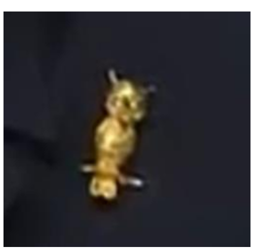
AM
FX

Brent Donnelly, Spot FX Trader
1 (212) 525-8469
brent.x.donnelly@us.hsbc.com

Good luck with ECB today.

Is the owlish outcome priced in?



Current Views

Flat

Thursday, March 12, 2020

Forexplainer #13

Trading Fast Markets

Welcome to Forexplainer Number 13. As I wrote on March 12, 2019 (AM/FX: Forexplainer 1): Once a month, around mid-month, I will publish a longer-form piece called "Forexplainer". Sometimes it is something educational I read elsewhere, and sometimes it is something I write myself. Thanks for reading.

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 trading is mostly boredom with the occasional period of terror. Things are often quiet but what matters is how you 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 the whole thing boots off.

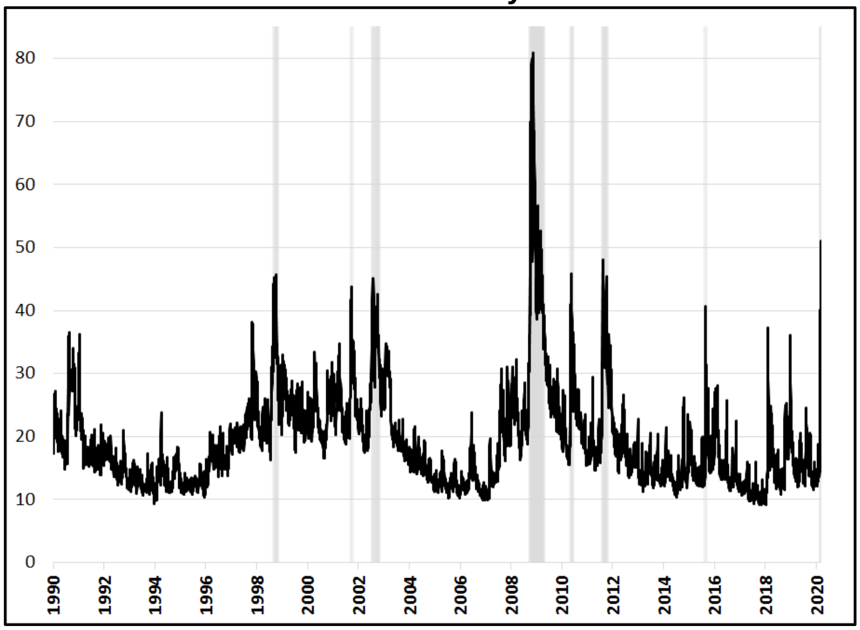
In this Forexplainer, I am going to talk about fast markets and, more specifically, trading during a crisis or extreme high volatility event. Trading crisis markets and trading idiosyncratic bursts of extreme high volatility involve most of the same skills and concepts.

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:

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

VIX marked with vertical shadow any time it closed above 40



The vertical shadows (where the VIX went above 40[2]) 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

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. It's hard! Fast markets are scary but they are the best times to make money. To truly excel at trading you need to crush fast markets.

First, take care of your physical and mental health and your family, then think about markets.

Here are some tips for trading in crisis markets:

[2] There is nothing special about the number 40 in particular, this is just a level we rarely see in the VIX. I chose it somewhat arbitrarily.

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 five 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 is a rough guide but should be a good starting point in most markets. Wider than usual stops make sense in a crisis (even after adjusting for volatility) given the kurtosis of daily returns.

   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, some 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 always important in trading but that balance can be the difference between crushing a crisis period or getting crushed by it.

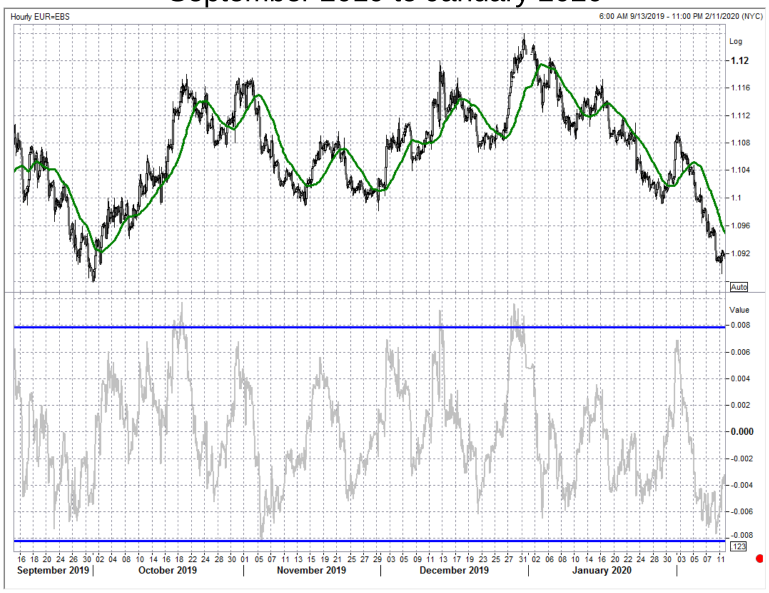
2. **Keep an open mind and use your imagination**. When COVID-19 hit, the market took oil from $65 to $50 as concerns about consumer demand knocked a market that was already bulled up on "cheap" energy stocks. Then the OPEC meeting in early March crumbled and crude plummeted from $50 to $27 in a week. 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. Which 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 sentiment driven risk aversion and crisis 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. 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:

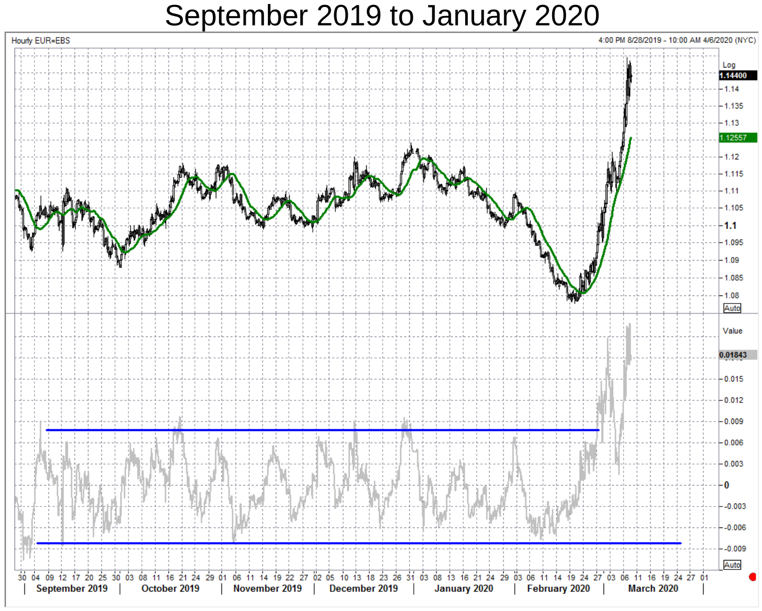
EURUSD (top, black) vs. deviation from the 100-hour MA (gray, bottom)
September 2019 to January 2020



Green line on both charts is the 100-HOUR moving average

You can see that the gray line (bottom of the chart) oscillated consistently between -80 pips and +80 pips[3] 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 heck 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



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

[3] See horizontal blue lines. Note: 80 pips = 0.0080

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 might 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 themselves 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. That said, the enjoyment of trading can admittedly be lost in times like these because you are more worried about your family's health or well-being than the overnight AUDUSD range.

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

   <u>A few other thoughts on crisis trading</u>

   During times of fear, there is a standard way that risk aversion plays out in the stock market. Markets don't always follow this pattern but they do follow it a surprising proportion of the time.

Anatomy of a sell-off

Thursday	Hmm, I'm getting a bit nervous here…
Friday AM	I need to hedge, this looks really bad
Friday PM (if stocks are in bull market)	I better buy some bonds or sell some Spooz to hedge my weekend risk
Friday PM (if stocks are in bear market)	*I better cover some shorts into the weekend just in case (2PM to 4PM squeeze)*
Saturday	Everyone reads all the alarming media coverage of the scary thing that knocked us down on Friday
Sunday Asia / Monday morning	Things gap open lower and selling builds as Asia falls cascade into Europe. NY traders press their shorts
Monday around 4PM	The lows
Tuesday	Turnaround Tuesday as shorts get squeezed
Wednesday	See saw battle between bulls and bears
Thursday	Hmm, I'm getting a bit nervous here…

Spooz is slang for S&P 500 futures

The most reliable part of this pattern is "Turnaround Tuesday". This is the tendency for stocks to rip higher on Tuesday if they sold of the Friday and Monday before. It is a simple human pattern that occurs because when the news appears bad, traders get nervous into the weekend and sell some of their holdings on Friday. Then, they read all kinds of negative media reports about the big scary thing and that scares them into selling more on Monday.

Investor selling sucks in momentum traders who go short on Monday. This adds to the selling pressure. Then, Tuesday comes and there is nobody left to sell. And then the shorts get squeezed and this triggers Turnaround Tuesday.

In case you think this sounds silly, have a look at the statistics. This table shows every Tuesday after S&P dropped 1.5% or more on Friday and 2.5% or more on Monday:

Turnaround Tuesday

Date	TUE	WED	THU	FRI
3/10/2020	4.7%			
2/6/2018	1.7%	-0.5%	-3.8%	1.5%
8/25/2015	-1.4%	3.9%	2.4%	0.1%
10/4/2011	2.2%	1.8%	1.8%	-0.8%
3/31/2009	1.3%	1.7%	2.9%	1.0%
3/3/2009	-0.6%	2.4%	-4.3%	0.1%
11/18/2008	1.0%	-6.1%	-6.7%	6.3%
10/28/2008	10.8%	-1.1%	2.6%	1.5%
8/6/2002	3.0%	2.0%	3.3%	0.4%
7/23/2002	-2.7%	5.7%	-0.6%	1.7%
3/13/2001	1.5%	-2.6%	0.6%	-2.0%
average	2.0%	0.7%	-0.2%	1.0%
median	1.5%	1.7%	1.2%	0.7%
% higher	73%	60%	60%	80%

Since 2001

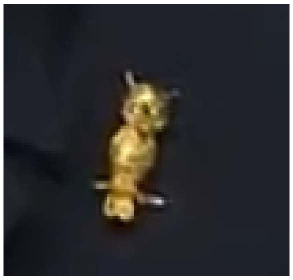
Also remember: Health and family first, markets second.

Thanks for reading. Have a wise day.

Good Luck ↕ Be Nimble

Good luck with ECB today.

Is the owlish outcome priced in?



Christine Lagarde’s owl pin at the last meeting was a cool touch

https://www.cityam.com/ecb-keeps-rates-on-hold-at-christine-lagardes-first-policy-meeting/

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