

Fade-Self... One Trader's Commentary

Strategy

6 October 2005

"On The Rocks"

*"I have taken more out of alcohol than alcohol has taken out of me."
- Sir Winston Churchill*

*"I hate to advocate drugs, alcohol, violence or insanity to anyone, but
they've always worked for me."
- Hunter S. Thompson*

What do the above have in common?....And more importantly what do they have to do with trading? Well, first they were both entertaining and certainly colorful authors. Second, what do they have to do with trading...Nothing I guess. Except I was thinking about all the things I've seen clients do and try to do in the futures markets that made me question- A. Their sobriety, and B. Their sanity. Trading and the emotions that tend to go along with trading highly leveraged assets can make people do some terribly irrational things. Ok, so you were stopped out on the low of the move and the market proceeded to rally back and you WOULD HAVE made a huge profit....nobody's out to get you...or you're 1 lot. It's the function of the market- sometimes stops get run. Weak hands get run out of the market by stronger hands. How do you avoid it. No, not by NOT USING STOPS! You simply jump back in. Admit defeat. But enjoy the fact that you lived to trade again. And by the way- Egomaniacs- shouldn't stay away from the futures markets too- nobody is larger than the market. If you're making money on a trade- DON'T REVERSE! Unless you're Soros or Goldman- you're not going to turn the market all by your lonesome. Play the percentages- stay with the trend- and in trading swallow your pride once in a while. That way, you see, in 5 years you'll have a futures trading track record- instead of a horror story.

Equities- S&P 500 On The Rocks

7 days ago we wrote- "I think we will see a solid pullback in the S&P to 1170 in the next month. That would be 60 points." We considered that a fairly bold prediction. Well, the last trade in the December S&P was 1209.00 and falling. 1603 in the Dec. Nasdaq. It's 11:15 on Wednesday and we've fallen 23 points in the S&P in the last seven trading hours. That's nearly half the move I was looking for. I hope you sold calls if you're long. If not, I'd cut your losses. We could be in for a dreary October.

Treasuries- Red Bull/Vodka

Interest rates have gotten a Red Bull like pick me up in the last few weeks. Regarding the 10-Year Note- last week I wrote that, "I'm selling it. I think you'll see 110.00 soon and over the next 3 months you'll see 102.00. Each point is \$1000. Each tick is \$31.25." If you'd opened your account that day and that was your first trade- you'd be up 19 points by now ($19 * \$31.25 = \593.75). On 2 contracts you'd be up 1.2% in your first week. That's just the bottom line. There are no guarantees in trading- you're not going to make money every time you trade.

I look for the Fed to continue to raise rates 25bp's each meeting. Even at 5%- if inflation is rising- real rates are still very accommodative. Remember, nominal rates are meaningless- always focus on real rates (Nominal- Inflation = Real.) I would look for bonds to accelerate lower rapidly when the Fed actually PAUSES their rate hikes. This would mean that they believe that inflation is no longer a worry and that rates can be left at a neutral level (wherever they deem rate neutrality to be.) Following is actually a chart of the March 06 Eurodollar contract. (Keep in mind this is essentially the 3-Month LIBOR rate.) To determine the interest rate that this contract implies- just subtract the price of the contract (.9545) from 1.00. ($1 - .9545 = 4.55\%$ implied interest rate for 3-Month LIBOR by next March.)



Metals- "The Silver Bullet"

There is a 90% chance that December Silver will trade \$8.03/oz in the next 6 weeks. Write it down. (or buy a contract, sell a put, buy silver coins, call your monex dealer, or go up in your attic and raid it for family heirlooms to pawn.) Just pay attention to what I'm saying. I mean come on- have I ever lead you astray? Silver has consolidated long enough- now its showing strength in the face of a dollar rally- time to get aggressive. As for Gold- hedge your longs by selling \$480 December calls. We could be in for a quick pullback in the next week or two to the \$450 level if we do move lower keep adding to your position. The trend is strong. What about copper? What about it- keep buying it. \$1.82 last and moving higher. It is volatile- you could lose 5 cents in a day- but as long as you can weather it- don't sweat.

Energies- "Gasoline"

Apparently, the name for a whiskey and water is Gasoline. I'm not a big fan of the drink or the market right now. I think we could quite a bit lower very quickly as the uncertainty of Katrina and Rita fades. I'd say you'll see \$1.75 again in the next week. Crude will also be taking a bit of a breather in the next week- as we will likely pullback to at least \$60.50. That would be another \$2500 per contract. I think that will present another solid buying opportunity. Don't get me wrong- I'm still very much a long term bull in the crude and distillates, however Natural Gas is the main bull play right now. One contract purchased last week at this time would have yielded an opportunity to make \$1.36 (\$13,600 per contract.) The natural has nearly tripled in price in the last year. Of course, a special disclaimer should be applied to the natural gas market. First of all, the margin on a contract is \$18,000. To put that in perspective you could pick up 35 Dec. corn contracts for the same amount of capital. I require at least \$75,000 (or 4 times required margin) for anyone to trade natural gas on my desk. It is simply untradeable with any amount less. This is a market that you can count on seeing \$5,000 to \$10,000 swings every day. On the stock side- I would certainly suggest buying natural gas companies as a proxy.

Currencies- "Oktoberfest"

If you're planning a trip to Germany I would rejoice because I think you'll need less Euro to enjoy the festivities. Dollar strength and Euro weakness could reach levels we haven't seen in nearly a year. I'm currently short the Euro and Pound with November puts written against. It's possible you could see 115.00 in the Euro before the New Year. That would be about 171.00 in the Pound and 73.00 in the Swiss Franc. Perceptions of higher inflation can be witnessed in the fact that Gold (which has been negatively correlated to the dollar for the last three years) has been rallying and bonds have been breaking. Whether inflation is really a budding problem or not- is not the issue. It is perceived to be a problem and therefore is self fulfilling. That means that the dollar will gain strength because the interest rate differential between it and other major currencies will widen. This will continue until actual inflation does develop (as witnessed by a shift up in wage unit labor costs.) When that happens the real interest rate differentials will narrow because investors will require a premium nominal rate to compensate for the loss of return to actual (not perceived) inflation. Got that? No? Well, just buy the dollar, buy gold, sell the bonds, and sell the Euro.

Fade-Self (fād-sɛlf) verb.

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

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