Tuesday, January 25, 2022

amFX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230

Poor quality flash photography was the original laser eyes

Current Views

Long 03FEB CADJPY 90.00 put
Spot ref: 90.80 /// Price 75 pips

Take profit 88.65

Hitting the trifecta

It is rather unusual for the NASDAQ to drop 4% or more and close positive on the day. Here are the prior instances since 1999 and what happened after.

NQ performance x + # of days after (-4% intraday, close positive)

	x+1	x+3	x+5	x+10	x+20
3/20/2000	4%	8%	9%	-6%	-22%
5/22/2000	-9%	-6%	3%	9%	18%
10/26/2000	0%	2%	2%	-6%	-15%
12/26/2000	1%	-4%	0%	-4%	3%
1/8/2001	0%	8%	8%	16%	6%
2/23/2001	2%	-8%	-10%	-13%	-19%
11/12/2001	3%	4%	6%	5%	7%
6/26/2002	3%	-3%	-3%	-4%	-15%
7/15/2002	-1%	-3%	-9%	-8%	-10%
1/23/2008	2%	0%	0%	-3%	-2%
10/10/2008	12%	-6%	0%	-10%	-3%
10/23/2008	-5%	3%	6%	-2%	-21%
11/13/2008	-7%	-5%	-18%	-5%	-3%
12/12/2008	-2%	1%	0%	-3%	-1%
11/9/2016	-2%	-3%	-1%	1%	1%
3/19/2020	2%	3%	7%	4%	18%
1/24/2022	-2%		???		
Average	**0.0%**	**-0.5%**	**0.1%**	**-1.8%**	**-3.7%**
Median	**0.6%**	**-1.3%**	**0.4%**	**-3.6%**	**-2.5%**

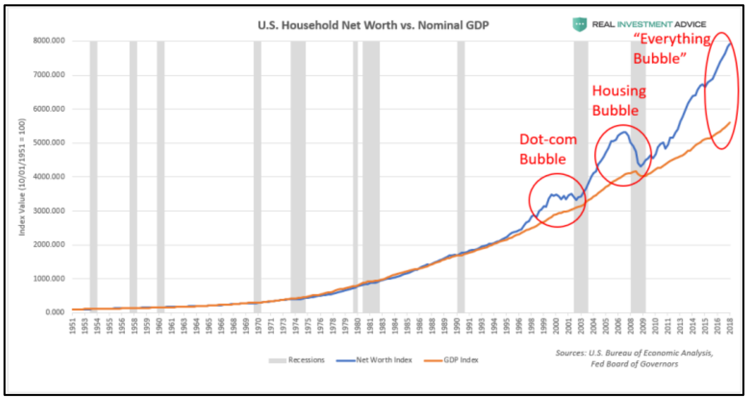
Now interestingly, Bloomberg ran a quick story that comes to a completely different conclusion. For full transparency, I present it here, but to me, it smacks of overfitting / datamining as their parameters are:

1. NASDAQ down 4% or more and close positive (same as my condition)
2. Daily RSI < 30
3. Bearish prior candle with close below day's open
4. Bullish candle on signal day

Their sample size is five occurrences, so I like my study better given the larger sample and simpler parameters. I tried to contact the reporter to see why he chose those specific parameters but haven't heard back yet. Thx JW for sending me the story.

Why it is so hard to time a bubble

Many people have been calling for a crash in stocks since 2010 or 2013 or 2017 or whenever based on various charts such as Household Worth vs. GDP. Like this one:



https://realinvestmentadvice.com/why-u-s-household-wealth-is-in-a-bubble-part-1/

That chart is convincing! But it was making the rounds in 2016 and 2017 and 2018... The everything bubble has been a worry since at least 2014!

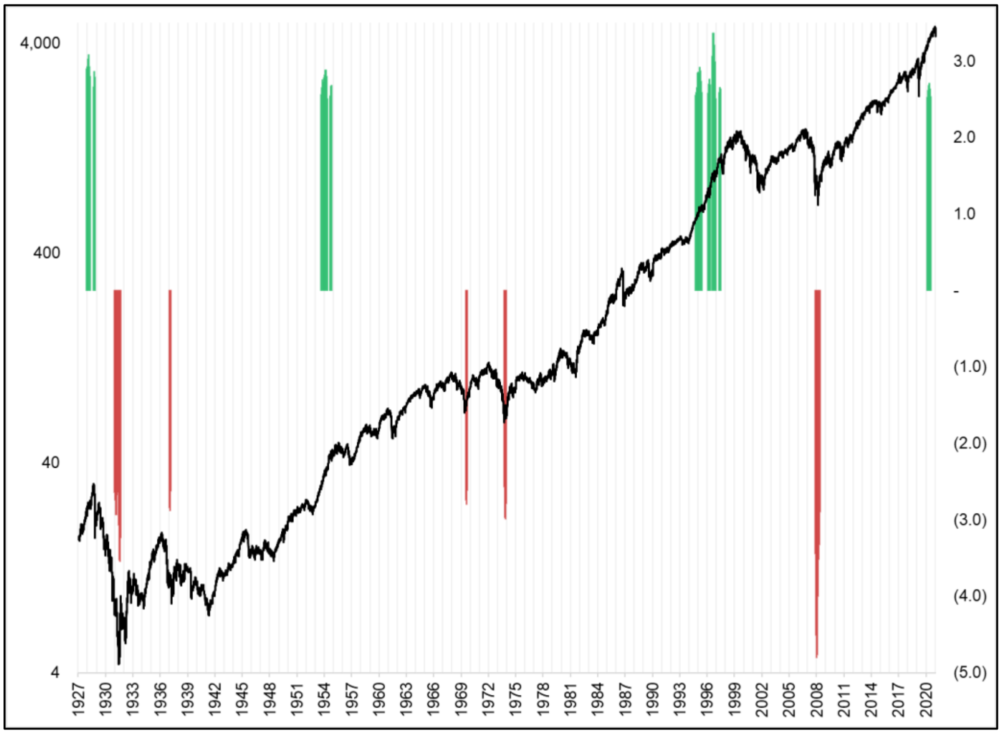
https://www.nytimes.com/2014/07/08/upshot/welcome-to-the-everything-boom-or-maybe-the-everything-bubble.html

Look at the track records of asset managers focused on bubbles, and you will see that writing about bubbles is great for clicks but not great for returns. The reason is: it is fiendishly hard to time a bubble and if you’re off on the timing, you miss generational bull markets. People believe they will know it when they see it, but they usually see it a few years too early and by the time it pops, they have gone broke on shorts, bled half their AUM due to underperformance, or stopped into longs at the ding dong highs.

Here are all the times SPX was above or below its 1-year moving average (252 days) by 2.5 standard deviations or more:

S&P 500 (log) since 1928

Green bars are when SPX is more than 2.5 SD above the 252-day MA
Red bars are when SPX is more than 2.5 SD below the 252-day MA



Right y-axis is standard deviations. Left y-axis is S&P 500 (log)

You can see a few things here:

1. If you define a bubble as 2.5 SD above trend, stocks were in a bubble for four years from 1996 to 2000. This sounds silly at first, but remember, Greenspan issued his infamous "Irrational Exuberance" comment in 1996! Here's an excerpt from a December 6, 1996 CNN story:

   Investors were rattled by a familiar lightning rod: Fed Chairman Alan Greenspan. In a speech Thursday night, the powerful central bank chief warned that "irrational exuberance" in the stock market was reason for concern. Greenspan struck a nerve by suggesting that Wall Street is riding a speculative bubble.

2. People criticize the Fed for not recognizing bubbles but they tried once and it didn't go very well!
3. If you sold in December 1996 because you thought it was a bubble like Greenspan, you never had a chance to buy lower, even during the bear market after 2000 or the crash of 2008.
4. BUT… If you bought in 1998 or 1999, you were underwater for 10 years.
5. Bubbles are dangerous for bulls and bears.
6. The high-quality actionable signal is not the bullish bubble but the fear extremes. The red bars are when the SPX was 2.5 SD below the 1-year MA. Those signals were useful.

My 2.5SD measure is overly simple but the point remains: people love to call bull markets bubbles and most bull markets are not bubbles. **The reputational and financial gains that come from correctly identifying and timing a bubble are enormous and that is why people are so attracted to the challenge.** But it's a tough game to play. Fortunately, as traders, we don't need to commit to one side or the other and lock in for years and years. We can be aggressively Bayesian and adapt to changing conditions over time.

The best traders make the most money in the highest volatility environments. Volatility is great for trading. Even in a crash year like 2000, we made tons of money from both the long and short side as the selloffs were epic, but the rallies were colossal too. The best way to trade this sort of market is with an open mind and max flexibility. Strong views weakly held. I put a short and relevant excerpt from Alpha Trader in the appendix at the end of today's am/FX (How to Trade Fast Markets).

What now?

My view for the past few weeks has been you can't be long risky assets until we get a fear trade exemplified by at least two of the following three outcomes:

- Crypto down 15% in one day. CHECK
- VIX at 35 CHECK
- NASDAQ down 5% in one day. CHECK

Three out of three! Hard to stay bearish after that kind of capitulation move but also as you can see from the grid on page 1, high volatility is not bullish, on average. **The nailing of the fear trifecta means that my "No Fear" hypothesis has now expired. We got the fear.** Now, I want to keep an open mind, see what happens with the Fed, and look forward, unbiased. Once month end is out of the way, there could be a nice short USD trade, but it's WAY too early to think or write about that. I'll write about it Monday if I still feel the same way.

Finally, I am sticking with the CADJPY short because I believe the Bank of Canada will not hike tomorrow and because my best guess is that stocks are now finding a 4250/4400 consolidation zone in the S&P. A consolidation in stocks and a "no hike" from the BoC should be the right formula for CADJPY lower still. My confidence on BoC is not SKY HIGH but I think the event is 30/70 for a hike and the market has it priced 70/30 so it's a decent EV bet to take the other side. Take profit (cover delta) at 88.65 cuz we're running out of time.

TT is a meme

It is amazing to watch the Turnaround Tuesday phenomenon turn into a meme and move to the left so the last two have been on Monday afternoon! This is classic efficient markets hypothesis by the way. When a phenomenon becomes well known, the market front runs it and the effect moves left (earlier). This has happened with the month end flows in FX as well. Have a laser-focused day.

good luck ⇅ be nimble

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https://twitter.com/donnelly_brent/status/1485296713921449987?s=20

APPENDIX: Trading fast markets

From Alpha Trader

Markets alternate between order and chaos. Chaotic markets (often called "fast markets") generate temporary inefficiencies and outsized opportunities but also tend to be short-lived, dangerous, and volatile. Order and equilibrium are the market's default state, but when chaos arrives, so does disequilibrium. Dislocations present the opportunity for traders to capture abnormal returns. Fast markets are high risk and high reward. Here is a primer on trading fast markets.

Trading fast markets

In World War 1, there was a famous quote:

"Modern warfare is months of boredom punctuated by moments of extreme terror"[1].

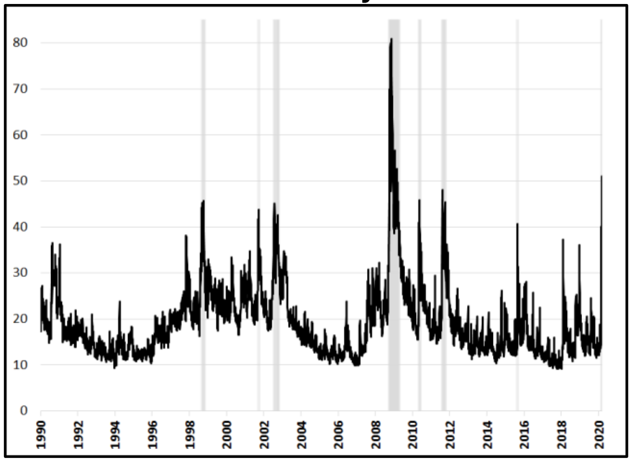
I would paraphrase here and say modern trading is hours of boredom punctuated by minutes of extreme terror. Things are quiet most of the time but what matters is how you act and react when the guano hits the rotating blades.

Crisis markets can provide the best opportunities for profit and the greatest chance of ruin. Markets can lay dormant for months, then go completely insane. A whole day can go by without excitement, then a headline hits at 4:00PM and everything boots off.

In this section, I discuss fast markets and, more specifically, trading during a crisis or extreme high volatility event. Trading crisis markets and trading idiosyncratic bursts of extreme high volatility involve most of the same skills and concepts.

It is usually easy to identify when a crisis is happening but for simplicity, I would say any time the VIX is above 40, that's a crisis market. Looking at all days since 1990, the VIX closed above 40 just 2.2% of the time. Here is a chart:

VIX marked with vertical bar any time it closed above 40



[1] https://english.stackexchange.com/questions/103851/where-does-the-phrase-of-boredom-punctuated-by-moments-of-terror-come-from

The vertical bars are all famous events in financial market history:

1998	Asian Financial Crisis, Russia Crisis, LTCM meltdown
2001/2002	September 11 / Dot com bubble burst
2008	Global Financial Crisis
2010/2011	Eurozone Crisis
2015	Energy crisis and China deval
2020	COVID-19 and Saudi / Russia oil price war

There is nothing special about the number 40, it's just a level we rarely see in the VIX.

When markets are in crisis, you need to trade differently. You need to be faster and smarter. The challenge is to be both more careful and more courageous at the same time. That is hard to balance! Fast markets are scary, but they are the best times to make money, and to truly excel at trading you need to crush fast markets.

Here are some tips to help you trade fast markets:

1. **Correct position size is the difference between winning and losing in a crisis**. Too big is not OK; you might blow up or get fired. Too small is not OK either; you need to seize the moment. Trading in fast markets is when the most money gets made and the alpha traders emerge.

   I remember as volatility went to the moon in 2008, I changed my normal trade size in USDMXN from 20 million to 3 million and I was still amazed (scared) by the volatility of my P&L. If you can size dynamically using forward-looking estimates of volatility, that is ideal. Look at what options markets are pricing for 1-week volatility. If you can't do that, look at the average daily range over the past 5, 10 or 20 days.

   As a rough logic check: for day traders, your stop loss should rarely or never be closer than within 1/3 of a day's range. For swing traders, use one full day's range. In other words, if you are trading Apple common stock and the average daily range over the past 5, 10 and 20 days is $25: day traders' stops should be $8 or more away from the entry point and swing traders stops should be at least $25 away from entry. This should be a good starting point in most markets.

   If you are getting stopped out and chopped up every day, your stops are too tight. A smaller position with a wider stop is necessary in crisis markets but you need to be mindful that you don't get so small that you are trading meaningless positions that won't move the needle on your P&L. Yes, a lot of traders get blown up in a crisis, but a lot just hide under the desk and reveal they are fundamentally risk-averse actors who are not really fit to trade moving markets.

Striking the balance between too big and too small is vital in trading and that balance can be the difference between crushing a crisis period or getting crushed by it.

2. **Keep an open mind and use your imagination**. When COVID-19 hit in 2020, the market took oil from $65 to $50 as concerns about consumer demand knocked a market that was already bulled up on "cheap" energy stocks. Then the OPEC meeting in early March crumbled and crude plummeted from $50 to $27 in a week. The pressure from COVID-19 started the ball rolling then the Saudi pledge to pump like crazy broke the back of the oil market. Anyone watching oil go from $65 to $50 might have thought that was enough of a move. "It's a big move! I'm going the other way!" *Not a good plan*. Eventually oil went to MINUS $40. This leads to the next point about crisis markets.

3. **In crisis markets, there is no such thing as overbought and oversold**. Don't be the person that fades the whole bear market all the way down. In a crisis, stocks can stay oversold for ages and then get wildly overbought days later. You need to differentiate between run-of-the-mill risk aversion and crisis-level risk aversion.

   Most risky asset sell-offs are routine affairs that should be traded using sentiment and overbought and oversold signals. When you see put/call ratios or the Greed & Fear Index or DSI or whatever positioning indicators flashing a reversal signal, it is normally time to pounce. But in a real economic or financial crisis, these signals are useless.

   For example, there is a simple metric I use to calculate overbought and oversold which I call The Deviation, as discussed in Chapter 10. It measures the difference between the current price of an asset and the 100-HOUR moving average. As The Deviation gets to prior extremes, it can give a nice mean reversion signal. Here is an example using EURUSD:

EURUSD (top, black) vs. deviation from the 100-hour MA (gray, bottom)
September 2019 to January 2020

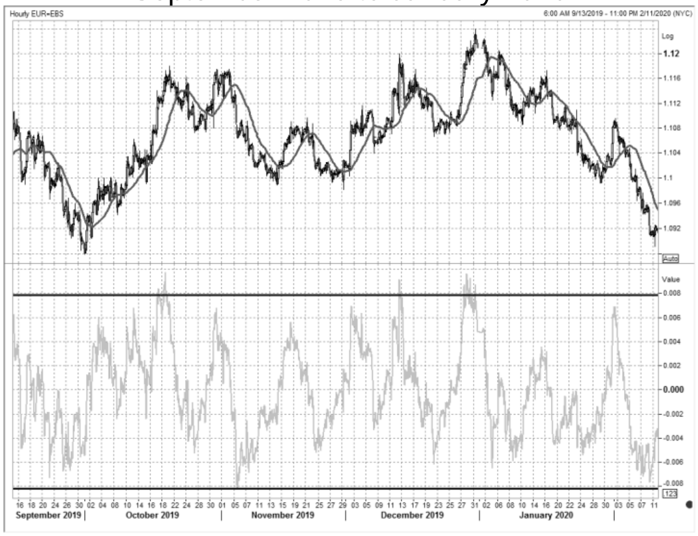


Chart courtesy of Refinitiv

You can see that The Deviation (the gray line in the bottom panel) oscillated consistently between -80 pips and +80 pips[2] over the course of five months and the overbought and oversold readings offered up some decent reversal trades. Then, the COVID-19 crisis hit and all hell broke loose. Now look at the same chart, adding February 2020:

EURUSD (top, black) vs. deviation from the 100-hour MA (gray, bottom)
September 2019 to January 2020

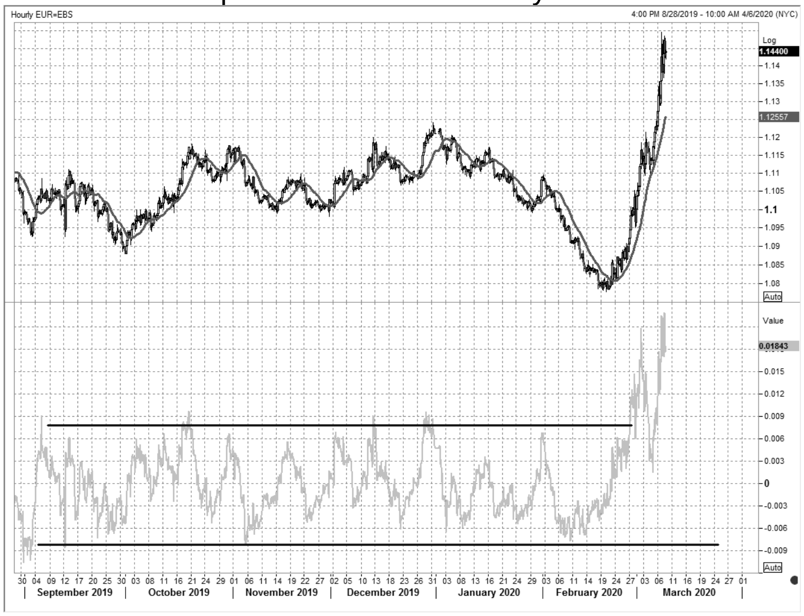


Chart courtesy of Refinitiv

As the crisis hit, the old measures of oversold were blown away as EURUSD ripped higher.

4. **Have courage.** Insane markets are the reason you got into this business. Don't hide under your desk and hope for the tornado to pass. Get involved and trade like you know you can. Don't put yourself in a position where you look back years later with regret. It is better to try and fail than to forever wonder what kind of trader you could have been.

   By the time the 2008/2009 Global Financial Crisis was over, careers were made and lost. Some of those lost were not people that blew up but just traders that sat there doing nothing while their peers extracted insane P&L out of thin air. Most of my best trading memories are from crisis periods because these periods deliver fast, volatile, and exciting markets.

   Like any high stress profession (pro sports, jet fighter pilot, professional poker…), it all comes down to how you respond in the periods of extreme stress. Don't be shy, get involved.

   Recognize when your product transitions from normal trading to a fast market and adjust your position size and trading strategies accordingly.

END

[2] See dark, horizontal lines. Note: 80 pips = 0.0080

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