Tips for Traders | 6/16/2008

I Spy a Large Trading Opportunity-How You Can Too

Looking for a trade when you have an opinion is a double edged sword: If you are correct, it can be the most rewarding trading experience, because you not only make money, but your opinion was proven correct; but if you are wrong, your trading instincts and abilities are generally hindered because traders tend to hold their opinions in front of them as a shield and often ignore the cues that tell them that they are wrong-thus their losses on positions taken when they have an opinion tend to be much larger and more damaging to their capital base.

In general, I try to approach each market, each day, with no opinion and as I do my market analysis, I try to let the market show me that it is going to do something-or nothing. I like the market to 'play the first card' before I get interested, because I know that detachment keeps me at my highest level of focus and I am less likely to force a trade. But I would be less than honest if I said I never had opinions or that I never went looking for trades with an idea in mind. Like all traders, I am human, and I do have opinions. I do my best to recognize when I am looking with an opinion already formed and then I make certain I 'look both ways before I cross the street' (or attempt to enter the trade).

In the past eighteen months or so, the financial news has been dominated by the plight of the poorly performing mortgage portfolios and the worsening economic conditions in the United States. The Fed Chairman has gone out of his way to lower rates and speak soothing words to an increasingly nervous public, hoping to dampen the effects of this lending crisis on the economy. Almost all economists have focused on this dilemma, to the point where some high profile economists and bond portfolio managers have been calling for four percent 'zero down payment' mortgages for the masses as a fix for the housing industry. Because of my extensive economic background, I, too, have spoken out about the real danger of this situation-for example, in an interview on MSN, I highlighted the Muni Bond Auction held in New York State that attracted NO buyers. The response from people that viewed that interview was incredible: People could not believe that the State of New York could hold a Municipal Bond Auction and no buyers would show up, at any price!

We are at a crossroads in this country and perhaps in all of the Western Societies, as the economic torch may be passing to the emerging giant countries: China and India. The demand for resources from these new emergent economies dwarfs any economic policy changes the United States might make; in effect, we are no longer the masters of our own destiny.

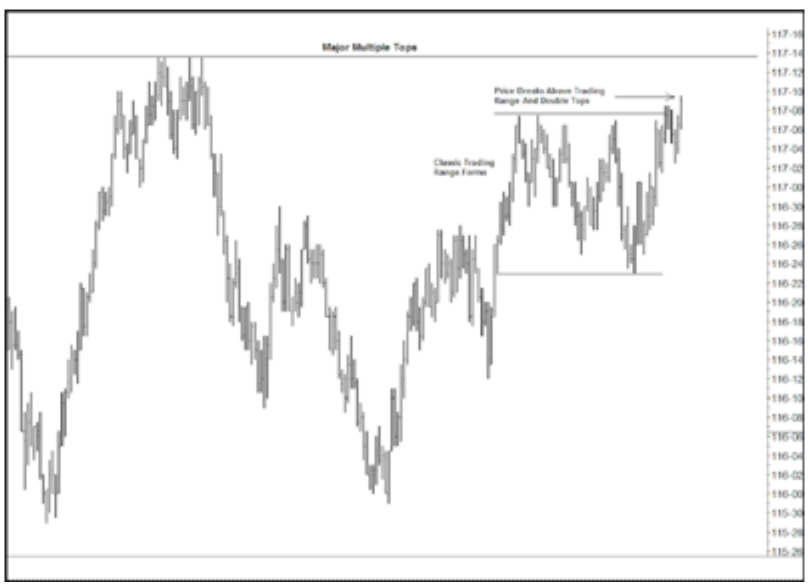
Though I have been highlighting the dangers of the lending crisis in this country for some time, I have been pointing out a much larger and more dangerous crisis that has been unfolding in front of our eyes for the past four or five years: The tremendous growth of the money supply in this country and its eventual inflationary effects. After the September 11th terrorist attack, Alan Greenspan and the Fed began printing money at an unprecedented rate. And because Mr. Greenspan had ceased publishing the wider measures of money supply growth (specifically, M3 and its components and derivatives) and has been pointing to the very narrow M1 measure of money in circulation as the proxy for monetary growth, the public and most economists have been lulled to sleep. The Fed has been saying that M1, (once it has been massaged and adjusted by the Fed), has been growing at about three to four percent on an annualized basis, which is about in line with the questionable measures of inflation the United States government has been publishing over the same time frame.

But for those that know where to look and how to do the simple math, the components of M3 are still published monthly and are available on the regional Federal Reserve web sites. This much wider measure of the money supply shows a very dire picture: M3 has been growing at 17-20 percent for more than the last three years! This translates to core inflation of 20 percent or more. And if you have been buying basic groceries, gasoline, healthcare and all the other necessities that I purchase for my family of four, you'll know that in the real world, prices of the basic necessities have more than doubled in the past four years. Now couple this huge growth in inflation with falling housing prices, falling purchasing power and lower or stagnant wage growth and you have a real recipe for disaster. But cutting interest rates and talking positive is not going to solve these problems. These problems faced Fed Chairman Paul Volcker and he gave the United States economy the prescription that cured it-in his words, we had enjoyed the fun of the party, now we had to pay with the pain of the hangover. In the face of mounting criticism, Volcker began raising interest rates, slowly getting the money supply in circulation under control until he had wrung out inflationary pressures. Once inflation was under control, the economy and its components like housing prices and wages began to recover.

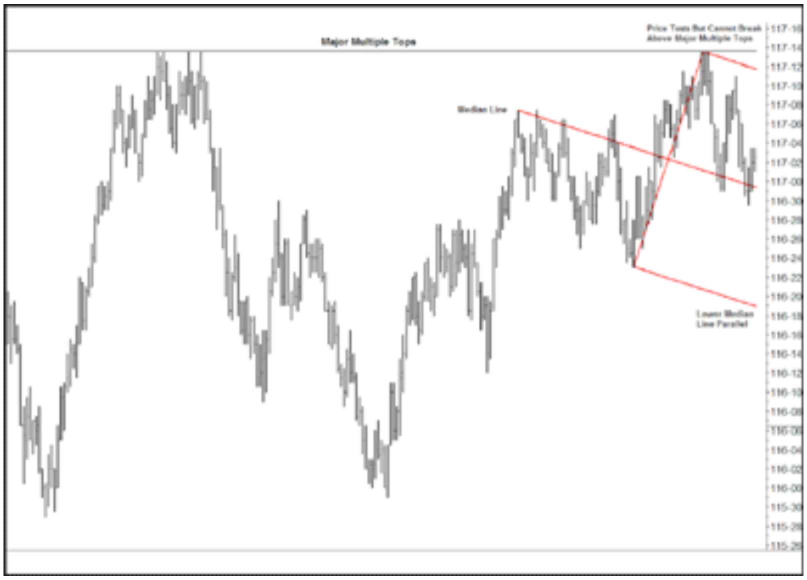
I truly have felt nearly alone decrying the threat of 20+ percent inflation over the past three to four years. But I believe others are now coming to the realization that the threat of massive inflation far outweighs any negative effects of soft or falling housing prices and bad loan portfolios. In my opinion, fighting inflation must be the first priority of the Federal Reserve and once the inflationary pressures are curbed, steady monetary policy must be pursued religiously. If this means a good number of loan portfolios get marked to zero, then so be it. If it means those that paid far too much with no down payments and borrowed money with 'interest only' mortgages on 'McMansions' will lose their homes and perhaps have to declare bankruptcy, then the sooner, the better. All wounds heal better when the medicine is administered sooner rather than later. Let's get on with the cure.

If you haven't guessed by now, I have a real opinion that there is a great deal of inflation in the United States, no matter what the 'massaged and manipulated' CPI and PPI numbers show. I believe we are experiencing at least 20 percent inflation on an annualized basis and that means the US bond market is headed in one direction: Down. The Chicago Board of Trade's bond future is currently trading around 112 ? and I expect that within 24 months, it will be well below 100. Now that I have revealed my opinion, remember that I gave a warning earlier that looking for a trade when you had an opinion was a two edged sword, so though I constantly monitor the bond futures market for an opportunity to get short, the trade set up and the risk reward and the stop loss must all be of the highest quality when I see what looks like an opportunity, because I know my opinion may be clouding my focus and skills.

Let's look at a recent bond futures chart:

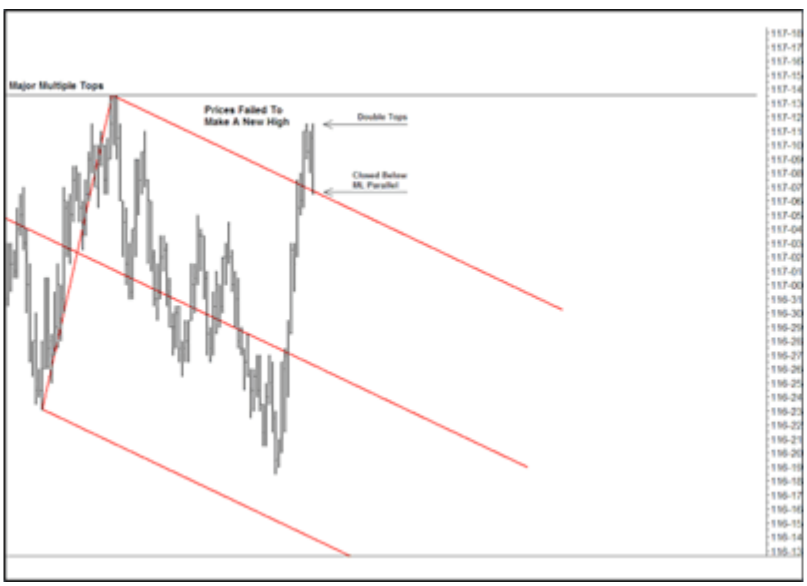


Looking at the chart above, you can see that prices tried to climb above 117 14/32 many times but found rock solid resistance at the area. After trading a bit lower, prices climbed back higher and then formed an Energy Coil or classic trading range a bit below this area of resistance. Please note that I outlined the trading range and that eventually, price broke and closed above this area of congestion.

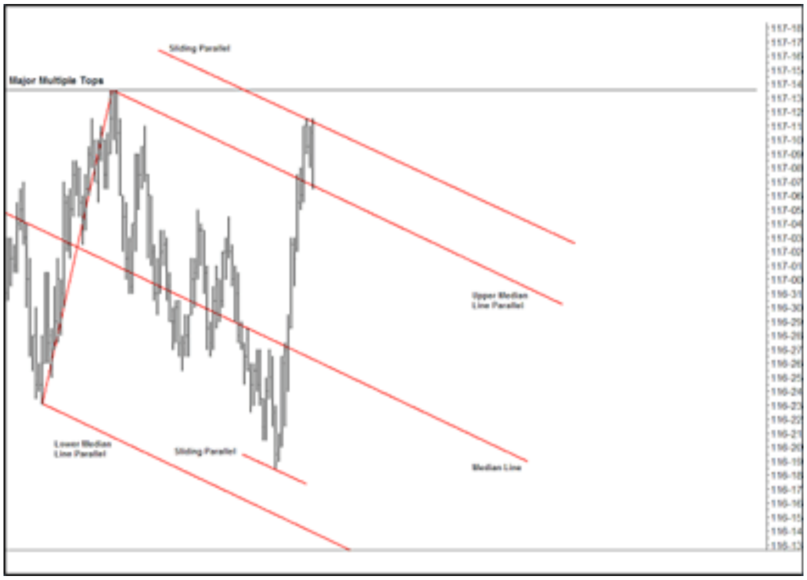


Price climbed higher and after three consecutive bars tested the 117 14/32 area again, bond futures prices began making lower highs and lower lows. At that point, I added a red down sloping Median Line and its Parallel Lines to show me the probable direction of price.

You can see on the chart below that price traded lower, heading down towards the Lower Median Line Parallel but failed to make it down to test this 'most likely line.' According to median line theory, price should make it the 'next most likely line' 80 percent of the time-and when it doesn't, traders should be on the lookout for a larger than normal movement in the opposite direction.

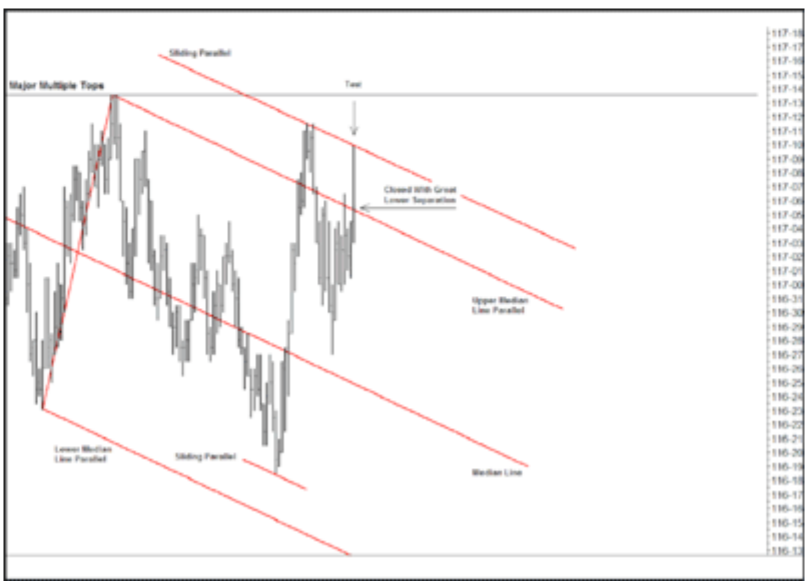


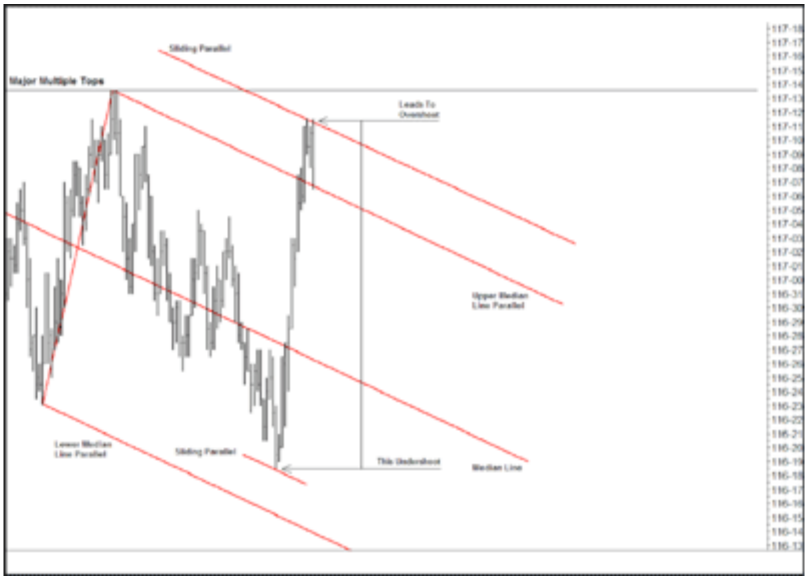
Normally, price would be contained by the red down sloping Upper Median Line Parallel but because price did not trade down to its 'most probable line', it broke above the Upper Median Line Parallel. Looking at the details of the price action above this Upper Parallel, you can see that price failed to re-test the 117 14/32 area, left double tops and then headed lower-the last bar closing back under the Upper Median Line Parallel and on its lows. All of these are signs of weakness. Let me illustrate this simple principle on another chart:



Note I added a Sliding Parallel where price stopped on the down side and another where it stalled on the up side. And you can see that they are about the same distance from their respective Parallel Lines (the distance from the lower Sliding Parallel to the Lower Median Line Parallel is actually ? a bond tick smaller).

This chart should clearly illustrate the concept: As the ancients said, ‘that which is below is like that which is above and that which is above is like that which is below’. The undershoot or inability of price to trade lower to its ‘next most likely line’ generally leads to overshoot of a similar size, as you can see in the chart below. This is not a well-known or popular trading measurement in the trading community, but I suggest you watch for it on your charts and you may soon be adding it to your trading tools!

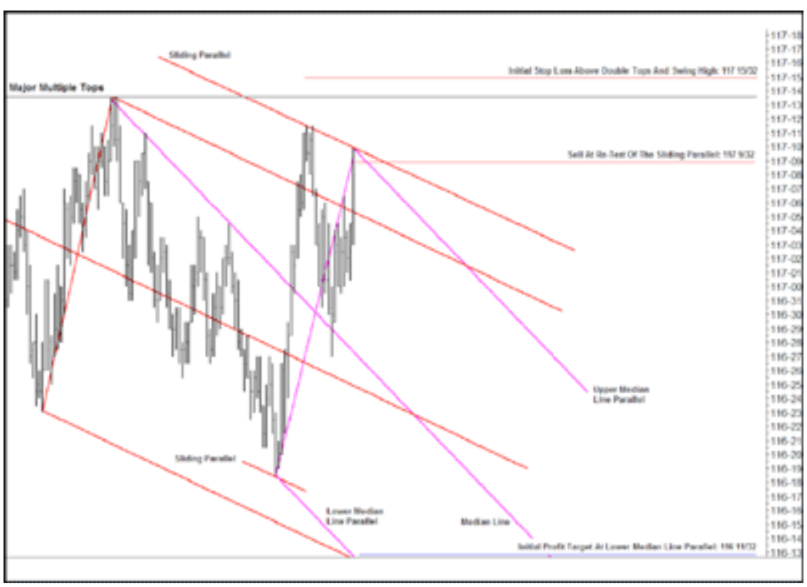




Remember that I am being extremely careful about my entries because I know and admit to myself that I have an opinion and my opinions may cloud my focus and trading ability, so I want price to show me every sign that it is setting up exactly as I want before taking a position.

Price came off hard after the double tops, nearly making it to the red down sloping Median Line before turning back higher. Then price tested the Upper Sliding Parallel I had drawn in through the double tops. Note that the bar that tested the Upper Sliding Parallel closed far from its highs, in the lower third of the bar, with great down side separation from the high of the bar to the close of the bar. This is another major sign that there are sellers in this market at the higher levels. Have I seen enough quality signs of weakness to be interested in a short bond future position?

I added a magenta down sloping Median Line and its Parallel Lines and anchored it off the last bar that just tested the down sloping Upper Sliding Parallel.



Note that price is making lower highs and is moving away from the solid 117 14/32 area of resistance. I want to get short as close as possible to that area, because I assume there are sell orders at or just before that area. These limit sell orders will act as a buffer to keep my initial stop loss order from being hit if I can afford to hide it above this area of significant resistance. I've diagrammed my orders for the potential trade I have in mind on the chart above:

1. I want to be a seller of bond futures at a re-test of the Upper Sliding Parallel. On this chart it may appear I am selling in front of the line, but that is a function of the scale of the chart. Price will intersect with the Sliding Parallel at a price slightly less than 117 10/32, so I choose to enter my limit sell order at 117 9/32.

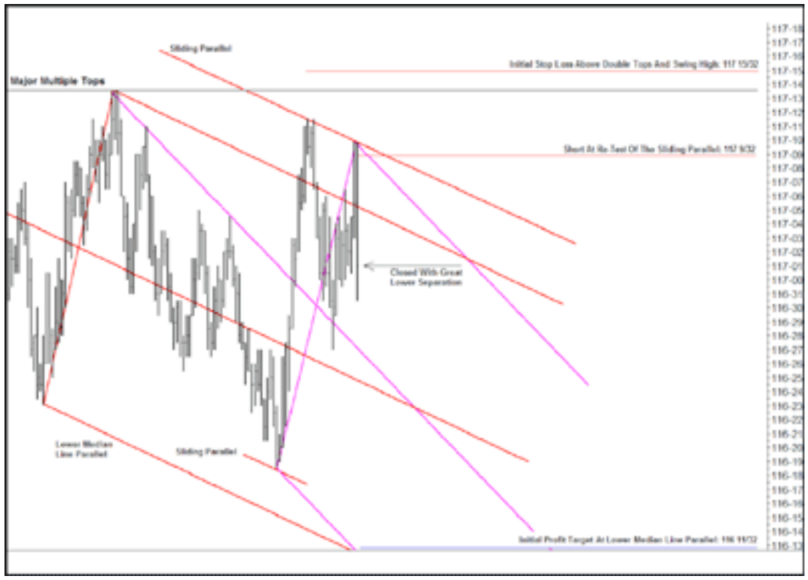
2. My initial stop loss order is above the double tops that I used to draw the Upper Sliding Parallel and more important, above the rock solid resistance at 117 14/32. I am going to work an initial stop loss order at 117 15/32 and I expect there will be limit sell orders by many traders at or before the 117 14/32 multiple tops that will act as protection for my stop loss order at 117 15/32.

3. My initial profit target is a test of the area where two Lower Median Line Parallel Lines come together (an area of confluence) and that area is at 116 11/32, though because I am trying to get short against down sloping lines, that profit target will move lower as price passes to the right because the lines are down sloping-meaning the longer it takes to hit my profit target, the more I will potentially make on this trade. As I have said many times, statistics show that trading with the slope of the lines, which is tantamount to trading with the prevailing trend, gives me a 10-12 percent edge.

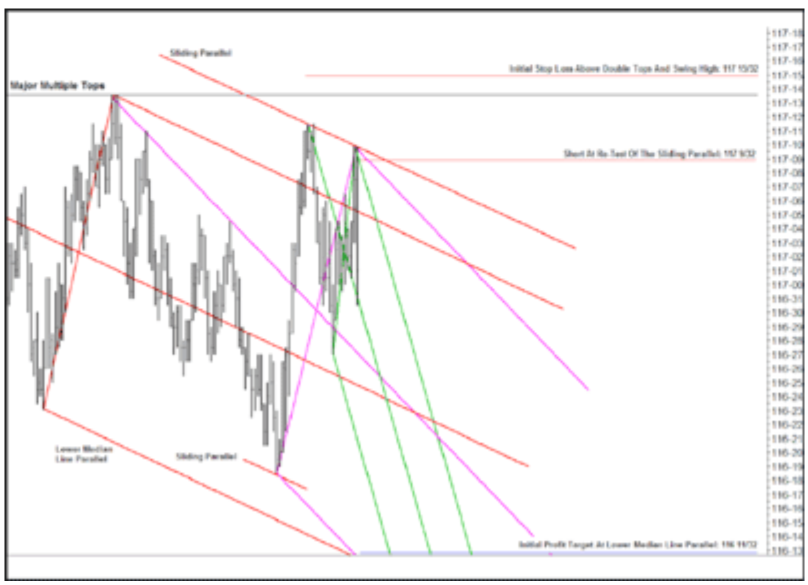
4. I am risking six ticks in the bond futures to make a potential 30 ticks, so that means my risk reward ratio is 30/6 or 5:1. That is a very good risk reward ratio-I never enter a trade with a risk reward ratio lower than 2:1.

I review my orders one last time, check the charts to make sure I haven't missed a nuance and then place my limit sell order at 117 9/32 and my initial stop loss order at 117 15/32 in the market at the same time. I want immediate protection should my limit sell order get filled-I don't want to be trying to type in my stop loss order while the market runs away from me-so I ALWAYS enter my stop loss orders at the same time I enter my entry orders. I cannot enter my profit order until and unless the market fills my limit entry order.

Price came back up and tested the Upper Sliding Parallel, leaving double tops again and in the process, my limit sell order at 117 9/32 is filled. This bar also closed in the lower third of its range, with great down side separation, which is again a sign that there are sellers in this market at higher levels-a sign of weakness.

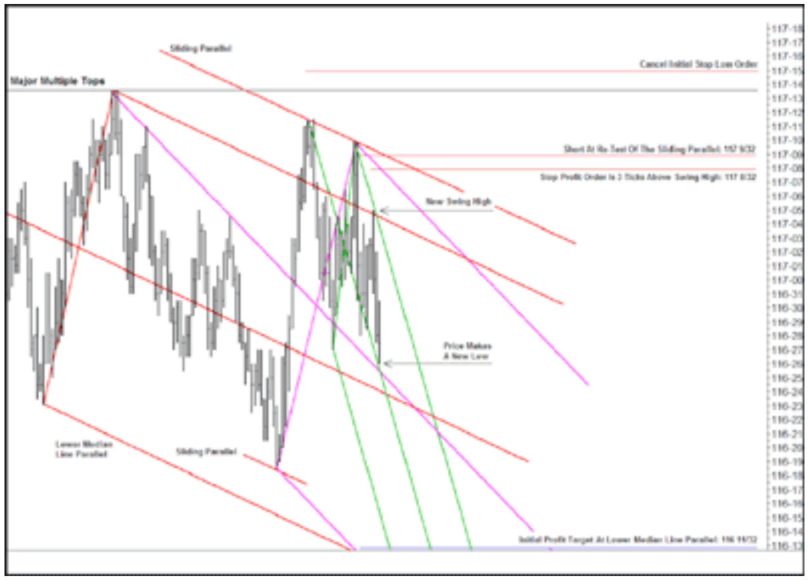


Once I see my price print, I check my electronic platform to make certain that my limit sell order was filled. Then I check that my stop loss order is in the market. Finally, I can enter my profit order, my limit buy order at 116 11/32.



Once I am short, my mind begins to manage the potential outcomes of the trade. I draw in a green narrower Median Line and its Parallel Lines, because this set of lines will give me a much clearer prediction of the probable path of price if I am correct and price moves lower from this level.

Price consolidates a bit and then tries to climb back above the Upper Median Line but runs into the confluence formed by the red down sloping Upper Median Line Parallel and the green down sloping Upper Median Line Parallel.

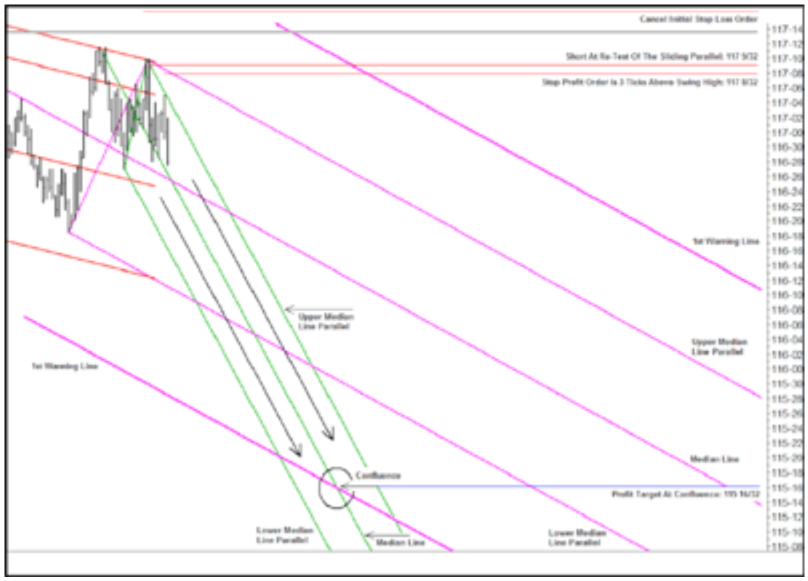


These two lines act as an upper barrier and repel price. When price heads lower and breaks below the prior swing low, making a new low for this move, we confirm that we are making lower highs and lower lows, which is a sign for a cascade lower—a formation that should eventually lead price to my profit target.

Once price makes a new low for this move, it confirms the recent test at the confluence of the two Upper Median Line Parallels as a swing high. I now expect that there will be limit sell orders at or slightly before this new swing high, so I cancel my initial stop loss order at 117 15/32 and move it three bond ticks above this new swing high, to 117 8/32. I am now playing with the market's money, and that is always the best situation to be in!

But as the last bar on this chart closes and I cancel and replace my stop loss orders, something clicks in my mind. If you have children, you've probably played 'I spy with my little eye' many times and suddenly I spy something. Let me diagram it out for you!

I removed the extensions of the original red down sloping Median Line and its Parallels to make the chart less busy. When I added the down sloping green Median Line and its Parallels and then watched price make a new low, confirming lower highs and lower lows, and then saw the top heavy resistance at 117 14/32 that has been tested and tested and tested hanging over this market, I immediately saw a new potential formation in my mind: a Chimney, which is a near vertical pathway that allows price to move in one direction with little or no resistance until the chimney's target is reached.



I added the lines of force in the chimney formation to the chart above, as well as a circle surrounding the most probable target for this formation, the confluence formed by the Lower 1st Warning Line below the magenta Lower Median Line Parallel and the green down sloping Median Line. Because of the great deal of overhead resistance and the amount of time price has spent trying to break above the 117 14/32 area, I think a steep chimney formation rather than a gentle cascade is much more likely to form when traders patiently watching their 117 13/32 and 117 14/32 limit sell orders suddenly decide its time to sell 'at the market', chasing this market lower.

In the end, I may be incorrect about which formation appears, but the stop orders are the same, so I decide to cancel my limit buy order, which was based on a gentle cascade formation lower, and instead replace it at the area of confluence that is based on the steep chimney formation. That area of confluence comes in at 115 16/32, which nearly doubles the risk reward ratio on this trade in my favor.

Price climbs again to test the green down sloping Upper Median Line but cannot climb above it and three bars later, price makes a new low for the move. That makes this last test a new Swing High, so I can snug my stop profit order three ticks above it, because I expect there will be traders trying to get short at or just in front of this new Swing High.

I am now working a stop profit order at 117 3/32. I’ll continue to ‘box in profits’ until either my limit buy order is filled at 115 16/32 or my current stop profit order is filled. Each time price leaves a new lower swing high, I’ll move my stop profit order lower. One way or another, I’ll end up with a profit on this trade now, so it’s a simple matter of paying attention to money management details and order management. Most traders find this the most boring part of trading, but the better you are at money management and order management, the more money you will book per trade—and I am known for surgeon-like money management and order management skills.

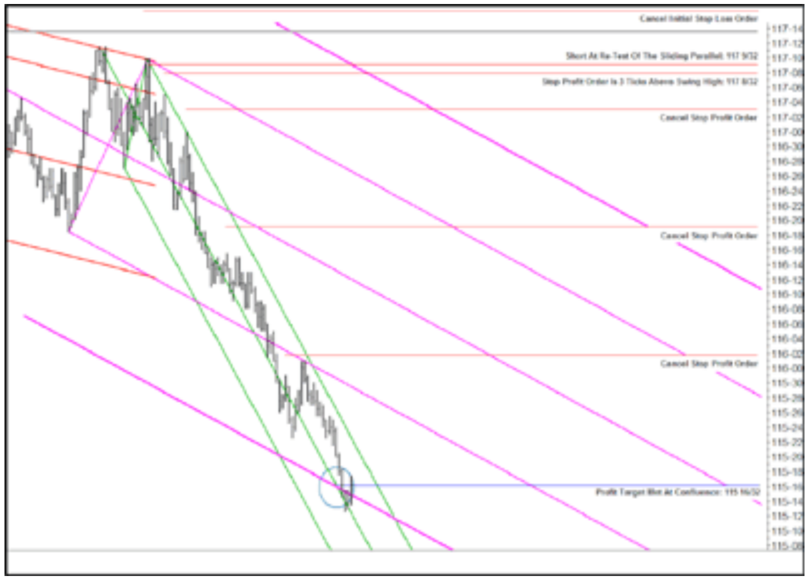
Price begins to move down and away from the Upper Median Line Parallel now as fresh sellers enter the market. Each new low draws in more sellers and although the market appears to be trading in an orderly fashion, you can see there are very few up side retracements to sell. Price finally consolidates around the green down sloping Median Line leaving two small spikes higher and then making a new low for the move again, which confirms these spikes as Swing Highs. Once again, I snug my profit order to three ticks above these new Swing Highs, at 116 19/32. I still expect there will be fresh sellers at or just below this new Swing High—it still looks and feels to me that there are fresh sellers in this market, traders that wanted to get short at 117 13/32 but didn't get their chance, so they are looking for any opportunity to get on this one way train lower.

As I have mentioned several times, trading with an opinion can be extremely dangerous, because your focus, judgment and skills can be clouded. But note how careful I have been to box in profits at every opportunity in case price begins to back up. I cannot rely on my emotions to allow me to make a rational snap judgment when I have an opinion, so I ALWAYS protect myself with 'hard' stops, even if they are stop profit orders. If it is time to get out, I want my orders sitting in the market in advance, so no judgment comes into play—price will take me out at my stop profit order or at my limit buy order. All I have to do is analyze price as it unfolds and then adjust my money management orders accordingly.

Price continues to head straight lower because those waiting for a pull back just can't find one to get short! One by one, they get dragged into this market and that pushes price in my favor.

After another fifteen lower bars of similar range, price again consolidates around the Median Line, leaving a small spike high and then making a new low for the move. In reality, these are mini-swing highs. But I have so much profit in this position now and these mini-spikes are the largest pullbacks price is exhibiting, so I have to use them to box in profits.

Price leaves a new swing high again once it makes a new low for the move, so I snug my stop profit order from 116 19/32 down to 116 2/32. Remember my limit buy order is at 115 16/32, so I am getting close to the point where one or the other will be filled. But it won't matter which is filled now—either order will leave me with a huge per contract profit.

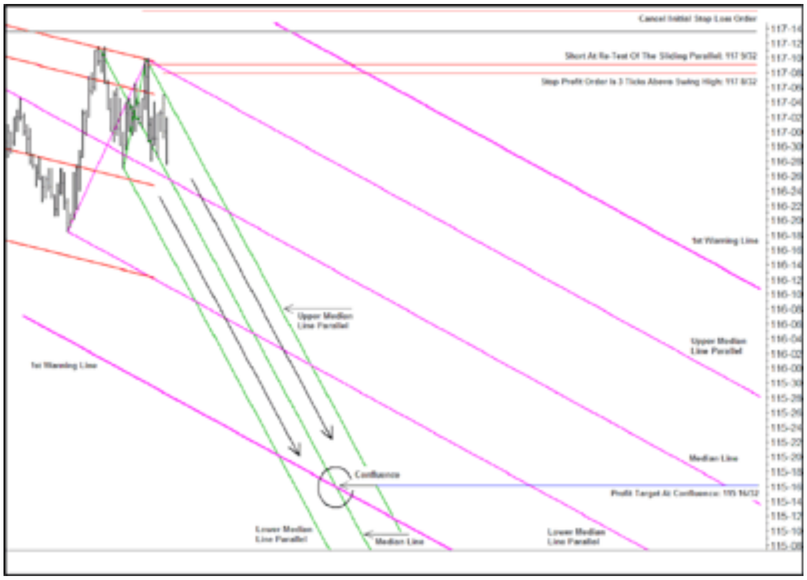


Prices climbs a bit higher and tests the green down sloping Upper Median Line Parallel again but it contains price and the decline begins again—if you look close, you can see price came within one tick of my stop profit order but the traders waiting on the sidelines still trying to short this market had enough limit sell orders to halt the move to the upside before it reached my stop profit order. Always use the protection of market formations if they are available because you get the added protection of traders trying to enter in the direction of the prevailing trend—and remember, you get a 10-12 percent edge when trading with the prevailing trend!

Once the Upper Median Line Parallel acted as solid resistance, price turned lower and made a new low for the move about ten bars later. And a few bars later, price traded through my limit buy order at 115 16/32, filling my profit order. I quickly checked that I was flat and working no further orders and that I had bought and sold an equal number of contracts. Then I did a mental calculation of what I should of have made on the trade—roughly $1800 per contract before brokerage—and I made sure my electronic platform showed a similar amount per contract.

Remember, if there is an error, I want to find it now, while I am close to the current price, not in the morning when price could be anywhere! It's too difficult to find and execute such a nice trade to give profits away on errors.

Now let me show you one last thing about this trade. There's another characteristic to a chimney formation that you have to keep in mind when trading them:



Once chimney formations have reached their targets, they tend to head in the opposite direction in the same 'near vertical' fashion, so the use of tight stop profits to box in profits is essential when trading these formations. If you get a good amount of profit in your position, you need to be protected at all times in case you were incorrect about the chimney's final target.

Looking at the chart above, you can see the price recovered nearly 2/3'rds of its downward move as traders that had chased price lower and gotten short at poor entry areas were forced to peel off their short positions at a loss. As price traded back higher in the chimney formation, the stop loss buying began to feed upon itself, driving prices higher and higher until the market finally reached equilibrium.

Always use stops! And always use proper money management to box in profits as they unfold—if your capital is at risk, you need to be paid!

I wish you all good trading.

Best,

Tim Morge

tmorge@sbcglobal.net
www.medianline.com
www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
Web sites: www.marketgeometry.com or www.medianline.com