Inside the Mind of the World's Smartest Trader: Part 2A & B

We've already described a model for tracking smart money order flow at a tactical level in Part I HERE. Now we'll examine how the smartest trader in the world thinks strategically...

2A: Anchoring Trade Analysis in a Primary Trend Model

High frequency timeframes (daily & intraday) are often noisy, yet that's where most traders focus their time and effort. It's really the low frequency timeframes (quarterly & monthly) which drives trends and controls how various market structures (price swings and price patterns) are going to resolve, and smart money traders use that edge to great advantage.

The idea of a primary trend is to isolate a timeframe where the bids or offers in that timeframe dominates the bids or offers in lower timeframes. In this way a primary trend is a **CONTROLLING TIMEFRAME**.

Our research indicates that rising Quarterly **EQUILIBRIUM PRICE** levels is the dominant variable which drives primary bull trends—in virtually all markets. The quarterly U. S. earnings cycle and the calender-driven cycle of quarterly seasons provides the dominant data points for institutional money flows.

At the end of each quarter, we run a proprietary calculation to determine these Quarterly Equilibrium price levels. **An equilibrium price level can be thought of as a price that expresses a consensus value for that particular stock or commodity etc**.

In the monthly futures chart (right) for Crude Oil (WTI, Sweet Light) futures the dark blue line at **X** represents Quarterly Equilibrium price levels plotted over a monthly chart.

We also run new estimates every month for the new quarter (light blue line at Y) equilibrium levels. We call this an **Estimated Quarterly Equilibrium**. When the dark blue line is clearly rising, Quarterly Equilibrium price levels are rising and the Primary Trend Indicator (PTI) is up.

GENERAL STRATEGY: In the shorter timeframes (weekly and daily) the major reactions back to Quarterly Equilibrium (the light and solid blue lines) are strategic opportunities to

re-align portfolios by reducing short inventory and increasing longs and you can see by scanning these charts that it is generally the correct strategy.

Likewise, when the solid blue line is clearly in decline (see the 10-yr Notes chart, right) Quarterly Equilibrium price levels are declining and the **PRIMARY TREND INDICATOR (PTI)** is down.

Notice the primary trend reversed from up to down in the 1st Quarter of 2006 and the rally in the 1st Quarter was nothing more than a strategic opportunity to reduce long inventory and increase short inventory.

In the monthly **Dollar** chart, (right), the solid blue line is also Quarterly Equilibrium. Notice the primary trend turned down in the 2nd Quarter 2002 and exerted a controlling influence as **EVERY** major rally attempt in a daily or weekly timeframe failed for 2 years running. After a brief primary bull move up, the primary trend turned down again in the 3rd Quarter 2006.

Finally, look at the **S&P 500 Stock Index** monthly (see chart, page 3). It entered a primary trend bear market in the 1st Quarter of 2001 when the Quarterly Equilibrium reversed from declining to rising—once again **EVERY** major rally failed for two years running.

The primary trend indicator for the S&P then reversed up in the 3rd Quarter of 2003 and again **EVERY** major decline has recovered to new highs for two years running.

Accordingly to this chart, as of June 2006, the recent decline is

a correction, not a bear market, because quarterly equilibrium is still rising. Therefore, when the SPY moved back to quarterly equilibrium we began increasing long inventory in certain individual stocks very close to the extreme low in June of 2006.

BOTTOM-LINE: In this article, when we talk about the **PRIMARY TREND (PTI)** as up or down, we are referring to this specific condition of rising or declining quarterly equilibrium—which is dominating the price action in the lower timeframes (weekly and daily).

To convert a general strategy into viable tactics, we use a finer degree of resolution than monthly bars. In Part 2B, that follows we drill down into weekly bars and introduce the notion of "ideal trade location" and revisit something called "variant perception."

2B. Identifying Strategic Corrections

In Part 2A, we defined a primary trend and provided examples showing that almost **ALL** major corrections back to quarterly price levels **REVERSE BACK** in the direction of the primary trend. The only exceptions occur when the primary trend itself reverses and these events are infrequent.

Here in Part 2B, we introduce the notions of **ideal trade location** and revisit **variant perception**.

We'll focus on two major strategic opportunities that occur in markets where the risk-reward is **asymmetrical**—which means the risk exposure is a fraction of the potential reward.

IDEAL TRADE LOCATION. We call these two situations "ideal trade locations" because they represent optimal price regions for making portfolio adjustments (initiating or closing out shorts and longs). But ideal trade location also varies according to: 1) the type of market environment you are facing and; 2) the location of price relative to rising or declining quarterly equilibrium levels.

Markets exhibit a high degree of efficiency, but they are not 100% efficient. This means profits holding long or short inventory are far more probable, if you are selective about

where you initiate changes in your long or short inventory.

VARIANT PERCEPTION. Profitable trading situations tend to coincide with a divergence in the perceptions of various kinds of traders as to what exactly is occurring in a given market. This type of divergence is called a "variant perception." We'll illustrate how this manifests strategically on a chart shortly.

The first of two ideal trade locations is what we call a "strategic correction".

STRATEGIC CORRECTIONS. When the primary trend is up, a retracement back to rising quarterly equilibrium is a strategic correction.

NOTE: Likewise, retracements into strategic sell zones present a set of opportunities to increase short inventory or reduce long inventory.

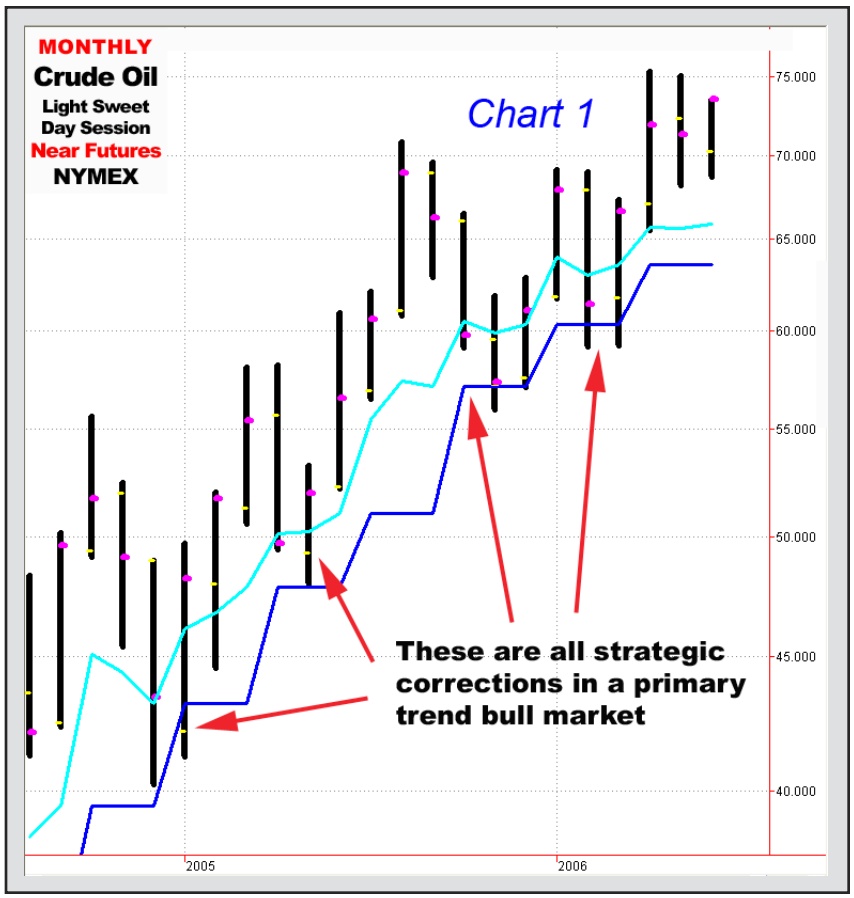


Chart 1. In the chart (right), there are four strategic corrections in Crude Oil.

During strategic corrections we need a finer degree of resolution in order to monitor price action more closely.

Chart 2. The Crude Oil chart (right below), is a weekly chart, not a monthly chart. This chart has the higher timeframe quarterly equilibrium displayed (light and dark blue lines).

STRATEGIC BUY ZONES. We call the zones (green boxes) between the most recent Estimated Quarterly Equilibrium (the light blue lines) and the Quarterly Equilibrium (the dark blue lines) a "strategic buy zone."

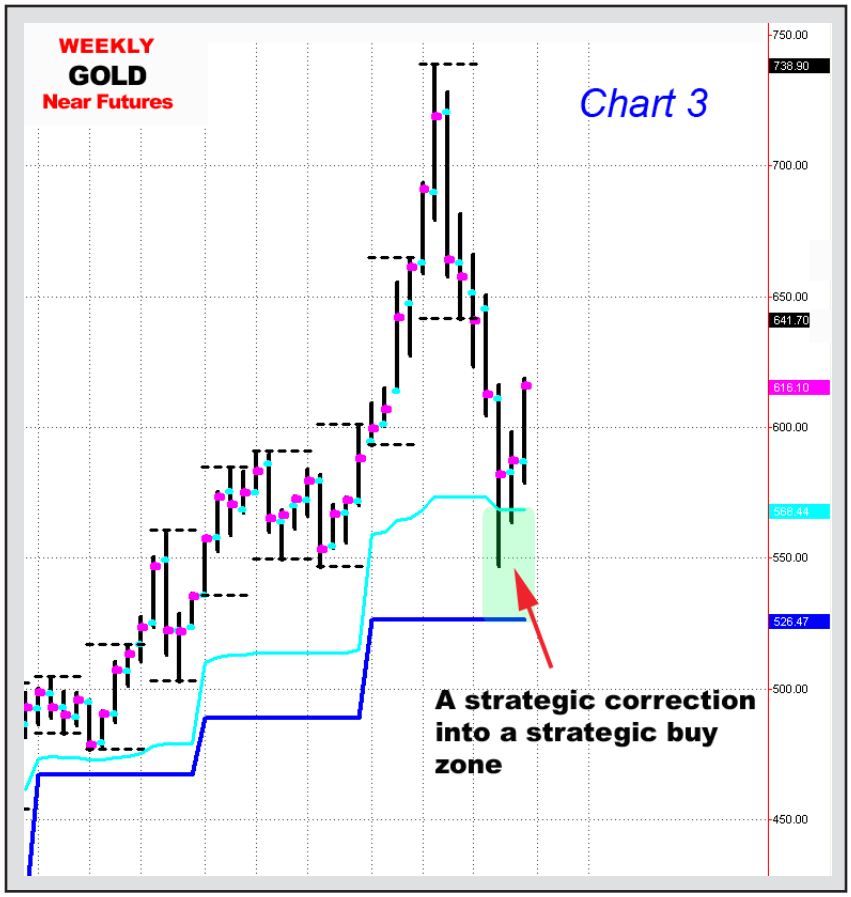
In Chart 2 there are three strategic buy zones visible in Crude Oil.

Note: In a strategic correction, the ideal trade location for initiating changes in long and short inventory is within a strategic buy or sell zone.

In primary trend bull markets, when price moves into strategic buy zones, the correct strategy is to increase long inventory and decrease short inventory.

A STRATEGIC CORRECTION IN GOLD FUTURES

Chart 3. In the weekly Gold chart (right) the deep reaction into the June '06 low was a strategic correction into a strategic buy zone.



Since the quarterly equilibrium is still rising the move into the strategic buy zone was a move below rising value levels—a transient opportunity to accumulate long inventory or reduce short inventory.

Chart 4. All tradables (commodities, futures, stocks, stock indices, bonds, FOREX pairs and individual stocks) obey the primary trend rules we've described here.

Here is the Google monthly chart (right). Even in a large trading range the extreme reactions within the range offer strategic opportunities to initiate longs in strategic buy zones.

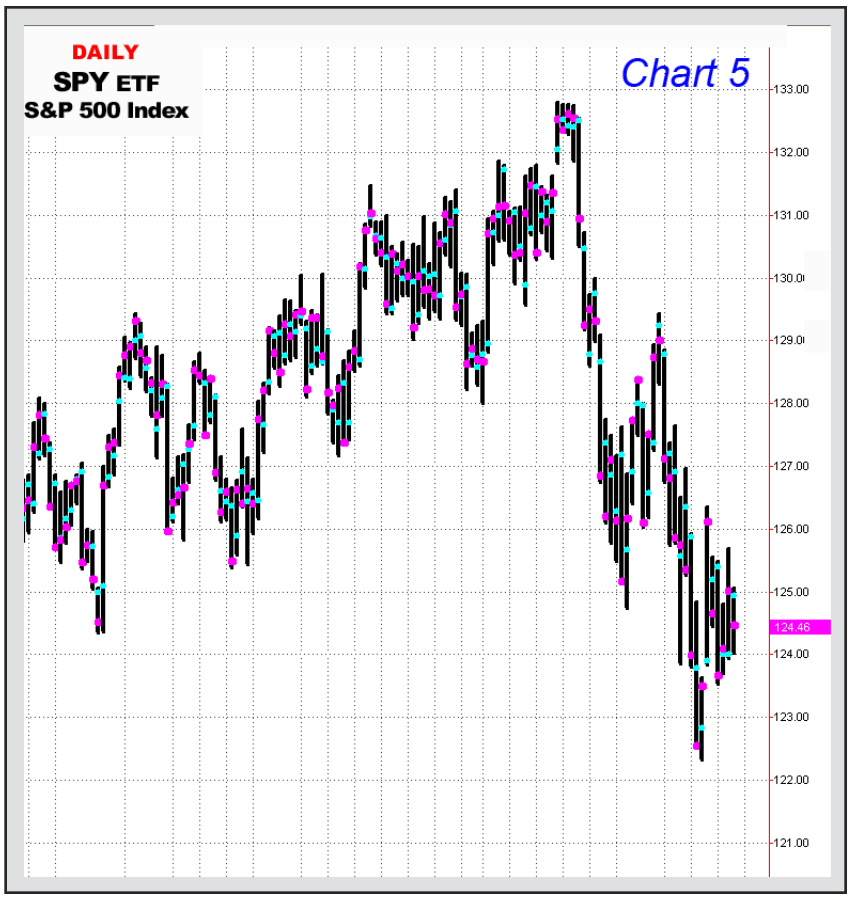
VARIANT PERCEPTION

Momentum traders tend to naturally gravitate to high frequency (daily and intraday timeframes) High frequency timeframes also tend to be relatively noisy and difficult to read.

Value traders, on the other hand, tend to naturally gravitate to low frequency data points (monthly & quarterly timeframes) because value-based analysis tends to incorporate larger spans of time.

Chart 5. In May-June '06 the daily SPY (at right) appears to be in a high momentum move down, a disorderly free fall.

Chart 6. The low frequency monthly chart, below, illustrates that the price action that appears to momentum traders (in Chart 5) as a high momentum move down with no bottom in sight in the daily timeframe is, in fact, an orderly move to equilibrium in this higher timeframe.



VARIANT PERCEPTION

This is an example of higher timeframe variant perception among different groups of traders observing the same price, only at different frequencies.

In this particular case, momentum traders perceive that the probability for a continuation of the move down is higher than the actual probability. This is an error in assessing probability because historically major reversals back up tend to occur after thrusts into rising quarterly equilibrium levels

Value traders perceive that the probability for a significant continuation of the move down is a low probability because they expect major reversals to occur at rising quarterly equilibrium levels.

This is not to suggest that momentum traders are always wrong. Sometimes momentum sellers can overwhelm value buyers and reverse primary trends.