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Trading Opening Range Breakout

In this article on range breakouts in the Forex markets, Ron Schelling shares an opening range breakout strategy that is specific to the British pound/U.S. dollar that exploits the structure of the Interbank market.

This article is the second about range breakouts in the Forex markets while our first article about breakouts was in the Sept. 2009 issue. Opening-range breakout techniques have long been favorites of intraday stock index traders. A similar technique can be used in the currency market to capitalize on price moves in the Forex markets, for example in the British pound.

THE FOREX MARKET

The popularity of foreign exchange trading (Forex, or FX) has accelerated rapidly in recent years as the prospect of 24-hour, high-leverage, highly liquid trading has caught the interest of many traders around the globe. Previously, access to this market was restricted to corporations, hedge funds, large Commodity Trading Advisors and other institutional investors.

With the ascendancy of online trading, many firms have opened up the "cash" currency market to individual traders, providing leveraged trading as well as full-feature execution platforms, charts and real-time news. Also the cost of trading online accounts has been reduced and attracts many retail traders as well.

Unlike the U.S. currency futures markets, which have fixed daily trading hours, the Forex market is a seamless, 24-hour market. Trading occurs between large banks (which is why Forex is sometimes referred to as the "interbank" market), with numerous broker-dealers providing access to this market for individual traders.

At 2 p.m. USA Eastern time each Sunday, trading begins as markets open for the week in New Zealand, followed by Sydney and Singapore. At 7 p.m. USA Eastern time, the Tokyo market opens, followed by London at 2 a.m. and, finally, New York at 8 a.m.

Many Forex websites have pages in an easy to read way showing these timesframes graphically and even in real-time. This overlapping movement of currency trading among market centers allows traders to react to news immediately, and provides the added flexibility of determining their trading schedules.

If important overseas news occurs while the U.S. currency futures markets are closed, the next day's opening could be a wild ride. Daytrading the foreign currency market is definitely one of the more challenging endeavors an aspiring trader can pursue.

The higher degree of leverage (as high as 50 or 100 to 1) that is available in this market can increase profits, but it equally accelerates losses, which makes the issue of trade timing and selection that much more critical to success.

The opening range breakout strategy takes advantage of the shift from trading from one market center to another in the 24-hour Forex trading environment. The opening range breakout strategy is a currency-specific trading strategy designed to capture the first directional intraday move that often occurs within the first few hours after the European market opens, which begins at approximately 7 a.m. European time. The strategy works best with the British pound/U.S. dollar (GBP/USD) rate.

Because this currency rate trades lightly outside of London trading hours, the surge in trading every morning in the U.K. gives it a "real" market opening, which the strategy looks to exploit. The charts show that British pound/U.S. dollar trading is virtually non-existent during Asian trading hours, however when the London market opens, GBP/USD accounts for nearly one-quarter of all Forex trading.

Currency rates with more continuous, 24-hour trading will have less of a distinct open/close as they pass through the different money centers. For example, the USD/JPY, which dominates Forex activity during Asian trading hours, still accounts for 17 percent of trading during the European hours.

Before explaining the specific logic behind the methodology, let's take a look at the trading rules and setup. The trading rules are for short trades, but the strategy can be reversed to trade on the long side.

1. The pair makes a new range low at least 25 pips below the opening price after the early Frankfurt/London trading in the GBP/USD rate begins around 7 a.m. GMT.
2. The pair reverses and trades 25 pips or more above the opening price.
3. The pair reverses once again to trade back below the intraday low established in step 1.
4. Sell a breakout below the London low.
5. Once filled, place an initial protective stop no more than 40 pips above the entry price.
6. After the market moves lower by the distance between the entry price and the stop, cover half the position and trail a stop on the remainder.

Figure 1 – GBP/USD 5-minute bars

These simple rules position you to profit from common behavior that can occur in the GBP/USD when the London/European market opens.

Here is the logic behind this strategy:

The British pound/U.S. dollar rate tends to have lower trading volume outside European/London trading hours because the majority of GBP/USD spot deals are worked through United Kingdom and European dealers. This gives the European/British interbank community tremendous insight into the currency pair's actual supply/demand picture.

The opening range breakout strategy works when Interbank dealing desks use this intelligence to trigger stops on both sides of the market, resulting in new intraday highs and lows. Once these orders are cleared from the books, the market is primed for its first real directional move of the day, which is what the strategy is designed to capture.

The following chart *(figure 1, above right)* shows a prototypical opening range breakout trade on a five-minute chart. The first vertical line marks 12 midnight USA Eastern time. The second vertical line denotes the Frankfurt opening and the third line shows when London traders begin entering the market.

When the Frankfurt market opened, GBP/USD moved lower, taking out any nearby sell stops. However within 15 minutes of London entering the picture, the market reversed to the upside.

The pair was free to make the first real directional move of the day, and it fell 90 "pips" before buyers stepped in.

The next chart *(Figure 2)* illustrates a variation of the opening range breakout strategy that commonly occurs when there is an abnormally wide opening range. In this case, the British pound traded up >20 pips after the London open to establish the top of its range.

Then, it came under pressure and sold off 65 pips to make a new low (horizontal line).

The currency traded up 50 pips before reversing and plunging below the former low. In this case, a trader could still justify entering a position, since the basic principles behind the trade were still present.

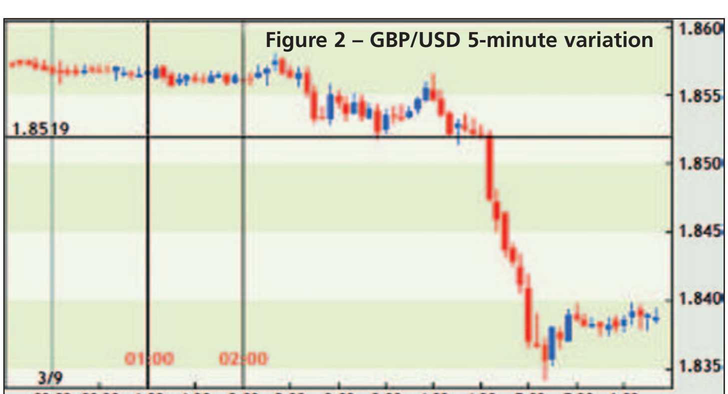

Figure 2 – GBP/USD 5-minute variation

The opening range breakout strategy allows you to limit initial risk and capture good moves early in the London trading session. This methodology is the product of years of watching the currency markets and the approach is based on the workings of the global Forex market and attempts to exploit its structure. **TFJ**

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