How To Trade The Forex Market Using The HUD

> "Nowhere is more nonsense talked than by currency experts about foreign exchange."
> ~ Sir Winston Churchill

The currency market is a favorite market of mine to trade.

It's global. It trades around the clock (except on weekends). And it's the penultimate macro asset where a whole range of factors can come into play: central bank policy, geopolitical risk perceptions, regional politics, trade flows, growth, inflation, etc…

You can read more about how I analyze currencies from a purely macro viewpoint in *Soros' Currency Framework*.

For today's piece, we're going to walk through how I use the FX tab on the HUD to quickly get a view of where the tailwinds and headwinds are for the major pairs, where the crowding and fragile trends are, signs of inbound inflection points, and then we'll drill down further showing how we use the HUD to stack conditional edges on a trade.

We'll use the short US dollar trades we put on in the Fall of last year as an example.

To start though, I want to share some clips from one of my all-time favorite but little-known trading books, which is *The Way of The Dollar* by John Percival.

The book has been out of print for years, though someone mentioned they saw a digital copy on AMZN not too long ago. I have a PDF of it somewhere which I'll post to slack when I get a chance.

As a quick aside, John Percival was an interesting cat as well as an incredible trader. I don't know the exact numbers but I've heard that he turned somewhere in the ballpark of a few million into $700m+ in under two decades.

Information on him is tough to come by, as he is a pretty private figure.

From what I've read though, he was born to an English family living in Karachi in 39', went to Oxford, did a stint as an FT Lex Columnist, worked IB in the Middle East for a bit, settled in

Chop wood, carry water…

Bahrain where he started a logistics company flying international freight, which is how he learned the hard way about how currency moves can quickly wipe out thin margins.

This prompted him to move to London where he studied currency markets, eventually starting his own newsletter called Currency Bulletin. This led him to start his own fund, Chescor, which was one of the more successful currency-focused funds for years. Last I heard, he retired from markets just a few years ago.

I'd heard that he used to have all his old newsletters hung up on his site, CurrencyBulletin.com, which has been shut down for a long time now.

I'd love to get my hands on his old archive so if any of you come across them, or if you know John and can connect us, please let me know. I'd be super appreciative.

Anyways, one of the reasons I'm a fan of John and his book is because he speaks the MO language. He's a *Play The Player* type of trader… John sums up his approach in the book thusly:

> *As readers know, my approach to analyzing the currencies – its method – is essentially anti-crowd. We look where the crowd is not looking for an underlying rationale for the direction of the main trend. And we use a series of contrarian sentiment indicators designed to orient us in the opposite direction to the crowd. This method has worked well, and it is timeless so it should always work. The method is OK. If we can have confidence in it and can apply it, we shall win.*
>
> *Because the system's constituent parts are mostly based on human behavior which doesn't change, we can be confident it will continue to work.*
>
> *The financial markets, as anyone familiar with them knows, are deeply paradoxical. They have a logic of their own which in a way is the opposite of normal logic. Hence the market adage "sell on the news" applies to good news, not bad news.*
>
> *Hence other bits of market lore like "a bull market climbs a wall of worry: a bear market flows down a river of hope." Markets do whatever they need to do to confound the greatest number of people.*

Chop wood, carry water...

This happens because prices reflect expectations. If everyone expects unemployment to rise, or a trade balance to fall, or inflation to remain steady, there is no intrinsic reason why they should be wrong: the expectation doesn't affect the outcome.

But if everyone expects shares to fall, or the dollar to rise, there is every reason why they should be wrong: because current share price levels already reflect the expectations of lower prices, and the current level of the dollar already discounts a rise.

In other words, the expectation vitiates the outcome.

Vitiate is a great word. Need to use that one more.

John's entire approach is based on three basic assumptions *(1) the crowd tends to lose money; (2) it tends to be right for the trends but wrong at both ends, and (3) therefore it would pay to go contrary to the crowd at the 'ends' or price extremes.*

The underlying equation he created for this is: *a price extreme = an extreme of consensus + an extreme of speculation.*

His four "sentiment gauges" used to measure these extremes are:

1. IMM Open Interest
2. The Consensus
3. Perception of the Trend
4. Reaction to news

IMM Open interest is the total number of open contracts at the close of trading. Either, the total number of longs or the total number of shorts (note: the net of the two is always zero in futures markets) that are held into the close.

The Consensus, John writes, "is a subjective gauge… We read the papers and specialist commentators and we talk to people, and we conclude that most punters are facing one way."

It's actually much easier to get a read on consensus in today's age. We can not only quickly chart the full CoT positioning data but we can get positioning data from the major banks, set

up Twitter filters for currency pairs, and quickly scan a number of popular market news sites to develop a feel for such things.

The **Perception of the Trend** is just that, it's about having a process for identifying which *way* the trend is going and *how* it's trading. This is one of those things where it sounds incredibly simple but where I find most people don't have hard-pressed rules for doing so, which is to their own detriment.

Here's how John approaches the problem… And I'm including a lot here only because it's such an important concept to grok (emphasis by me)

> *The disadvantage of the fractal nature of market fluctuations is that you can get in a muddle over the underlying trend and its minor and medium corrections and extensions. One solution is to simplify and reduce the problem to just two constituents – the major underlying trend and its main corrections, which are the medium-term, multi-week/multi-month corrections. That way all we are concerned with is the main trend and corrections to the trend.*

> *The art of analysing financial markets is always to be able to reduce the problem to a simple black and white, yes or no issue. That way, if our analysis tends to be right, what we are doing is shifting 50/50 probabilities into 55/45 or 60/40 probabilities in our favour. And if we can always do that, we must win in the long term. (The temptation is to make complex bets that X will happen and that y will happen: those are 25/75-type bets, of which we should have no part).*

How many times have you had high conviction on a thematic or broader trend but you got knocked out by the short-term price swings?

Overly focusing on the trees and losing sight of the forest is one of the more common and costly traps for traders and investors. It comes from not having a management process that aligns with your timeframe and trade views.

How do we solve for this?

Like Percival says, hard code your inputs. Simplify the decision-making process. Align your management rules with your analysis timeframe.

All of this is central to what we do and what we're building at MO.

There are a number of ways to define a trend. Our preferred method is to use the SQN Market Regime type, as this gives us a host of additional valuable information about the characteristics of the tape (such as volatility and momentum characteristics). We also use monthly charts for big-picture trend analysis. All of this helps us take the guesswork out of our process, and place the probabilities in our favor.

Lastly, there's the **Reaction to News**. John writes:

> *An early sign of a change in the perception of the trend is the way the market reacts to news. During the bullish phase, prices tend to rise on good and bad news alike. Then there is a change and good news fails to help the market. Finally, prices fall on good and bad news alike, and the trend has well and truly changed from up to down. The same applies in mirror image to bear phases.*
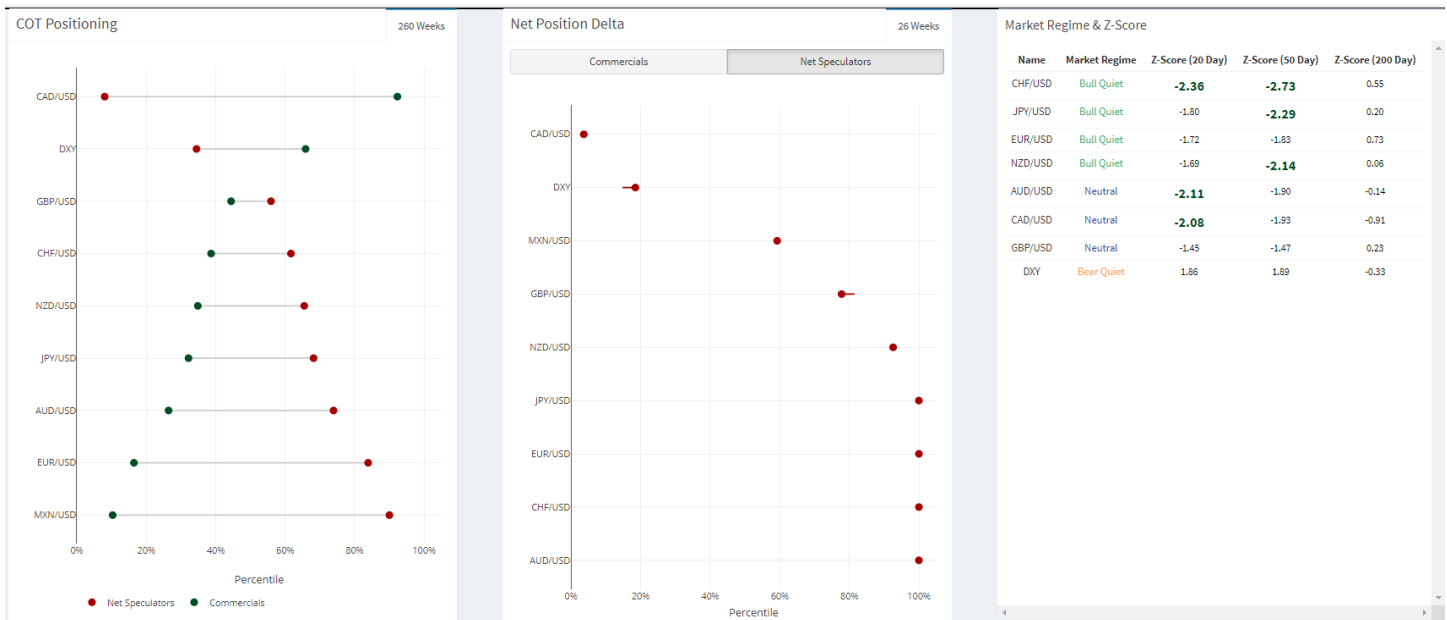>
> *…What makes a price move is surprise…*

This is nothing new. Gauging how the tape is trading relative to the consensus and incoming news goes back to before the days of even Livermore and Baruch. But, importantly, it's how this stuff fits together and is implemented that matters.

A popular misconception is that you need to do something complex and exotic to make money in markets. You need a genius-level IQ, machine learning algos, a deep understanding of the plumbing of the global financial system, etc… The reality is that success comes from having a straightforward process and then executing that process ruthlessly.

That's it.

Okay, now let's jump into our HUD tools and walk through a workflow and show you how these tools improve on each of Percival's gauges, and some.

Similar to the Commodities Tab, the top section looks like this.

Chop wood, carry water…

Name	Market Regime	Z-Score (20 Day)	Z-Score (50 Day)	Z-Score (200 Day)
CHF/USD	Bull Quiet	-2.36	-2.73	0.55
JPY/USD	Bull Quiet	-1.80	-2.29	0.20
EUR/USD	Bull Quiet	-1.72	-1.83	0.73
NZD/USD	Bull Quiet	-1.69	-2.14	0.06
AUD/USD	Neutral	-2.11	-1.90	-0.14
CAD/USD	Neutral	-2.08	-1.93	-0.91
GBP/USD	Neutral	-1.45	-1.47	0.23
DXY	Bear Quiet	1.86	1.89	-0.33

It shows an aggregation of three things:

1. Net Speculator vs Net Commercial positioning on the chart on the left.
2. Net Position Delta which measures the rate of change in both Commercial and
3. Speculator positioning over a 26-week period, in the middle.
4. SQN Market Regime and overbought/sold price vs 20, 50, and 200-day moving average spreads, in the graph to the right

So at a quick glance, this row tells us where the extremes in positioning are. Which markets are seeing the *biggest* changes in that positioning. And what the SQN Market Regimes (which quantifies trend and vol characteristics) are, along with how overbought or oversold each asset is across three different timeframes.

This tool helps us exploit three embedded characteristics of the market:

1. The market tends to move in a way that hurts the most people, most of the time
2. Trend, mean reversion, and momentum are the three key forces behind price moves
3. Regimes matter… Markets top in SQN Bull Volatile Regimes and bottom in Bear

Volatile ones

If some of this is sounding familiar, that's because it is. We use the Trifecta Lens for analyzing every asset, whether it be FX, Commodities, Equities, etc… But FX markets differ from other markets in how we read the positioning data.

In commodities, we look for speculative extremes as areas of interest, signals to dig in further to see if we should fade the herd.

But in FX, the specs often crowd into the trends of major USD pairs early. And so it's much more important to track the shifts in positioning relative to the tape over time and use both, along with extremes in Open Interest in order to pick potential turning points.

Steps 1 through 3 of our process are the exact same as what we laid out in our tutorial of the Commodity Tab, so we won't reiterate those here.

Yield Oscillator

Sitting right below the top three charts we have our aggregate yield spread oscillator graph on the left and our momentum chart on the right.

Our yield-spread oscillator is a measure of the rate of change in both the 2-year and 10-year yield differentials of the major pairs. The dot shows the current reading while the trailing line shows the change from two weeks prior, giving us the direction of change.
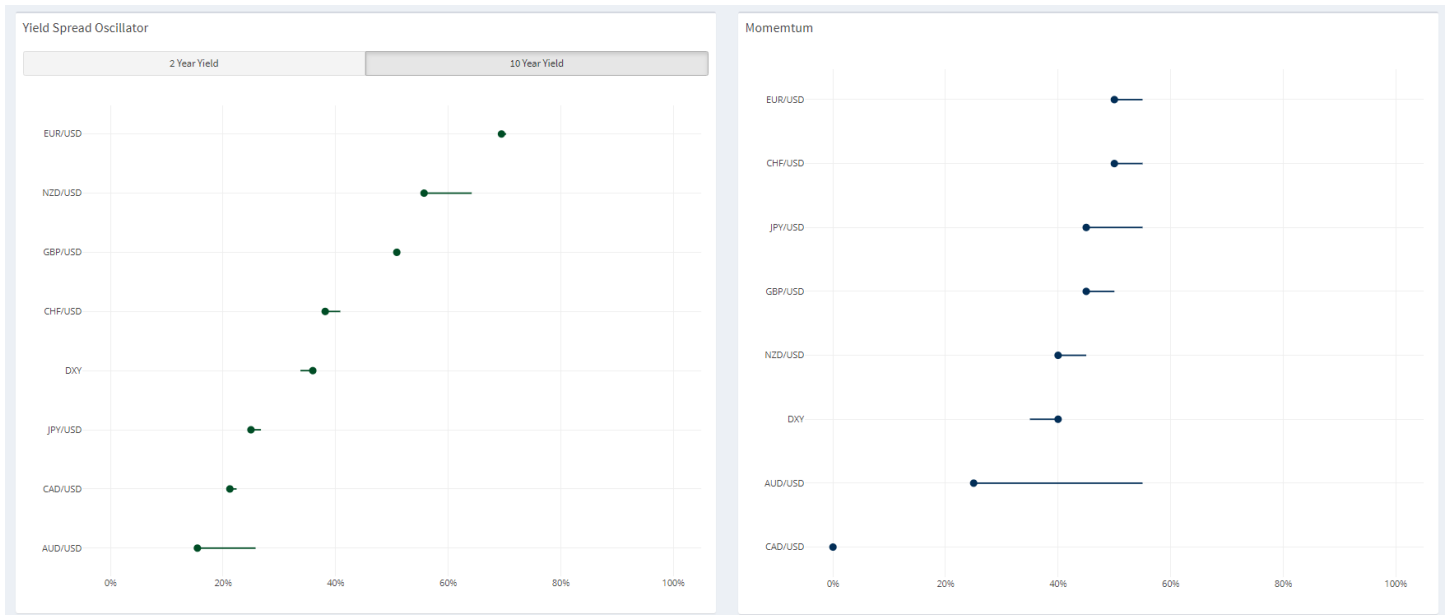
The idea here is simple. <u>Over the long term, major currency pairs tend to track their yield spreads</u>. And like most things in markets, it's not so much the *absolute* level that's important but rather the *rate of change* (the trend *and* speed of that trend) that subsequently drives action in currencies.

The way to read the above chart on the left is the following:

- Readings below 50% and falling (tail to the right) means interest rate spreads are moving against the currency that sits in the numerator (on the left side).
- Readings above 50% and rising (tail to the left) mean rate spreads are moving in the base currency's favor.

For instance, CADUSD has the most bearish yield spread oscillator profile. Its 10yr spread is at 15% and quickly moving lower (long tail to the right).

This is only one input but in general, we want to be long currency pairs with rising rate differentials and short those with falling ones.

More on this below.
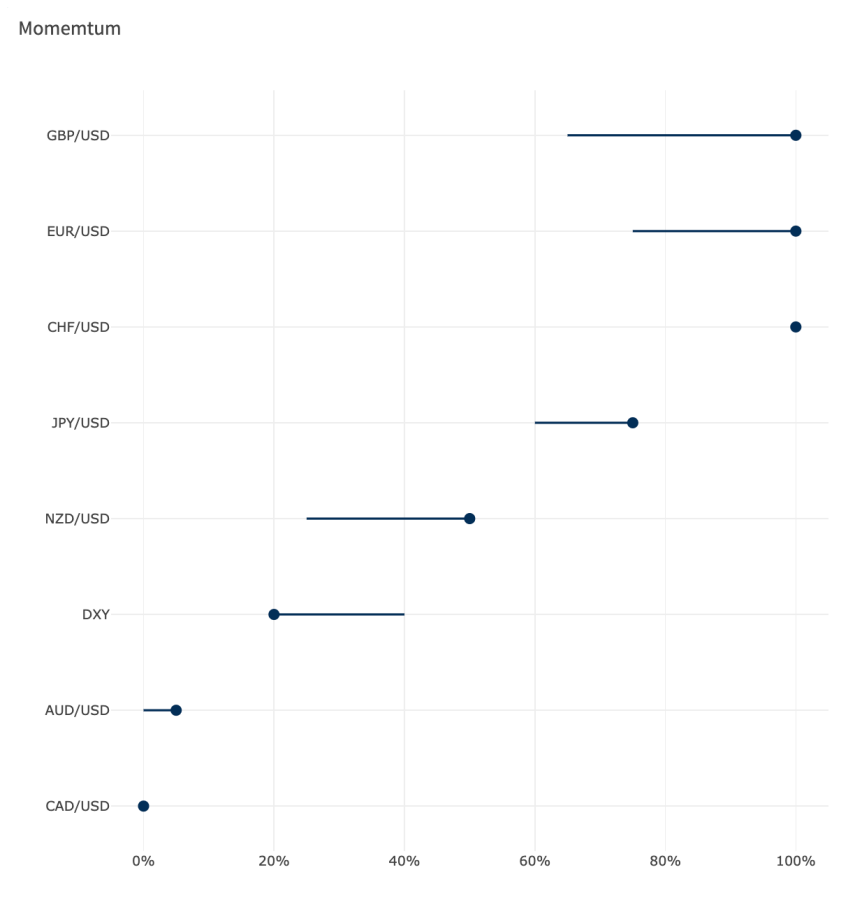
Yield Spread Oscillator
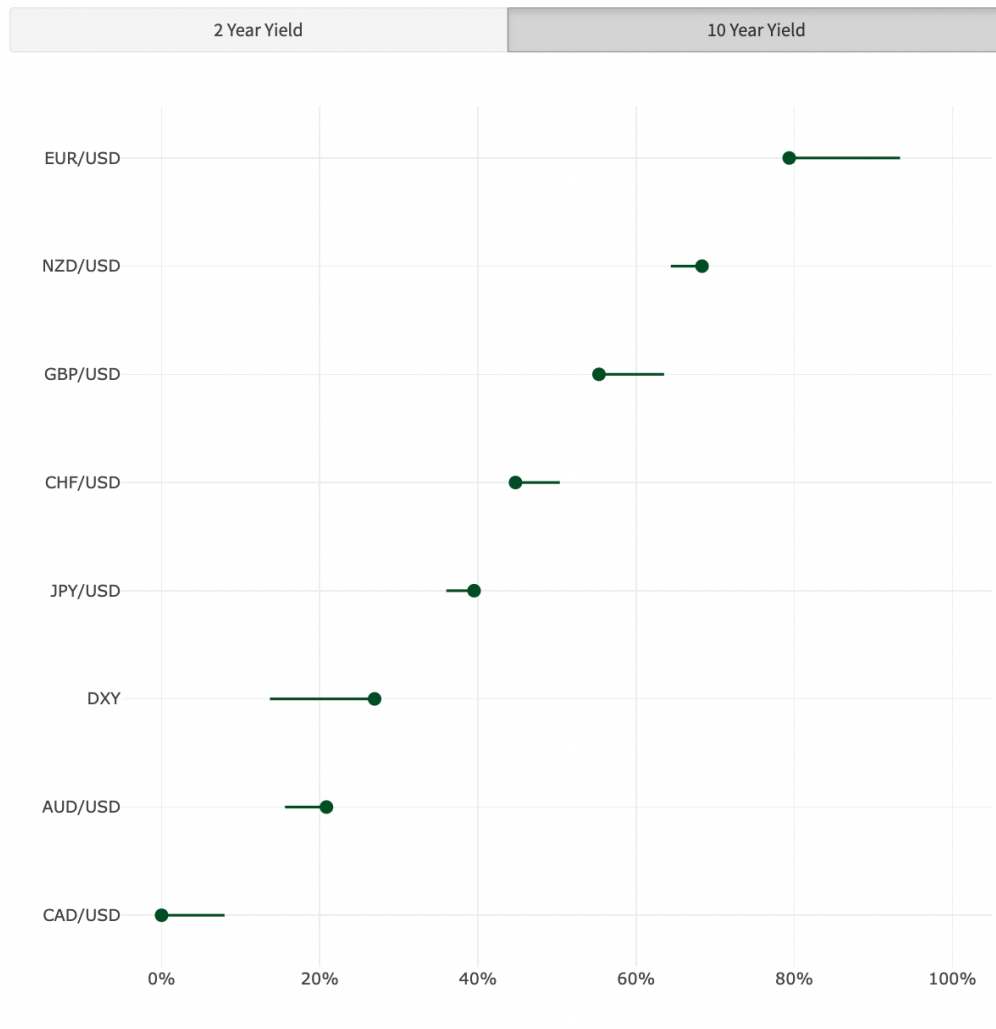
Momentum

Momentum is one of the more consistent and reliable factors. This is because, as I often write, <u>markets in trends tend to stay in trends</u> (80% of the time). Read differently, markets with strong momentum tend to maintain their strong momentum.

Our momentum measure looks at price relative to all of its moving averages from 2 days on up to a 100-days.

Using CADUSD as our example again, we can see that its momentum is very bearish (0th percentile). While we can see that many other pairs have accelerated against USD over the past two weeks, most notably GBPUSD (the long tail shows the rate of change in momentum over the past two weeks).

Multichart view

Similar to the Commodities tab, we have all the major net positioning charts, Bollinger Band Width, Overbought/Oversold graphs, and Seasonality. The only difference here is the nominal yield spread, the yield spread oscillator, and the momentum charts.

Yield Spread & YIeld Spread Momentum

Below our multi-chart view we get down to the big chart at the bottom where we can look at each indicator as a time series in more granularity.

We'll use the big chart to go through a quick workflow.

Starting with nominal yield spreads which are charted below. Green shaded area is 10yr yield spreads. 2yr yield spreads are in purple. The black line is the currency being analyzed. The below example is the trade-weighted dollar (DXY) so this is its weighted aggregate yield spread.

This gives us a snapshot on where major driver in developed market currency pairs is headed. We can see that yield diffs, especially the 10yr (green) led the way on the USD bull market in 2014. They rolled over in 19' and trended lower preceding the 2020 top. And then led the most recent bull run higher and have retraced since the latest peak.
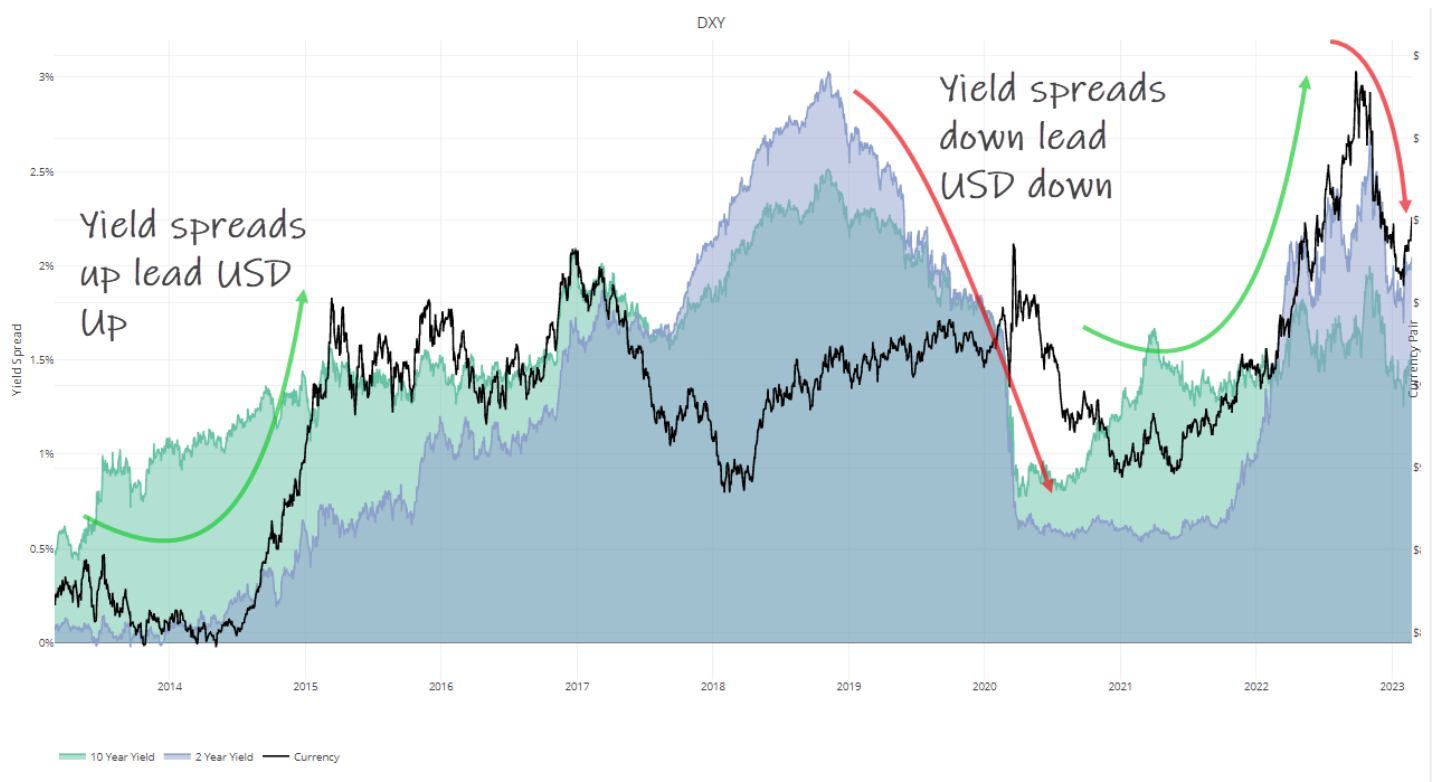
The yield spread oscillator gives us another way of looking at this. Remember, a high reading means yield spreads are trending in the base currency's favor and vice versa for low readings.

We can see that starting in early 2014, the oscillator for both spreads stayed primarily above 80% all the way through mid-15', before starting to show some weakness. More recently, the

oscillator signaled the DXY bottom and subsequent bull market well in 21', leading by 3 months.

It's since fallen to zero as US yields work off their overbought levels and crowded positioning.
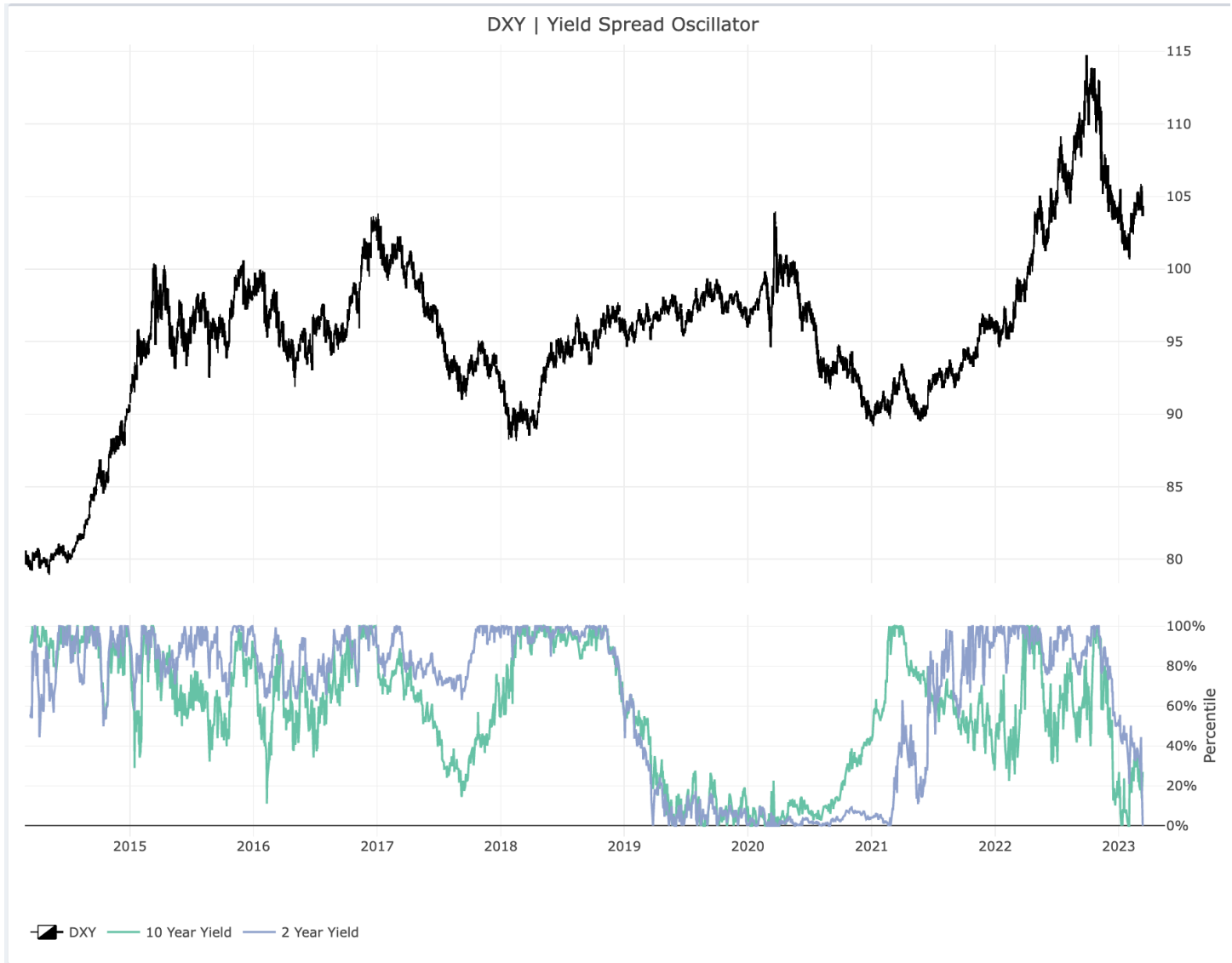
So just briefly looking at nominal spreads and their RoC for DXY, we come away with a bit of a mixed picture. Nominal spreads are still in a broader uptrend, though they're corrective. While the oscillator shows momentum in those spreads is moving entirely against the DXY at the moment.

By itself, this doesn't paint us a particularly cogent picture, which is fine. Most of the time, there's nothing to do. But we can take a look at another pair to see if there's anything more actionable. Looking at our aggregate oscillator and momentum charts we can see that NZDUSD has a top two spread oscillator profile for both 10s and 2s and momentum has strongly started picking up in its favor over the last two weeks.

The charts below show both the nominal spread and oscillator trending up in NZD's favor.
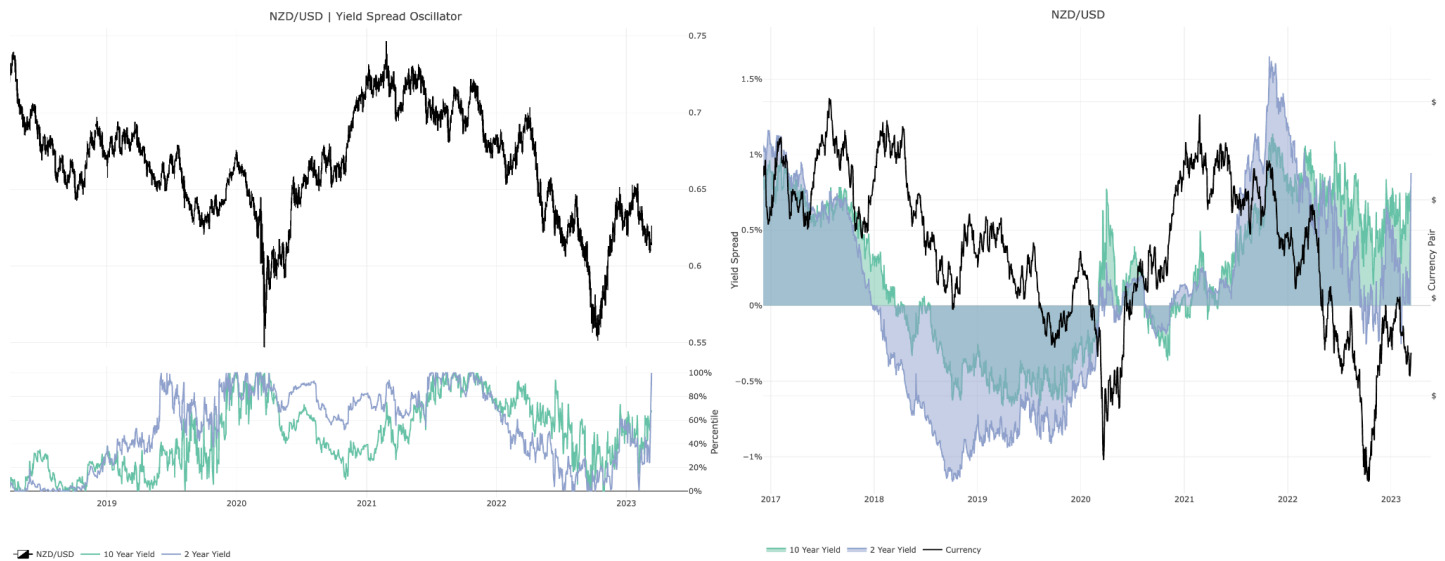
Positioning is supportive of a continuation of the move up. Large specs (red line) are trending higher but are still far from crowded, which is exactly what we'd want to see if we were bullish on the pair.

NZD/USD | Large Speculators Net Position
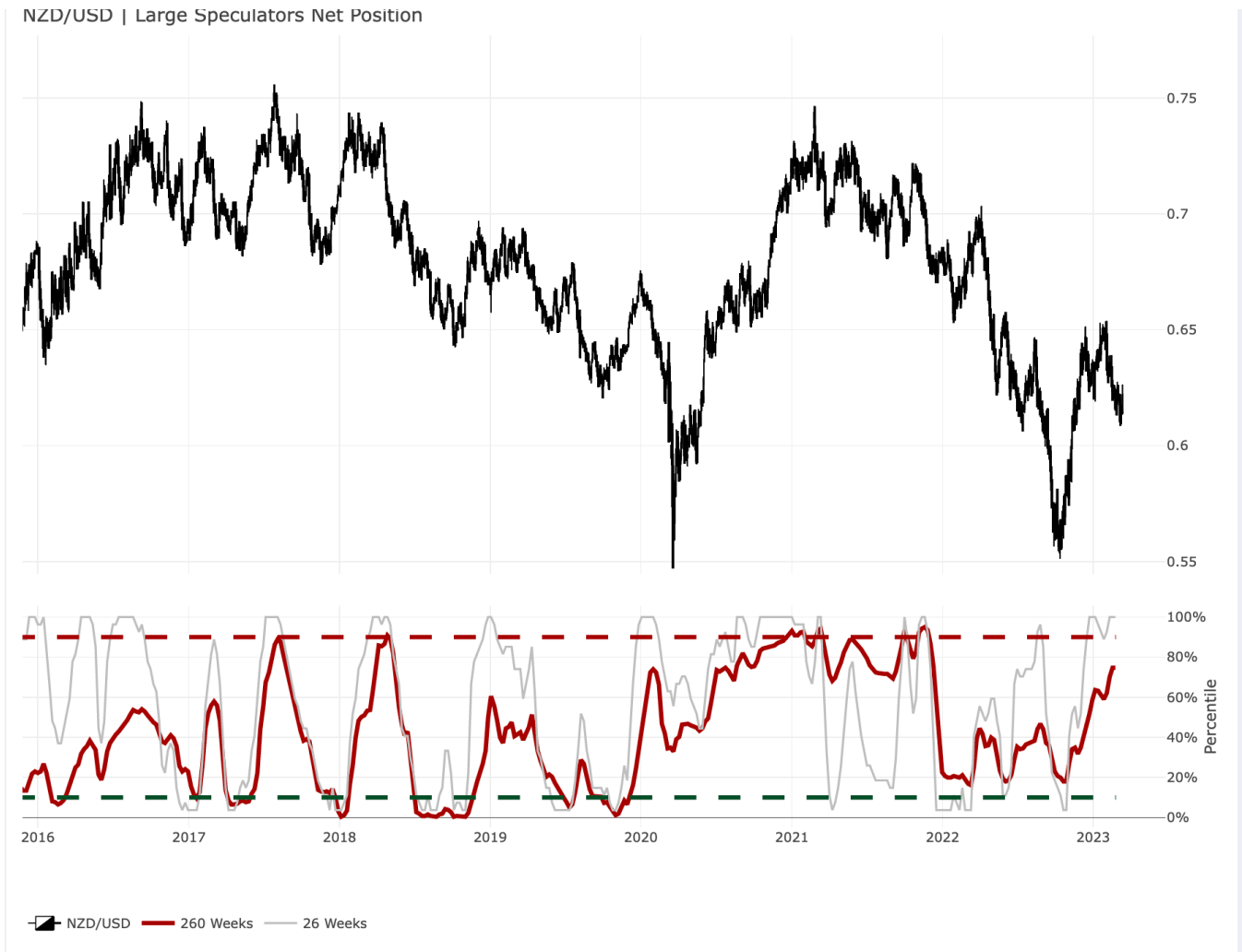
The pair is coming off 2std oversold conditions, which is good as these mean reversion forces will be supportive.

But, seasonality only remains supportive for another two weeks before turning into a sizable headwind.

Seasonality

NZD/USD

All in all, this is a trade that I think is worth taking but one that I'd size smaller and be quicker to take profits / move up stops, as there's not a significant tailwind of conditional edges though the odds are supportive.

Your Macro Operator,

Alex