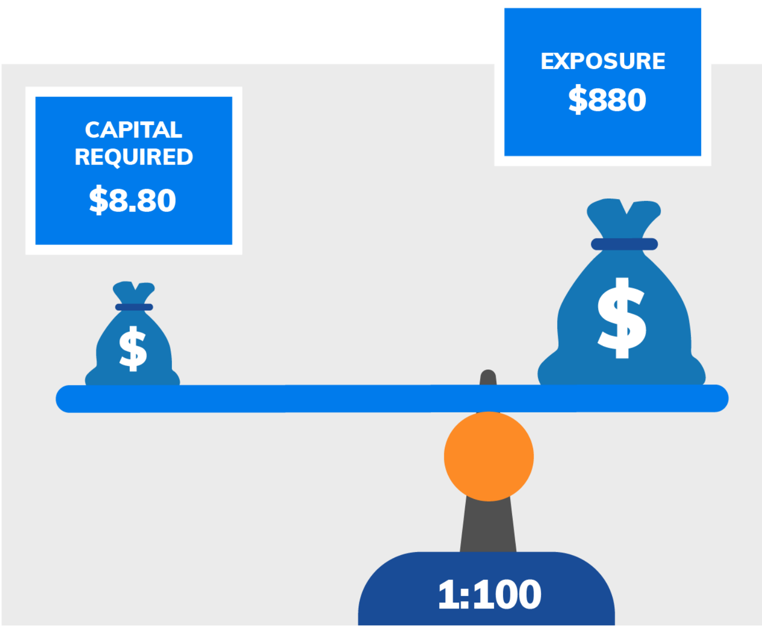
Volatility is characterised by unpredictable fluctuations in pricing and is defined as the rate at which this pricing rises or falls given a particular set of returns. All assets are subject to some level of volatility, and the frequency and size of price changes varies significantly across asset classes. While it is predictable in some markets – and even desirable in order to foster greater profit margins – volatility increases the potential for loss, meaning a seemingly vanilla trade can go wrong. There are of course indicators that might signal incoming market fluctuations – such as economic volatility, geopolitical tensions or changing policy. Yet these are not standalone, and markets are susceptible to a huge range of upsets that can be difficult to predict.

## 3.2.2 Leverage

Buying and trading CFDs typically involves leverage. This is where a trader stakes only a percentage of the value of the underlying asset they want to trade on, but accepts exposure to the full value of the profit and loss associated with the asset's changes in price.

This means traders can take large positions for comparatively less trading capital – opening the door to big wins and handsome rewards, but also risking similarly steep losses. So, for instance, you can open a US$100 trade on an asset worth US$1,000, using leverage of 10:1. On this basis, if the asset increases in value by 10%, you've doubled your money, but if it drops by just 10%, you've lost your stake altogether. This balance of high risk and high reward requires careful management.

**UNDERSTANDING LEVERAGE**




**Leverage increases the exposure you gain with your capital.
This offers the chance for bigger profits – but also bigger losses.**

## 3.3. HOW DO I MANAGE RISK?

There are several techniques that can be employed to make sure the risks associated with trading are controlled, rendering the trading experience smoother and more enjoyable. From beginners to experts, having these tactics in your arsenal will render you a savvier, more confident trader.

### 3.3.1. Select the right broker

As discussed earlier in this section, selecting the right broker is an important step in managing counterparty risk in particular. Look out for established names that are well regulated and pay attention to the jurisdictions your broker is regulated in. Some are less stringent than others and your protection will be less as a result.

There are additional benefits that span far beyond ensuring you are trading with a reputable partner. For instance, higher-quality trading partners will generally have a wider range of risk management tools and better features available, which will allow you to manage your trades in better, more sophisticated ways.

### 3.3.2. Manage your capital-to-trade ratio

When trading, one simple way to ensure you aren't exposed to excessive losses is to keep a tight handle on your capital-to-trade ratio – that is, the amount of capital you leave exposed to losses in trades compared to the total amount of capital you have available.

A sensible rule in this respect is not to exceed a capital-to-trade ratio of 5-10% and not to risk more than 2% of your overall capital on any one trade. This doesn't mean only ever taking very small positions – it means hedging your risks on whatever positions you choose to take. One simple way to do this is through stop-loss orders (see the next section).

### 3.3.3. Take-profit / stop-loss orders

One of the most common and straightforward risk management tools is to set up "orders" alongside trades. These are instructions that are executed automatically when certain conditions are met. There are two kinds of orders that can be used to automatically close an open position as a form of risk management: "take profit" and "stop loss". Take-profit orders instruct the position to close at a predefined rate of profit – in other words, once it reaches a certain point above the current market price (or below in the case of a short position). Its purpose is to close the position in the expected best-case scenario before the trend reverses. Conversely, stop-loss orders sell the position at a predefined rate below the current market price for a long position, or above the current market price for a short position. Its purpose is to stop losses from dropping below a certain point and therefore setting a limit on how much an investor is comfortable losing on a trade.

We mentioned earlier that it is a good rule not to risk more than 2% of your total capital on a given trade. This is something you can configure directly using a stop-loss order. If you invest all your available capital of US$10,000 into one position, and you want to limit your risk to 2% of your capital, you can simply set a stop-loss order to close the trade the moment your losses hit US$200.

## 3.3.4. Take out protection on riskier trades

Certain brokers have enhanced risk protection offerings that allow its users to employ tools to tailor and enhance their trading experience. For instance, AvaTrade's AvaProtect™ gives traders a simple way to protect their investments. For just a small fee – similar to the premium on an insurance policy – AvaProtect provides users with full protection against any losses for a predetermined timeframe. Similar tools are often used by professional traders, big financial institutions and wealthy hedge funds.

Unlike stop-loss orders, which trigger a quick exit from the trade once the price begins to fall and therefore net an instant loss, AvaProtect allows users to stay in the trade, riding out any short-term drops in value and benefiting from the positive overall momentum of the position. What's more, this means that while the downside is limited, there are no limits to the maximum value of the trade, allowing users to benefit from unpredictable movements in potentially less stable markets without ending up out of pocket.

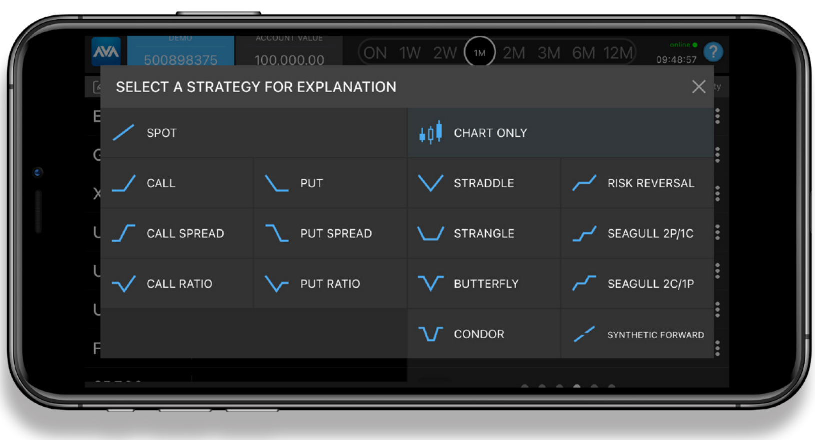
In practice, this kind of protection can be highly useful in trades where there is a significant element of doubt over the way in which the market will move. Certainly, volatility makes price movements larger and less predictable, and this kind of protection can swing the odds in favour of trading clients, making it an invaluable tool for ensuring traders can tolerate losses on a higher proportion of trades and still come out in profit overall.

## 3.3.5. Options

For the more experienced trader, options trading offers a more sophisticated way to hedge risk, with traders buying and selling financial contracts that give them the option to purchase or sell an underlying asset for a certain price within a set period of time. Traders can either buy a call option – giving them the right to purchase an asset at a given price – or a put option, entitling them to sell at a given price.

In practice, rather than committing capital up front, options trading means the only exposure a trader takes on is the premium charged to buy the option. If, after buying an option, the market then does not move in the direction anticipated, the trader does not have to invest the rest of the capital they put on the trade, giving them far greater flexibility and reducing any potential losses.

Traders can also sell call and put options and can combine these in many different ways to create advanced strategies – such as spreads, ratios, straddles and strangles – that account for more complex market views and manage the risks associated with them. For more information on options and the strategies surrounding them, see here.



# 4 NEXT STEPS

This is an exciting time to be trading and it's no surprise that many are now looking to try their hand and expand their horizons. As we have seen, volatility creates opportunities to take advantage of price movements in a range of markets. But at the same time, the market can move against you, so it is critical to understand the factors at play and how to manage the risks.

This guide is here to help you with this. But trading is a rich and complex industry, with numerous facets and nuances beyond the scope of this guide. You should now have the foundational knowledge to reach further and explore new concepts and strategies. At the end of this guide, you can find a list of resources that can assist you in building out your knowledge as you continue on your trading journey. We hope you find this helpful and happy trading!

**Useful links:**

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