Factor Update, July 24, 2016

Market Review

Candidate Factor Moves are currently ongoing in:

- Nifty 50 (SGX)*
- Medtronic (MDT)*
- LRCX*
- Cotton*
- British Pound
- FTSE 100*
- Emerging Market Index*

A Candidate Factor Move was terminated this past week in Robusta Coffee. Candidate Factor Moves are developing in Copper and EUR/NOK. This issue of the Factor also comments on U.S. Dollar Index*, USD/TYR, Soybeans*, EUR/USD*, Crude Oil, Canadian Dollar futures, Silver, Gold and global stock index markets. *Signifies a position in the Factor Tracking Account

The focus of my attention

This issue of the Factor Update may contain charts for some markets that are of "charting interest" only and not subject to "trading pursuit." A trader can have all the opinions he or she wants – but what matters are the order that are entered. A trader has NO control over the outcome of a trade. A trader's only control is over the processes of analysis and the subsequent entry of orders. A trader is nothing more than a glorified order enterer. Markets in which I am holding or considering orders include:

Existing positions

- U.S. Dollar Index – protective stops and target
- Medtronics – protective stop and target
- Nifty 50 – protective stops and target
- FTSE – protective stop and target
- LRCX – protective stop and target
- Cotton – protective stop and target
- Emerging Market Index – protective stops and targets
- EUR/USD – protective stops and targets
- Soybeans – protective stop and target

New positions

Cotton (Dec) – entry order with protective stop
Copper – entry order with protective stops
GBP/USD – alert
EUR/NOK – alert
Candadian Dollars – entry order with protective stop

The Factor Tracking Account is currently leveraged at 4.6 to 1.
The margin-to-equity use for futures and forex positions is 22.1%.

Winning trades are the by-product of losing trades

I hate to be the bearer of bad news to some of you, but taking losses is the primary job description of a market speculator. If losses offend you or upset your emotional chemistry, if you consider "being wrong" to be a character fault or a "problem" with your trading approach, if you even think that the marketplace cares what you think or what you do, then market speculation is probably not for you. Trading is mostly an exercise of throwing mud against the wall to see what sticks – and most lumps of mud fall quickly to the floor. I have known many extremely profitable career traders over the years and very few of them have a win rate in excess of 50%. Almost to a person, these traders view taking losses (many losses) as the process of finding winners.

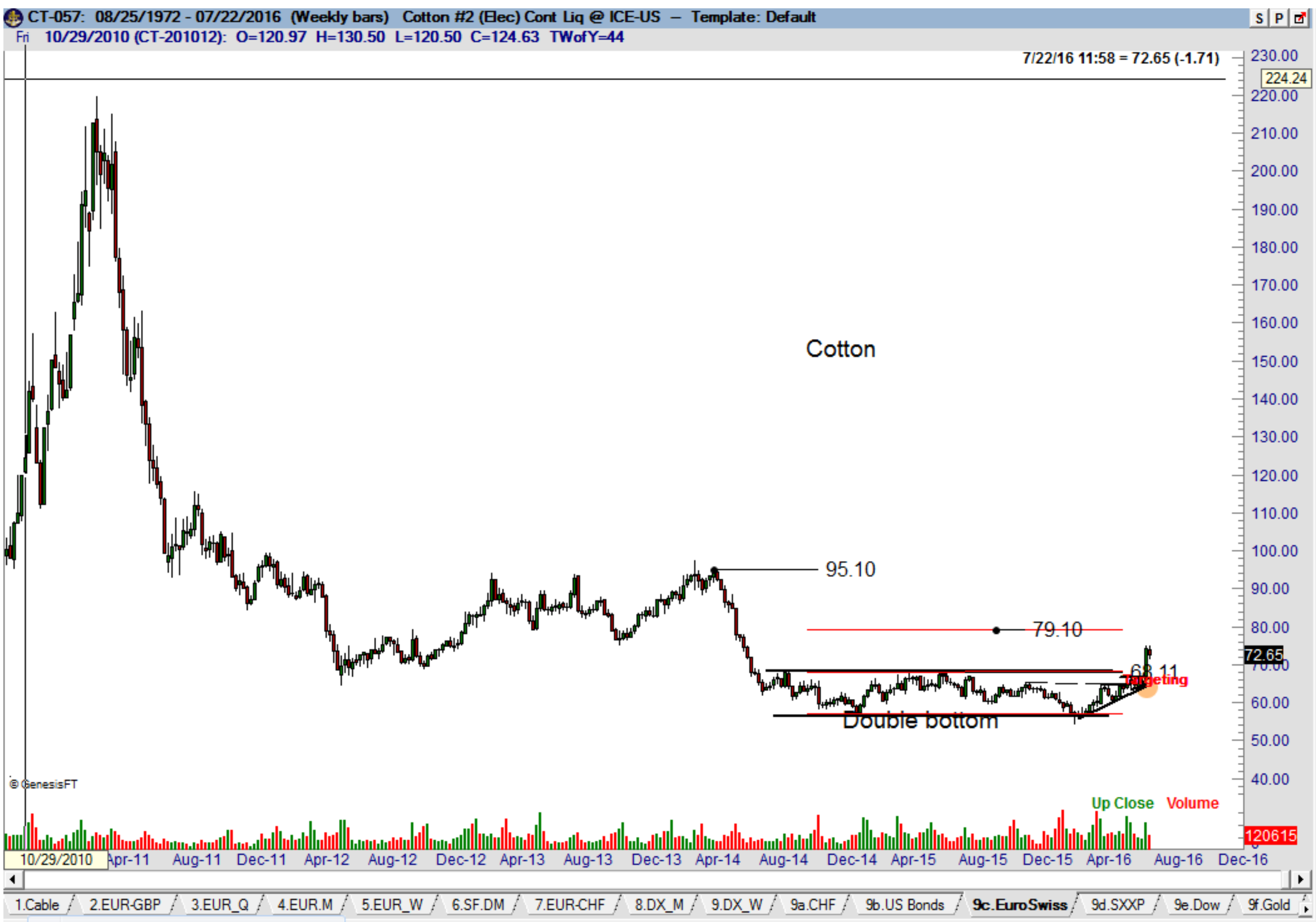
I am not offended by being wrong on a market call – it is absolutely not a big deal to me. It is always an amusement to me when tweeters go out of their way to remind me of bad market calls. To be a successful profit taker, a trader must first become good at taking losses. Sorry – both profits and losses are part of trading. I know of no other service similar to the Factor that provides a frank discussion of losing trades, losing days, losing weeks, losing months and even losing years (I have experienced several net losing years along the way). I am in no way embarrassed to be wrong on my market analysis or on trades.

If losing trades and being wrong bothers you then the Factor is not for you – in fact, trading is not for you. If you become obsessed with making money back in the same stock, forex pair or futures contract in which you lost capital, then you need to seriously examine if you should be involved in market speculation.

Candidate Factor Moves in Progress

Cotton (weekly and daily graphs)

The dominant chart construction in Cotton continues to be the completed 24-month double bottom on the weekly chart. The targets of this bottom are 79.10 (the measured move) and 95.10 (May 2014 high). The Dec contract was launched by a 5-week pennant. My preferred set-up is when a brief and decisive daily chart pattern develops just prior to the breakout of a weekly chart configuration. Factor is long, having taken partial profits at 73.48. A period of congestion or even a sizable correction would be very normal given the magnitude of the Jul 11-13 advance. I have an interest in returning to a fully leveraged long position. My thinking is that many speculators might have their protective sell stops at the Jul 12-13 gap. I am willing to accommodate such sell stops if the market breaks back that far. The specific target of the Dec contract is 78.48.



See daily graph, next page.

Trading commentary

I want to start this Update by posing a question to those of you who are experienced (or not-so-experienced) discretionary traders. This question will set the tone for this Update and my current thinking on portfolio construction.

> *Have you ever been in a trade that proved to be fabulous only to mess it up prematurely by getting stretched out into too many other peripheral trades?*

My guess is that your answer is "*Yes, yes, yes, yes*!" Well, I am in a quandary right now. I want to stay extremely focused on one theme (long DX and short EUR). My risk on this theme is 145 BP to initial stop levels (EUR = 43 BPs and DX = 102 BPs). I really want to expand this risk towards 200 BP if given the right opportunity. If what I think might take place in EUR and DX actually happens I could be a 2,000 BP-plus trade. Trading themes producing 20%-plus returns against an entire trading account do not happen every year.

The question facing me is how to keep my eye on the prize when a number of worthy chart configurations in other markets develop and are completed? For example, trading signals occurred this past week in Soybeans, Gold, T-Bonds and S&Ps. It is not that I am adverse to these signals – it is that I do not want to get spread thin. I want to remain focused on the trades that offer the most outstanding profit opportunity.

When focused on a potentially extraordinary trade I will engage other markets on five conditions:

- The signals must be decisive and not subject to alternative interpretations
- The patterns must be at least eight weeks in duration
- My sizing must not exceed 60 BPs
- I do not want to get trapped into a new position by intraday volatility
- I will be much more aggressive than normal in advancing stops in the direction of a profitable price move

Trades offering a profit potential of 1,000 to 2,000 BPs do not cross my path very often. But when they do I want to become super selective with dynamic risk management on any other markets I enter.

Emerging Market Index (weekly and daily charts)

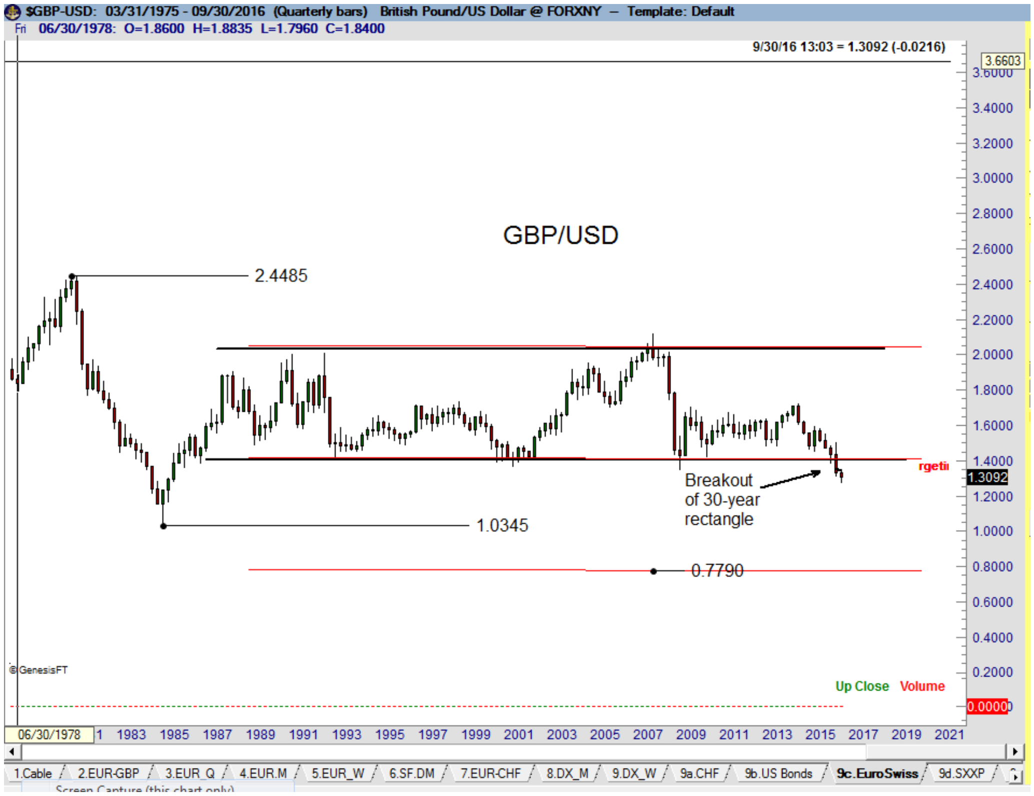
The dominant chart construction in EM is the completed 10-month H&S bottom pattern on the weekly chart wherein the final stage of the right shoulder was an independent 5-week H&S on the daily graph (red box). I continue to note that there is substantial overhead resistance on the weekly graph above 850. The initial profit target is 951 with a further potential of 1100 (Sep 2014 high). The daily chart exhibits a possible 5-day pennant. There was a time in my trading when I used shorter-term chart developments such as this to pyramid a trade. I no longer do so. Factor is long.

<u>FTSE 100 (quarterly and daily charts)</u>

The dominant chart construction in the FTSE is the completed 10-month H&S bottom pattern, as shown on the daily chart. I continue to note the 16-year congestion on the quarterly graph. While the daily chart H&S has a target of 7298, significant resistance on the longer-term graph exists at 7000. Factor is long FTSE.

GBP/USD futures (quarterly and daily graphs)

The dominant chart construction in the Cable is the completed 30-year rectangle on the quarterly graph with targets of 1.0345 -- with .7790 as an outside possibility. Several prominent forex chart analysts have cited a possible H&S bottom on the daily graph, as shown. My own opinion is that this consolidation will more likely become a H&S failure sell signal. A decisive close below the existing right shoulder low of 1.3064 would tilt the odds in favor of the H&S failure labeling. Factor is flat. I may consider a short position depending upon subsequent price action.



Guidelines for using intraday stops vs. close-only stops to enter a position

An often asked question from Factor members deals with using intraday stops vs. closing price stops to enter a position. This is an important issue for two reasons. First, extreme upside and downside price volatility is created by HFT and short-term algo traders to run blocks of stop orders – only to have prices quickly reverse in the opposite direction. Second, and related, the closing price is the most important price of the day. Most HFT and day traders are flat by each day's close so that the settlement price is the price at which position traders are willing to commit margin capital. In other words, the closing price is stripped of the influence of the funny money.

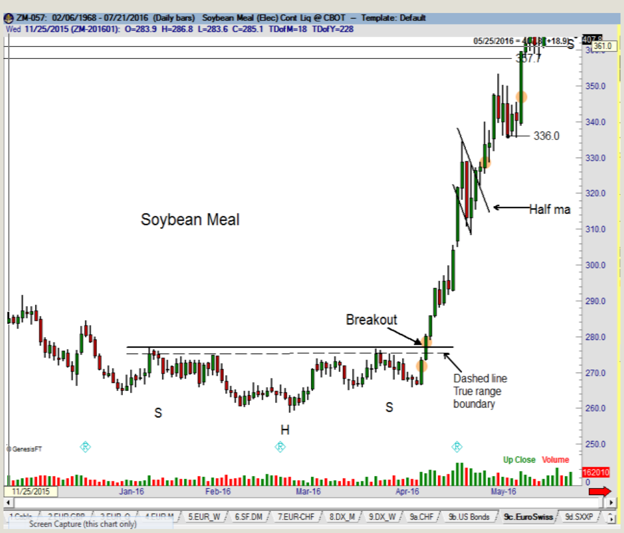
A closing price completion of a chart pattern is what counts. Yet, there are some downsides to waiting for a closing price completion of a pattern before taking a position – the biggest of which is that a breakout with an extremely wide-bodied bar (WBB) might force a trader to immediately chase a move in order to become positioned. A recent example is the Jul 12 completion of a weekly chart double bottom in Cotton. Traders who waited for a closing price completion of the double bottom in Cotton were forced to significantly downsize the trade, thus negatively altering the reward-to-risk profile.

I use a combination of intraday and closing price stops to enter a trade. [A day-only stop order entered to become effective one or two minutes before the close is a proxy "stop-on-the-close-only" order.] In some cases I may enter an entire position with an intraday stop order – in other cases I may split my entry between an intraday stop and a close-only stop – in other cases I may enter my entire position on the close.

Following are general guidelines I consider important when using intraday stop orders to enter a position:

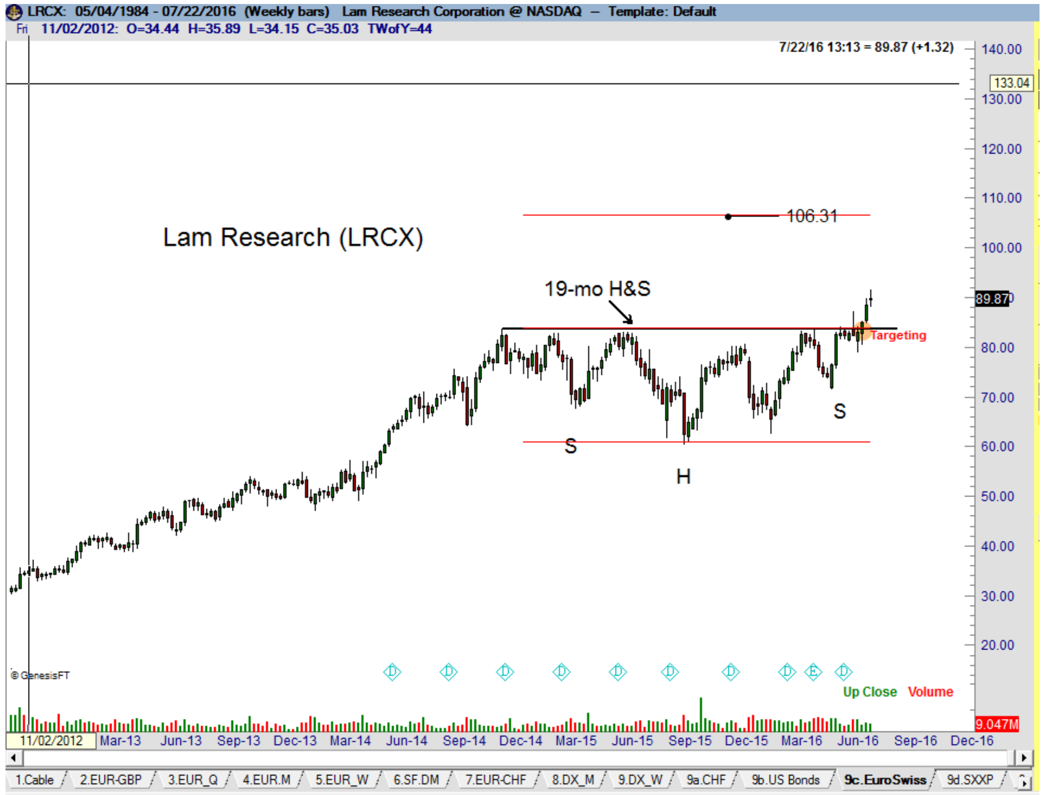
- The breakout should be through a horizontal boundary (rectangle, right-angled triangle, H&S, pennant)
- The boundary should be well-defined and not subject to alternative interpretations. Alternative boundary lines are most often linked to the presence of extended spindles on a candlestick chart.
- A pattern wherein the boundary line using orthodox lows (or highs) is similar to the boundary line using the true range (body of candlestick bar) is the most compatible with intraday entry stops
- Intraday entry stops should be avoided in overnight markets in all except the most liquid 24-hour markets (examples would include EUR/USD, Crude Oil, Eurodollars, USD/JPY)
- Intraday stops orders should be avoided for extended patterns longer than four or five months in duration
- The more contact points defining a boundary line, the more appropriate an intraday entry stop becomes
- In my proprietary trading, a trade entered with an intraday entry stop should seldom carry a risk greater than 60 BPs

Recent examples of intraday breakouts meeting the above criterial include Cotton and Soybean Meal.



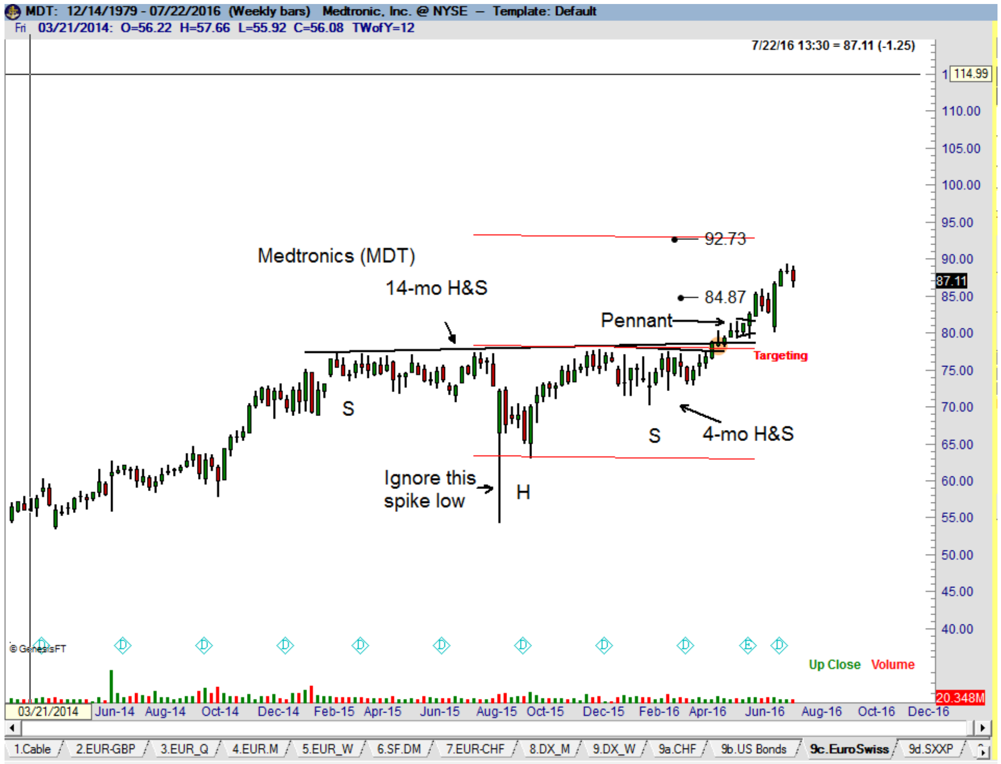
Lam Research Corp (LRCS) – weekly and daily graphs

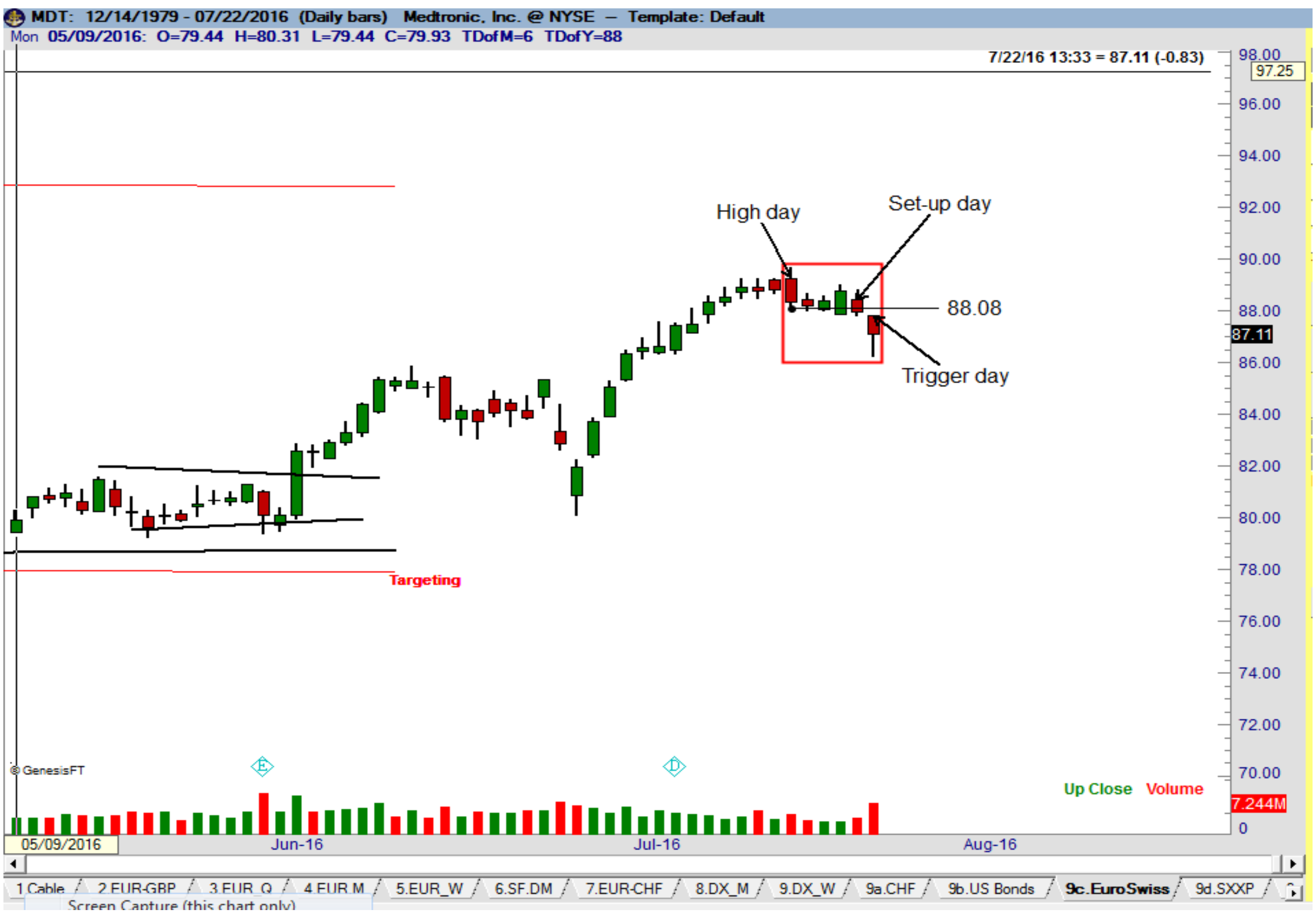
The dominant chart construction in LRCS is the completed 19-month continuation H&S on the weekly graph. This pattern has a target of 106.29. Note on the daily chart the premature breakout Jun 20 through Jun 23. Had I noticed this chart earlier I would have bought this breakout, only to be stopped out by the Jun 27 decline. The WBB advance on Jul 8 was a secondary (and the real) pattern completion. Factor is long.



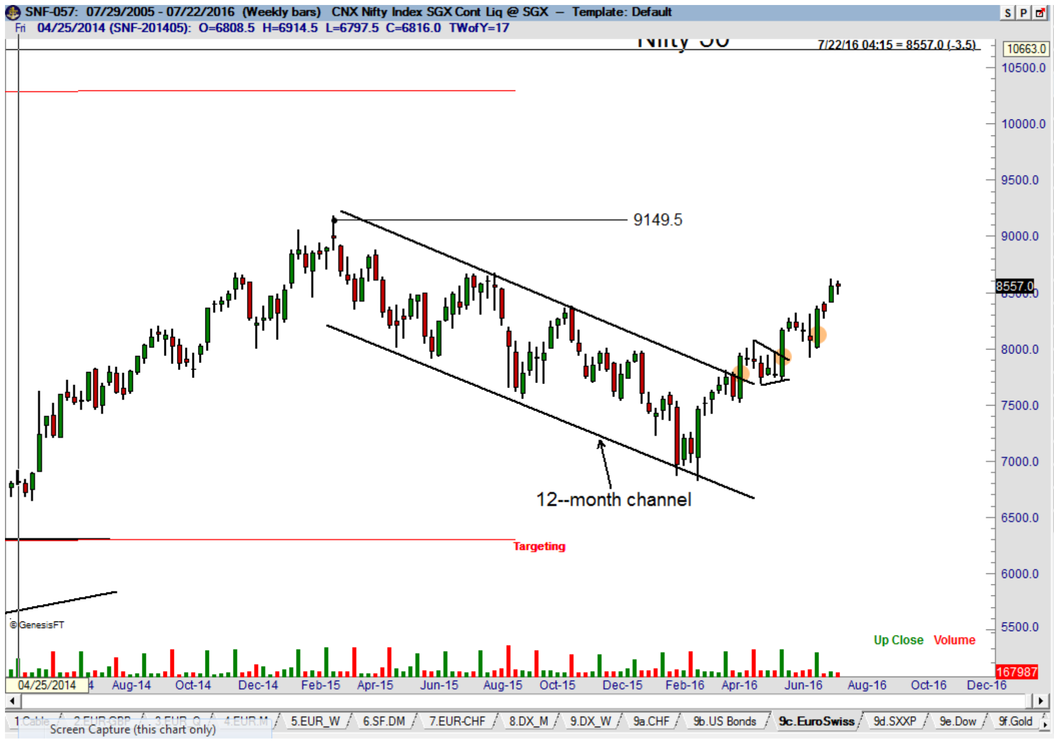
Medtronic (MDT) – weekly and charts

The dominant chart construction continues to be the completed 14-month continuation H&S pattern on the weekly graph with a target of 92.73. Factor is long a 50% position. MDT has traveled more than 70% of the distance from the breakout to the target. A 3DTSR was triggered on Friday, however I overrode the rule and remain 50% long. I will use Friday's low to defend the position.





<u>India SGX Nifty 50 (weekly and daily charts)</u>

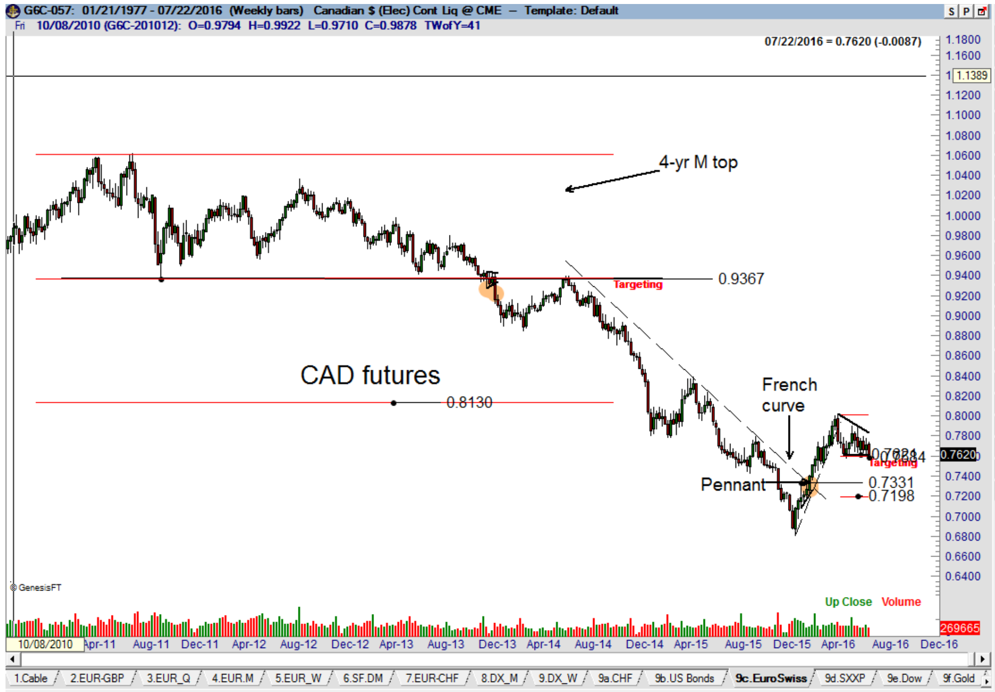


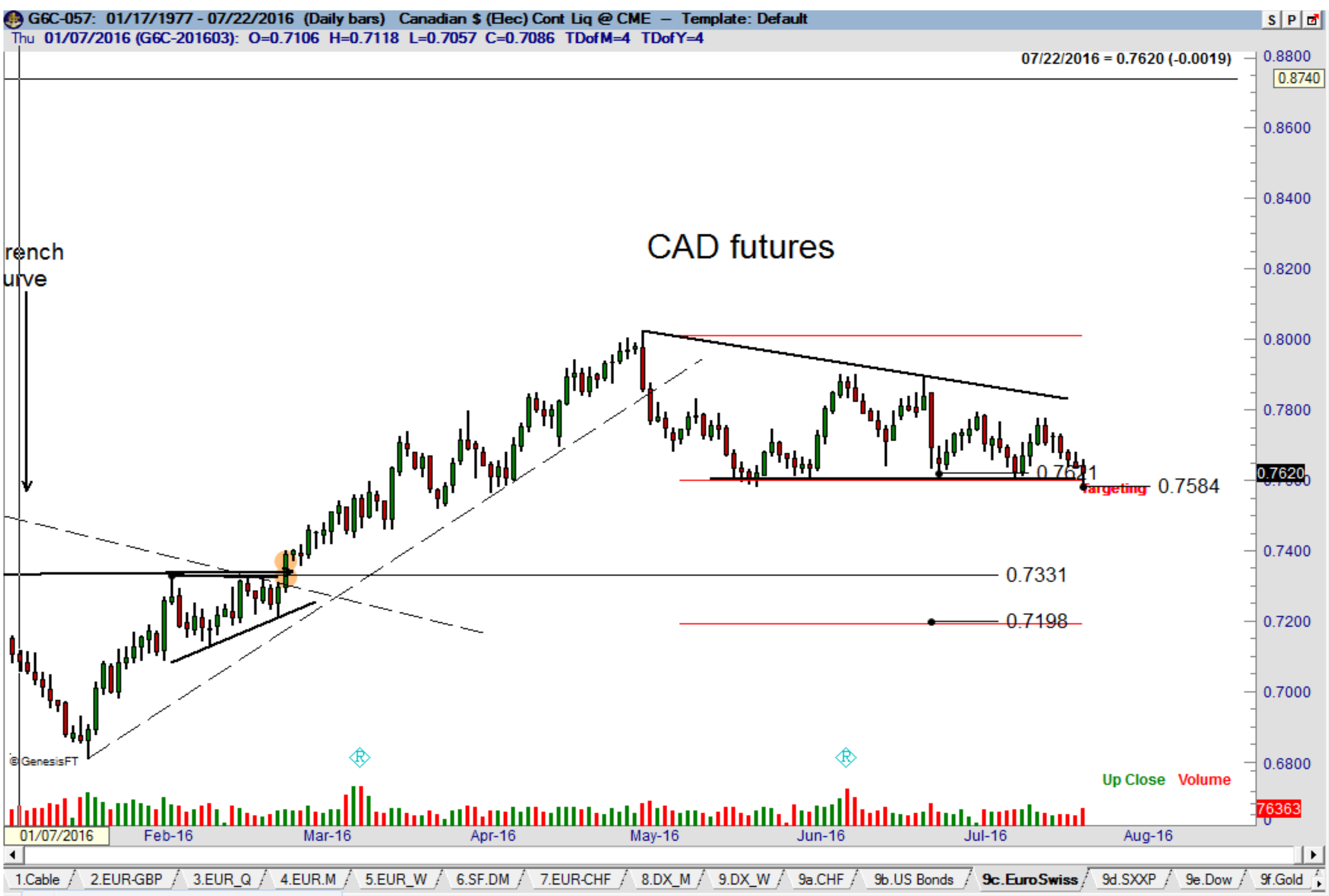
[Note: Longs in the Jul contract must now be rolled into the Aug or Sep contracts.] The dominant chart construction in this stock index remains the 6+ year ascending triangle on monthly (not shown) and weekly graphs and the 12-month channel completed on the daily graph on Apr 13 (launched by a 4-week pennant). The targets in the Nifty are 9,144 (the high of the channel) and 10,248 (monthly graph objective). The daily chart exhibits a small pennant (red box) that could launch the next leg up in this trend. Factor is long the Nifty.

Other Markets

Canadian Dollars futures (daily and weekly graph)

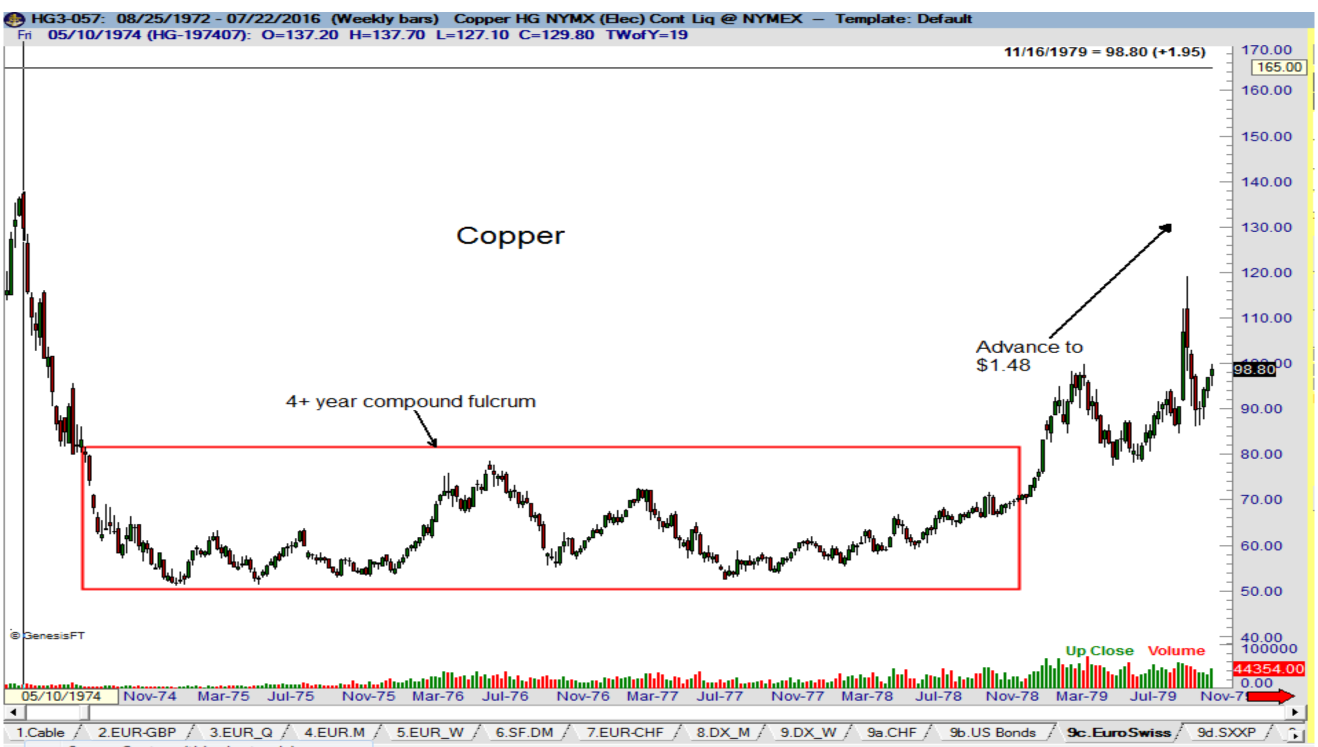
The Jan '16 through May '16 bear market correction in the Canadian Dollar appears to have run its course. The daily chart appears to be forming a 12-week descending triangle. The lower boundary of this triangle rests at around .7600. The market attempted to punch through this zone on Friday, only to close back within the congestion area. A move below Friday's low would now be a sell signal for me with targets at .7331 and .7211.



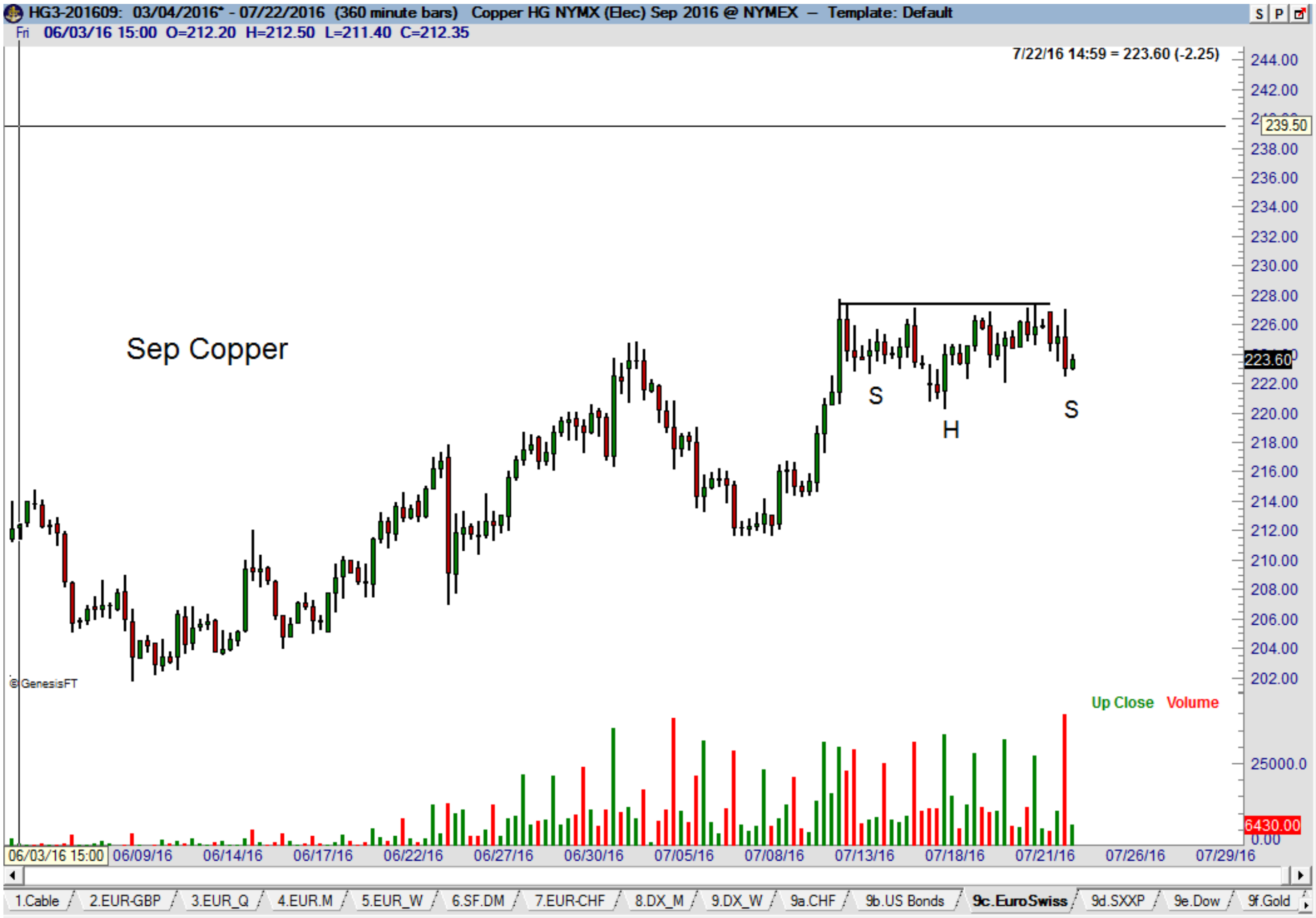


Copper (misc. charts)

The foundational premise of classical charting principles is the tendency for markets to repeat certain geometric patterns (with some variations) over and over and over again. Another feature of classical charting principles is that the same patterns can form in different time frames. Some chart patterns are extremely common, such as symmetrical triangles and flags. Some are less frequent, such as broadening patterns. The compound fulcrum is extremely rare – appearing in the futures and forex markets once every three or so years. The current daily chart of Sep Copper futures displays a possible compound fulcrum. An almost identical compound fulcrum configuration formed on the weekly Copper chart in the late 1970s. The outcome of that pattern was a doubling of the price during the following year. The compound fulcrum does offer a trading challenge in that the final portion can take the form of a rounding or saucer pattern – and rounding patterns are difficult for momentum traders. Factor is flat. Note that the intraday graph displays a possible continuation H&S pattern. I will use this formation to enter a long position should an upside breakout occur.

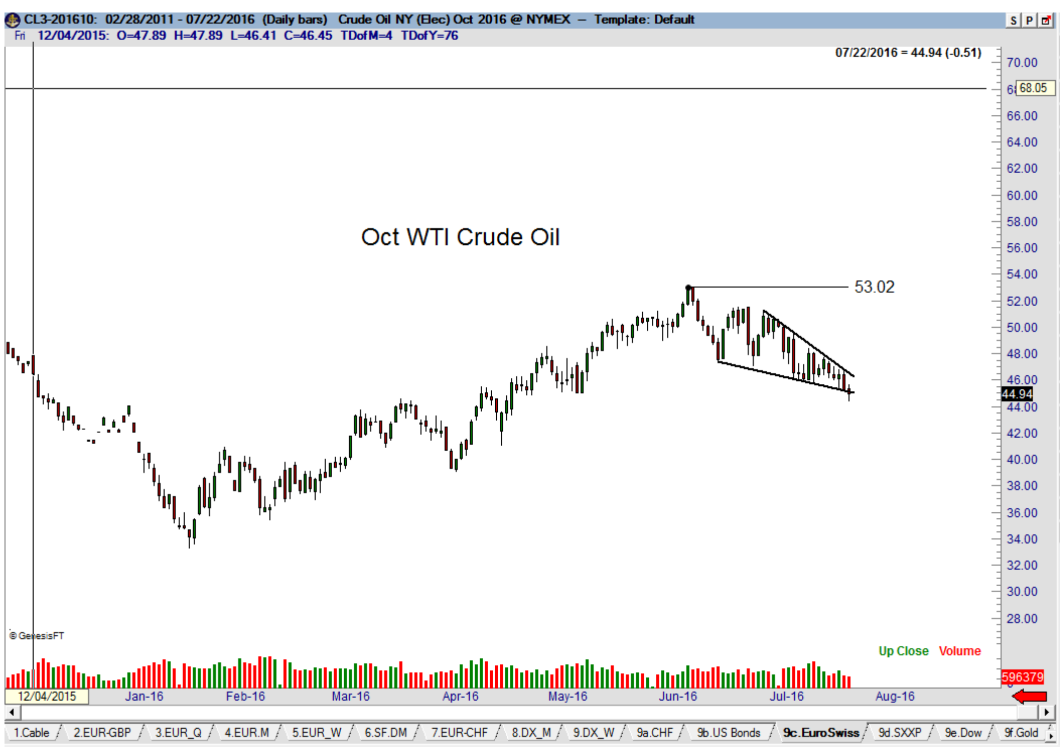


See additional Copper graph, next page.



Crude Oil

The decline from the early Jun high in Crude Oil has taken the form of a 5+ week falling wedge on the daily chart (Oct futures). Typically the falling wedge is a corrective pattern – suggesting an upside breakout and test of the 53.02 high. In some instances prices will accelerate through the bottom boundary of a falling wedge – a pattern knows as a running wedge. Factor is flat.

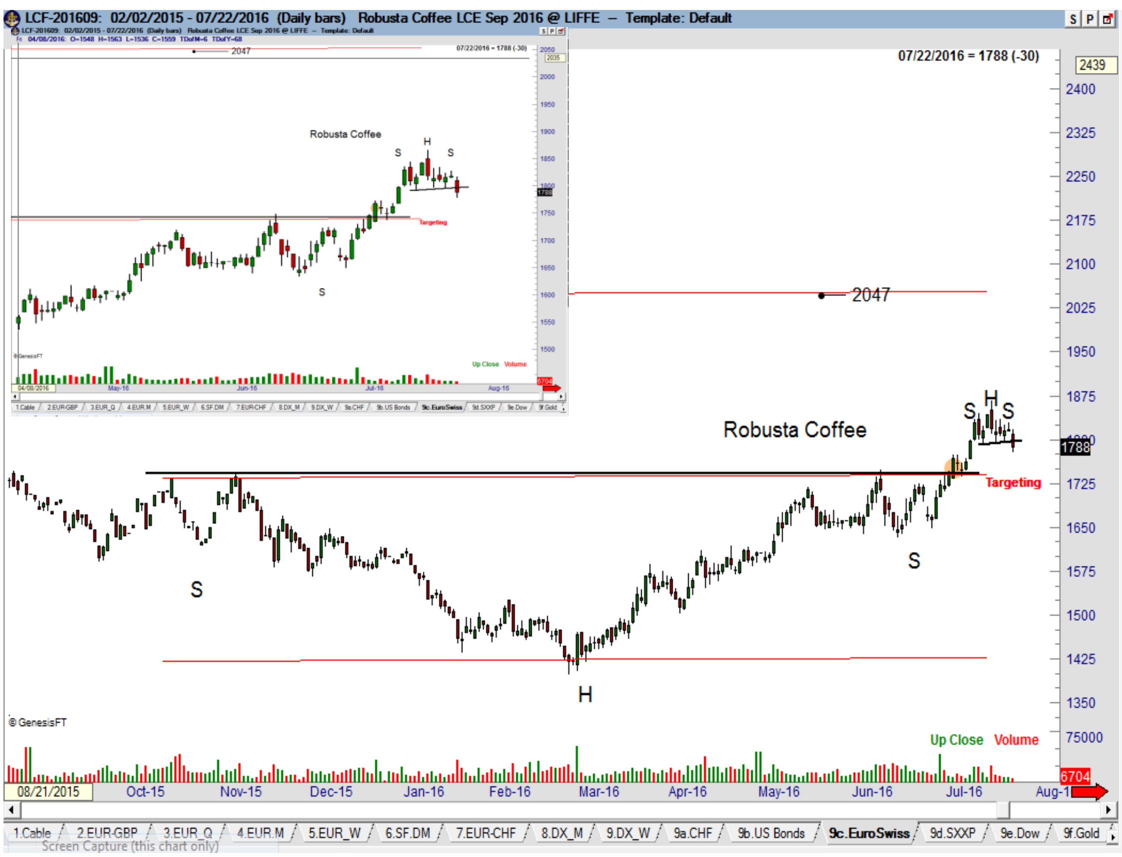


EUR/NOK (daily graph)

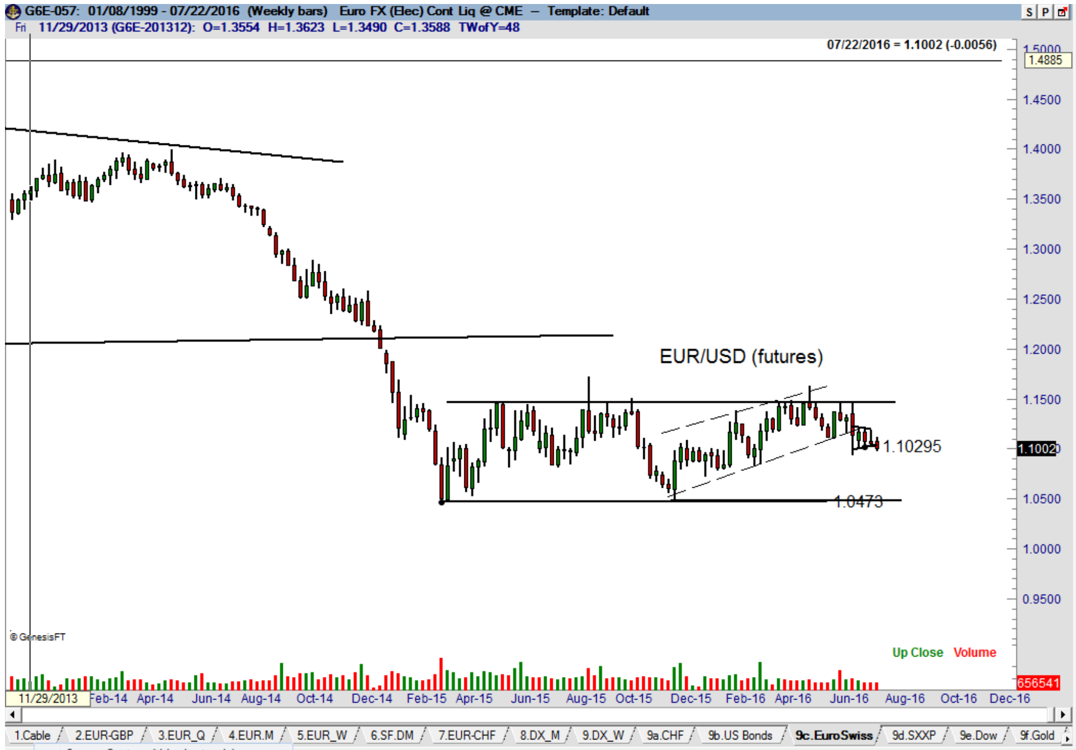
This forex cross continues to trace out a possible 11-month H&S top on the daily graph. I might become enticed to take a position in this cross depending upon the nature the completion of the pattern. Factor is flat.

Robusta Coffee (daily graph)

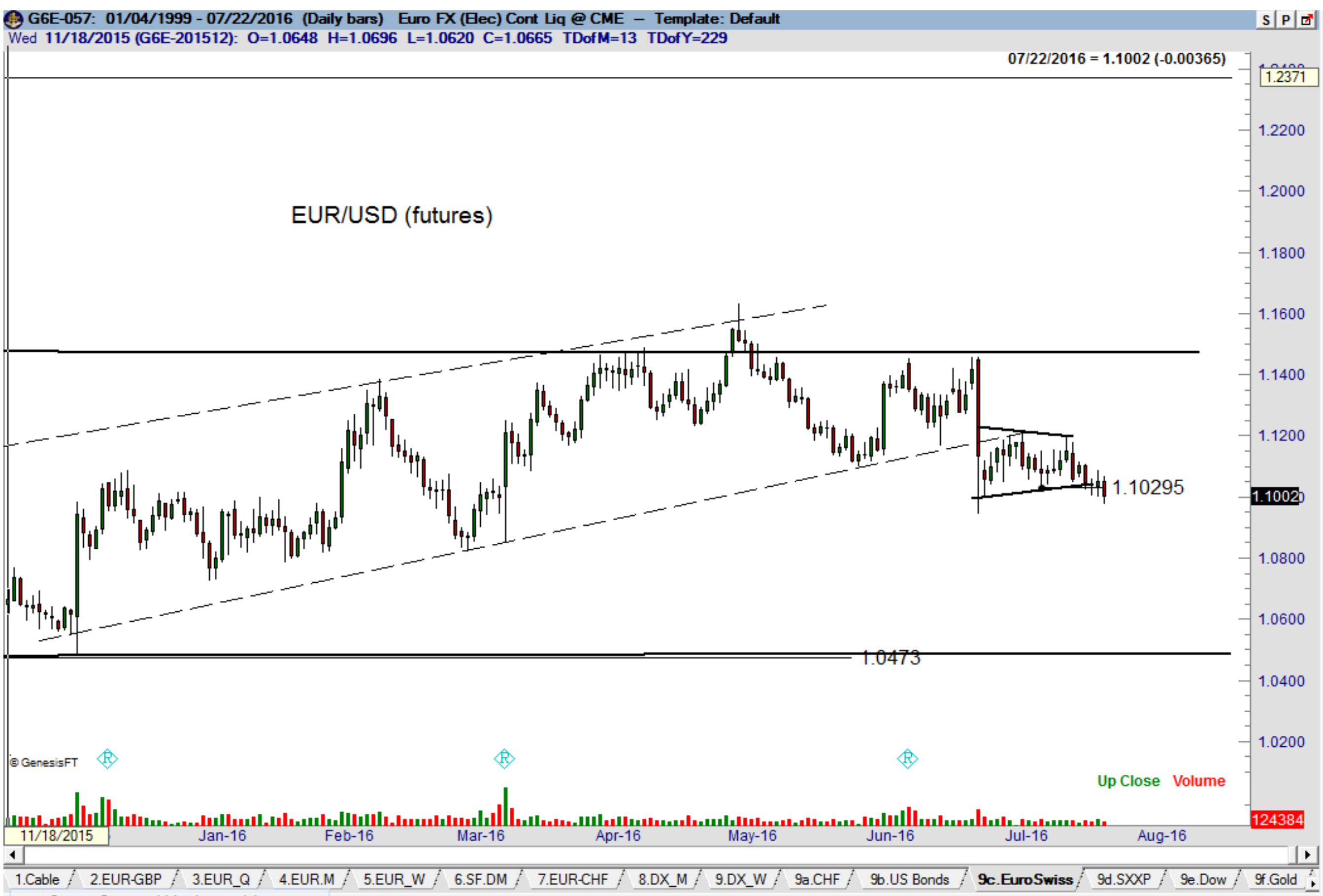
The decline on Friday completed a small, but recognizable, H&S top pattern (see inset). While the underlying H&S bottom on the daily chart is substantially more significant than this 2-week reversal pattern, nevertheless I must respect the price action. I was stopped out on Friday. If Friday proves to be a small bear trap I will not hesitate to re-establish a long position.



EUR/USD futures (weekly and daily graphs)

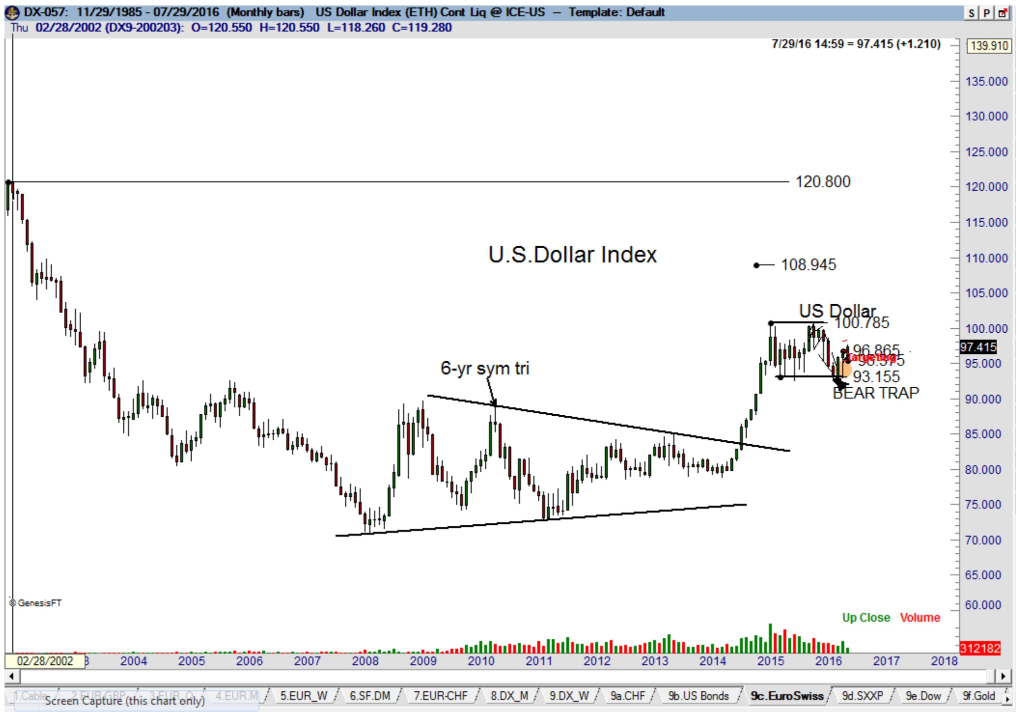


The dominant chart construction in the Eurocurrency is the possible 17+ month rectangle developing on the weekly graph. The Jun 24 Brexit decline penetrated the lower boundary of a 7-month channel on the daily and weekly graphs. The decline on Friday confirmed the completion of a 4-week pennant on the daily chart. All-systems-are-go for a decline toward the lower boundary of the major weekly chart rectangle. Factor established a short position in EUR/USD on Tuesday. EUR is highly correlated with the U.S. Dollar Index.

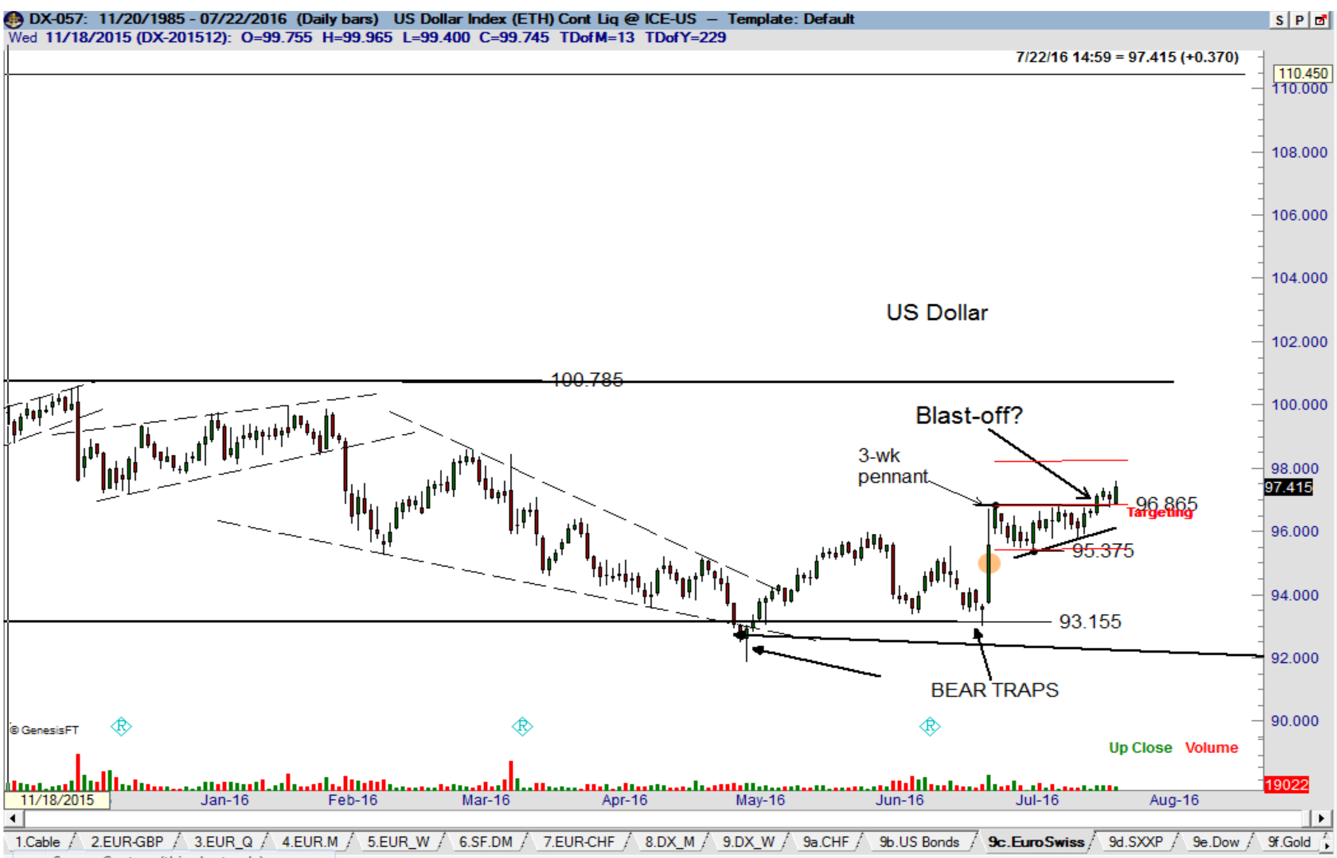


U.S. Dollar Index (monthly and daily charts)

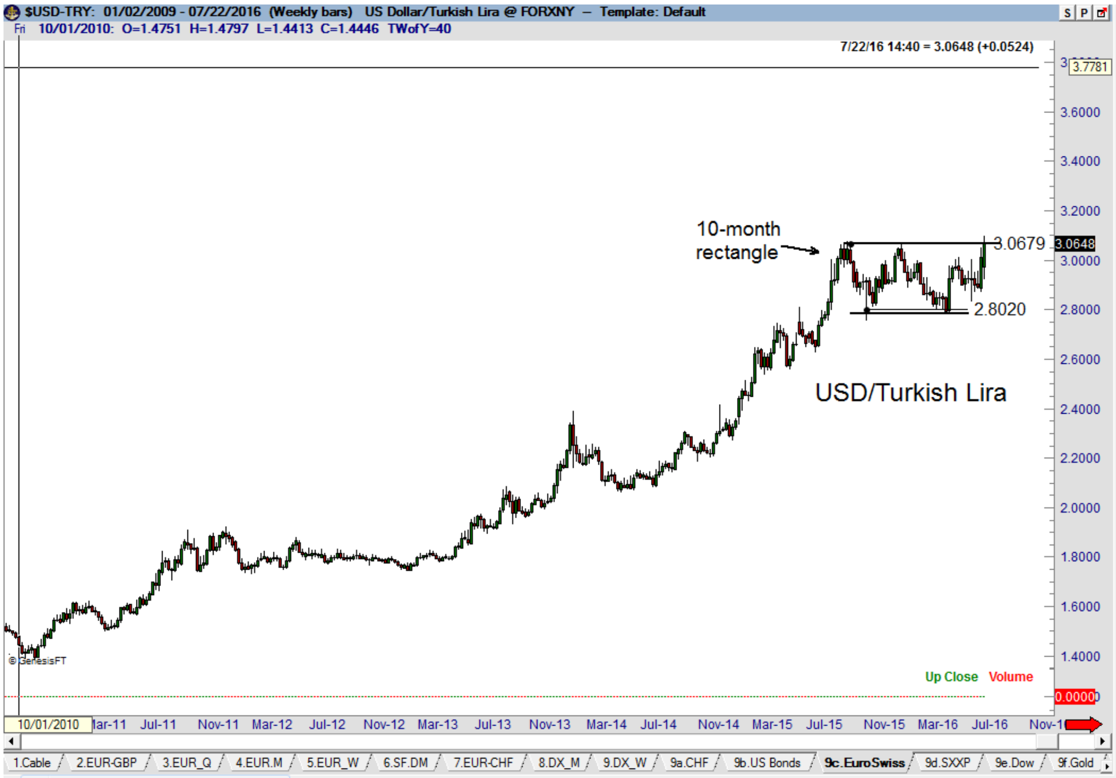
[Warning: The incompetent central bankers of the G20 countries meet this weekend in China. Exchange rates will, no doubt, but high on the agenda. Nothing would surprise me from this gang of thieves. Expect volatility early next week.]



Same song – 100th verse (that's the number of consecutive weeks I have been a long-term "super bull" on the U.S. Dollar). The advance in Sep 2014 completed a massive 6-year symmetrical triangle bottom. The market has been forming a continuation rectangle since Mar 2015. I believe this rectangle will eventually be resolved by an upward breakout followed by a move to 109, then 120. The advance on Tuesday completed a 3+ week pennant on the daily graph. The hard retest of the pennant on Thursday now becomes my line of defense on a portion of my position. Factor is long with breakeven stops should the entire trade go south.

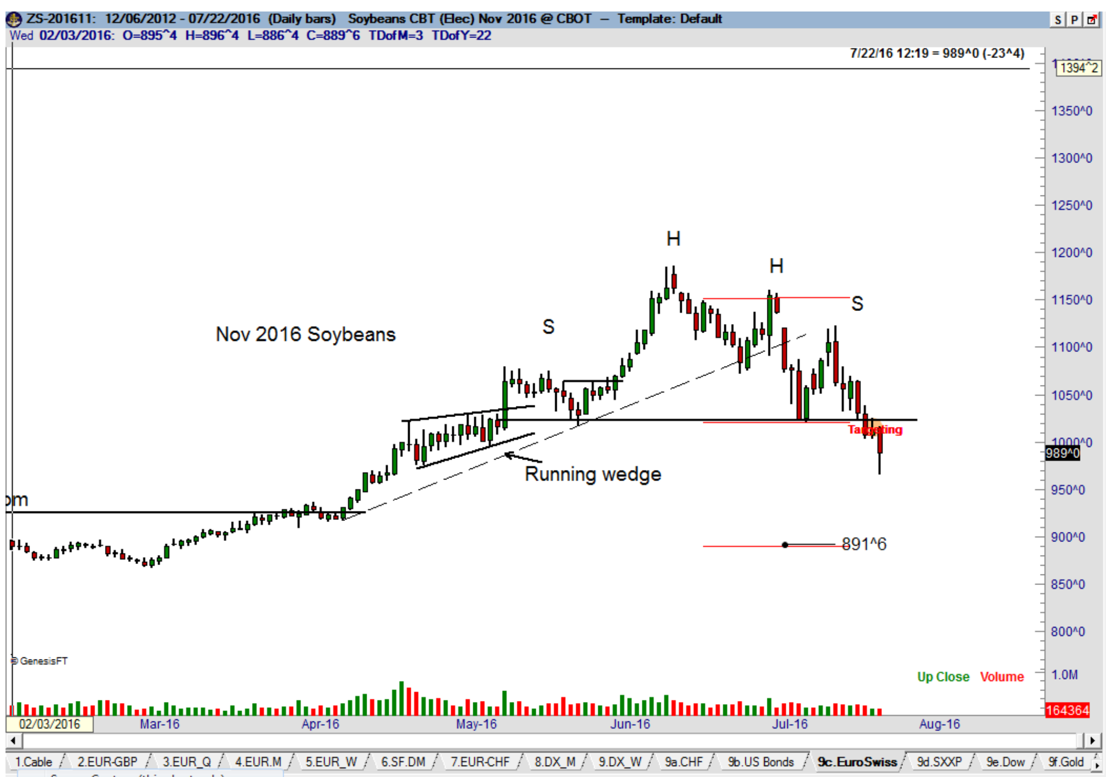


USD/TRY



Amidst Turkey's apparent evolution to a dictatorship, the Lira made an all-time low against the USD this past week (all-time high in the USD/TRY cross), but the 10-month rectangle on the weekly chart was not decisively penetrated on a weekly basis. Factor is flat. I have no interest to trade a crossrate that will be determined by an unstable political situation. This, to me, is akin to gambling.

Soybeans (daily graph)



The daily chart of Nov Soybeans displays a possible twin-headed H&S top pattern, completed on Jul 20. There are problems with this interpretation, including:

1. The height of the shoulders lack symmetry
2. The double head is awkward
3. Defining the mid-May high as part of a distribution process rather than as a correction in the previous bull trend is a questionable interpretation

Nevertheless, the H&S top (if correctly diagnosed) has a target of 891. Factor is short.

Member Q&As

Note to members: Peter cannot answer each and every question received, especially multi-part questions. The Factor staff does their very best to capture the essence of similar questions from multiple Factor members and reword the inquiry into a paraphrased version. We regret that many specific questions do not get answered immediately. Understanding the spirit and strategic nuances of Peter's trading requires several years of tracking his trading and commentary. Also, Peter is hesitant to provide specific answers regarding the tactical aspects of his trading because he so strongly believes that each trader must struggle through many issues on their own. Please continue to submit your questions, but understand if they are not addressed directly or immediately. – Jolleen Oleson, Director of Administration

Question:
What are the success statistics of the head and shoulders patterns you post on Twitter?
-T.R., Minnesota (Yea Minnesota, my home state)

Answer:
Great question. Thanks for asking it. My long-term win rate going back to 1981 is just above 42% -- meaning that 58% of my trades have been losers or break-even affairs. Thus, the odds of most of the patterns I have traded of working has been less than 50%. The head and shoulders pattern, when properly diagnosed (many of the H&S I see on the blogosphere are NOT labeled correctly), will be successfully resolved more than 50% of the time.

But, the question of the probability of a pattern working misses the essence of market speculation completely. Chart patterns represent possibilities, not probabilities, and certainly not certainties. A better metric than the percent success rate of a pattern is its win/loss ratio value – adjusted for various protective stop strategies. Historically, the payout ratio for my proprietary trading of H&S patterns has been about $2.15 win to $1 loss. Thus, even if the H&S has less than a 50% chance of working the pattern has been a key contributor to net bottom profits over time.

My foundational perspective on any pattern is this:

- Think in terms of possibilities, not probabilities
- Any given trade is more likely to be a loser than a winner
- Make protecting trading capital the first priority
- Allow winners a chance to grow

Question:
When does the three day trailing stop rule apply? Does the trailing stop rule price, when identified, trigger the exit of the trade on an intraday basis or on a closing basis only?
-Various Factor Members

Answer:
As a general rule, the 3DTSR applies under three circumstances:

1. When the triggering of the 3DTSR puts my entry position into a loss, preempting a wider stop
2. When the 3DTSR bars are part of a small, but recognizable, reversal pattern
3. Once a market has reached 70% of the distance from the entry price to the target

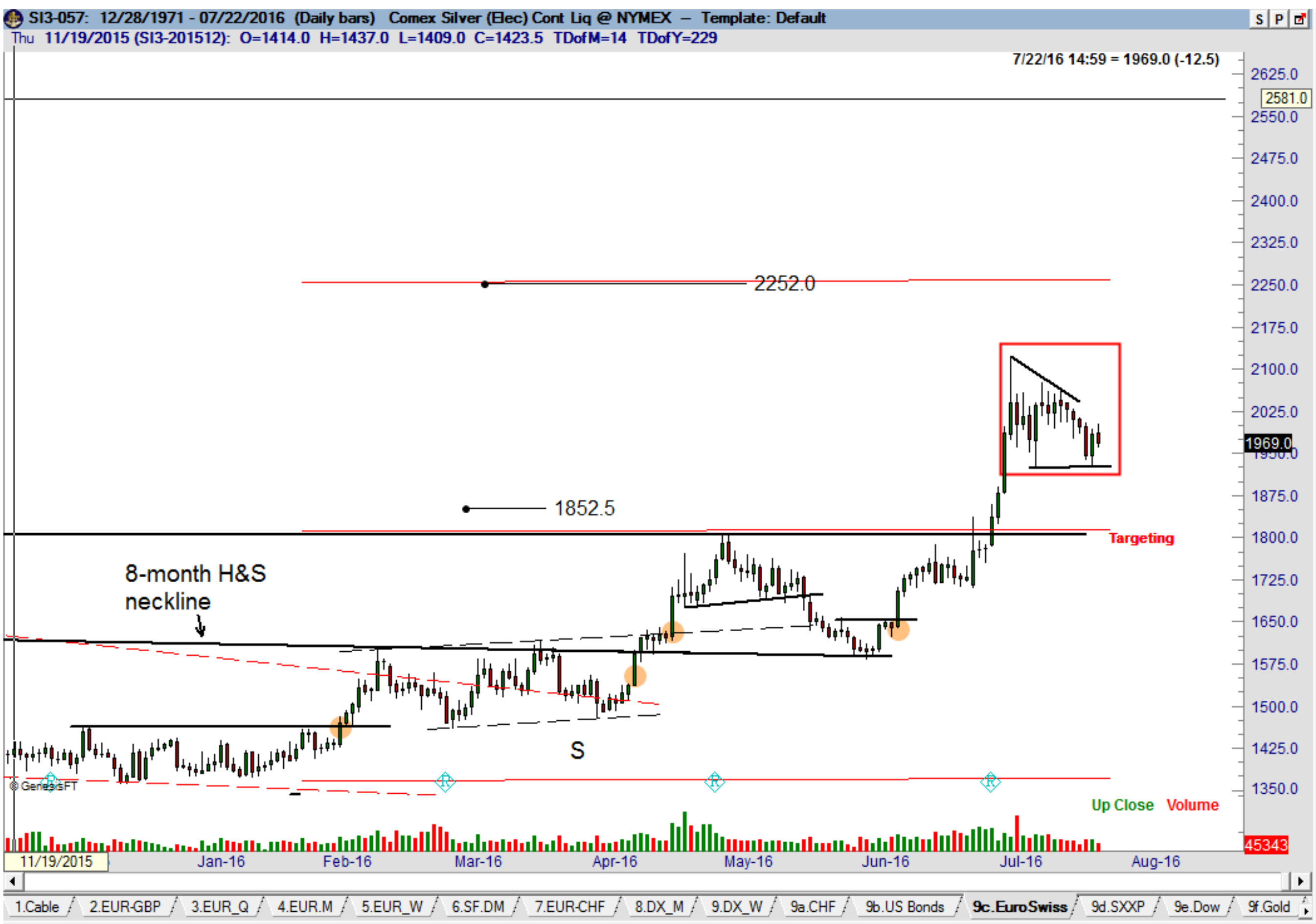
Typically I use an intraday stop to trigger the 3DTSR – but as a discretionary trader there are exceptions.

Question:
Do you use a maximum risk for all of the positions in an overall portfolio you carry at any point in time?
-Sebastian P., Singapore

Answer:
There are two risk metrics I consider on a "total portfolio" basis. The first is the composite BP risk of all positions relative to their initial stop levels. As of Friday's close, this portfolio risk was 834 BPs. The second is the composite BP risk of all positions relative to the current stop levels – in other words, what would be the damage if all positions were stopped out simultaneously. As of Friday's close, this portfolio risk was 382 BPs. I can tolerate a 1% to 2% down day, but I will begin jamming stops should the damage exceed 2%. Of course, there could always be a case when I am traveling or out of touch with the markets and every position is stopped out – although in more than 40 years of trading I cannot recall a case when this has happened.

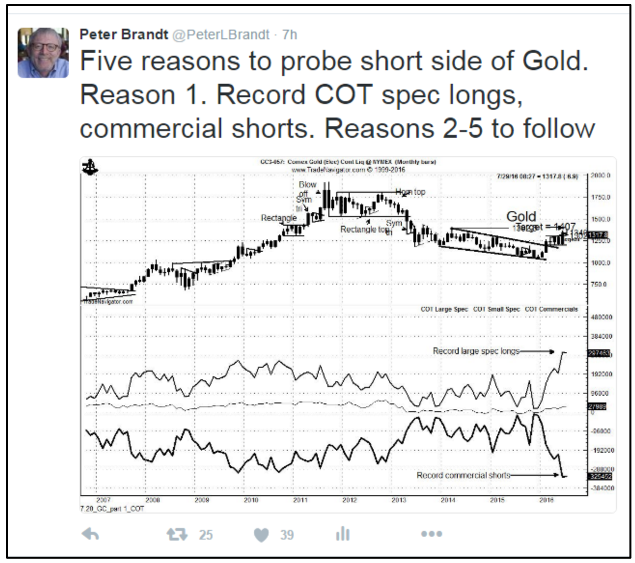
Silver (daily and weekly charts)

Silver remains in a dominant bull trend. A giant base exists under the market. The next target is 2250. Factor is flat. The daily graph is in the process of forming a consolidation of some form (red box) – yet to be determined. It will be interesting to monitor this consolidation in the days and weeks ahead. I am open to the idea of returning to a long position in Silver.



Gold (daily chart)

On Wednesday I tweeeted five reasons to probe the short side of Gold. Among the reasons were:

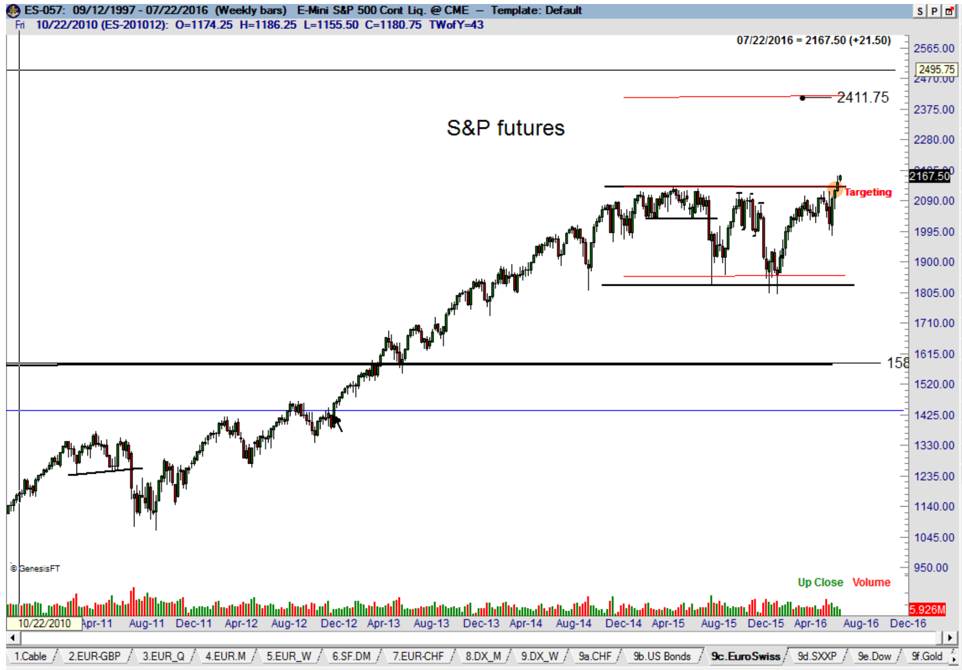


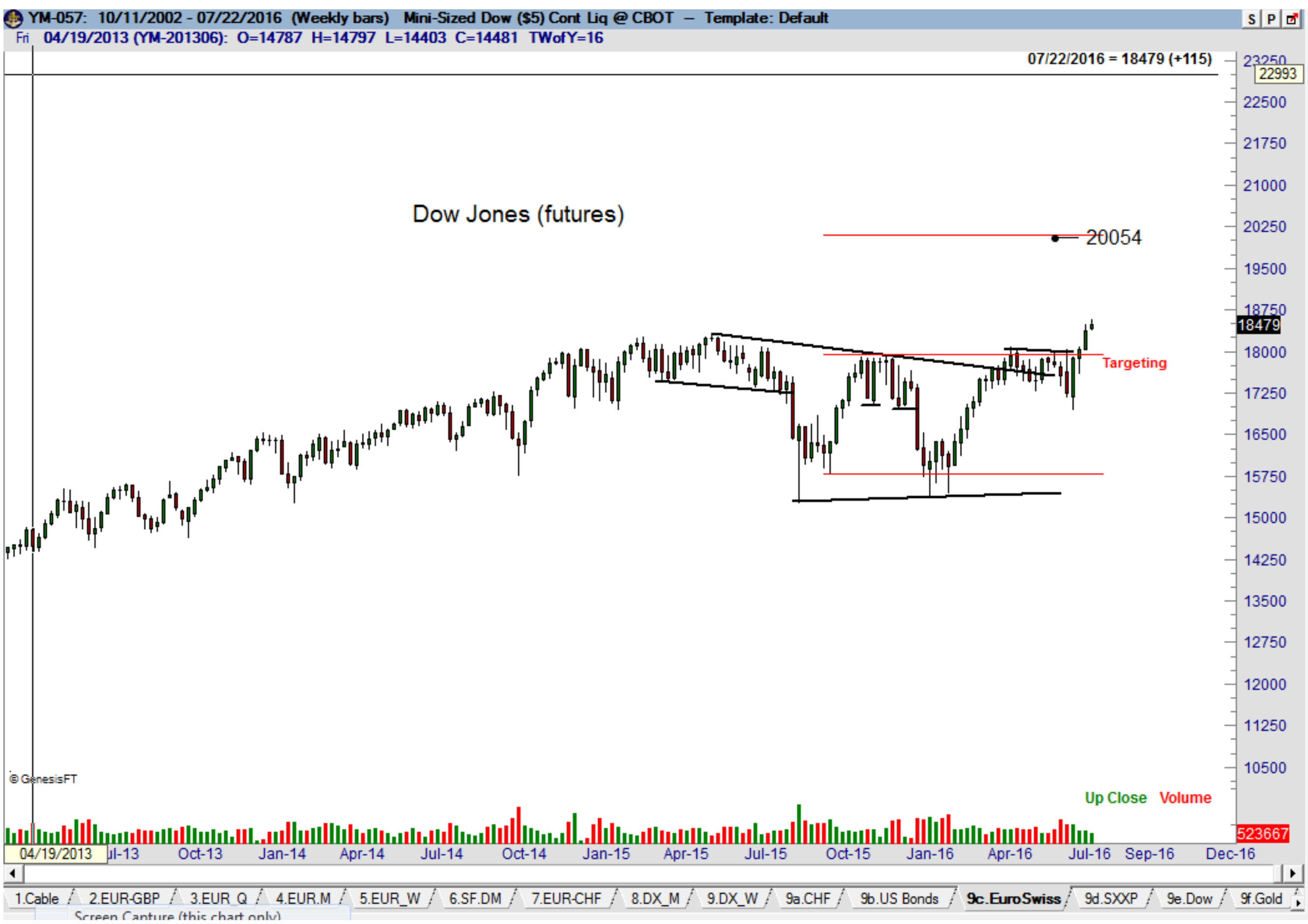
1. All-time historic spec longs and commercial short positions. In and of itself, this COT profile is not necessarily bearish. However, if prices start to decline it could spell trouble ahead.
2. Bullish sentiment readings last seen at the 2011 top
3. Perhaps I speak to the wrong people, but everyone I know is a Gold bull
4. The decline on Wednesday completed a 4-week H&S top. Normally this is not a long enough reversal pattern to entice me into a trade.
5. The completion of the H&S top may be an indication that the previously mentioned 16-week continuation broadening pattern has failed

I did probe the short side of Gold with an extremely light position and tight stop ($10 per oz.) which was quickly triggered for a 34 BP loss. My position was light and stop was tight precisely for reasons discussed elsewhere in this Update -- namely, my focus is on the U.S. Dollar. Perhaps I played the position too tightly. The rally on Thursday did not penetrate Wednesday high, or did the high on Friday exceed Thursday's high. Factor is flat. If Gold rallies into a more recognizable right shoulder, then turns down, I will be more interested in a short position.

Stock Index markets

The Dow and S&Ps have broken cleanly into new all-time highs territory. I should be long, but am not – I will count this as a missed trade in the S&Ps from Jul 11. The S&P Index has a possible target of 2411 and the Dow has a possible target above 20,000.





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Factor LLC 7/22/2016

Model Tracking Account Trade History and Portfolio

Initial capitalization: $100,000 (See disclaimers and notes below)

Effective date April 18, 2016

		Entry									Pattern		Exit				
Market		Date	L/S	Price	Size	Initial stop	BP risk	Current Stop	Stop Date Δ	Target	Weekly	Daily	Date	Price	Net	Capital to carry trade	Value of trade (entry)
MDT	Medtronics	4/28/16	L	80.06	50	76.49	70	85.98	7/22	92.73	14-mo H&S	4+ mo H&S				$ 4,003	$ 4,003
DXU6	USD Index	6/24/16	L	95.340	0.25	93.340	50	96.040	7/22	98.24r	Possible 16-mo rect	Bear trap				$ 2,200	$ 23,835
ZI NN6	Nifty50	6/28/16	L	8146	2	8024.0	49	8399.0	7/20	9144	6+ yr asc tri	4-wk pennant				$ 1,700	$ 32,584
FT1U6	FTSE	6/30/16	L	6406.5	0.5	6283.5	82	6548.0	7/22	6994	16-yr congestion	10+ mo H&S bottom				2800£	$ 42,603
CTZ6	Cotton	7/11/16	L	66.82	0.5	65.790	76	67.68	7/17	78.49	Poss 2-yr dbl bottom	5-wk asc tri				$ 1,000	$ 16,705
CTZ6	Cotton	7/11/16	L	66.82	0.5	65.790	76	71.49	7/20	78.49	Poss 2-yr dbl bottom	5-wk asc tri				$ 1,000	$ 16,705
MMEU6	Emerging Mkt	7/12/16	L	851.50	0.5	841.90	68	862.80	7/21	928.00	10-mo H&S	5-wk H&S				$ 1,125	$ 21,288
MMEU6	Emerging Mkt	7/12/16	L	851.50	1.0	841.90	68	844.60	7/17	928.00	10-mo H&S	5-wk H&S				$ 2,250	$ 42,575
LRCX	Lam Research	7/12/16	L	87.45	140	82.35	71	85.27	7/20	106.29	19-mo H&S	19-mo H&S				$ 12,243	$ 12,243
DXU6	USD Index	7/10/16	L	96.570	0.50	96.410	10	96.690	7/22	98.24	Poss 17-mo rect	4-wk pennant				$ 1,650	$ 48,285
DXU6	USD Index	7/19/16	L	96.915	1.00	96.480	42	96.42	7/22	Open	Poss 17-mo rect	4-wk pennant				$ 3,300	$ 96,915
EUR/USD	Spot fx	7/19/16	S	1.1043	100k	1.1086	43	1.1066	7/22	1.0651	Poss 17-mo rect	7-wk chnl/3-wk pennant				$ 3,865	$ 77,301
ZSX6	Soybeans mini	7/20/16	S	10.1850	2.0	10.3950	42	10.2725	7/22	941	11-wk H&S top	11-wk H&S top				$ 1,600	$ 20,370
												Trades as of			$ -	$ 35,936	$ 455,412