Liquidity Case Study

Now you know the IMPORTANCE of liquidity *and* how to MEASURE it. The last thing to learn is how to PROFIT from it.

I'm going to show you an example of when we used our understanding of liquidity to score big time market profits.

Let's rewind to mid-2015…

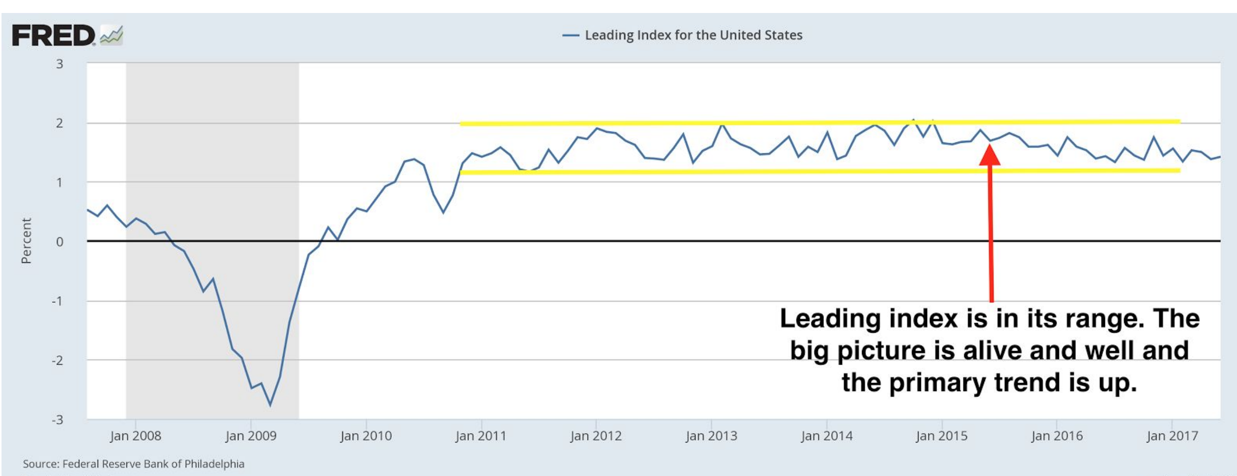
The market was chopping sideways after a long run-up, the dollar just completed a large rally, and commodities crapped the bed. *(Both the USD bull and commodity bear markets were easily predictable through the lens of liquidity, but we'll save that for a more advanced lesson.)*

To figure out which way the market was going next, all you had to do was to look at our liquidity indicators and see what credit was saying.

Let's start with our **long-term liquidity indicator — the US Leading Index**.

The Leading Index will, like its name suggests, lead the way and tell you whether a bull or bear market is around the corner.

Remember, we're concerned with the 0.7% line. That's the demarcation zone. If it crosses to the downside it'll signal the primary trend is ending.



A quick look at the chart shows that the Leading Index remained in a healthy consolidation zone, well above the 0.7% line.

This meant that even though commodities and emerging markets were having a fire sale, the US bull market wasn't about to end anytime soon.

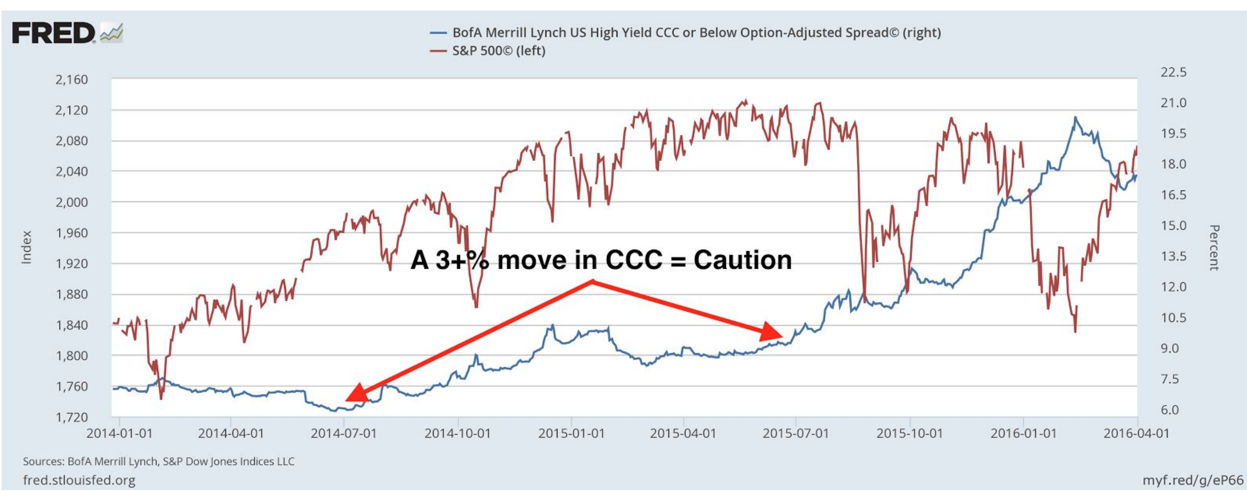
But that doesn't mean there wasn't a possibility of a 10-15% counter-trend selloff…

For a clearer look at shorter term strength and market direction, we had to drop down to our next two liquidity indicators.

Our mid-term liquidity indicator, the BofA CCC credit spread index, warned of potential counter-trend selloffs over the next 6 months. Remember the adage… credit leads equities.

With this indicator we're concerned with the *relative* change in credit spreads (blue line). A move greater than 3% signals instability ahead.

Trend is also important. An uptrending blue line means tighter credit which is bad for stocks and vice-versa for a downtrending line.



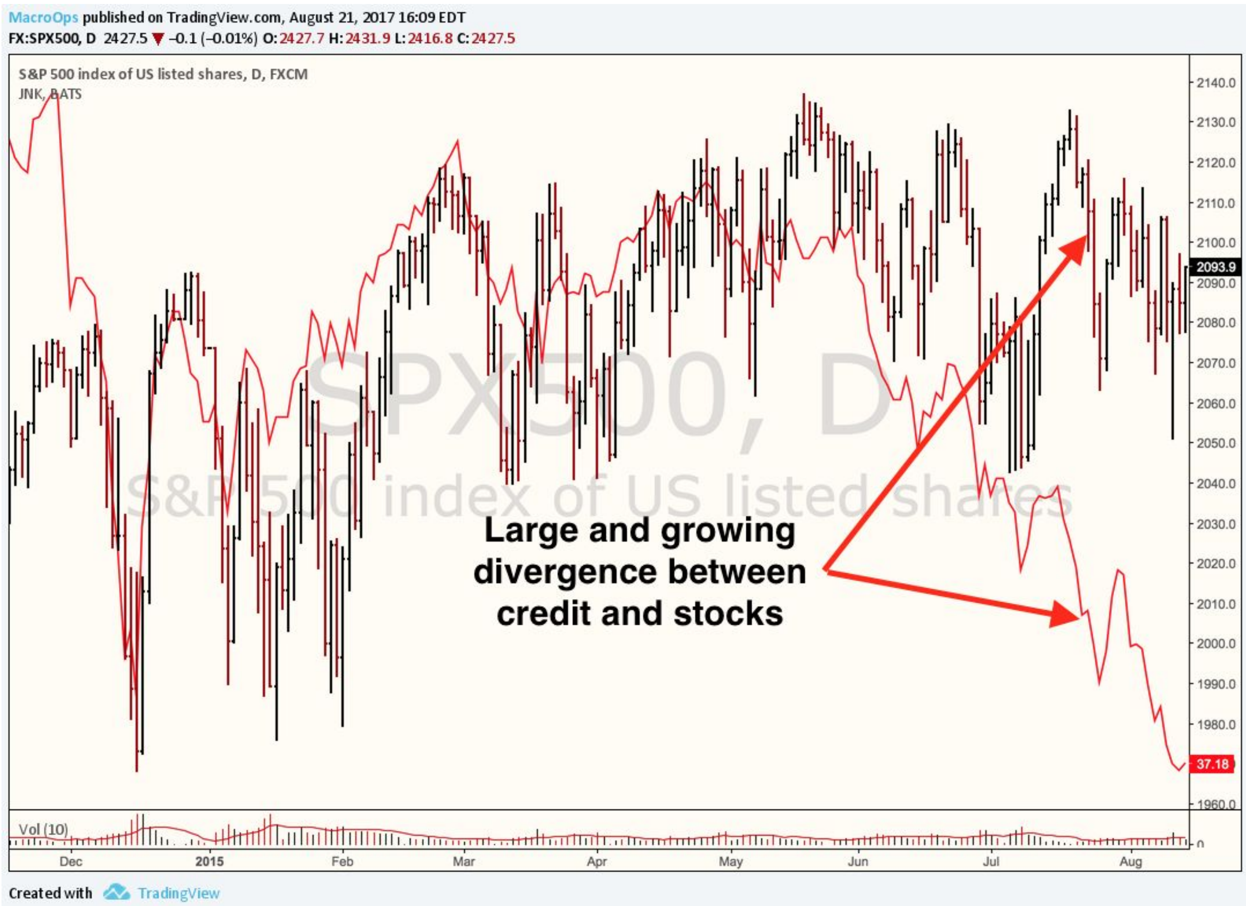
By mid-2015, the CCC index had trended upward more than 3% from its low in 2014. The trend was accelerating too.

With the S&P consolidating after a long upmove, it was time to be cautious. There was a good chance a market sell-off coming.

Our next job was to figure out the correct time to short the market to cash in on this coming sell-off.

That’s where our **short-term liquidity indicator, the high-yield ETF (JNK),** came in handy.

The trick here is to look for divergences between JNK and the broader market.



We can see JNK was selling off hard while the market continued to chop around.

This, combined with CCC index move, was a signal to get short. We bought a handful of index put options and made out quite nicely.

Pretty simple right? You’d be amazed how many “seasoned professionals” don’t know how to do this…

Now the great thing about these indicators is that they *also* signal the end of a selloff, so you can profit by going long again.

The US Leading Index didn’t budge during the high volatility period of late 2015. That meant that long-term liquidity conditions were bullish.

Next we had to check our mid-term indicator and see what the CCC spreads were saying:

By January 2016, the CCC had reversed and began trending downward again. (Downtrending CCC = increasing liquidity = bueno for stocks.)

By April it had fallen by over 3% — the magic number. At the same time, the stock market began trending higher.

This meant our mid-term indicator, just like our long-term indicator, was giving us the all-clear signal to jump back into the market.

Finally, for further confirmation and to help with our timing, we could check our short-term liquidity indicator through JNK.

JNK bottomed with the market in February 2016 and then began trending higher along with stocks. The lack of divergence confirmed that the rebound in stocks was real and that it was time to go long.

Pretty awesome, huh!?

These are very simple, but powerful tools. You can use them to stay miles ahead of game… and hopefully make a great deal of money doing so.

I just showed you about 80% of how you can use liquidity to trade markets. This knowledge will do a lot for your P&L.

But the last 20%... that's where things get really interesting. That's where you can use liquidity to trade FX pairs and time major turning points in the oil and gold markets, amongst many other things…

Stick with Macro Ops and you'll learn all about these techniques too!

Your Macro Operator,

Alex