TradeMentor

Chapter 4.3

Speculating with CFDs

SPECULATING WITH CFDS

Traders often have moments when they feel the stars are aligned to favour a particular trade. And, though they may not be able to explain exactly why they believe a share or index is going to move in one direction or another, they just know the move is going to happen. Not wanting to miss the profits that would follow from the move they know is going to come, they place a speculative trade.

Speculative trades are typically short-term trades and traders generally employ them around major market events such as corporate earnings announcements and central bank interest-rate decisions. Traders want to quickly get into the trade, enjoy the profits that they hope will come from a quick move as prices adjust to the news from the major market event, and then get out of the trade.

CFDs are often the investment tool of choice for speculators. One of the most important advantages CFDs offer is leverage. As you know, leverage allows you to increase your exposure while minimizing your investment in a trade. Leverage can enhance you gains in a speculative trade, but it can also enhance your losses. Remember to utilize appropriate risk-management techniques such as trailing stops when placing your trades.

In this section we will outline situations which lend themselves to speculation and explain how to implement the speculative trade itself:

Contents

SPECULATIVE TRADING OPPORTUNITIES

Speculative trading opportunities arise frequently, and most of them tend to have one thing in common: they are based on news announcements. Whether the news announcement comes from a government providing information regarding the employment outlook in that country or from a company reporting its quarterly earnings, they have the potential to cause dramatic shifts in the market.

The following are examples of news announcements that could lead to ideal speculative trading opportunities:

- Breaking news
- Company reports
- Economic data
- Index additions/deletions

Breaking news announcements are unscheduled events that catch traders off-guard and are therefore the most difficult news announcements of which to take advantage as a trader. Some breaking news announcements, like merger announcements, are beneficial to share and CFD prices whilst other breaking news announcements, like fraud charges against a company's CEO, are harmful to share and CFD prices.

As you would expect, negative news typically pushes CFD prices lower whilst positive news typically pushes CFD prices higher.

Company reports are scheduled events that provide information regarding the current performance of the company and what the company expects to see in the future. Because these reports are scheduled well in advance traders have a chance to prepare themselves beforehand and take advantage of the announcement.

When you analyze company reports it is important to remember that the market is typically looking ahead at least six months down the road when it prices shares and CFDs. So, whilst the current earnings and performance numbers for a company are important, the future outlook the company provides must also be digested.

When a company's reports show it is performing well and is expected to continue performing well, share and CFD prices tend to move higher. When a company's reports show it is performing poorly and is expected to continue performing poorly, share and CFD prices tend to move lower.

Economic data comes out in news announcements that are typically scheduled months in advance, giving you an opportunity to thoroughly prepare yourself for the announcement. Economic data covers a broad range of topics including inflation and gross domestic product (GDP) information, interest rate announcements and unemployment figures.

Economic data announcements tend to affect broad markets, not just individual shares and CFDs. Accordingly it is often preferable to utilize index-based CFDs when speculating on these announcements.

When economic data shows the economy is doing well, share and CFD prices tend to move higher. When economic data shows the economy is doing poorly, share and CFD prices tend to move lower.

Index additions/deletions occur when major market-tracking companies like Standard & Poor’s decide to adjust the composition of their market-tracking indices. For example, if a company no longer meets the market-capitalization requirements to be listed in the S&P 500 index then Standard & Poor’s will remove it from the index.

Index additions/deletions tend to take place at scheduled times. However, the identity of the individual shares that are going to either be added to or deleted from the index is not known until the announcement is made. Of course many market participants are able to determine which shares are most likely to be affected, but there is no way to know for sure before the news comes out.

When a share is added to an index the demand for that share typically increases as index-tracking funds and others buy the share, which pushes its price higher. When a share is deleted from an index the supply of that share typically increases as index-tracking funds sell the share, which pushes its price lower.

The Expected is Already Priced In

One important thing to remember when you are looking for speculative trading opportunities around news announcements is that what is expected is already priced into the CFD.

Investment analysts, economists and other market participants are constantly analyzing anticipated news announcements, trying to determine ahead of time what the news is going to be. Whilst no two analysts will arrive at exactly the same conclusion, if you examine a spread of opinion you can determine the consensus.

Knowing the consensus, the average estimate, will help you to take advantage of price movements once the news announcement is released because the average estimate will already be "priced into" the value of the CFD. Here's how it works:

Once investors complete their analysis they start placing their trades to take advantage of where they believe CFDs are going to move in the future. They don't wait for the announcement itself. They want to be ahead of the market. So, by the time a news announcement is released, most of the major market participants have already placed their trades.

If a news announcement is released and the result is in line with the average estimate, the CFD will probably not move very much. Since most of the big traders will have already placed their trades there would be no new traders to jump in and move the CFD. If the actual number from the news announcement is higher or lower than the average estimate, however, the price of the CFD will have to adjust either up or down to factor in the new economic information - giving you an opportunity to enter a speculative trade.

IMPLEMENTING SPECULATIVE TRADES

Once you have identified a news announcement or other speculative stimulus that should cause share and CFD prices to move you have an excellent opportunity to take advantage of the price movement. You can do so in one of the following three ways:

1. You can enter your trade immediately following the news announcement
2. You can wait for the market to process the new information and enter your trade once a new trend has been established
3. You can set two entry orders, one above the current price of the CFD and one below the current price of the CFD, just before the news announcement is released

Entering Immediately Following a News Announcement

Entering immediately following a news announcement is typically the most difficult way to trade the news. Share and CFD prices tend to adjust sharply when the result of a news announcement is not what investors had anticipated. Depending on how quickly you get the news and how quickly you can enter your trade order, you may not be able to get into your trade before the price has already taken off.

Traders who try to jump into trades after the announcement has been released have to be prepared to pay more for their CFD, or selling their CFD for less. The price movement between the time when you enter your trade and when you are trading is actually filled is called "slippage". If you are comfortable with experiencing slippage in your trading account then you can explore this method of reacting to news. If you're not comfortable with experiencing slippage in your trading account then you should choose one of the other two methods for reacting to, or 'trading on', the news.

Entering Once a New Trend is Established

Most CFD traders who trade the news choose to enter their trades only once a new trend has been established. This is typically the easiest way to trade the news. Often when a news announcement is released the price of the CFD will fluctuate back and forth as investors try to determine in which way the underlying asset will move in the future. Once these investors have determined in which direction they believe the underlying asset is going to go, the CFD generally develops a strong trend in that direction.

CFD traders who wait for this new trend to appear ignore the noise that is generated as the CFD fluctuates back and forth immediately after a news announcement is released. Doing so gives them an advantage over traders who enter their trades too quickly only to being knocked out as the price reverses direction and hits their stop losses.

You will typically know in which direction a CFD is going to move within 2 to 5 minutes of when the news announcement is released. This gives the market plenty of time to shake out those investors who are trying to buck the new trend. Because this shake-out can happen so quickly, you would be wise to use a shorter-term chart to monitor the price action after a news announcement. Consider using a 1- or 2-minute chart.

Using Entry Orders Before the News Announcement

Placing entry orders before a news announcement is released is the most profitable way to trade the news when you are right and the CFD moves in the preferred direction. By placing your entry orders before the CFD moves in one direction or the other, you assure yourself of entering the trade at the price which you specify. In other words you don't have to worry about excessive slippage when you're using entry orders. As soon as the price of the CFD reaches your entry price you will be placed into your trade.

This method is also one of the riskiest ways to trade the news when the market whips back and forth immediately following the news announcement. For instance, if the price of the CFD moves higher immediately following the news announcement and then turns around and moves lower once the majority of market participants realize the news announcement was bearish for the CFD, you will be knocked into the trade once your entry order is hit and then knocked right back out of it once the CFD turns around and hits your second entry order.

One way you can prevent this from happening is by deleting your second entry order once the first entry order is hit. However, you will want to place a stop-loss on your trading after you hit your first entry order.

Disclaimer

The curriculum is produced for the purposes of general education.

None of the information contained herein constitutes an offer to purchase or sell a financial instrument or to make any investments. CornèrTrader and / or Cornèr Bank do not take into account your personal investment objectives or financial situation and make no representation, and assume no liability to the accuracy or completeness of the information provided, nor for any loss arising from any investment based on a recommendation, forecast or other information supplied from any employee of Cornèr Bank, third party, or otherwise. Trades in accordance with the recommendations in an analysis, especially, but not limited to, leveraged investments such as foreign exchange trading and investment in derivatives, can be very speculative and may result in losses as well as profits. You should carefully consider your financial situation and consult your financial advisor(s) in order to understand the risks involved and ensure the suitability of your situation prior to making any investment or entering into any transactions. All expressions of opinion are subject to change without notice. Any opinions made may be personal to the author and may not reflect the opinions of CornèrTrader and / or Cornèr Bank. Furthermore, please refer to Cornèr Bank and CornèrTrader full General Disclaimer.