CHAPTER 1

The Argument for a Sentiment-Based Approach

At its core, sentiment is a general thought, feeling, or sense. In free markets, sentiment refers to the feelings and emotions of market participants. All of the participants' feelings toward a specific market result in a dominant psychology that is either optimistic or pessimistic. Every change in price results from a change in the balance between optimism and pessimism. Price itself is a result of where collective psychology lies in the never-ending oscillation between optimism and pessimism. As oscillation suggests, the psychological state of a market experiences peaks (optimistic extreme) and troughs (pessimistic extreme). These sentiment extremes are what affect market tops and bottoms.

In the 1932 edition of Charles Mackay's classic *Extraordinary Popular Delusions and the Madness of Crowds*, Bernard Baruch wrote in the foreword that "all economic movements, by their very nature, are motivated by crowd psychology." Baruch went on to write in the same foreword that "without due recognition of crowd-thinking (which often seems crowd-madness) our theories of economics leave much to be desired."[1] It seems that so many, if not most, of the members of the financial community seem to forget these basic truths. Analysts, traders, and financial media members attribute reasons to price movements with an uncanny ease.

For example, "The government reported a larger than expected increase in the number of jobs created, which supported the U.S. dollar." Forget that the same report one month earlier indicated that fewer jobs were created than expected . . . and the dollar rallied anyway. On that day, the headline probably read something like this: Dollar Rallies Despite Downbeat Jobs Report. These examples are hypothetical, but if you follow the currency market, you have undoubtedly witnessed similar inconsistencies in financial reporting. How can the movement of a currency be attributed to an outside event such as the release of an economic indicator one month when the same currency and same economic indicator show absolutely no relationship in other months? If a relationship exists only some of the time, then by definition there is no consistent relationship. Yet, the majority of market participants base trading decisions on economic indicators anyway. Why? Even though the approach is suspect, it is conventional and popular and humans like to be with the crowd, even if they are wrong. It is much easier to be wrong in a crowd than be wrong by yourself.

Baruch also wrote in the foreword of *Extraordinary Popular Delusions and the Madness of Crowds* that:

> *Entomologists may be able to answer the question about the midges and to say what force creates such unitary movement by thousands of individuals, but I have never seen the answer. The migration of some types of birds; the incredible mass performance of the whole species of ocean eels; the prehistoric tribal human eruptions from Central Asia; the Crusades; the mediaeval dance crazes; or, getting closer to economics, the Mississippi and South Sea Bubbles; the Tulip Craze; and (are we too close to add?) the Florida boom and the 1929 market-madness in America and its sequences in 1930 and 1931—all these are phenomena of mass action under impulsions and controls which no science has explored. They have power unexpectedly to affect any static condition or so-called normal trend. For that reason, they have place in the considerations of thoughtful students of world economic conditions.*[2]

The last example that Baruch cited, the 1929 stock market crash, may be on the verge of repeating as I write this book in late 2007. The herding instinct is a fact of human nature and manifests itself in all our speculative activities; whether real estate, stock markets, or currency valuations. Markets move in trends but reverse at extreme levels of bullishness (tops) and bearishness (bottoms) as English economist Arthur C. Pigou explained: “An error of optimism tends to create a certain measure of psychological interdependence until it leads to a crisis. Then the error of optimism dies and gives birth to an error of pessimism.”[3]

This is the rule in all financial markets, where man’s impulse to herd creates extreme and unsustainable levels that ultimately lead to a reversal. Markets always overshoot and do not seek equilibrium as the Efficient Market Hypothesis (EMH) would have you believe.

A popular (if not the most popular) model used to trade foreign exchange (FX) among retail traders is based on economic indicators. Under this approach, a trader will buy a country's currency if the news of that country is considered good. If the news of a country's currency is considered bad, then the trader sells that country's currency. This model assumes that EMH governs markets because it assumes that market participants will make objective trading decisions based on rational thought (buy if the news is good and sell if the news is bad). However, market participants do not make objective trading decisions based on rational thought; they make subjective trading decisions based on emotions. If you have ever traded FX, then you know this because you have witnessed a currency rally that followed a worse than expected jobs report or an increase in that country's trade deficit. Still, the news was explained in order to rationalize the market movement. If explaining the news in order to rationalize the market movement proves too difficult, then the market move is often attributed to a "technical" correction or something similar.

This is not to say that news and economic releases are unimportant. It is imperative that you know *when* the releases occur because volatility spikes during these times as a great number of traders are involved in the market. Sometimes the correct move is to fade the initial reaction. For example, you are a sentiment-based trader and your analysis indicates that sentiment is turning from a euro bullish extreme. After a supposedly bullish euro new release, the EURUSD spikes 50 pips, right into a resistance area. Your bigger picture analysis suggests that the best move is to sell this rally. Sure enough, the EURUSD retraces all of its post news release gains within a few hours.

How do we know for certain that herding occurs in financial markets and particularly in FX? This book is dedicated to proving that it does occur in FX and to showing how you can take advantage of it. If markets were truly governed by the EMH model, which is the foundation for more conventional approaches to trading FX (such as the economic indicator model), then why do most news headlines and stories about a currency appear when that currency is at an important top or bottom? Why are those headlines increasingly optimistic as price rises and increasingly pessimistic as price declines? Why do more speculators buy as price increases and sell as price decreases? This last reality runs contrary to traditional economic supply and demand models that demand decreases as price increases. The only explanation for such behavior is that speculators are not thinking rationally when they make trading decisions. If they did, then a greater number of traders would buy low and sell high. What really happens though is that most buy high and sell low. The result is that most traders (probably 90 to 95 percent in FX) lose money and only a select few make a lot of money. If you understand this concept, then you can exploit it and be one of the few that does make money.

WHAT IS FUNDAMENTAL?

Anyone who is any good at anything will tell you that preparation is just as important, if not more important, than whatever it is that you are preparing for. Successful actors research their roles before filming begins. Sports teams practice and watch films of their opponents before they play against them. Similarly, in order to trade successfully (especially in a highly leveraged market such as FX), you must have a plan, an approach. An approach should not consist of buying because an economic indicator was strong or selling because the same economic indicator was weak. You probably have gathered by now that I do not find value in traditional fundamentals. What is considered "fundamental"—primarily economic indicators—is not actually fundamental to price at all. The charts in Chapter 2 support this claim.

Although I lean toward a technician's point of view, a successful approach to market analysis and trading is not as simple as buying because price is above the moving average or selling because price is below the moving average. Trading is hardly this black and white. A grasp of what is really fundamental to a market's movement—sentiment—is the key to success in the game of trading and speculation.

TOP-DOWN APPROACH

The trader must process information (preparation) before making a decision (the trade). There are two approaches to processing information: *top-down* and *bottom-up*. When implementing a top-down approach, information regarding the big picture is gathered first.

Big picture is the sentiment backdrop as defined by analysis of indicators such as (but not limited to) the U.S. Commodity Futures Trading Commission's (CFTC's) Commitment of Traders (COT) reports. Does futures positioning indicate that the currency in question is at or is nearing an optimistic or pessimistic extreme? Is the financial media providing any signals? It may sound unconventional (because it is—which is probably why it works), but the financial media often provides exceptionally timely signals. It is just as important to know when a market is not extreme because sometimes the best thing to do is nothing; sit with the trade you have on and ride the trend. There is a time to be a contrarian, but it is less often than most think. Some traders are contrarians just to be contrarians; they are always fighting the trend and never make money.

After you feel that you have correctly gauged the psychological state of the market, it is time to assess your risk and time your trade. Knowledge of the market's structure is essential to this next step. All markets exhibit the same patterns, on all time frames. This is known as the Elliott wave principle, or simply the wave principle. In the 1930s, Ralph Nelson Elliott discovered that crowd behavior will trend and countertrend in recognizable patterns. Although he primarily studied the stock market, the wave principle can be applied to any freely traded market. The size of the FX market makes it a perfect candidate for an analysis technique based on crowd behavior. You will be amazed at the accuracy with which you can gauge support and resistance and forecast direction and the extent of the directional move with knowledge of the wave principle.

Traditional technical indicators such as moving averages and oscillators aid in identifying the trend but should be used as secondary tools to sentiment indicators and price patterns. After all, you are trading price, not the indicator.

The goal of this book is to provide the tools necessary for developing a top-down, sentiment-based approach to trading and speculation in FX. I refrain from providing specifics such as entries or risk control because these are aspects of trading that everyone will approach differently.

REMINISCENCES OF A STOCK OPERATOR

If there is one trading book that has had a profound impact on me, then without a doubt that book is *Reminiscences of a Stock Operator*, written in 1923 by Edwin Lefévre. The fictionalized biography of Jesse Livermore (some say that he actually wrote it), one of Wall Street's all-time great speculators, the story is told through the eyes of the fictional Larry Livingston. (Livermore was the inspiration for Livingston.) Livingston's experiences and related commentary ring true to the point that it is hard to believe that Livermore himself did not write the book. Regardless of who wrote it, the book is responsible for many of the trading adages that are so common throughout the trading community. When I hit a trading rut, because of bad habits or simply flawed thinking, I always go back to *Reminiscences* for a reread and it always helps. If you have yet to do so, I strongly recommend reading *Reminiscences*.

I have compiled a few quotes from the book that I believe capture the importance of sentiment in trading and speculation.[4]

Market Dynamics Are Timeless

"Another lesson I learned early is that there is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens . . . has happened before and will happen again."

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"Nowhere does history indulge in repetitions so often or so uniformly as in Wall Street. When you read contemporary accounts of booms or panics the one thing that strikes you most forcibly is how little either speculators or speculation today differ from yesterday. The game does not change and neither does human nature."

Translation: Sentiment has been, is, and always will be fundamental to price in any market. Price patterns that occurred 50 or 100 years ago occur now and will occur in the future. A market price is determined by fear and greed, which is manifested through the activities of the market participants; traders, investors, speculators, and the like. This will never change.

Human Nature

"But in actual practice a man has to guard against many things, and most of all against himself—that is, against human nature."

"I sometimes think that speculation must be an unnatural sort of business, because I find that the average speculator has arrayed against him his own nature. The weaknesses that all men are prone to are fatal to success in speculation—usually those very weaknesses that make him likable to his fellows or that he himself particularly guards against in those other ventures of his where there are not nearly so dangerous as when he is trading in stocks or commodities."

"The speculator's chief enemies are always boring from within. It is inseparable from human nature to hope and to fear. In speculation when the market goes against you hope that every day will be the last day—and you lose more than you should had you not listened to hope—to the same ally that is so potent a success—bringer to empire builders, big and little. And when the market goes your way you become fearful that the next day will take away your profit, and you get out—too soon. Fear keeps you from making as much money as you ought to. The successful trader has to fight these two deep-seated instincts. He has to reverse what you might call his natural impulses. Instead of hoping he must fear; instead of fearing he must hope. He must fear that his loss may develop into a much bigger loss. And hope that his profit may become a big profit."

"I have come to feel that it is as necessary to know how to read myself as to know how to read the tape."

"On the other hand there is profit in studying the human factors—the ease with which human beings believe what it pleases them to believe; and how they allow themselves—indeed, urge themselves—to be influenced by their cupidity or by the dollar-cost average man's

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carelessness. Fear and hope remain the same; therefore the study of the psychology of speculators is as valuable as it ever was."

"The principles of successful stock speculation are based on the supposition that people will continue in the future to make the mistakes that they have made in the past."

"The speculators' deadly enemies are: Ignorance, greed, fear, and hope. All the statute books in the world and all the rules of all the exchanges on earth cannot eliminate these from the human animal."

Translation: It is natural for humans to follow the crowd. Following the crowd is ingrained in our DNA and is a big reason why our species has succeeded to the extent that we have. Following the crowd, in a general sense, has helped us thrive as far back as when we were hunter-gatherers. We feel safer as part of a crowd. It is easier to be wrong as part of a crowd. However, in the end, the crowd is wrong in matters of financial speculation.

A trader's main competition is not other traders, but him- or herself. Most traders lose money because our emotional impulses act as a barrier to successful speculation. The only way to overcome this barrier is to be cognizant of it.

I am not sure that it is possible to better explain the role that the human factor plays in markets than with the above quotations. Not everyone agrees, which is fine. This is one view, but I believe it is correct. There are many out there who have enjoyed success approaching the game another way. You must decide which approach works for you.

The rest of this book presents a framework that you can use to gauge where the market of your choice is in the never-ending oscillation between optimism and pessimism; so that you can trade accordingly.