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ATTACKING CURRENCY TRENDS

HOW TO ANTICIPATE AND TRADE BIG MOVES IN THE FOREX MARKET

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How to Anticipate and Trade Big Moves in the Forex Market

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Acknowledgments

I will always remember something Bill Kidder said to me 25 years ago, soon after I met him for the first time. He said, "Your dad was one of my first mentors. He gave me his time and taught me a lot about the markets. He is a good man." These words are very powerful words and they stuck with me.

Bill was my first trading mentor, and the first thing he taught me, without saying, was to follow in my father's mentoring footsteps. Over the last few years of my career I have been able to pay the favor forward—to be a mentor. Although it is less personal than the mentoring I received, I do hope it has provided a benefit to your trading. Remember, however, that ultimately you will need to "fish for yourself."

Other life mentors I would like to acknowledge include my wife, Debbie; my mother and father; my sons, Matt, Brian, and Bobby; my six siblings; and all my extended family members (and it is a very large clan). I cannot thank you enough for all your support and unconditional love. Professionally I would like to acknowledge Tom Bonen, Guy Whittaker, Ted Muller, Kim Hamilton, Tom Bergen, Joe Botkier, Emil Assentato, Shawn Powell, my hardworking colleagues at FXDD. Each has helped form me over the years in some way or another and my appreciation is not forgotten. I would like to acknowledge my "trading apprentices" that ask for advice and support my efforts at FXDD. You provide joy to my life through your successes as traders. I would like to thank the respected traders that have crossed my path on the various social media sites. Even though an alias may be used and we may never physically meet, trading is not as lonely because of you. I would like to acknowledge my spiritual mentors, including the vibrant and positive St. Patrick's community. I start and end my week at St. Patrick's and it gives me the direction during all the minutes in between. Last but not least, I give thanks to the ultimate spiritual mentor, God, for giving me wisdom, the humility to accept failure, the will and desire to correct my mistakes, the opportunity to pay it forward, and all the other incredible gifts from His amazing grace.

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Introduction

When I was in college at Clemson University, I dreamed of a career on Wall Street. My father, Joseph Michalowski, worked on Wall Street his entire career, working his way through the ranks. There have been very few people I have met who had a professional relationship with my father who did not say, "Your father is a good man. He taught me a lot about the markets."

One of the highlights of my father's career was working at Chase Manhattan Bank. He was once put in charge of uncovering, unwinding, and being the expert during the Drysdale Government Securities crisis that shocked Wall Street in 1982. The crisis, built on a string of reverse repurchase agreements that went wrong, sent repercussions throughout Wall Street when the boutique firm defaulted on an interest payment totaling $250 million. The knock-on effect of the crisis resulted in the Federal Reserve's issuing that now all-too-familiar statement, "The Fed stands ready as a lender of last resort."

What was the catalyst for the crisis? The use of too much leverage (i.e., risk) and the lack of a plan and controls. Compare and contrast this to the 2008–2009 financial crisis where the same fundamental faults led to a near-global financial meltdown. Twenty-seven years later the lessons have not been learned.

In addition to his knowledge of interest rate products and the markets, my father was a technician, or a chartist, who would painstakingly construct by hand bar charts of bond prices on grid graph paper. At night, he would tape together the pages when the prices moved above or below the boundary of the paper, or when a new page had to be added as time progressed. He would fold his "moon charts"—as he liked to call them—as deftly as an origamist would fold a piece of paper into a swan.

During the early years of his career and without modern technology, he was able to carve a career as a technical trader by keeping analysis basic, finding good trade locations, defining risk, and trading the trend. There were no Relative Strength Indices or Stochastic Indicators. Shorter time-period moving averages could be calculated if the trader was dedicated enough, but 100 or 200 bar simple moving averages were more difficult and time consuming (if they were even done at all). Exponential moving averages could not be done without the aid of larger computer resources.

Trading technically was simpler then than most technicians find it today. Bar charts and maybe point and figure charts were used predominantly, and to bring them to life, trend lines provided the bells and whistles, defining the trend in the process. My father and most other successful traders made money by attacking the trends. My father's career on Wall Street got me interested in trading, and that became what I wanted to do.

MY JOURNEY

I started my journey as a summer intern in 1981 for an interest rate trading pioneer named William Kidder (no relation to Kidder Peabody, a prominent Wall Street firm at the time). Bill was one of the first to use mispriced interest rate futures to arbitrage the U.S. Bill and Bond markets. In 1981 he started a software company with a goal to build a menu of programs used to exploit arbitrage opportunities in the interest rate markets. The programs would run on Apple IIs, one of the first desktop computers.

Bill's software was all about finding value and defining risk. I learned through Bill that all successful traders look to find good value and to define their risk. By doing so they are able to keep their fear to a minimum and trade more profitably.

To do the computer programming, Bill hired a team of college students—mainly from Ivy League graduate schools—and promised a lecture a day, an hourly wage, and a folding chair and computer. I did not qualify as an Ivy Leaguer—being a rising junior at Clemson University (not even an Ivy League institution of the south)—but I did qualify as being the son of Joe Michalowski. I was also "hulky" enough to carry a computer to trading rooms around New York City when needed, a task I was happy to do, being the wide-eyed undergraduate in the Big Apple.

I got the break I needed, and I was working on Wall Street, taking the morning train, reading the *Wall Street Journal*, and wearing one of my three suits in the rotation. Although hired for my hulk, I ended up holding my own with the Ivy League work colleagues, and the computer lugging was replaced by programming. I also learned a tremendous amount from Bill's morning lectures on the fundamentals of the markets, trading, value, and risk. The next year I was asked back for another summer internship opportunity. I became motivated to learn more. After graduating from college in the spring of 1983, I started full time with Bill's firm, selling the software to Wall Street's interest rate arbitrageurs.

The experience of the internship and my first job gave me a foundation for the business of trading, and more importantly, it also taught me about finding value in the market and defining risk.

In 1984, one of my clients at Citibank was looking for an entry-level trader for the interest rate arbitrage desk in the bank's funding area. Since the software they were to use was the software I helped develop and now sold, I was the obvious fit for the job. Green as I was to trading, I was offered a position, and my career as a trader began.

I worked for Citibank New York for six years, initially as a trader's assistant in the bank's funding department and later making markets in short-term forward rate agreements and interest rate swaps. In 1991, I was fortunate to move to London for four more years where I helped start up Citibank's short-term interest rate derivatives desk. It was during this time that I became more interested in technical analysis. I went to seminars, read books. Computers were becoming more mainstream. As a result, getting electronic price feeds into a spreadsheet could be done easily and allowed calculating the algebraic breakevens instantaneously. More sophisticated charting programs started to surface with the ability to add indicators and draw trend lines directly on the screen.

It was during this time I was introduced to a trading concept called Market Profile™. The Market Profile taught me to recognize different market patterns (i.e., visuals) that helped me understand "exact" risk and how to anticipate trends—two seeds that my father and Bill Kidder first planted in my brain. It became the basis for the development of thinking like a *successful* trader rather than simply being a trader. It was a foundation for moving to the next step.

THE MARKET PROFILE APPROACH

Market Profile was developed by a bond trader in the Chicago futures pits named J. Peter Steidlmayer. The concept centered on breaking down the day into time periods that each lasted a half hour. The periods were lettered A, B, C, and so on. For example, the letter A would be assigned to all prices that traded in the first half hour. The price need only trade once in the A half-hour window to get assigned a spot on the profile. In the second half hour, the letter B would be assigned to all prices that traded in that period. Prices that traded in the third half hour of the day would get assigned the letter C, and so on.

A "Market Profile" would develop with the price moving vertically from high to low. If a price traded in the A and B periods, the two letters would go side by side, A first, then B. This way, rows of letters going horizontally would start to develop as the day's profile was built at each price.

There were four types of days that would develop using the Market Profile. Each day fell into one of the buckets. By recognizing the type of day, a trader could discover important clues about value, risk, trade location, and even what might happen tomorrow. As a group, they started to teach me about key aspects of becoming a more successful trader. The types were normal distribution, nontrend, double distribution, and trend days.

Normal Distribution Days

The most common type of day was a normal distribution day. These would occur approximately 70 percent of the time, and at the end of the day would look something like Figure I.1. Not surprisingly, the normal distribution day looked like a normal distribution of a bell curve.

The profile, as it was termed, showed the high volume price, or HVP for short. This was the price that traded the most over the course of the trading day. In Figure I.1, the HVP was at 101-22 or 101 and 22/32nds (bonds

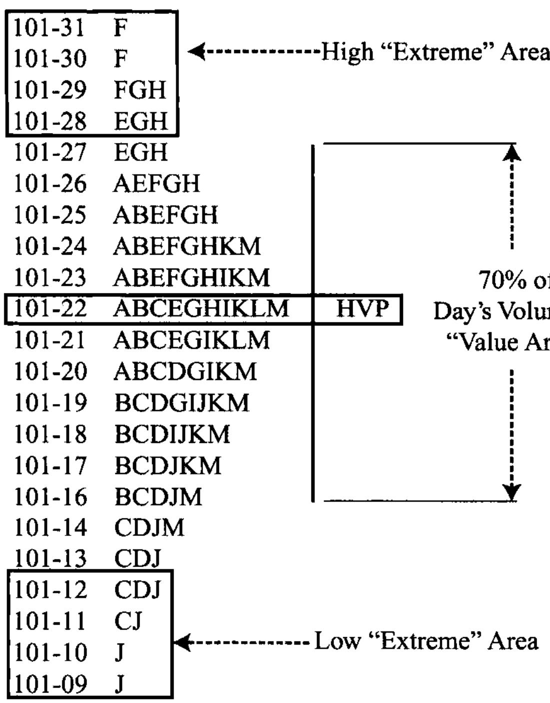

FIGURE I.1 Normal Distribution Day

and notes, which the system was developed using, trade in 32nds). The horizontal line at the end of the lettered distribution indicated that those prices were part of the value area. The value area was where 70 percent of the day's trades took place, representing roughly one standard deviation for those who might be mathematicians (I am not one, by the way). The Value Area in Figure I.1 comes in at 101-16 to 101-27.

Types of Traders During normal distribution trading days, the average trader would mainly trade around the middle of the Value Area, making a little, losing a little—basically treading water. A mentor of mine once called these traders the "Uncle owns the firm" traders. He reasoned that they could not get fired, by virtue of blood connections. However, blood only goes so far, so they would not advance in rank within the firm either.

The ends of the trade distribution bell curve were called the extremes. There were two types of traders who traded the extremes. The first type saw the market moving lower and just knew it was going even lower. They sold the lows only to have the market bounce right back where they would then cover at the upper extreme—or highs—for a nice large trading loss. These traders were termed the "Mother owns the firm" traders, since the only way they could ever keep their job was if their mother owned the firm.

The other traders who traded the extremes were doing the exact opposite. They would be buying at the low extreme and selling at the high extreme. They understood good trade location. They understood the type of market the day was developing (i.e., range bound), and what a normal trade distribution would look like at the end of the day (yes, it does help to visualize the normal bell curve developing). They were great traders, and they were termed the "Owns the firm" traders.

There was another set of traders: the ones who traded in the middle of the day's range, but were not satisfied enough at the positive extreme to take their profit. So instead they held the position and became scared enough to get out at the losing extreme—and book a loss. Needless to say, these traders were also "bad traders" and were a hybrid between the "Uncle" and "Mother owns the firm" traders. They likely got fired at some point.

Finally, there were those who traded in the middle and were content to take a quick profit near the profit extremes. They made smallish gains and were a little better than "Uncle owns the firm" traders.

So overall, there was one group (a small percentage, mind you) that made the money by buying low and selling high at the extremes. There was another that caught part of the day's ranges and made a living, but did not get rich. There was another group of traders that broke even in the middle and two groups of traders that consistently lost money (this was the bulk of the traders).

Although very simplistic, I began to think in terms of what kind of trader I was and what kind of trader I wanted to be. It was harsh to realize that I was likely an "Uncle owns the firm" trader. Needless to say, I wanted to be a Trader who "owns the firm" (or as close to it as possible), but did not fully know how. It is one thing to say you want to be good at something, and another to understand how to do it. I started to study the Market Profile further and search for clues that it told me about the markets.

Trading Clues from Normal Distribution Days It was thought that normal distribution days took place 70 percent of the time. The ranges differed from day to day, but the pictures ended up looking similar. Since seven out of ten days were "normal," I began to start to see and anticipate how the days might develop more clearly. Over time, I began to develop an idea of what a normal range was and began to think in terms of buying and selling near targeted extremes.

There were also some rules I learned that could be used to anticipate where the normal distribution day would peak or trough. For example, I learned that if you took the High to Low range for the first hour of trading and subtracted (or added) that value to a range extension down (or up), it would project the low price (high price) extreme for the day. Knowing this taught me how to be aggressive on breaks above or below the initial range, how to anticipate a move in the direction of the break, and target a level to take profit, or even to initiate a counter trend trade.

Because of things like rules, I was becoming a trader with a *reason for the trade* rather than a trader who traded because the price was moving higher or lower. I also learned that if I had a reason to do a trade, I also had a reason to get out of a trade if the market did not do what I expected it to do. I started defining risk. By defining risk I found fear from trading started to abate. With less fear I was able to stay in positions longer and to catch intraday trends. The pieces of being a real trader started coming together.

For example, in Figure I.2, the first hour (i.e., initial range) of trading during the A and B periods has a 16/32 range. When the initial range is breached on the downside during the C time period, the range extension rule says the market should target an extension level equal to the initial range of 16/32nds.

By following the rule for trade extensions, a short position at 98-10 would be initiated, with a target take profit level being at 97-27, 16/32nds lower. A stop for the trade would be if the price extends back above 98-14 (to 98-15), which was the low of the A period in the chart. With that stop in place, risk would be 5/32nds. The target gain would be 15/32nds if the target was reached. A risk/reward ratio of 1:3 was pretty good.

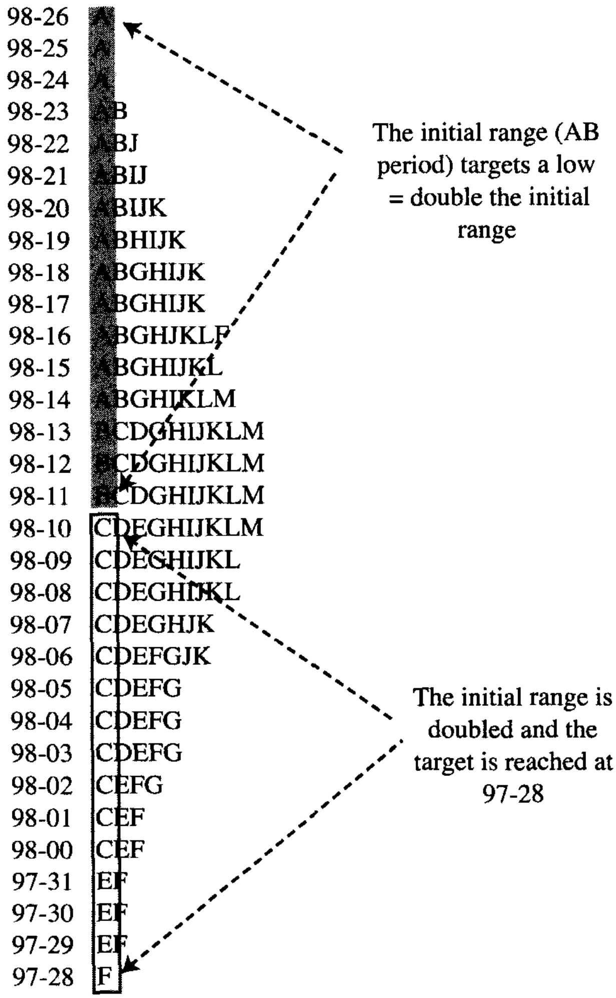

FIGURE I.2 Targeting the Range Extension

The "If . . . Should" Rule This process of trading was the foundation for what I now call the "If . . . Should" rule. The "If . . . Should" rule says: "If the market does XYZ, the market should do ABC. If it does not do what it is supposed to do (i.e., ABC), then *get out.*" We will discuss the "If . . . Should" rule further in Chapter 4.

The "If . . . Should" rule in relation to this example would say something like this: "*If* the market is a normal distribution day and the price moves below the initial trading range (first hour of trading), the market *should* double the initial trading range in the direction of the extension. If it does not do what it is supposed to do, then *get out.*"