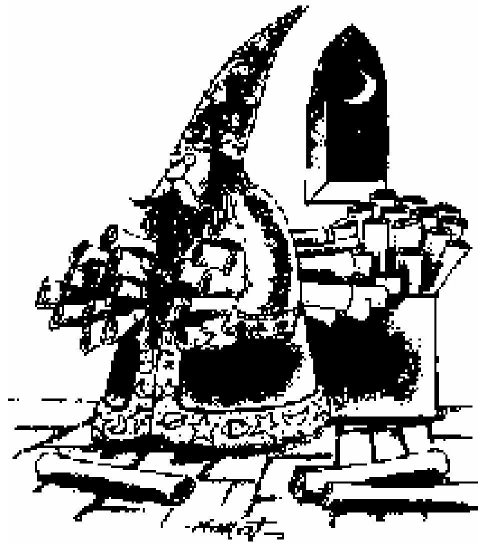
Chapter 11

COMMON SENSE TRADING

This trader is ready to go.



Trading Wizard

Yes, he has all his tools in place. Just look at all those charts. What's more, he may have found the secret of trading by the moon. If not that, surely he has worked out something using the stars. Just look at the magical data symbols on his hat and the fringes of his coat. From the look of it, he has been at it all night. The charts stacked in the back may be part of a black box system. In fact, as you can see, the box is at least partially black, isn't it? Here's a quote from an issue of a well known Wall Street periodical: "Black box trading systems are dead. Old-fashioned human brain-work and intuition are the keys to success." This is a direct quote from the manager of one of the most successful hedge funds.

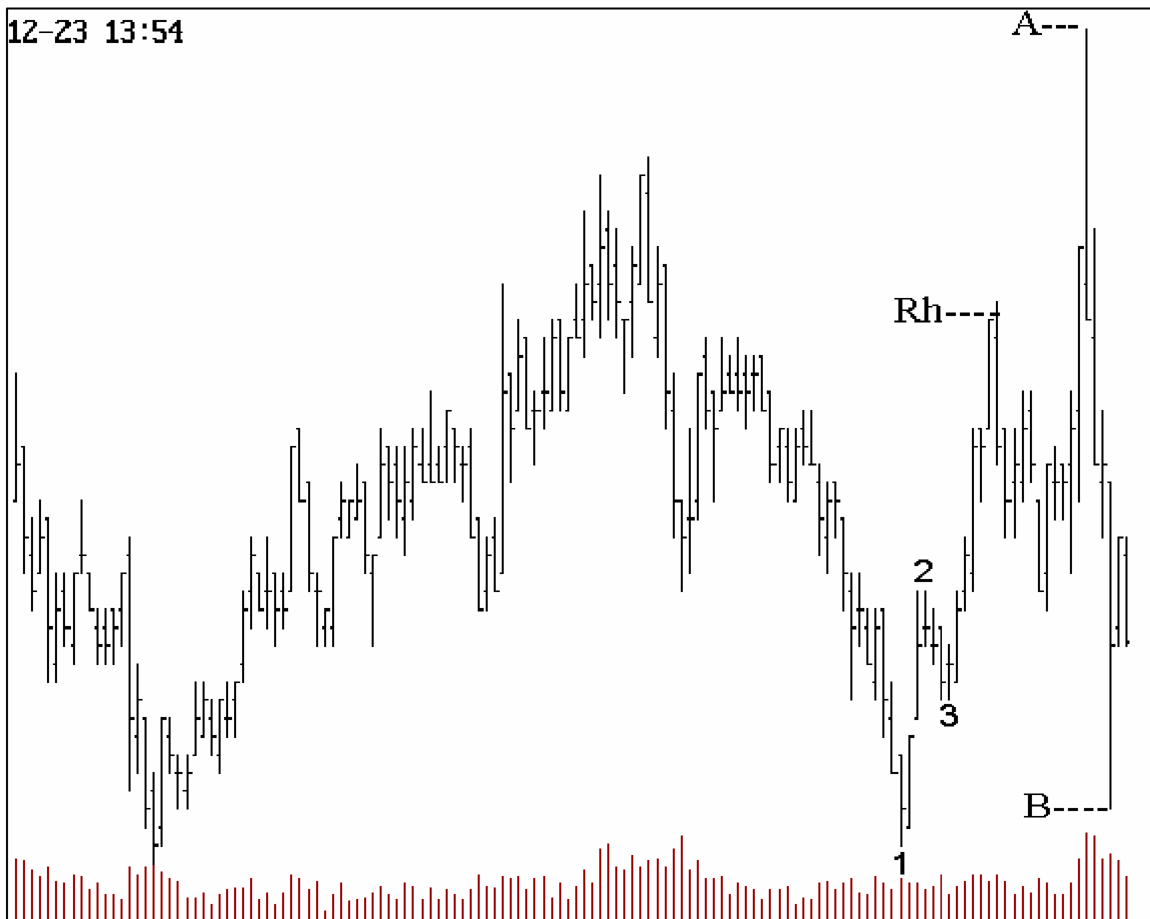
Now ask yourself, "If the smart money knows that mechanical systems don't work, why don't I?" Many managed commodity pools which trade mechanical systems get the stuffing beat out of them every year. Conclusion: mechanical systems, trading models, even neural nets may not work when the trading gets rough. Neural nets, which have had some degree of success, can be lethal when given too little or too much training. It is difficult to find a correct balance. Even then, human intervention is the only way these nets can be optimized. Left to themselves, they make too many mistakes. They will, when left alone, fail to time trades correctly, and also compute incorrect valuations.

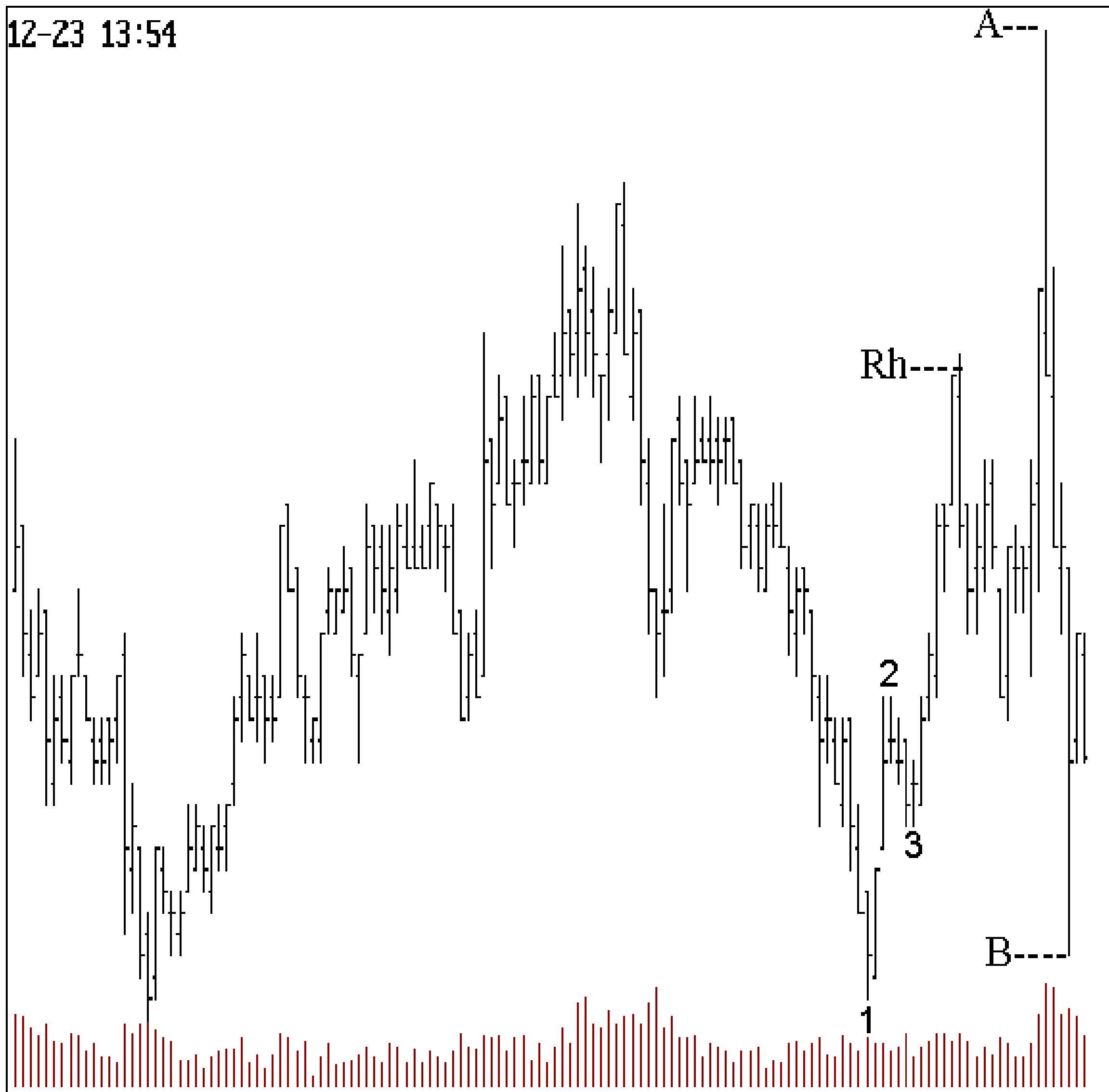
We recently received a call from a broker who is also a system developer. He said, “I really like your stuff. You are right about systems, they don't work. I think you have something to offer that no one else teaches, common sense.”

MORE COMMON SENSE

We have said and written many times that during the last two weeks of the year one should avoid trading futures, especially one or two days before Christmas, and again one or two days before New Year’s day. While long options may be okay to trade with great caution, futures become far too dangerous. One year we determined to watch for and capture an example of why we avoid trading futures during the holiday season, or the day before any holiday throughout the year.

In the example that follows and the chart below, you will see what can happen when a market gets thin, i.e., illiquid.





On December 23, this normally very liquid market did a very strange thing. With no economic justification, and rather suddenly, the price of the underlying leaped upward, traveling in a matter of a few minutes to the high you see marked "A." Almost immediately, the market turned and plunged downward from "A" to "B" in less than 15 minutes. Now for the rest of the story.

The only traders around at the time were the public trading from their computers, and a few of the market movers and insiders. The latter decided it was time for them to take home a nice Christmas present for their families. In what was no doubt a coordinated collusion, they ran prices up to the high at "A" taking out any and all stops between

the beginning of the move and the high made at "A," and then they guaranteed themselves even greater profits by running everyone out of the market on the way down from "A" to "B."

Now you may think that you would have been clever enough to have placed a buy stop just above the area of the Ross Hook (Rh) and once long, have taken profits and gotten out when you saw the market failing to go higher. Here's the sad news: Other than stops already in the market, the locals were not filling outsider orders. You would have gotten an "unable" on your exit stop. The market was said to have been “fast,” and the market movers would never have let you out until prices reached close to or at the level of "B."

This kind of stop running and "market fun" can happen in any market when it is thin. Oh yes, the daily chart (not shown) looks just like it would on many other days, but the intraday action was murder. A lot of people were going to have a dark Christmas. Plenty of money was lost to the market movers on the maneuver that took place that day. That was true seasonal trading by the insiders. It was open season on any outsider who was foolish enough to be trading that day.

One other item that comes up from time to time is the alertness one needs to have towards report days and other events which can and often do affect certain markets. One such event occurred in the realm of presidential speeches and it had an immediate and definite impact on the financial markets. The stock index futures in particular had a strong reaction to a speech declaring that there would be a middle class tax cut. War and rumors of war also greatly affect markets. During periods of great tension, virtually any report can greatly move a market.

You must ask for and obtain a calendar from your broker or from any exchange on which you trade. These calendars contain important notice dates for futures and futures options traded at the various exchanges. You must also realize that these calendars are not always accurate. Quite often report notices are missing from them. We use two different calendars at Trading Educators, but at times they are not in agreement. More often than not, the calendar we obtain **FREE** from the exchange is more complete than the cheap piece of junk put out by many brokers.

However, either or both can be missing certain supposedly recurring reports that appear one month and fail to appear in the next. Certainly, speeches by presidents, chairmen of the Federal Reserve, Federal reserve governors, foreign dignitaries, loose-mouthed congressmen, and other events which may rupture or explode sector stock prices, do not appear in the event calendar.

You must always look out for your own affairs. Even though it was not noted on a calendar, the fact that a president was giving a much publicized speech about a tax cut should have put on guard anyone who trades in financial markets. The President's topic and words were sufficient for his speech to have been treated as a report. The markets had a strong reaction to what he said.

An easy way for you to tell whether or not something may have happened that would affect the stock index markets is to look at both the currency and interest rate markets ten to fifteen minutes after they have opened. If you see that the currencies have made a significant move prior to the opening of the stock index markets, then take that as your cue. In other words, use common sense. It is, after all, your money. Also look at T-Bonds and Eurodollars. If either have had a significant move prior to the opening of the stock index markets, trade with caution. On report days certain stock indexes often undergo wild gyrations. On a day when a report causes a large move in one of the other markets, some stock prices may also reflect such a report.

But what about other markets? Is there a way to tell what is going to be in the various reports? Is there a way to be forewarned? At times, yes! And at times, there is even something you can do about it!

Quite a few years ago, when the bonds commenced having an evening trading session, we began to notice that there was often an unexpected amount of direction, activity, or both, in the bond market the evening prior to a report day. It was not always the case, but it was sufficiently often for us to suspect something none of us would like to believe.

But as much as we don't enjoy thinking of the crookedness and deception extant in governments and markets, one would have to be

truly naive to not realize that there exists a great deal of corruption and dishonesty in today's markets.

It became obvious that there were persons with foreknowledge of the content of major reports, and those persons were trading on that knowledge during the evening trading session of the bond market. The evening session provided them with a wonderful way to sneak in during the night when most traders are not watching.

What we noticed in the evening session of the bond markets is also true and can often be seen if one charts the price action of financials traded in the Globex session of the Chicago Mercantile Exchange. You can sometimes see the corruption taking place during the night in the S&P 500 E-mini futures contract. But then isn't that the traditional time frame within which most thieves do their work?

If you see that a lot of action has taken place during the night session and early morning trading, be alert. Be on guard to protect yourself.

You have a responsibility to look out for yourself. This is hardly a stable world and anything can happen to cause the markets to go berserk at the open.

Those of you who have access to such data should learn to watch the early stock index trading that takes place prior to the opening of the stock markets. You must surely check that every day that you trade. If a major move is going to take place in the S&P 500 stocks, you may see it in the trades that occur prior to the opening of the day session of the stock index futures markets.

We want to interject a cautionary note: A lot of books and seminars are touting the value of using the full-size S&P 500 futures as a trigger point for engaging in short-term intraday trades in any of the mini contracts. This is an extremely amateurish approach to trading. The correlation between the mini index you are seeking to trade and the movements in the full-size S&P 500 may be very slight. There are many days when the minis go their own way. We have seen and experienced a great number of traders, who because they really don't understand how to trade, attempt to use movements in the full-size S&P 500, and who ultimately lose a great deal of money. The

movements in the S&P 500 can experience a far greater magnitude of fakery than do the movements in the minis.

Nor does it pay to watch movements in an individual stock or stock sector, which have at the very least the governor of supply and demand which keep their price movements somewhat in check. This is not true of the S&P 500 futures. We have been told that in one particular book there is an account about a strategy of following the full-size S&P 500 to day trade. The author bases one of his winning examples on trading that took place in mid August of 1997. Apparently the author was ignorant of the fact that volume during that month and the next had dried up to a point never before experienced in the S&P 500 futures, and that a move of the magnitude of well over 800 ticks ($4,000) had occurred much to the dismay of the principals in the S&P 500 trading pit. This excessive large single move was followed within days by a single move of well over 500 ticks ($2,500). An 800 tick move in the S&P at the time these trades took place was valued at $50 x 800 or $4,000 per contract traded. In other words, a trader buying a 10 lot in the S&P suddenly found himself $40,000 dollars poorer when the market ticked lower by 800 tick points literally in a fraction of a second. Amazingly, within a short time most of the loss was recovered. But pity the poor futures traders who bought just prior to that one 800+ tick meltdown. If you are willing to key your mini trades from the S&P 500, you may be in for a shock. There are much better ways to trade. Mainly, learn how to read a chart, and in particular, pay attention to the chart of the mini index you are trading.