

Fade-Self... One Trader's Commentary

Strategy

3 August 2005

"The Torrents of Summer"

"Never mistake movement for action." – Ernest Hemingway

In trading, never mistake price action for a change in market realities. More specifically- the more violent the price action- the less you should trust it. The trends that endure the longest are the ones that grind along unassumingly. This is because a slow grind delays the capitulation of those in losing positions. Losing 5% in a day causes panic offsetting. However, losing half a percent a day for a month may not result in any trading- the duration of the trade might even cause the losing position holder to have more conviction and add to the loser.

This is especially true for counter-trend movements. The stronger the trend- the more violent the price action is likely to be in order to convince the weak hands to reexamine their outlooks. Those who panic and capitulate just add more fuel to the rally.

I have an indicator that I use to gauge the strength of trend. I call it velocity and it very basic. I simply divide the short-term moving average by the long-term moving average. I consider 0-2% neutral, 2-4% grinding, 4-6% accelerating, and 6+% parabolic. In a neutral market you usually are witnessing a new trend developing or an old trend exhausting- either way I wouldn't trade it. In a grinding environment I sit back and allow the market to do its work for me- this tends to be the longest of the stages from a temporal standpoint and that means lots of chances to jump at profits. This is where patience is most important in trading. An accelerating market is one where volatility is increasing and is the best environment to add to positions both on strength and on pullbacks. The trend is not in danger at this point. The trend is in danger when the market goes parabolic- these moves generally involve unsustainable movement and volatility. Both prices and volatility are likely to return to the mean at this level in my opinion. Just an idea I use that may be useful.

Equities- The Dow Also Rises

It is however just being dragged along for a ride. I just don't think that the economy is healthy enough to support a strong stock market over the next few years. However, the stocks just keep marching higher. My magic number was 1250 in the S&P- the high of the move is now 1248.50. The Nasdaq and Russell have outperformed trading at 1635 and 690 respectively. If you would have taken my initial trade recommendation on July 14th and bought the indices you'd be sitting on \$1350 per mini S&P, \$1240 per mini Nas, \$475 per mini Dow, and finally a whopping \$1800 per mini Russell. Now, **futures is risky**. I'm not making any type of guarantees or assurances about what my predictions might result in in the future- but the past three weeks have been lucrative ones.

Treasuries- A Farewell to Bonds?

Not so fast. The trend has been grinding lower (-.7% velocity.) We're lower than last week by about \$800 per contract, but I think there will still be a significant rally before we break the 113.16 area in the 30-Year Bond. The reissue of the 30-Year had very little effect on the market itself this week- nor do I expect it to have a real impact. The low of the move in the bonds has been 114.14. Once we hit 114 I would move towards delta neutrality by selling puts against short positions. I think a bond rally will coincide with the broad based currency rally versus the dollar that I've been calling for.

Metals- To Continue to Have or to Have Not - Copper

Still holding copper. Last trade \$167.20. Since the first edition of this newsletter (when I begged you to buy copper) we are up ~\$3200 per contract. Its been a slow grind higher (3.9% velocity.) This has been the best kind of trade- profits and low volatility. Since we got into the copper again on July 5th- we've seen 12 days that made new all-time highs.

Meanwhile, I suggested staying away from Gold and Silver for a while- but if you insisted to buy I recommended 417.90 and 665 respectively. Ok, silver didn't drop below 695- however the low trade in gold was on July 15th at 418.20. Last trade today was \$436.90. If you've traded gold before you know how close that is...alas close won't get you that Cuban cigar- so I'm forced to digress. Stay long copper- but be careful in the gold and silver. I would continue to stay on the sidelines in both markets.

Energies- For Whom the Barrel Rolls

July 2005 was the 34th month in the last 37 where crude oil finished the month higher than it started. It just doesn't pay to short crude- or to buy puts for that matter. I'm currently flat, but if we break \$62.50 that could change. The sell-off this week was attributed to the larger than expected inventory build. At 200,000 bpd this number was inflated due to the storms in early-mid July holding up cargoes. All the cargoes that had been delayed showed up at the same time- it didn't necessarily have anything to do with actual production numbers. I think were likely to see a decent bounce back up in the crude Thursday morning.

On a weekly basis crude is reaching parabolic levels of velocity (~6.1%). This certainly doesn't mean that its going to drop soon, but what it does mean is that the reward left in the trade probably doesn't jive with the risk. The pullback is likely to come in an avalanche of selling that will make it hard to exit in an orderly fashion. The last two \$8-10 dollar pullbacks in crude were preceded by 14% velocity at their peaks. So, there is more room to the upside- but if we hit \$65-67 in the next month I would probably be hedging my bets.

Currencies- The Young Man Across the Sea

The youngster I'm talking about of course is the Euro. Like E. Hemingway, the Euro seems to believe that life isn't worth living unless you have some stories to tell. It's had a wild ride- and we're in the midst of the reprieve I was looking for. 123.55 is last in the September Euro. That's about 400 points from its low a month ago. That's a solid move (\$5000/contract.) I'd look for 125.50-126.00 in the next four days. This is probably the beginning of a trend turnaround that will take the Euro back above 130.00 in the next 3 months.

The Yuan revaluation has become a non-even. The Chinese have said that it will likely be five years until they reach fully floated status. (And their definition of a free market is definitely different from most Westerners) So, if you were betting on Yen appreciation and bond liquidation- you can toss your tickets. This will be a gradually shift that will take place over years- the shock of a 30% revaluation would stunt Chinese growth and send U.S. interest rate skyrocketing. For now, Mr. Snow should be happy as a puppet clam that the Chinese have made even this symbolic gesture.

Over the next two weeks I expect extremely bearish trade in the dollar across the board. My opinion is not fundamental. I just think the hedgies want to make some money before Labor Day. That way- they can turn a 3-day weekend into a celebratory week. Watch for the Canadian to break 83.50, the Swiss to hit 80.50, Pound at 1.8150, Yen 91.00 and Euro 125.50....All in the next 15 days.

As always, I hope the information has been informative and entertaining. If you're not making any money from these trends- then maybe the timing is right to open an account and get your feet wet. If you've never traded futures before, options can be used to create limited risk propositions that will make the transition to futures more comfortable. If you're a veteran- then put your money where your mouth is and call the guys at my trading desk and open an account. If you're just learning- then by all means- keep reading the newsletter and feel free to email any questions about trading, my ideas, or good places to nosh in Chicago.....- FS

Fade-Self (fād-sēlf) *verb.*

1. In trading- to take objective conscious action that is directly in opposition to the trader's gut instinct.

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