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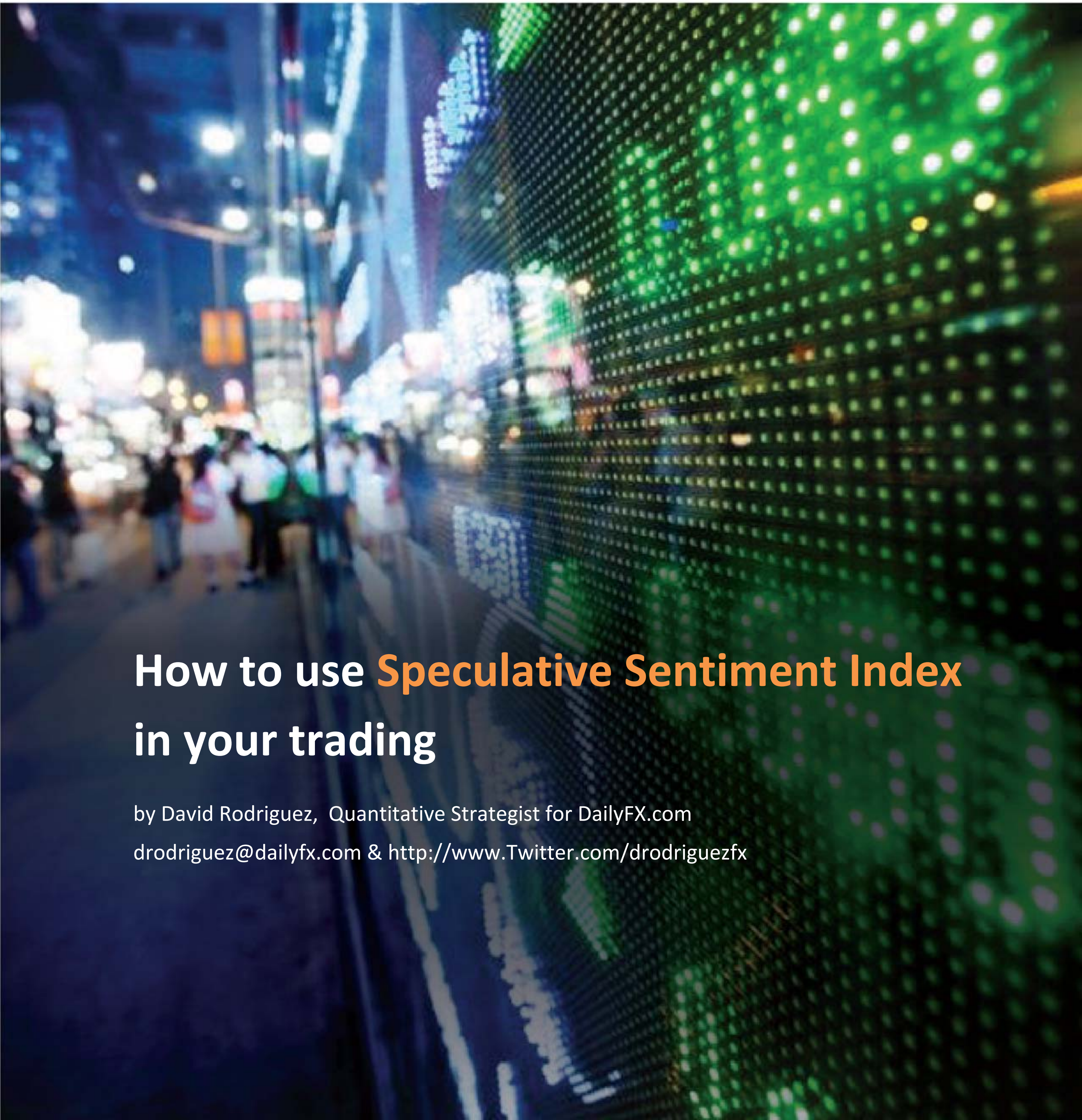

How to use Speculative Sentiment Index in your trading

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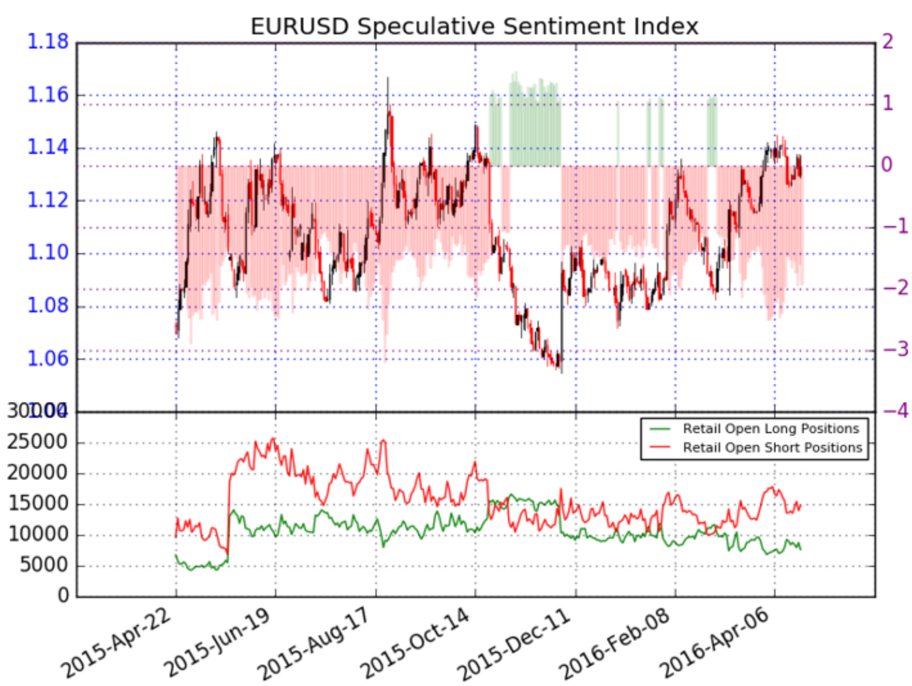
Hello traders and welcome to our guide on the FXCM Speculative Sentiment Index (SSI)—an excellent tool to gauge trader positioning and sentiment in the FX market.

Unlike major equities or futures markets, there is no single centralized exchange for forex trading. Such decentralized activity makes finding uniform volume or open interest data nearly impossible. FXCM, as an industry-leading FX broker, boasts important FX trading volumes and a significant trader sample. The firm makes its retail trader positioning data available to help fill this important gap in market information.

We call it the Speculative *Sentiment* Index because it's exactly that: a measure of bullish/bearish emotion. To do so, we do not take trade size into account and simply compare total open long positions to short positions. Let's take a look at a real chart to see further into this.

Here we have a chart of the FXCM Speculative Sentiment Index as shown on the Euro/US Dollar currency pair.



Data Source: FXCM Speculative Sentiment Index, Dealing Rates

Past Performance: Past performance is not indicative of future results.

First we'll note the "Retail Open Long Positions" and "Retail Open Short Positions" as shown in the sub-chart; the green line tells us how many open trades in our sample are currently long the Euro/USD and the red line shows the number which are short.

We distill these two numbers into a single ratio as shown in the primary panel. If there are more trades short than long, the SSI ratio will be negative and shown in red. If there are more trades long than short, the SSI ratio will be positive and the figure will be shown in green.

The candle chart inset in the main panel shows us how changes in the SSI have corresponded with changes in price.

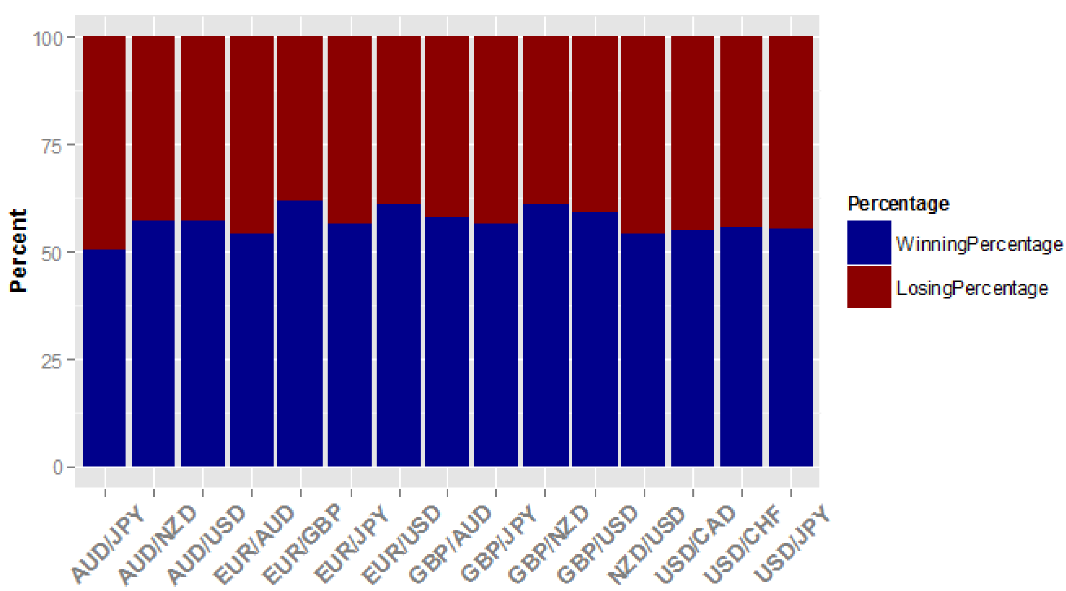
It may seem counterintuitive at first, but we typically use retail positioning as a contrarian indicator to price action. Or in short: if most are long, we forecast price losses. If most are short, we forecast price gains.

Why?

Let us borrow from our Traits of Successful Traders educational series to understand this dynamic.

We looked at over 43 million real trades placed on FXCM's trading servers from Q2, 2014 to Q1, 2015 and came to some very interesting conclusions. The first is encouraging: traders make correct predictions most of the time as over 50% of trades are closed out at a gain.

Percent of All Trades Closed Out at a Gain and Loss per Currency Pair



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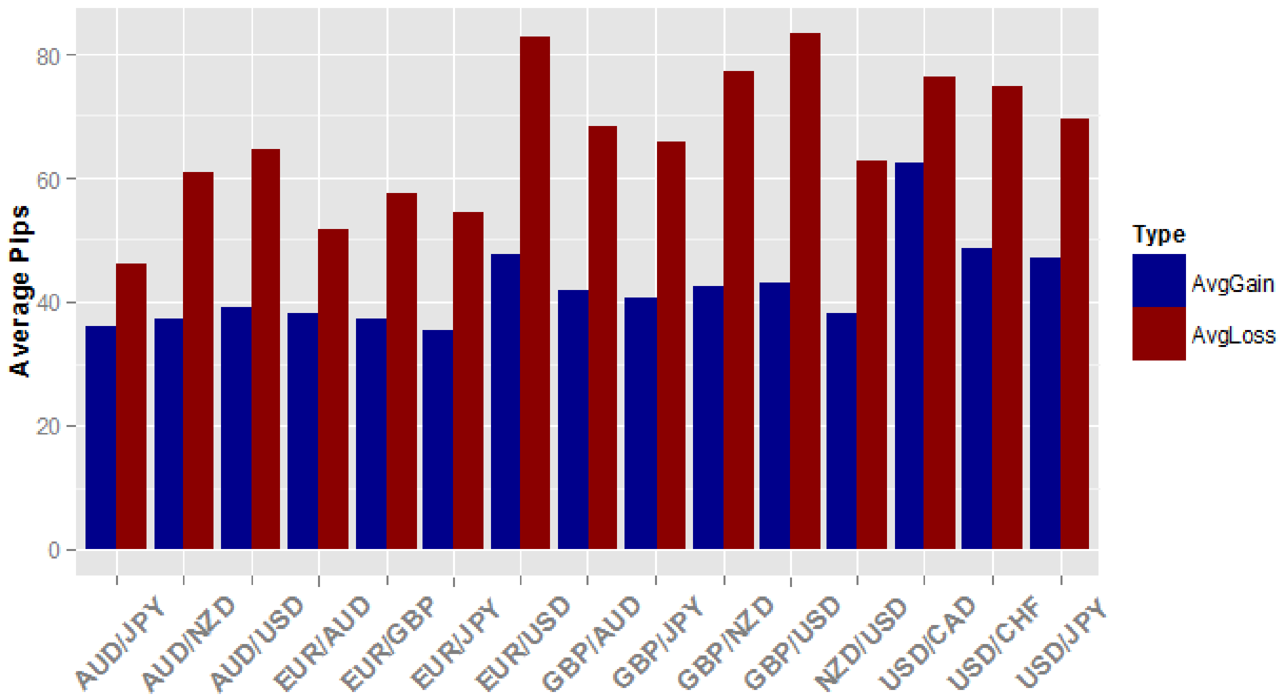
Data source: Derived from FXCM accounts excluding Eligible Contract Participants, Clearing Accounts, Hong Kong, and Japan subsidiaries from 3/1/2014 to 3/31/2015 across 15 most traded currency pairs.

Note: The dollar value of losing trades may exceed the dollar value of winning trades. Additionally, it is important to weigh the relative risk and reward of every potential trade before entering the market.

Past Performance: Past performance is not indicative of future results.

The above chart shows results of over 43 million trades conducted by FXCM clients worldwide over 12 months across some of our most popular currency pairs. The blue bar shows the percentage of trades that ended with a profit for the client. Red shows the percentage of trades that ended in loss. For example, the Euro saw an impressive 61% of all trades closed out at a gain. Yet this is only one piece in the puzzle—let us look at another key fact.

Average Profit/Loss per Winning and Losing Trades per Currency Pair

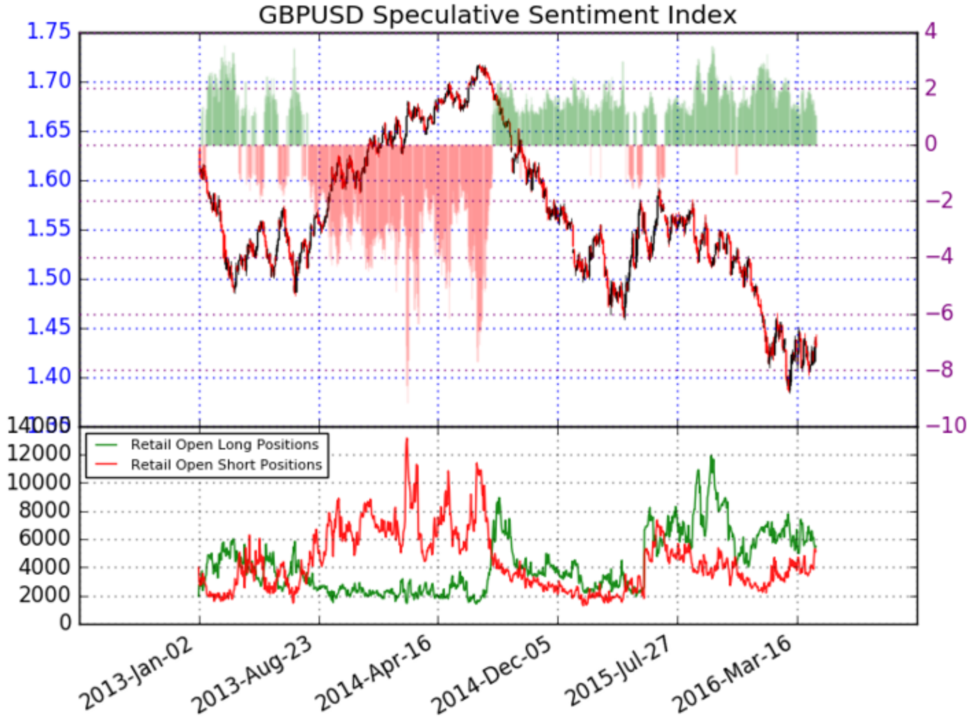


Data source: Derived from FXCM accounts excluding Eligible Contract Participants, Clearing Accounts, Hong Kong, and Japan subsidiaries from 3/1/2014 to 3/31/2015 across 15 most traded currency pairs.

Past Performance: Past performance is not indicative of future results.

The above chart says it all. In blue, it shows the average number of pips traders earned on profitable trades. In red, it shows the average number of pips lost in losing trades. Let's focus in on the Euro/US Dollar to illustrate. We see that EUR/USD trades were closed out at a profit of 61%, but the average losing trade was worth 83 pips while the average winner was only 48 pips. Traders were correct more than half the time, but they lost over 70% more on their losing trades as they won on winning trades. The track record for the volatile GBP/USD pair was even worse. Traders captured profits on 59% of all GBP/USD trades. Yet they overall lost money as they turned an average 43 pip profit on each winner and lost 83 pips on losing trades.

If we go against what the majority of traders are doing, we might expect to lose more often than we gain. Remember that past performance is not indicative of future results, but our experience shows that this may have nonetheless been a winning strategy. Let us see a chart on the British Pound/US Dollar pair to further illustrate this point.



Data Source: FXCM Speculative Sentiment Index, Dealing Rates

Past Performance: Past performance is not indicative of future results.

Our data shows that going against the trading crowd could make us lose on our trades more often than not. A closer look also shows that crowds can go really wrong when they're wrong. Our aim is to use retail FX trader sentiment to potentially catch and time major market swings. In this case we see that the majority of trades turned short the British Pound as it crossed above $1.50 in August, 2013. The trading crowd remained net-short the GBP/USD until the pair crossed below the $1.70 level 11 months later—a nearly-2000 pip move. Positions stayed net-long nearly without interruption over the following 10 months as the pair shed over 2000 pips.

Theoretically, a trader could have gained by doing the opposite of what the 'trading crowd' was doing. These examples are very much the exception and not the rule. And indeed the same chart shows that the majority of contrarian trades would have been closed out at losses. Yet our aim is to use retail FX trader sentiment to potentially catch and time major market swings—taking a contrarian view of crowd positions all the while.

See real-time SSI data via the FXCM Trading Station Desktop, twice-daily updates via DailyFX PLUS, and a weekly report on the top currencies via DailyFX.com.

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Past Performance

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