

## Trading on Expectations

One of the most important factors affecting the market's supply and demand equation (i.e., selling and buying transactions in the market) is the expectation of the participants—expectations about where prices are headed, fundamental reports, and the market's response to news releases. The Federal Reserve Board recently adopted an expectations model of the markets for economic forecasting, and now you can apply the same approach to your trading.

In 1997 testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan described the expectations model this way:

"Participants in the financial markets are susceptible to waves of optimism. Excessive optimism sows the seeds of its own reversal. When unwarranted expectations are ultimately not realized, the unwinding of these excesses can act to amplify a downturn, much the way they can amplify the upswing."

This presentation will teach you how to identify and take advantage of these waves (trends) of optimism and pessimism and their reversals.

You will also learn how Brendan combines elements of economic science (expressed in the Chicago Board of Trade's Market Profile) and the Nobel Prize-winning theories of expectations (as expressed in sentiment surveys) to develop a method for analyzing and trading the futures markets.

\* \* \*

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Brendan has authored several books which were endorsed by such well known and respected institutions as The Wharton School of Business and Coopers & Lybrand Consulting, and by major publications, including *Forbes* and *Barron's*. Brendan is a frequent lecturer at Vanderbilt University's Owen Graduate School of Management.

He also designed an economics course for Vanderbilt University (the only non-faculty member to do so), and is presently writing a textbook based on the course.

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## Pinpointing Trading Ranges, Trends and Reversals

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# **Major States of the Market**

- (i) Trading Range**
- (ii) Trend**
- (iii) Reversal**

# Major States of the Market

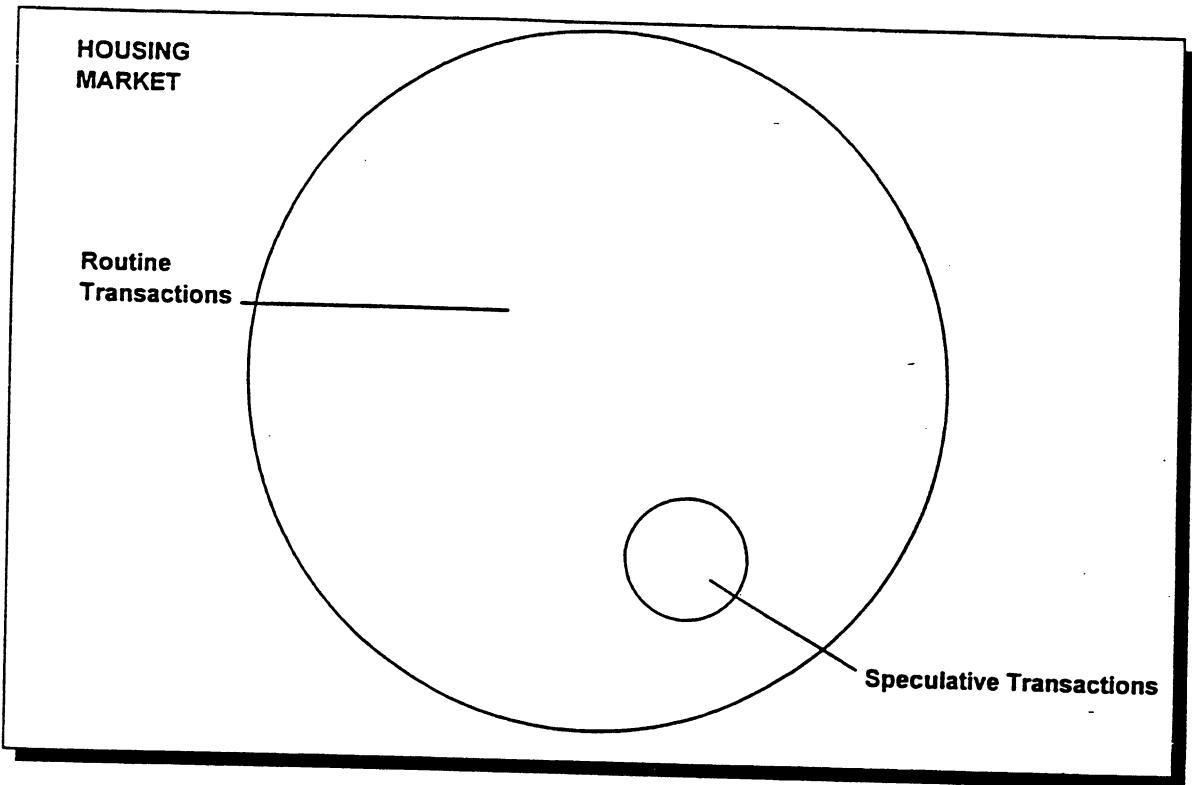
- (i) Random Walk Market = Trading Range
- (ii) Coherent Market = Trend
- 2      (iii) Chaotic Market = Reversal

"Because the future is always unfathomable, there are always buyers and sellers in every market. If the socialists were right—if the future could be accurately divined—markets would disband because nobody would ever take the losing side of a trade."

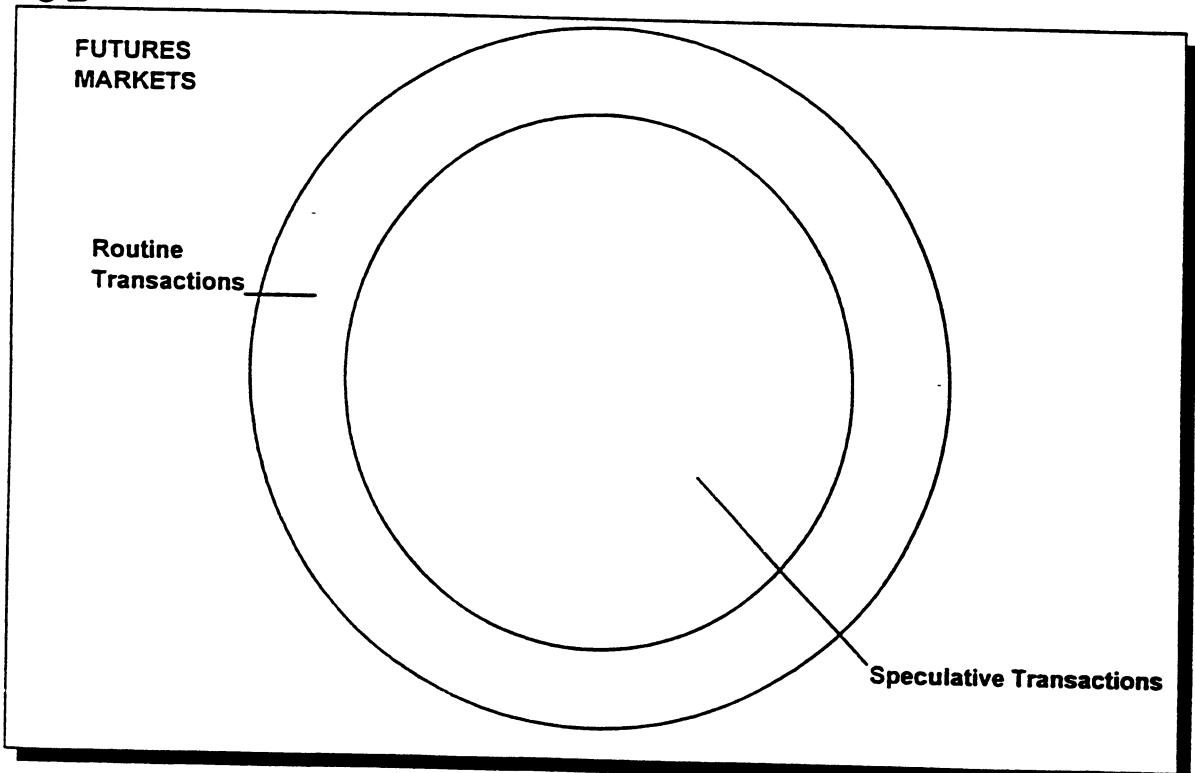
--James Grant of *Grant's Interest Rate Observer*  
Testimony before the House Banking Committee

Even if people could divine the future, they would still exchange their respective surpluses with each other; the routine, everyday transactions would still take place in the market. But the *speculative element* of the markets would certainly disappear. It would be pointless to speculate if everyone knew the future.

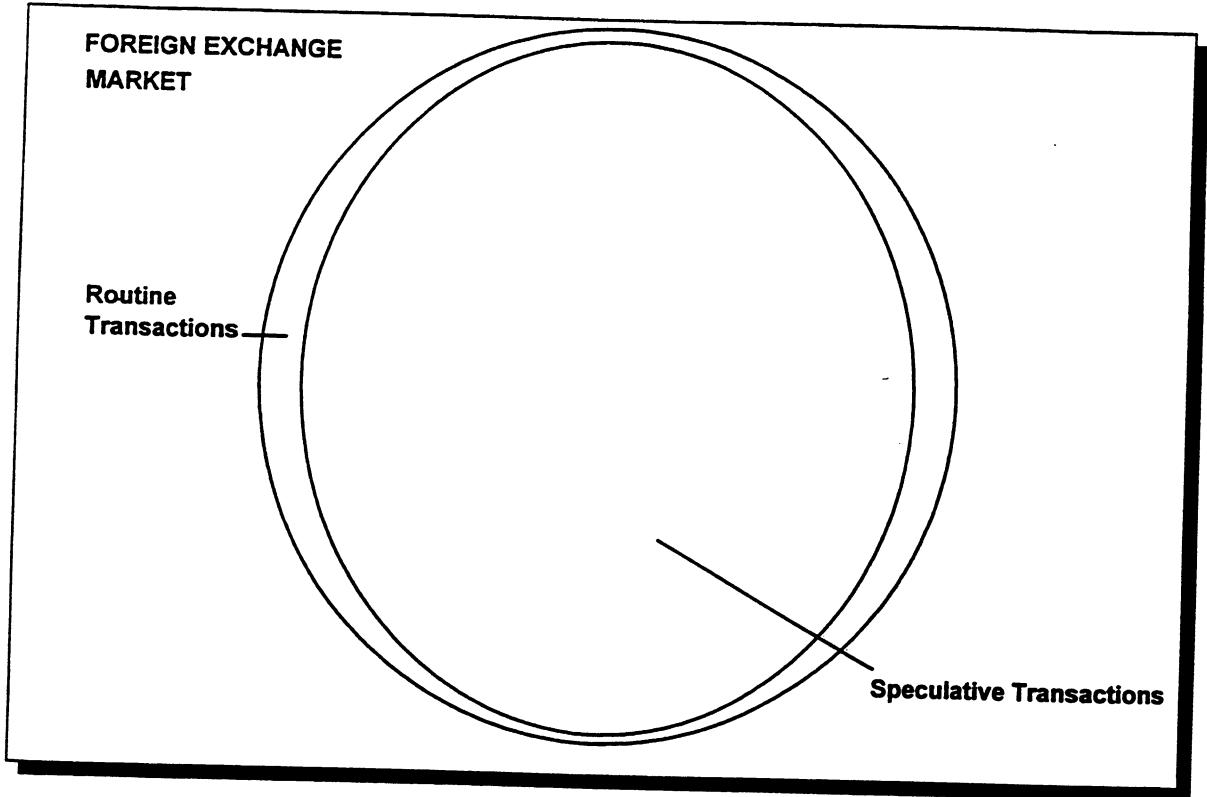
**5A**



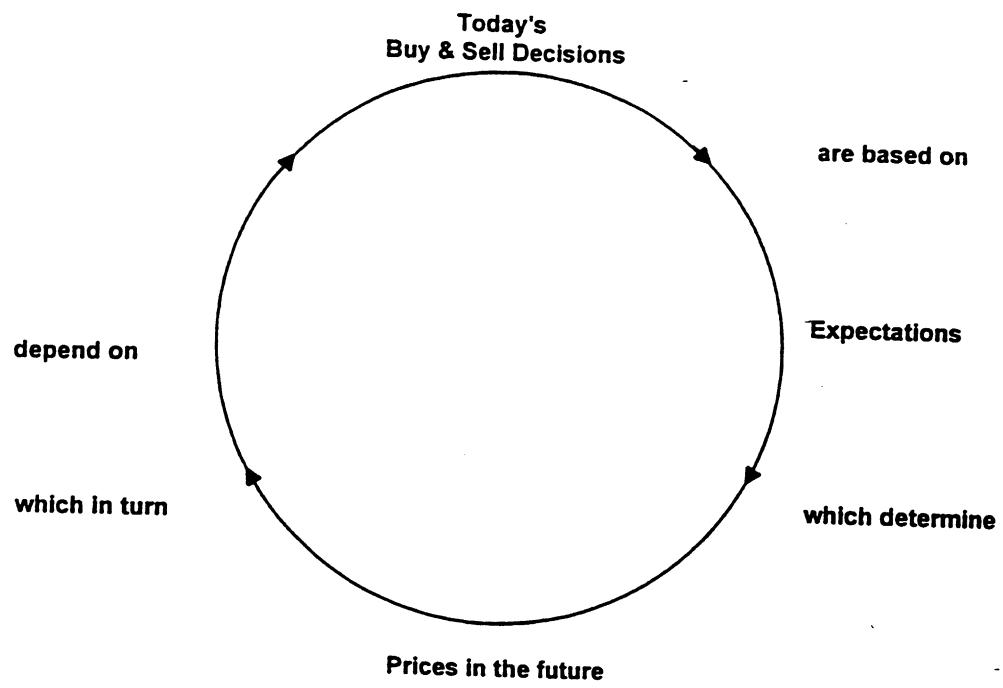
**5B**



**6**

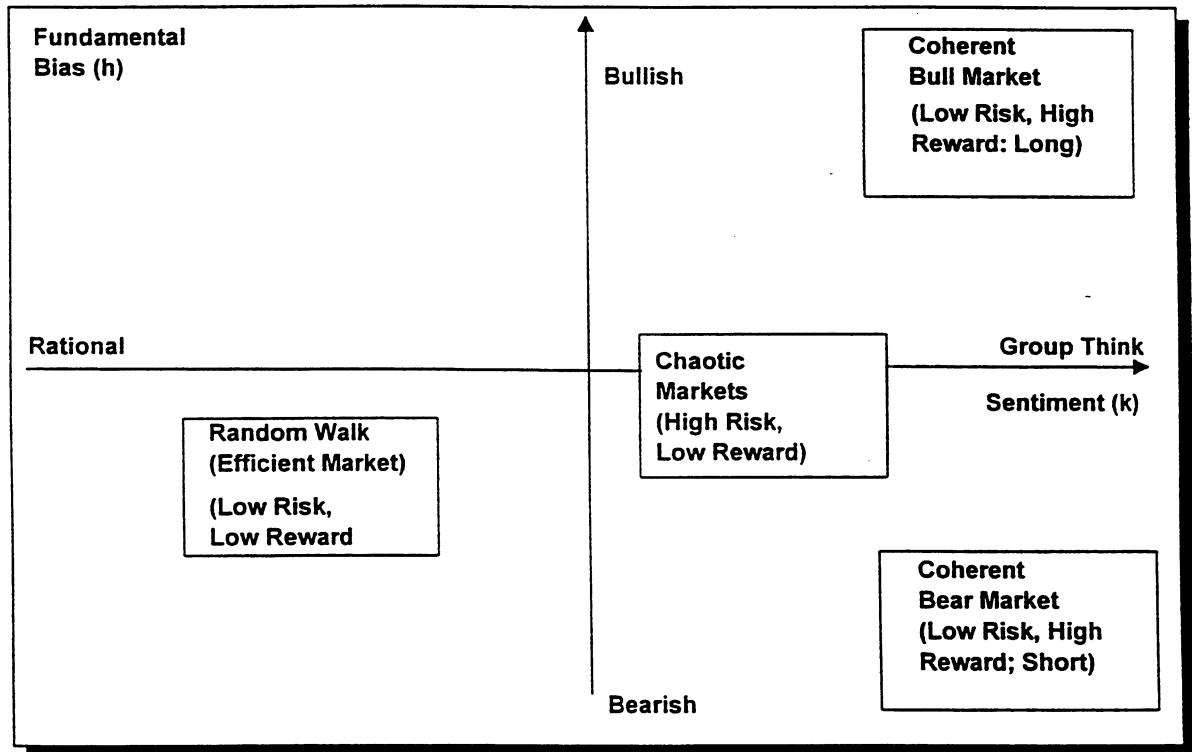


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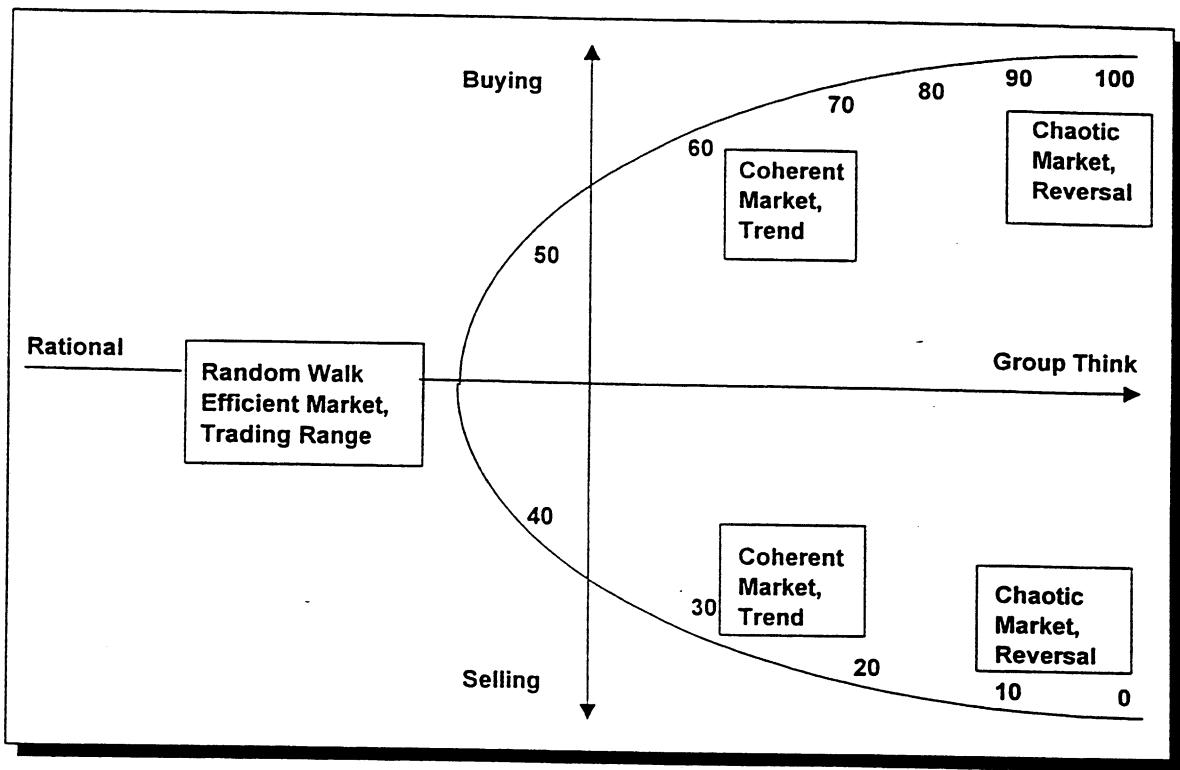
7

**Expectations + Transactions = Prices in the Future**



### Major Market States in the stock market

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## The Sentiment-Activity Model

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**The news comes in the form of:**

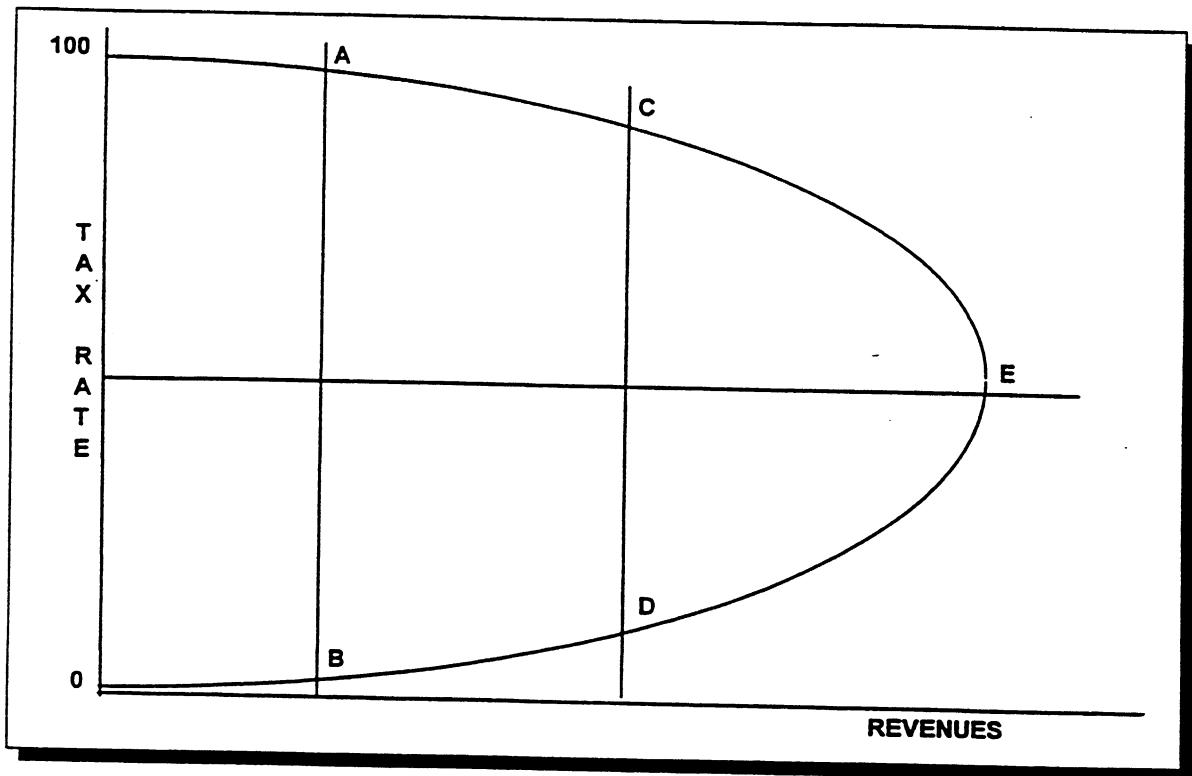
1. Regularly scheduled releases of economic or particular-market data.
2. Random news coming from out of the blue in the way of comments from government officials, or weather developments, etc.

**But regardless of which type of news any particular piece is, the market either:**

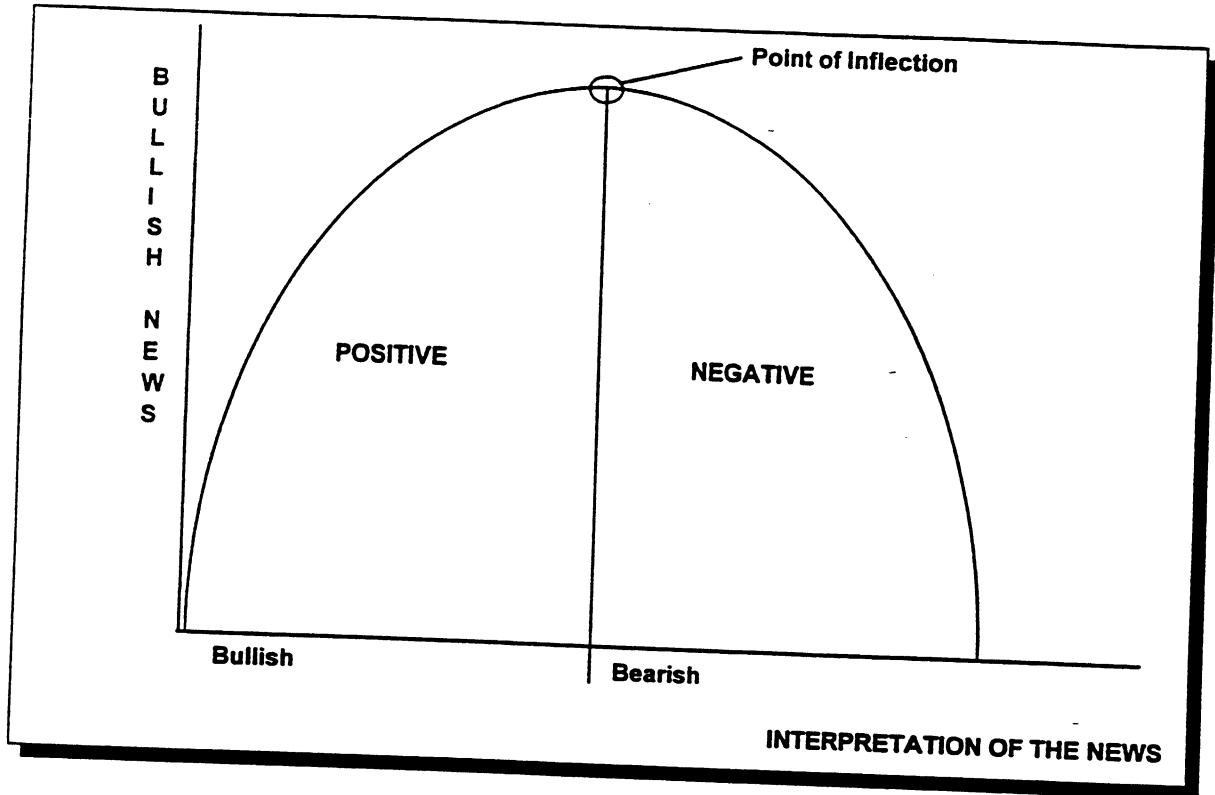
1. responds in typical textbook fashion,
2. shrugs it off, or
3. responds in perverse textbook fashion

**When the market reacts in the typical textbook manner, the explanation is obvious. But if market responds in one of the other ways, invariably the Monday-morning-quarterback analysts will offer up such enlightening explanations as:**

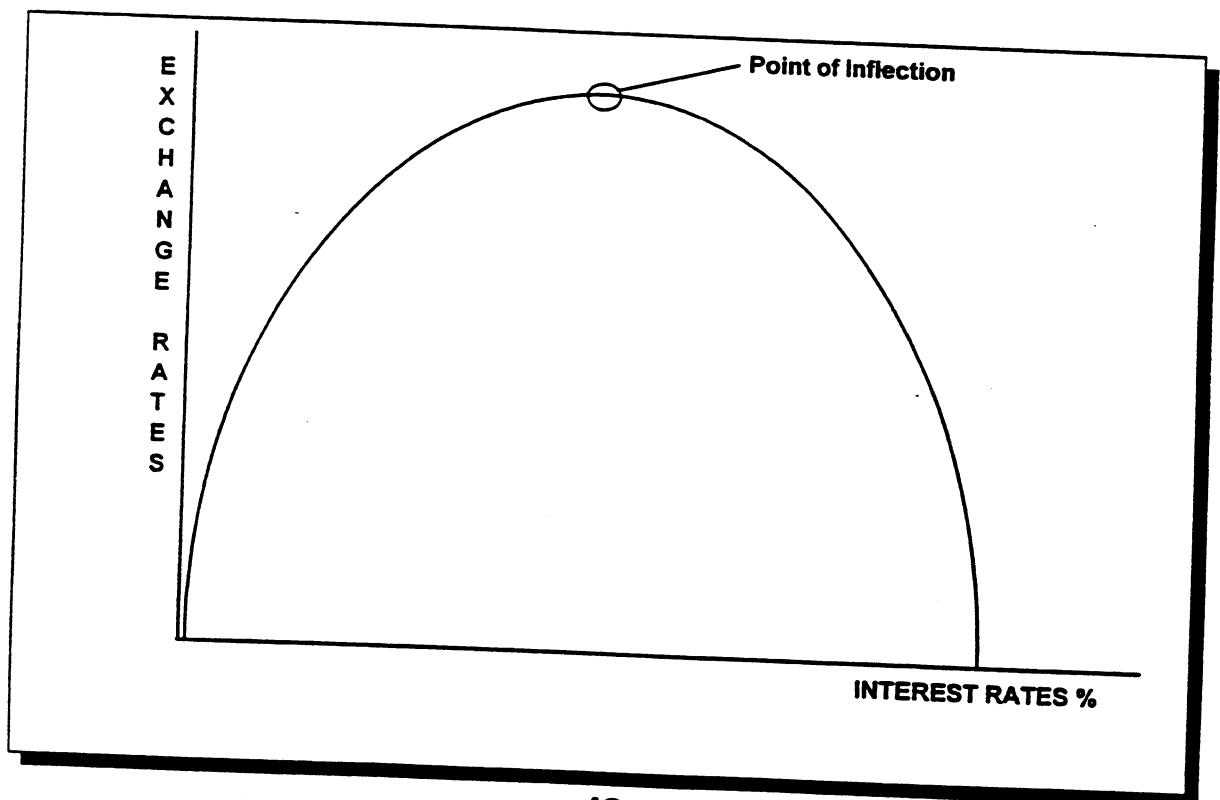
1. "the market had already discounted the news,"
2. "it was a classic buy the rumor, sell the fact,"
3. "that number represents history, what's coming next?"



**The Laffer Curve.** Initially, tax collections increase as the government raises the tax rate. But there is a point beyond which additional increases in the tax rate actually reduce the "revenues" collected.



The Expectations Curve



## SENTIMENT

One of the worst three months on record for the dollar was also one of the worst for currency forecasters. The *consensus* prediction among analysts polled by Bloomberg was the dollar would rally in the first three months of 1995. The reality: the currency slumped to all-time lows vs the Dmark, Swiss franc and Japanese yen. (Italics added)

--BLOOMBERG Business News on April 12, 1995

**On March 28, 1995** Reuters News conducted its routine poll of 20 economists to get their opinion as to whether the Bundesbank, Germany's central bank, would lower interest rates two days later at its regular bi-weekly meeting.

The economists' opinions were unanimous: the Bundesbank would not lower interest rates. As Reuters noted when the results of the poll were released, it was the first time in that interest rate cycle that the results of poll was unanimous.

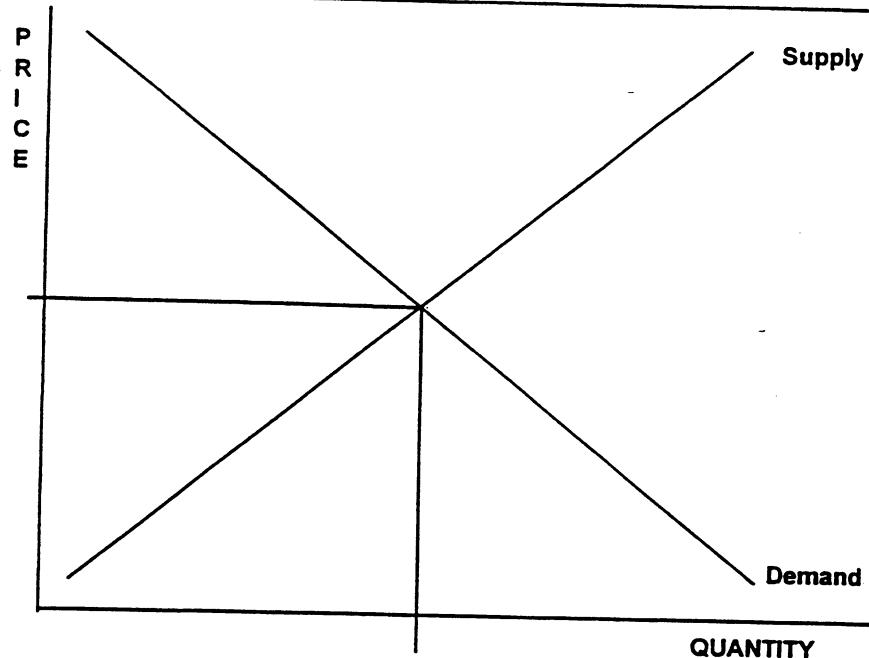
Two days later the Bundesbank cut the discount rate 50 basis points and its repo rate 35 basis points. So much for unanimity.

# Registering Sentiment

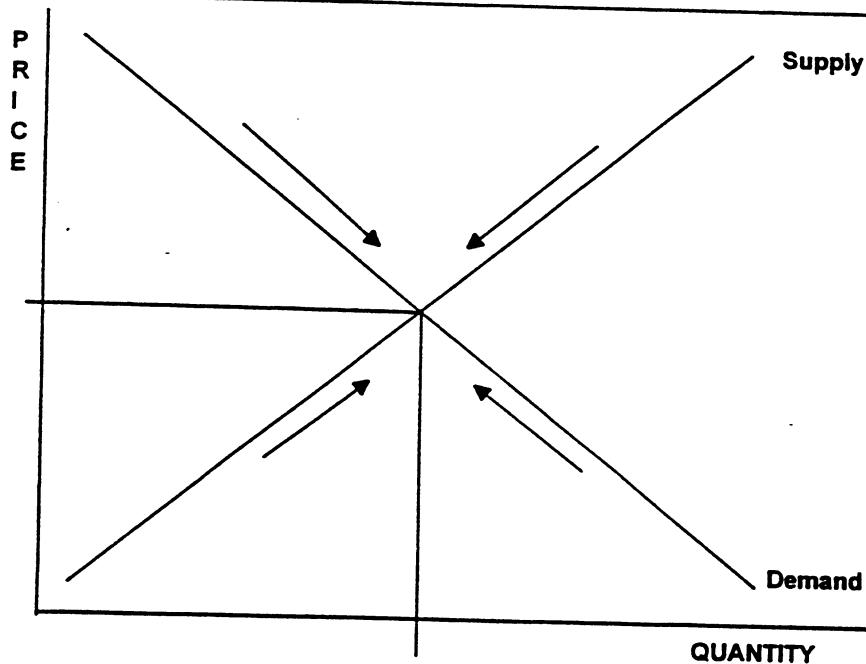
i) Bullish Consensus

ii) Daily Sentiment Index

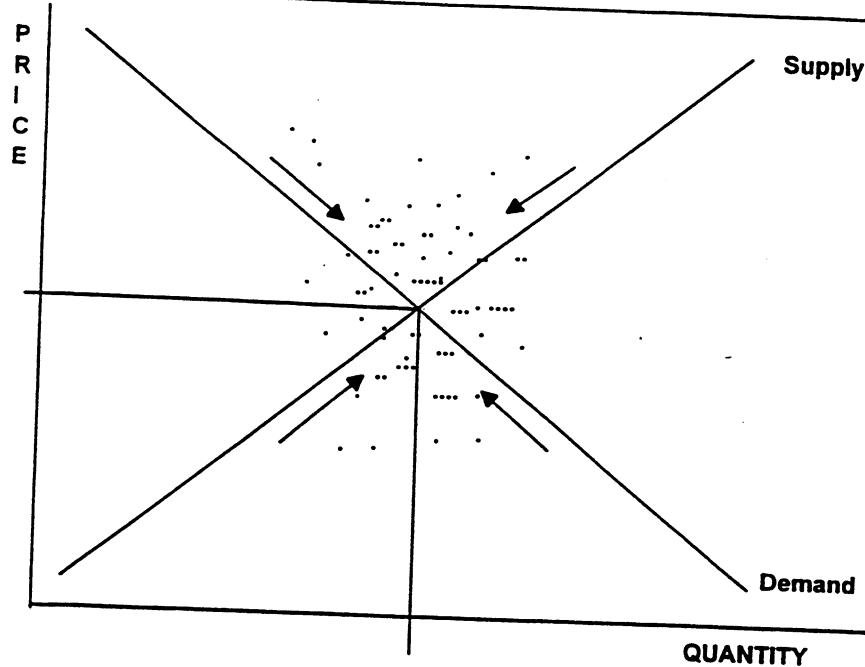
17a



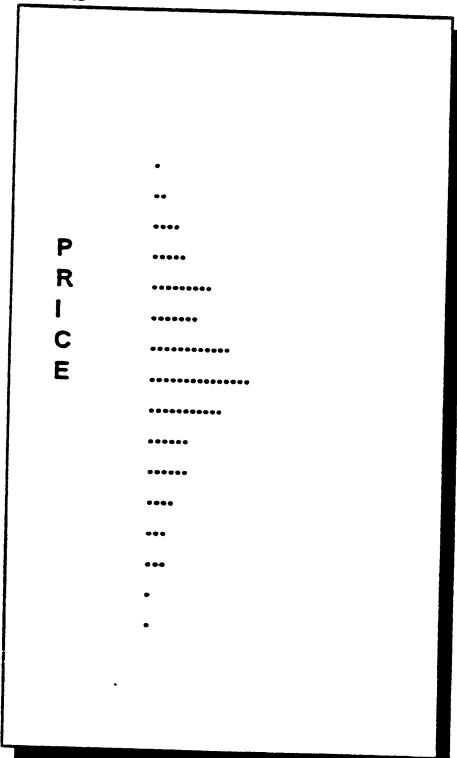
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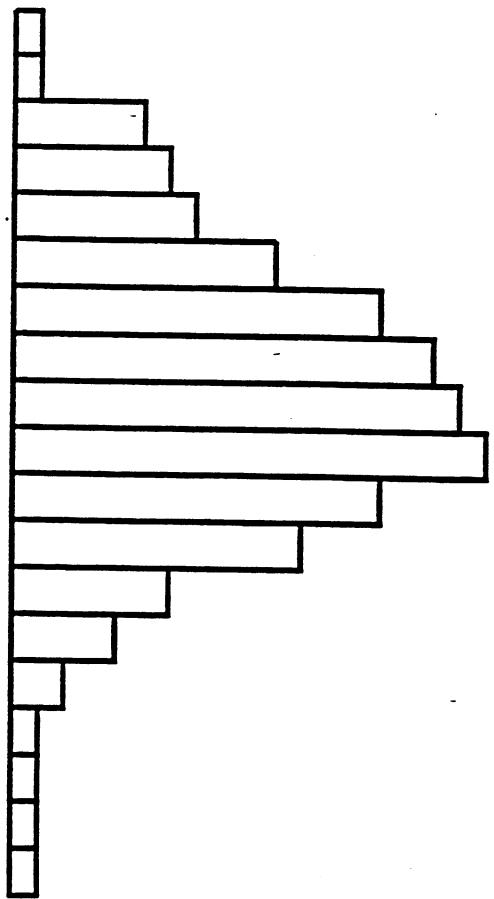
**18 a**



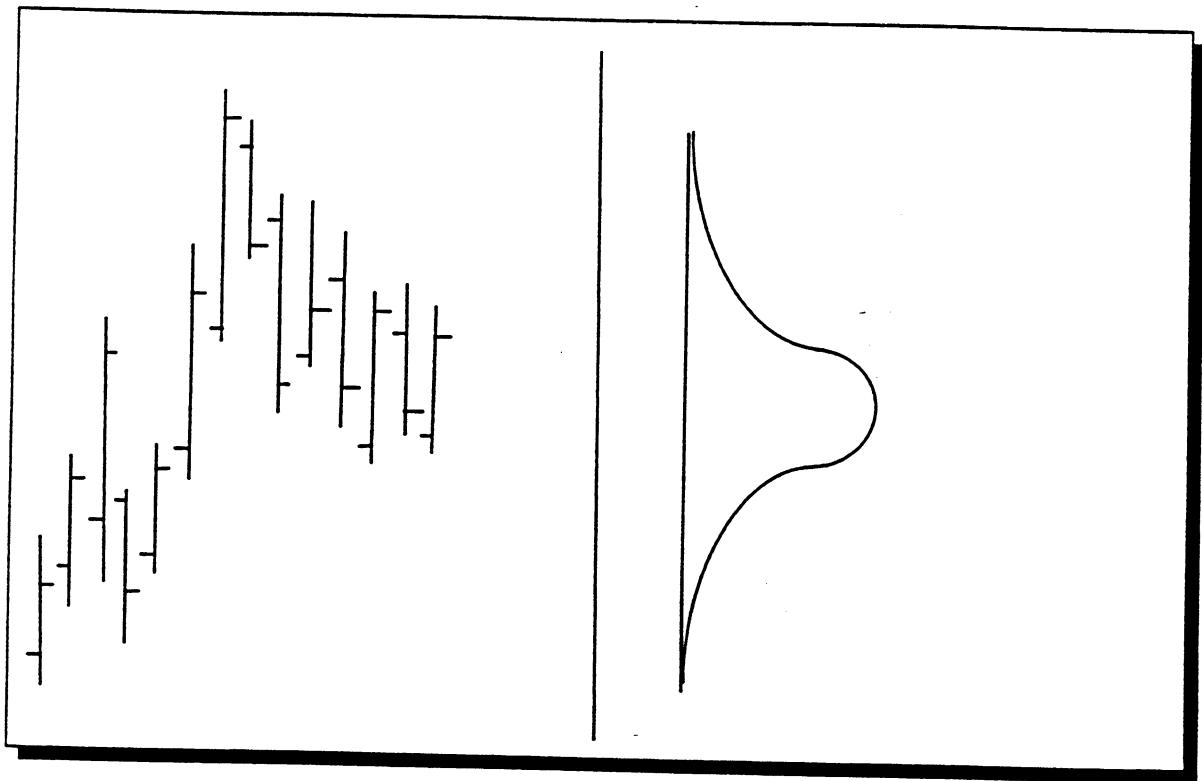
**18 b**



**18**



19



20

|     |        |
|-----|--------|
| 809 | D      |
| 808 | D      |
| 807 | D      |
| 806 | D      |
| 805 | D      |
| 804 | D      |
| 803 | DE     |
| 802 | DE     |
| 801 | DEF    |
| 800 | DEF    |
| 799 | DEF    |
| 798 | DEF    |
| 797 | DEF    |
| 796 | DEFG   |
| 795 | DFG    |
| 794 | DFGIK  |
| 793 | FGHIK  |
| 792 | FGHIJK |
| 791 | GHIJK  |
| 790 | GHIJK  |
| 789 | GHIJK  |
| 788 | HIJ    |
| 787 | HIJ    |
| 786 | HI     |
| 785 | HI     |
| 784 | HI     |
| 783 | H      |
| 782 | H      |
| 781 | H      |

Extreme on top = OTFT Selling

The brief time / price relationships at the top and bottom of this profile indicate rejection tails caused by the OTFT. The OTF seller perceives price away from value on the top of the profile, and the OTF buyer perceives price away from value on the bottom.

Extreme on bottom = OTFT Buying

|     |        |
|-----|--------|
| 809 | D      |
| 808 | D      |
| 807 | D      |
| 806 | D      |
| 805 | D      |
| 804 | D      |
| 803 | DE     |
| 802 | DE     |
| 801 | DEF    |
| 800 | DEF    |
| 799 | DEF    |
| 798 | DEF    |
| 797 | DEF    |
| 796 | DEFG   |
| 795 | DFG    |
| 794 | DFGIK  |
| 793 | FGHIK  |
| 792 | FGHIJK |
| 791 | GHIJK  |
| 790 | GHIJK  |
| 789 | GHIJK  |
| 788 | HIJ    |
| 787 | HIJ    |
| 786 | HI     |
| 785 | HI     |
| 784 | HI     |
| 783 | H      |
| 782 | H      |
| 781 | H      |

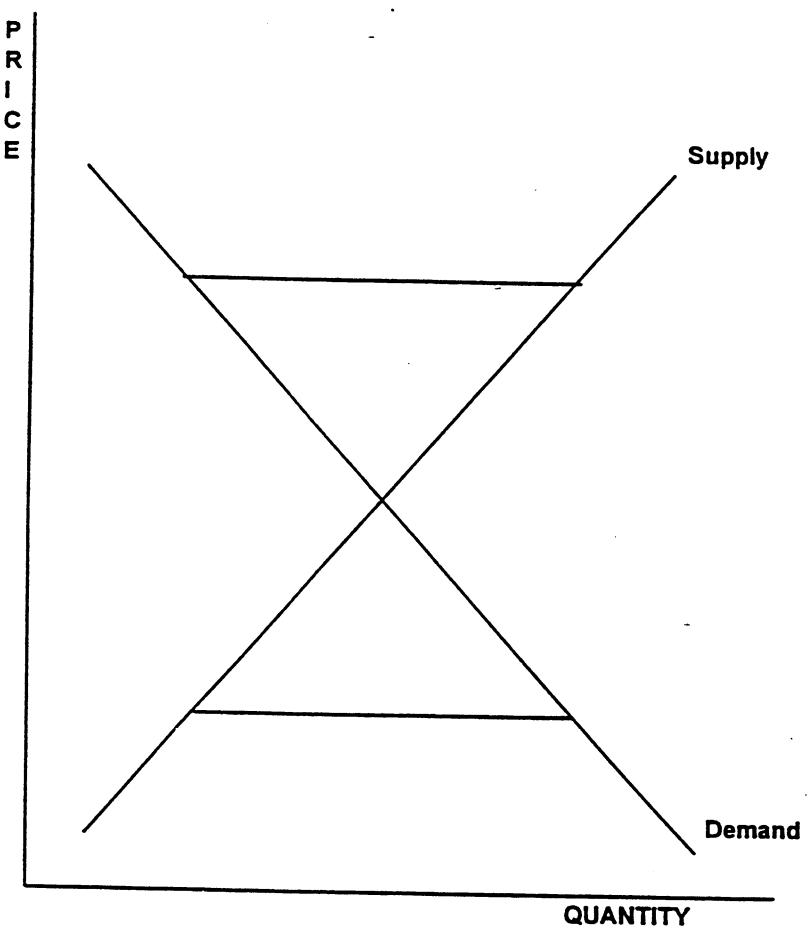
Sell orders from outside the pit overwhelmed the initial balance price range between 809 and 794 in the first hour of trading.

Range extension down, caused by OTF sellers.

|     |               |
|-----|---------------|
| 809 | D             |
| 808 | D             |
| 807 | D             |
| 806 | D             |
| 805 | D             |
| 804 | D             |
| 803 | DE            |
| 802 | DE            |
| 801 | DEF           |
| 800 | DEF           |
| 799 | DEF           |
| 798 | DEF           |
| 797 | DEF           |
| 796 | DEFG          |
| 795 | DFG           |
| 794 | DFGIK         |
| 793 | FGHIK         |
| 792 | <u>FGHIJK</u> |
| 791 | GHIJK         |
| 790 | GHIJK         |
| 789 | GHIJK         |
| 788 | HIJ           |
| 787 | HIJ           |
| 786 | HI            |
| 785 | HI            |
| 784 | HI            |
| 783 | H             |
| 782 | H             |
| 781 | H             |

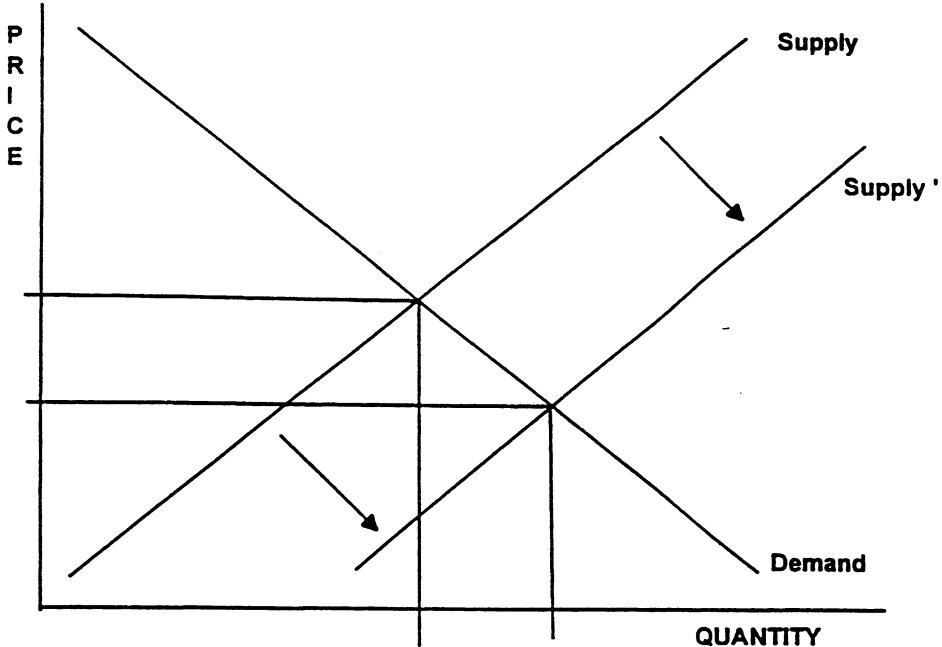
The "fairest" price in this profile was 792. The larger number of TPOs above that price compared to the number of TPOs below that price indicates net selling by the OTFT inside the TPO value area.

|     |       |
|-----|-------|
| 809 | D     |
| 808 | D     |
| 807 | D     |
| 806 | D     |
| 805 | D     |
| 804 | D     |
| 803 | DE    |
| 802 | DE    |
| 801 | DEF   |
| 800 | DEF   |
| 799 | DEF   |
| 798 | DEF   |
| 797 | DEF   |
| 796 | DEFG  |
| 795 | DFG   |
| 794 | DFGIK |
| 793 | FHIJK |
| 792 | FHIJK |
| 791 | GHIJK |
| 790 | GHIJK |
| 789 | GHIJK |
| 788 | HIJ   |
| 787 | HIJ   |
| 786 | HI    |
| 785 | HI    |
| 784 | HI    |
| 783 | H     |
| 782 | H     |
| 781 | H     |

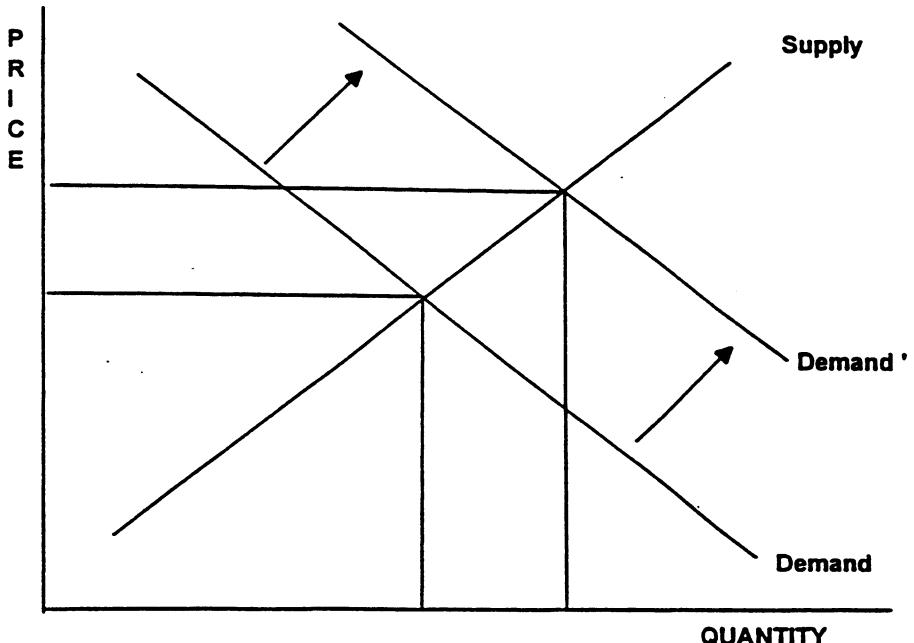


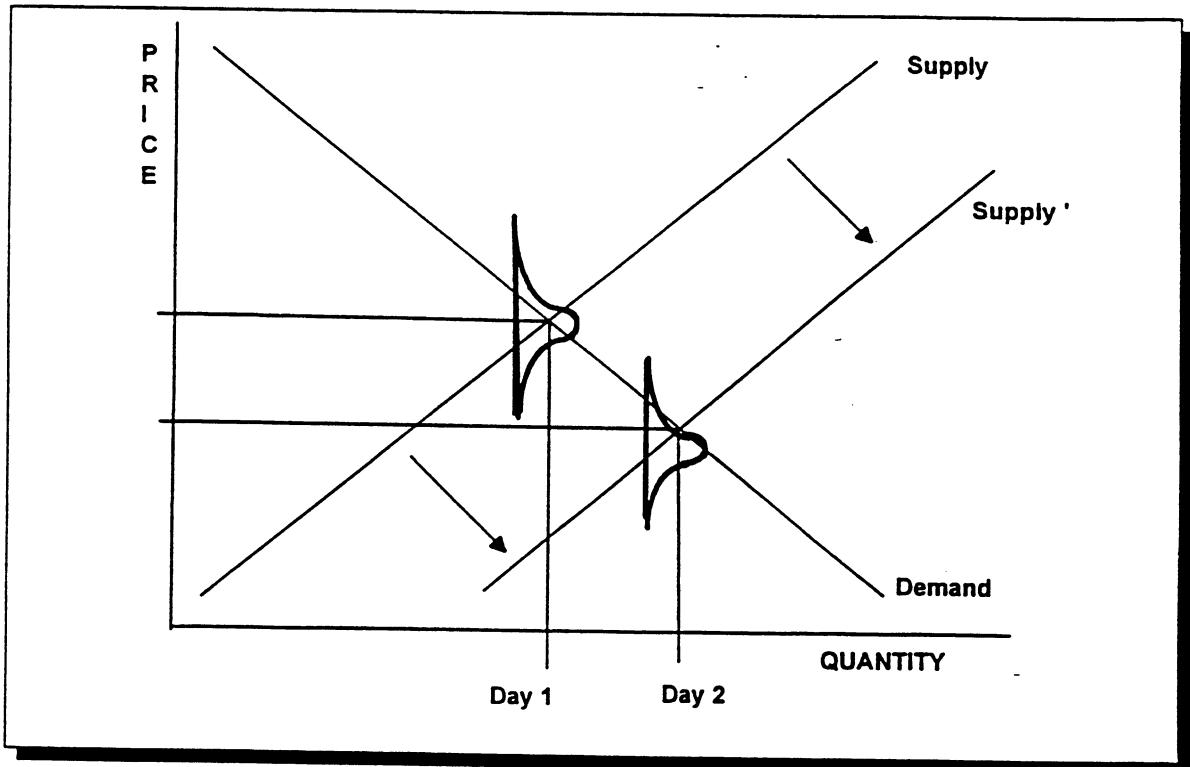
24

25 a



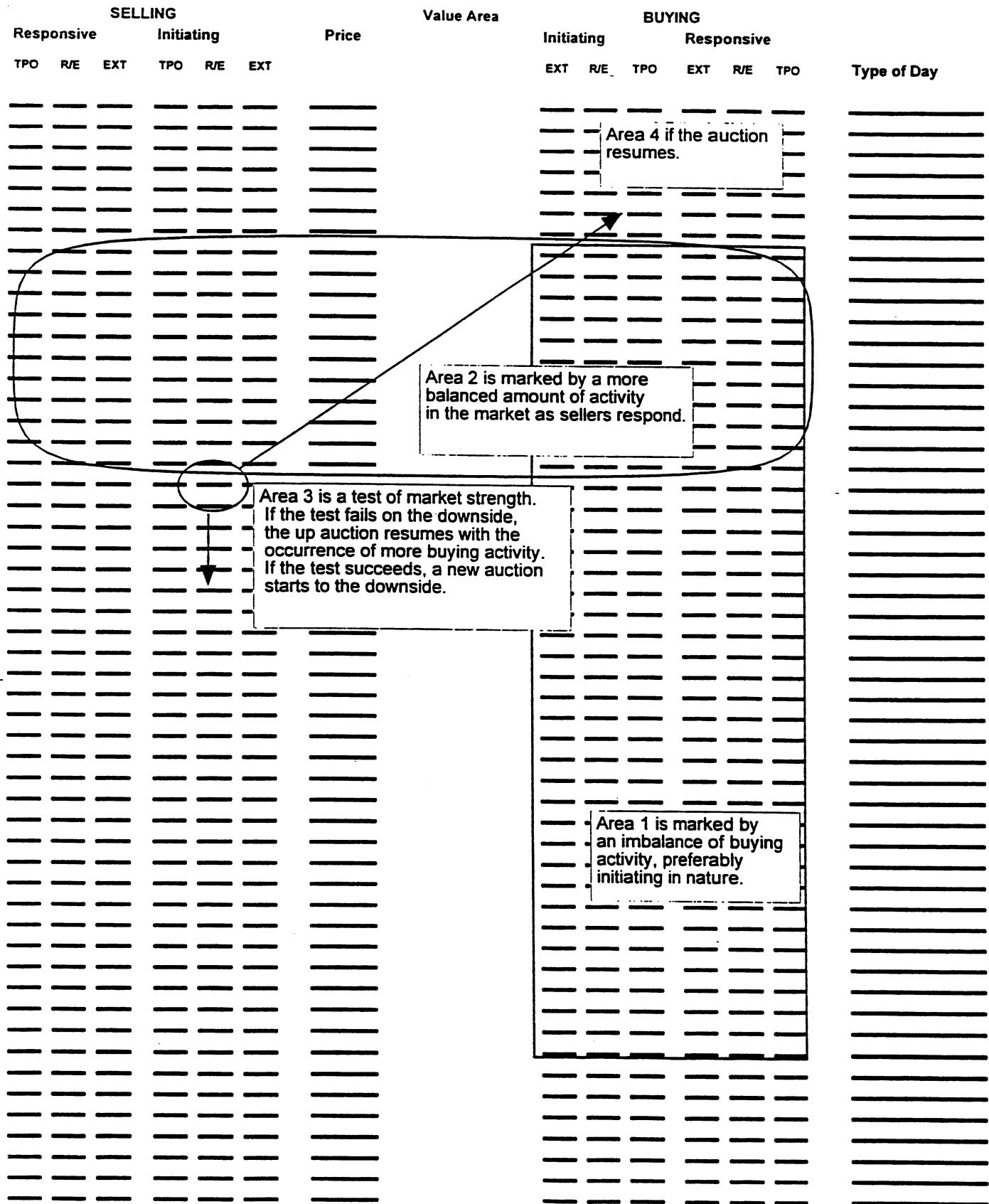
25 b





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## THE SENTIMENT-ACTIVITY MODEL

The model is a visual aid presenting a concrete illustration of the interaction between expectations and transactions in determining prices in the future.

The phenomenon conveyed in the model occurs over all time horizons.

Depending on whether one is a day-trader, two- to three-day swing trader, or even a multi-week trend follower, data from the appropriate time horizon can be monitored to determine what state the market is in and when it is moving from one state to another.

It follows that different strategies and different data are relied upon for making trades, depending on the trader's time horizon.

General observations and assertions, and specific rules for applying the model to both analysis and trading.

**(ii) Extremes in Sentiment surveys can be Relative**

**50% as Pivotal Area**

**50% May Constitute an Extreme Sentiment Reading**

## (A) General Observations

### (i) Tendency for Expectations to Extrapolate and Grow

Perhaps the most crucial observation is the general tendency for expectations to get more bullish as prices rally, and more bearish as prices break. Built in to people's expectations of future price direction is the tendency to extrapolate into the future the direction price has recently been going.

### (iii) The Crowd is Not Always Wrong

- A) It is true that the market sometimes immediately reverses the trend as soon as an extreme sentiment reading is registered, thus establishing the dictum that the "crowd is always wrong."
- B) other times the market stays in the same price range, refusing to reverse, and
- C) other times still the market will continue to move in the same direction despite the extreme readings.

Obviously, the trick is to discern which of these situations is likely to happen.

**Let's look at the bullish case for illustration sentiment reading is 80% or 90%:**

- 1. despite the extreme sentiment,**
- 2. at a minimum no selling activity materializes, and**
- 3. possibly even buying activity continues to enter the market, thus**
- 4. confirming and possibly increasing bullish sentiment.**

**Interpreting News in the different sections of the Parabola.**

**Typical response**

**Perverse response**

# Trading the Parabola

Extreme readings alone are not enough to justify fading the crowd.

Rather, it is only prudent to fade the crowd when extreme expectations meet opposite activity.

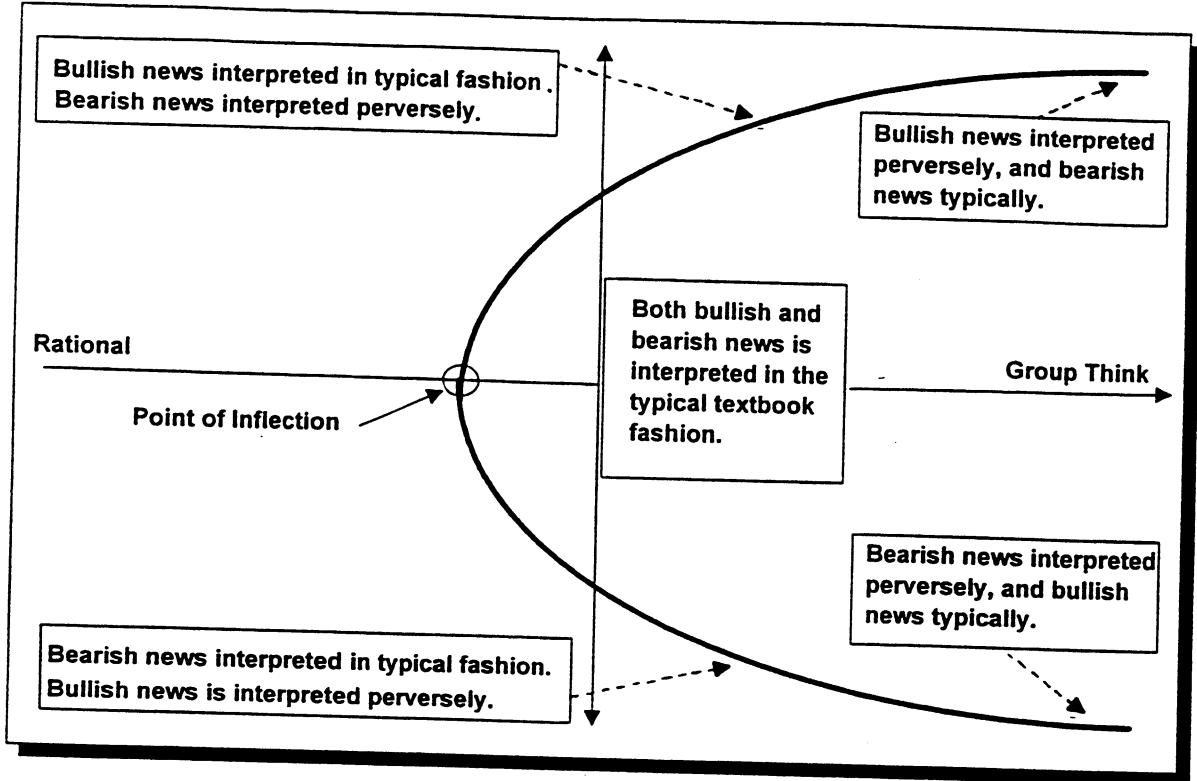
The crowd makes the trend.

*But, a starting point must be defined so that "with the consensus" is not arbitrarily selected in the middle of a market move.*

That starting point is at the edge of the Parabola.

Reversals and trends are intricately linked.

Arbitraging the two surveys.



**Response to the news based on market's location on the Expectations Curve**

To summarize the observations about the model:

1. trends are large price moves relative to the time elapsed,
2. *bull trends* start at the *absolute bottom* and *bear trends* start at the *absolute top*,
3. strong consensus coupled with activity produces these trends early on and reinforces these trends as they unfold,
4. the prevalence of strong consensus coupled with activity opposite the consensus produces reversals of trends,
5. trading ranges are marked by balanced expectations and random walk type price behavior.
6. news is interpreted either typically or perversely, depending where the market is on the parabola.

# Specific Characteristics

Erratic behavior in the DSI.

Arbitrage.

Enter at the Edges.

Breaking Out of the Trading Range.

## Trends & Reversals

Trends are formed by a combination of growing expectations and market activity in the same direction as those expectations. The complimentary interaction between these two factors serves to create a self-reinforcing process of prices and expectations feeding on each other.

Reversals occur when expectations are extremely bullish or bearish, but selling or buying activity, respectively, materializes from the speculative element of the market as evidenced in the Profile's market activity. Action has not been consistent with expectations, with expressed opinions of participants.

# Rules for Applying the Sentiment-Activity Model

## (i) Scalper

- (a) Above 80% or below 20% on DSI
- (b) Go with range extension opposite of sentiment
- (c) Stop Strategy at other edge of the day
- (d) Wait for other extreme in sentiment to exit on range extension

## (ii) Swing Trader

- (a) Pull stop up after first day of range extension against position

## (iii) Intermediate Term Trader

- (a) Above 80% or below 20% on BC
- (b) Imbalance on LTMA, or for a non trend day or neutral day
- (c) Follow trend on LTMA chart and monitor for change in trend day, especially on extreme sentiment in other direction

## **1. Expectations**

## **2. Market Activity (i.e., Transactions)**

and takes into account the other phenomenon observed in the market, namely:

## **1. The Expectations Curve Effect in response to news**

## **2. Crowd Behavior**

And combine to form:

## **3. Trends**

## **4. Reversals of Trends**

## **5. Trading Ranges**

**SIH8 6.820s as of close 2/19**

**Comdty GPO**

Vol 23,184y OpInt 48,327y

**BAR GRAPH for SIH8 -- SILVER FUTURE Mar98**

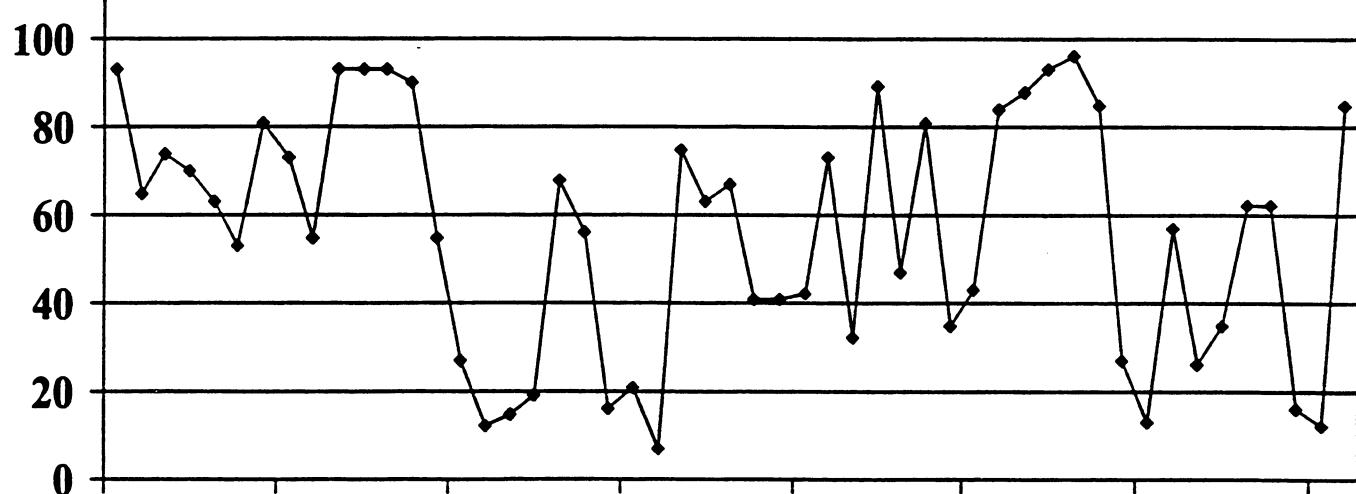
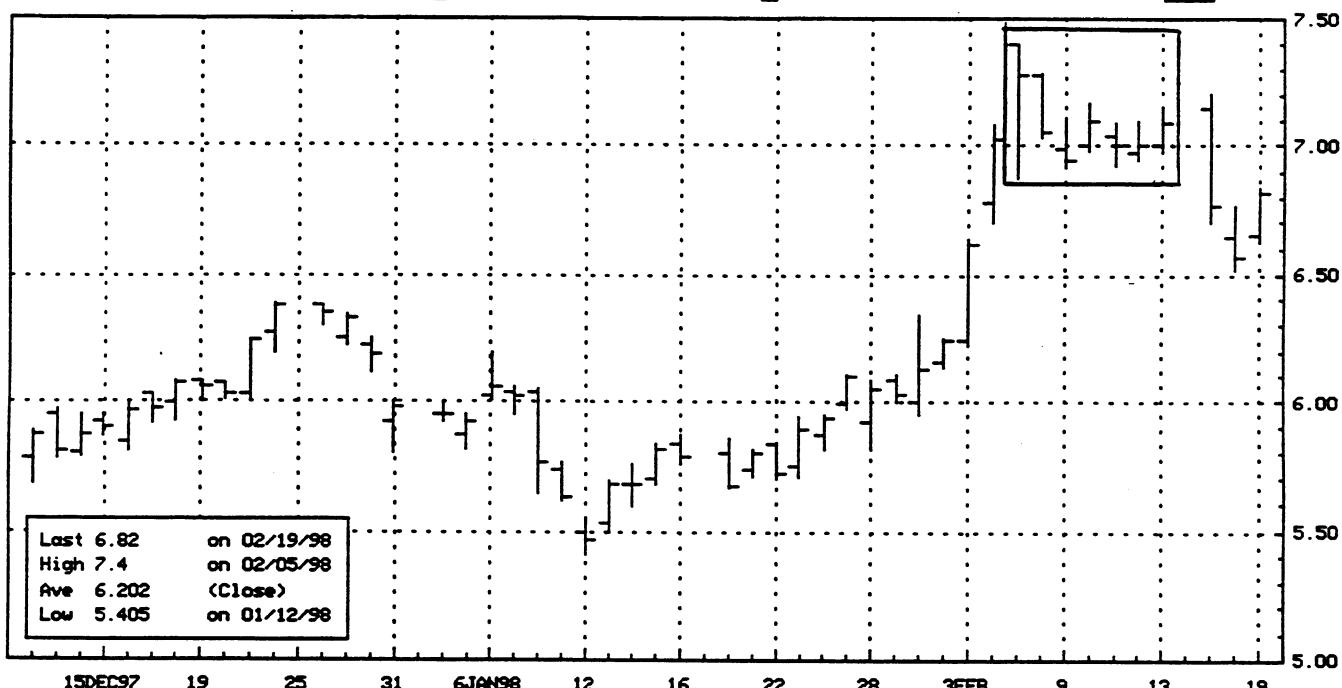
RANGE 12/10/97 TO 2/19/98 PERIOD D (D-W-M-Q-Y)

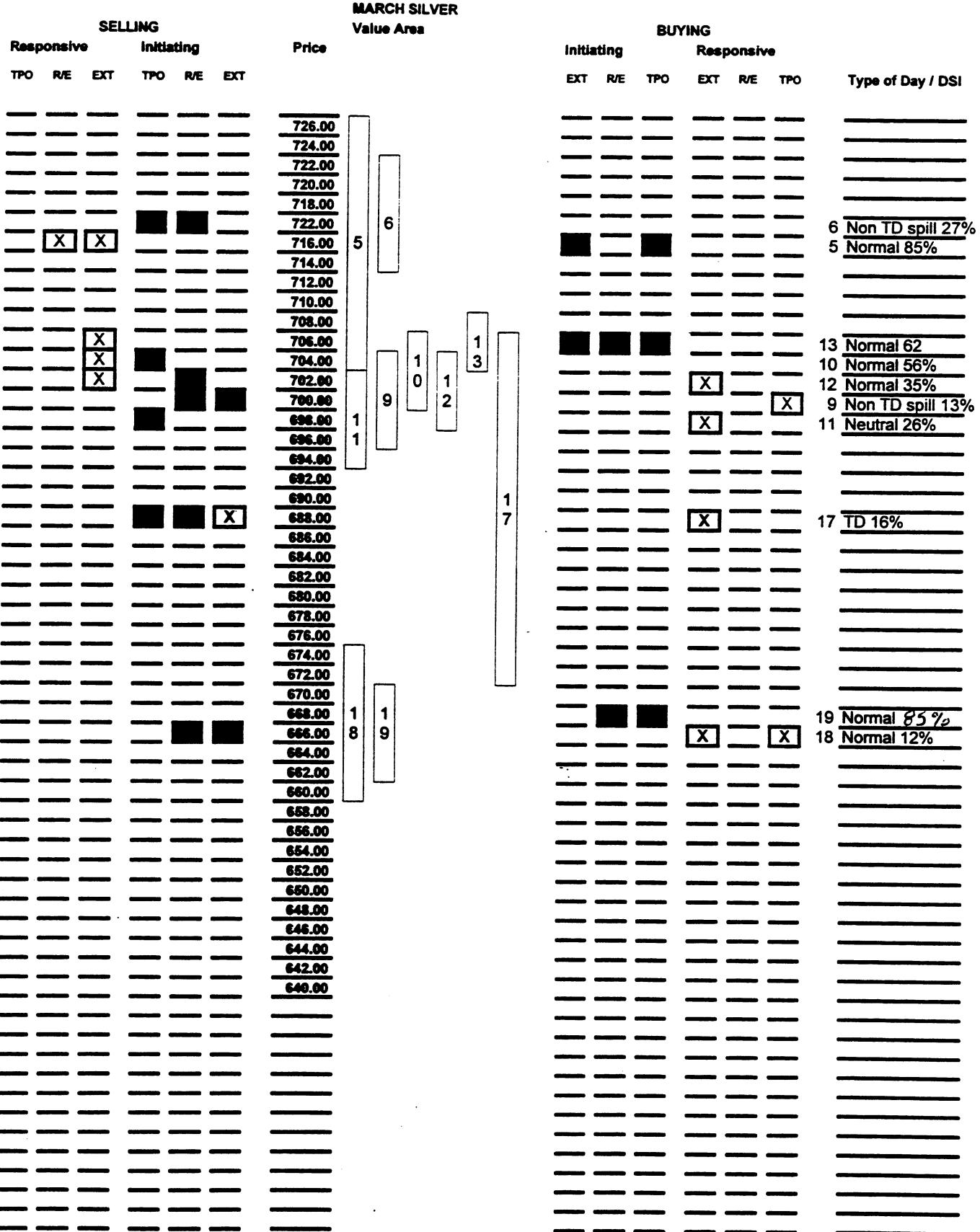
VOL/OI N (V-O-B-N)

MOVING AVE PERIODS

BAR/CANDLE CHART B (B-C)

VOL/OI M\_AVE 15 PERIODS



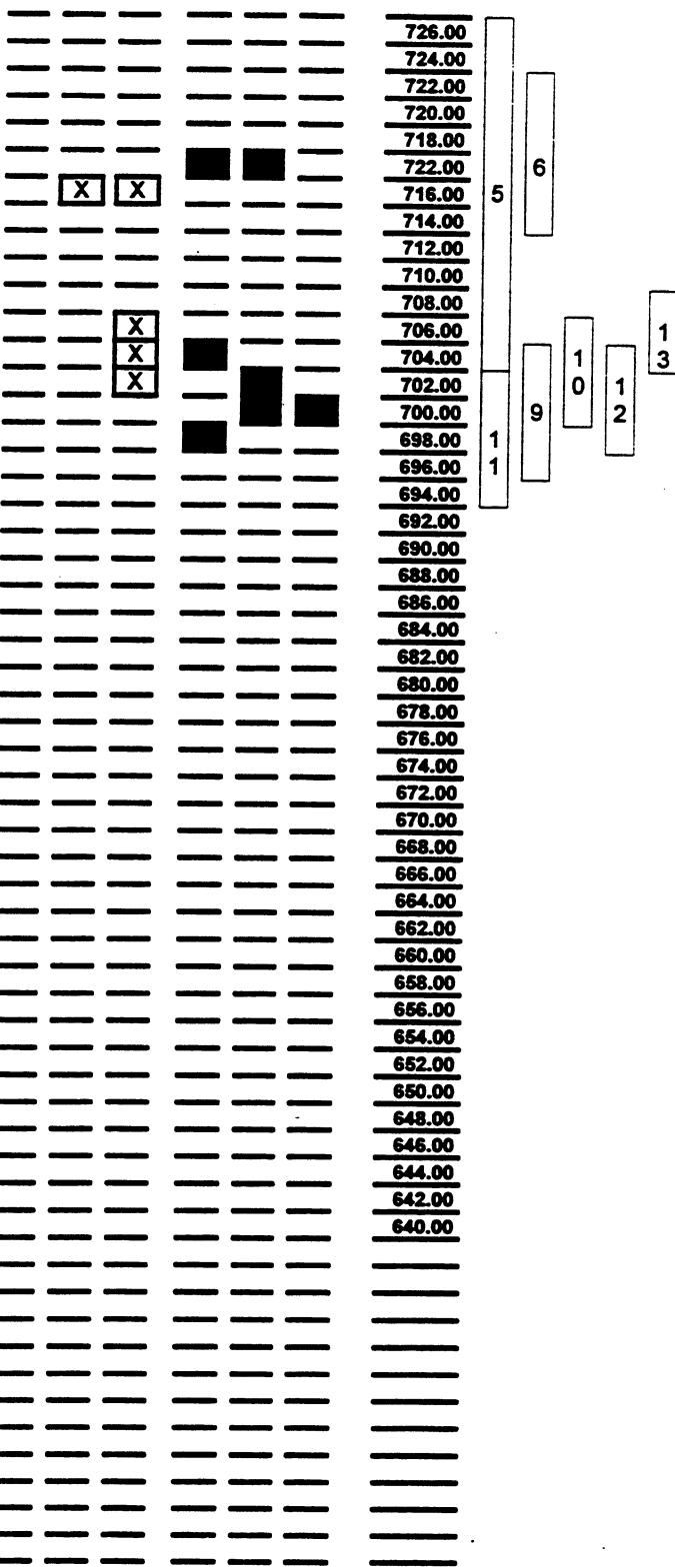


**SELLING**  
**Responsive                      Initiating**  
**TPO    R/E    EXT    TPO    R/E    EXT**

## MARCH SILVER Value Area

TPO B/E EXT TPO B/E EXT

## Price



**US1**

**127-21s** as of close 10/13

Comdty GPO

Vol n.a. OpInt 677,729y

**Bar Chart for US1 Comdty**

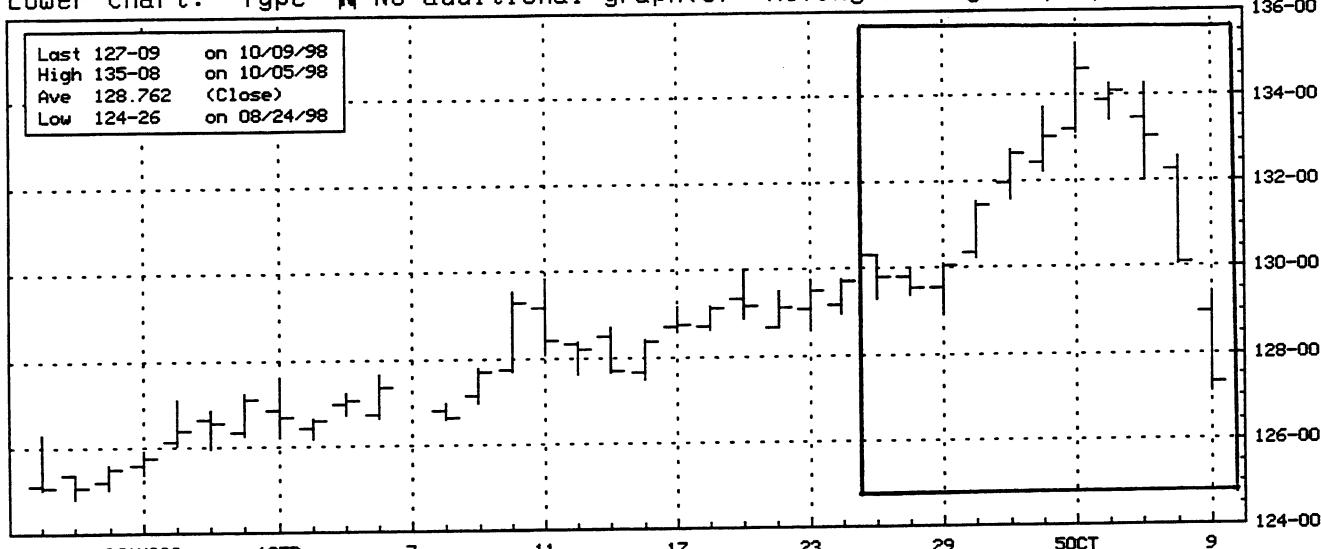
Range | 8/21/98 - 10/9/98

Period  Daily

Upper Chart: Type  Bar Chart

Moving Averages

Lower Chart: Type  No additional graph(s) Moving Average **15**

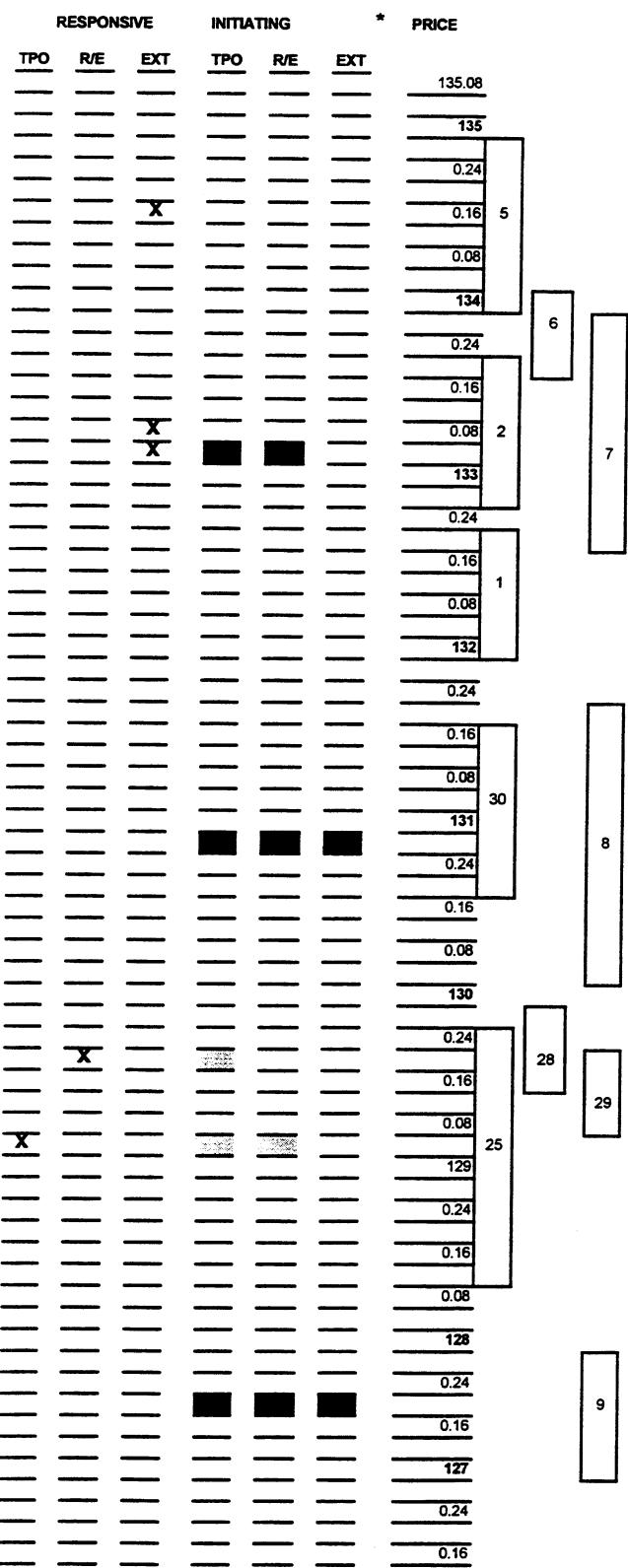


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Princeton:609-279-3000 Singapore:226-3000 Sydney:2-9777-8666 Tokyo:3-3201-8900 Sao Paulo:11-3048-4500  
G158-95-0 14-Oct-98 7:05:23



| SELLING    |     |     |            |     |     | BUYING |        |   |  |            |     |     |            |     |     |            |  |  |        |
|------------|-----|-----|------------|-----|-----|--------|--------|---|--|------------|-----|-----|------------|-----|-----|------------|--|--|--------|
| RESPONSIVE |     |     | INITIATING |     |     | *      | PRICE  |   |  | VALUE AREA |     |     | RESPONSIVE |     |     | INITIATING |  |  | DSI/BC |
| TPO        | R/E | EXT | TPO        | R/E | EXT |        |        |   |  | TPO        | R/E | EXT | TPO        | R/E | EXT |            |  |  |        |
|            |     |     |            |     |     |        | 135.08 |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 135    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   | 5 |  |            |     |     |            |     |     |            |  |  |        |
|            | X   |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 134    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            | X   |     |            |     |     |        | 0.08   | 2 |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 133    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 132    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 131    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 130    |   |  |            |     |     |            |     |     |            |  |  |        |
|            | X   |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            | X   |     |            |     |     |        | 25     |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 129    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.08   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 128    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 127    |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.24   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        | 0.16   |   |  |            |     |     |            |     |     |            |  |  |        |
|            |     |     |            |     |     |        |        |   |  |            |     |     |            |     |     |            |  |  |        |

## SELLING



## BUYING

| RESPONSIVE |     |     | INITIATING |     |     | DSI/BC             |
|------------|-----|-----|------------|-----|-----|--------------------|
| TPO        | R/E | EXT | TPO        | R/E | EXT |                    |
|            |     |     |            |     |     | 5 89/90            |
|            |     |     |            |     |     | 6 81/89            |
|            |     |     |            |     |     | 2 7 91/88<br>22/86 |
|            |     |     |            |     |     | 1 97/86            |
|            |     |     |            |     |     | 30 93/82           |
|            |     |     |            |     |     | 8 11/83            |
|            |     |     |            |     |     | 28 43/80           |
|            |     |     |            |     |     | 29 65/78           |
|            |     |     |            |     |     | 25 32/81           |
|            |     |     |            |     |     | 9 6/76             |