Why YOU Should Trade CME Currency Futures Instead Of Cash FX

By Timothy Morge

As I said earlier, by the late 1980's, I was one of the largest and most successful cash currency traders in the world. Why in the world would I be telling you now that it is in your best interest to trade in CME Currency Futures instead of cash FX, when you are CONSTANTLY bombarded with advertising and articles in the trading magazines extolling the virtues of the cash FX market?

When I was ran FX trading at First Chicago, roughly 90 percent of the total FX volume in the world went through the interbank market, which means a bank FX desk was on one side of the transaction in 9 out of 10 trades. The cash FX liquidity of that era is unparalleled and none of you should make the mistake of thinking that the current cash FX market is anywhere near as liquid as it was back then. Banks have drastically cut back on their risk profiles, because it is much more lucrative for them to borrow short-term money at historically low interest rates and then lend it right back out again at sky high rates in the form of credit card balances financed at anywhere from 8 to 21 percent annualized rates of return! And it is equally lucrative for them to make 100 percent no down payment loans at a six percent APR, when they can borrow the money 3 or 4 percent lower than that all day long. Why risk making markets and holding positions in the FX market when you can just bulk up your credit card business and add staff to your mortgage area?

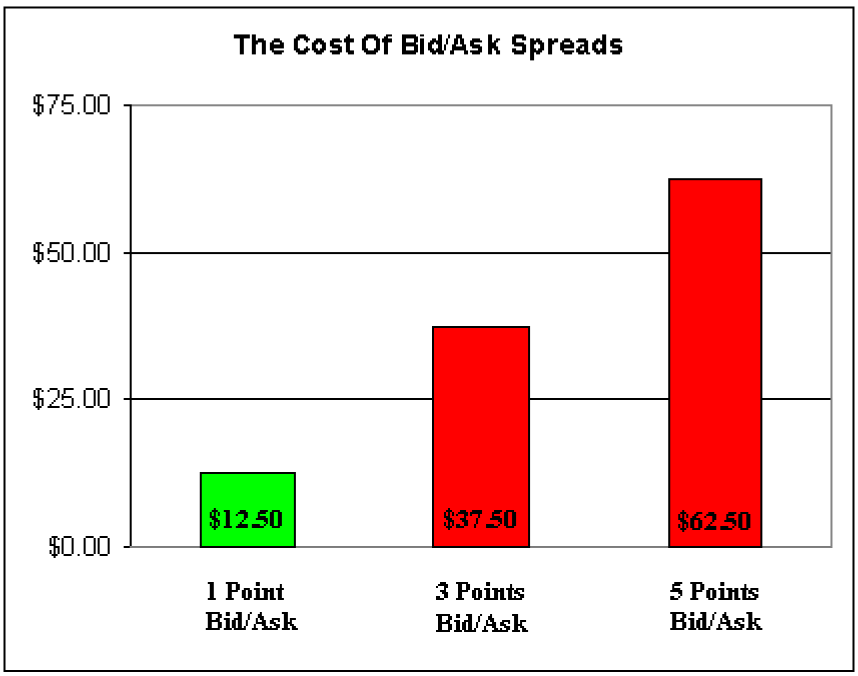
A recent study by The Bank For International Settlements, the group that has access to ALL the cash currency transactions that take place around the world each day, states that in 1990, banks were responsible for over 90 percent of all foreign exchange transactions. By 1998, that number had declined to roughly 82 percent. In 2004, that number was below 65 percent and a current estimate is that banks barely account for half of the FX transactions that take place.

I can tell that you're thinking, "That's ok. I wasn't going to call a bank for my quote anyway! If brokers and these non-bank firms that specialize are a bigger part of the marketplace, that's good for me, right?"

Well, I have news for you: There are SO MANY of these firms popping up, spending SO MUCH MONEY advertising to get your trades because it is SO lucrative for them to get your business. Just because the banks don't want to earn the "spread" on you, don't think these folks aren't smart enough to see a great opportunity when it knocks on their door. Let's look at some of their claims:

They say: We guarantee you a 3 Point spread on up to $1 million U.S. dollars!

The really aggressive cash FX brokers offer their best clients 3 point spreads' although 5 point spreads are still very common. The bid/ask spread on the CME Euro FX futures, for instance, is one point wide, all day and all night. That means that even if you decide not to try to buy on the bid or sell on the offer, but instead go "to the market" and take the offer or hit the bid on your electronic terminal, the spread at the CME is one point. Period. The difference? Paying three points in the cash Euro FX is worth $37.50 versus paying one point in the CME Euro FX futures, which is worth $12.50. That's quite a difference. And paying five points is worth $62.50! And as I said, you CAN often buy on the bid or sell on the offer, especially when putting on your position, which means many times, you'll have NO spread to pay! That's quite a difference.



They say: We don't charge you brokerage!

Look, brokerage is the least of your worries and expenses. For example, Spike Trading, one of the hosts of this webinar, will do your electronic CME Euro FX trades at $6 per round turn, and if you look at the difference between the 3-5 point bid/ask spread you'll get at the cash FX brokers versus the one point bid/ask spread I constantly see at the CME, you'll see that $6 in brokerage is less than ½ a point and doesn't really figure into this equation. When you add it all up, the net cost to you, as a trader, favors doing your currency trading on the CME in the major currencies.

They say: The cash currency market averages over $13 trillion a day

This apparently implies that the total volume traded in the cash currency markets works in your favor. But the truth is in the actual execution. What do I mean by that? Just this: Will YOU get better prices and have your limit orders and stop orders executed at better rates in the cash FX market or the CME electronic futures markets?

As a CTA, my programs have been trading currencies in their portfolios since late 2003. When trading Euro FX, with on-shore and off-shore clients, the average trade size from late 2003 to the present is the equivalent of roughly 550 CME contracts. In general, I use limit orders for entries and profit orders, and stop loss orders for stop loss exits. As I go into the statistics from the hundreds of trades in the Euro FX made over that time frame, keep in mind the difference in spreads offered in the cash market versus the CME electronic markets.

Since late 2003, in the CME Euro FX futures, in the hundreds of trade entry signals generated in my trading programs, I was not filled on my full amount [roughly 550 contracts] when using buy or sell limit orders on only three occasions. Remember: When using the CME electronic futures contracts, price doesn't have to "trade through your limit" for you to get a fill—you simply get filled as price trades at your order level. But at a cash FX broker, they generally don't fill your order UNTIL and UNLESS price has traded through your limit level, so you would not have experienced anywhere near as many fills as I did in my actual programs, had you been using the cash FX markets exclusively. Why? Cash FX traders fill you **when it suits them**—it is an unregulated industry in that sense and there is NO audit trail, nor any single central market place where your order is worked. But the CME is strictly regulated and there is a real-time accurate audit trail of all trades made available to anyone trading in that market. When it comes to entry orders and getting filled on the bid or the offer, there is NO COMPARISON: The CME markets win hands down.
What about the execution of stop orders and how that may relate to the cash FX brokers that point to the $13 trillion traded in the cash FX market each day? Since late 2003, averaging 550 CME contracts, the slippage on my single worst fill on a stop loss order that was executed in the CME electronic market was 1.3 points. The average slippage was 0.6 points and many times, there was zero slippage. Given that the cash FX market spreads are 3-5 points wide, I assure you that the fills I get in the CME electronic markets are much better than what I would experience in the cash FX markets.

Do I even HAVE cash FX brokerage relationships? Yes, I have credit lines with the three largest cash FX banks and have direct access to their traders, 24 hours a day. I can certainly use their services if I feel they will give me better fills. Here's a pointed example: The single worst fill I experienced while trading in the

Euro FX markets during this period was a fill given to me by the largest cash FX bank in the world. They filled me 27 Euro FX points PAST my stop loss level! They told me that other banks were “not quoting them prices” and they had to wait until someone showed them an offer before filling my stop loss order. In other words, they waited until they had ZERO risk and could assure themselves a profit before filling my order.

That’s NOT what happens when you trade the CME electronic currency futures. All bids and offers are housed in one market and you have direct access to all the bids and offers. Where your order gets filled depends on what orders are available, NOT upon whether someone else can make money on your stop loss order. In this specific example, I pulled time and sales from the CME electronic Euro FX futures from the same time frame and did an extensive examination to determine where I would have been filled, had I left my order in the CME electronic futures market. Instead of 27 points of slippage, I would have experienced at most four points of slippage. Besides the research done on the time and sales at the CME, I can tell you that I was watching live trading on the CME while I was on the phone, trying to get the cash FX trader to give me the price on my fill—and as I told him at the time, he filled me 20 points worse than where the CME was trading while we were talking! And while prices did spike higher on the CME over the next five minutes after I got my fill from the cash FX trader, the high on the CME NEVER got within five points of where the cash FX trader initially filled me. The bottom line: don’t equate total volume traded with liquidity and depth at any point in time. Measure it as it applies to you—Trade where you get the best fills on a consistent basis.

So what’s the bottom line? Most traders will find better fills and experience significantly lower net costs when trading the major currency at the CME using their electronic contracts. No matter what you read in the hundreds of ads sent your way via email and in all the trading magazines, if you do your homework, you’ll find the CME electronically traded major currencies are the best bet, by a long shot. As I said, that’s where I trade my 550 lots—and I make my decision by where the best fills are and where the best net profits can be achieved, because just like you, the more money I make trading, the more money I get to keep.

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