

**HOW TO BEAT
WALL STREET**

JB MARWOOD

First published by The New Minimalist in 2013

Cover and book design by The New Minimalist 2013
Updated in 2015

www.thenewminimalist.com

Proofreading and editing by Copy Correct

www.copycorrect.ca

Copyright © Joe B Marwood 2013

JB Marwood has asserted his right to be identified as the author of this work in accordance with the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the copyright owner.

ISBN 978-1494228170

Copies are available at special rates for bulk orders.

Further copies are available from

www.jbmarwood.com

DISCLAIMER

This book is an educational document and is sold with the understanding that neither the author or publisher will accept any responsibility for losses or risk as a direct or indirect result of using ideas, applications or trading systems described in this book. Trading systems are presented in a fair and accurate way but may benefit from extra testing and further customisation. Trading in financial instruments (such as equities, fixed income, foreign exchange, futures, options, CFD's and all other types of exchange traded or over the counter financial instruments) carries a high degree of risk and is only suitable for investors who are able to sustain substantial losses. In the case of margin trading (such as futures, options, CFD's or leveraged equity trading for instance), the risk of loss could be greater than the amount the investor has initially deposited into his/her account.

SYSTEM CODE & EXTRAS

Note from the author:

Thank you for taking the time to read this free preview. To gain access to the trading system code, Excel spreadsheets, and bonus material, please purchase the full version on Amazon or at jbmarwood.com

Thank-you.

CONTENTS

Foreword	9
My story	11
How it all began	14

CHAPTER 1: TRADING FUNDAMENTALS

Trading philosophies	20
Different types of traders	21
Central banks	29
Keynes: Macroeconomics and expectations	33
What is inflation?	36
The typical market cycle	38
Assessing market cycles using indicators	40
Investing in money markets	42
Investing in bonds	45
How the trade balance affects currency prices	47
Getting started in bonds, stocks, forex and commodities	50

CHAPTER 2: TIMING

Methods to time the market	56
Advanced timing methods	62
How to trade long-term trends in the stock market	67
How to develop your own indicators	69
How to use momentum investing to your advantage	71
Dollar cost averaging	73

CHAPTER 3: RISK

Money management	78
Trading psychology	82

CHAPTER 4: TRADING TIPS

How to beat the professionals at their own game	88
Diversification...again	90
The magic of compounding	94
The effect of news releases on the markets	96
How to trade non-farm payrolls	97
How to buy the rumor, sell the fact	100
Another approach to trading the news	101
The sharing community and trading with social networks	103
Safe havens for your money	106
How to avoid blowing up in the stock market	108
Some more trading secrets	116
Some tips from the top	120

CHAPTER 5: TECHNICAL ANALYSIS

What is Technical Analysis?	126
How to day trade using pivot points	130
How to trade with Japanese candlesticks	135
How to trade with Bollinger bands	139
How to trade pullback patterns	143
How to use the MACD indicator	145
How to use the RSI indicator	150

How to use the DMI indicator	152
Positive volume index	154
Trend following with moving averages	157
Different types of moving averages	160
Williams percent range (WPR) oscillator	162
How to trade parabolic moves	163
How to use the average true range	165
Some final tips for technical analysis traders	167

CHAPTER 6: TRADING SYSTEMS

Why use a trading system?	172
Measuring system performance	176
Getting started on your trading system	178
Trading system 1: Moving average crossover	181
Trading System 2: Four weeks up in a row	182
Trading System 3: Trading the noise	183
Trading System 4: Trading the noise plus shorts	184
Trading system 5: Trading gradients	185
Trading system 6: Dollar cost averaging	186
Trading system 7: Donchian style breakout	187
Trading system 8: Breakout with EMA confirmation	188
Trading system 9: Trend following with the TEMA	189
Trading system 10: Bull/Bear fear	190
Trading system 11: Simple RSI with equity curve filter	191
Trading system 12: The range indicator (TRI)	192
Trading system 13: Volatility breakout with Bollinger Bands and chande VPI	193
Trading system 14: Trading the gap	194
Trading system 15: RSI with the VIX	195

Trading system 16: Trading the TED	196
Trading system 17: Simple MACD with EMA filter	197
Trading system 18: Cherry picking penny stocks with EMA crossover	198
Trading system 19: Using the Commitment of traders (COT) report	199
Trading system 20: Finding cheap stocks with linear regression and average true range	200

CHAPTER 7: RESOURCES AND BONUS MATERIAL

Resources and links	204
Best of the blog and bonus material	212
Investment scams to avoid	212
Types of orders	214
How to take advantage of the carry trade	217
What is the effect of hot money on the economy?	219
How to spot a currency crisis	220
Using the martingale technique	222
How to choose the best forex broker	224
What is a forex expert advisor?	227
10 tips and tricks for using Metatrader 4	230
Review of ZuluTrade	234
About the author	235
Glossary of terms	237
Index	245

FOREWORD

Following the financial crisis of 2007-2008, many veteran traders were faced with a totally different financial landscape in which to operate. The 'new normal,' a term first coined by Pimco trader Mohammed El-Erian, became the finance community's go-to phrase for a world order which bore more similarities with the post-Depression era than anything investors had previously experienced.

This 'new normal,' characterized by persistently sluggish growth, high unemployment and political wrangling over debt ceilings and budget deficits, is now five years on and shows no sign of abating.

But it is not only political parties that stand to lose from the new period of economic stagnation. Financial markets, as a result of huge injections of artificial liquidity from central banks, now reside atop a mountain of debt and are precariously placed, should we see any reduction in liquidity or future drop in growth.

Indeed, it could be argued that the super loose monetary policy used in response to the biggest recession since the 1930s has actually heightened risk, and the resulting artificial rally in global stock markets has created a world in which markets are now scarily dependent on the money flows from central banks.

Much like a heroin addict becomes dependent upon the drug, the financial markets have become dependent on the monthly injections of quantitative easing from the Federal Reserve, and it is for this reason that every Federal Open Market Committee meeting is now watched with bated breath by most traders.

Just like the symptoms of withdrawal when such a drug is taken away, the potential for significant market volatility is profound. Given that these risks are so prevalent, there has never been a more crucial time to learn about the financial markets.

Inflation onslaught

At the heart of the problem that financial markets face is a battle

between stagnant economic growth and the coming onslaught of inflation, brought on by years of easy money.

Normally, this would not present too much of a problem since periods of economic stagnation can be reinvigorated by central bank intervention.

However, to believe this is to forget that central banks have now used up all of their bullets. Indeed, central banks now sit on a mountain of debt with no alternative but to scale back, or 'taper,' as the Federal Reserve like to call it – language that has already caused significant turmoil in stock markets over recent months.

With the prospect of future monetary unwinding, the already fragile growth picture seen in most developed nations has the potential to stall even further.

Indeed, recessions typically occur every 4 to 6 years in developed countries, meaning we are now overdue.

Financial deficits need austerity, not additional debt; which is why when the next slowdown comes, as it surely will, the financial come-down is likely to be as severe (if not worse than that of 2007-2008).

Central banks cannot inject any more liquidity because the debt is too high and they cannot cut interest rates because rates are already at zero.

You can see now why the propping up of huge, failed institutions is rarely conducive to a smooth running financial system.

So what will be the future of finance and how will the next billionaire traders make their fortunes? One answer lies in the new breed of technology. If history has taught us anything it is that those who succeed are generally those who are able to embrace new frontiers.

The new frontiers

It is true that the Internet has brought with it many advantages and benefits to traders. However, the world we live in is now faced with information overload and a rapidly changing business environment.

For financial markets, this means new risks – long tail events and flash crashes, as well as, new opportunities such as social trading and new analytics. (You will find these subjects addressed later in the book.)

Traversing the new world, with its gluttony of information, requires ever more sophisticated tools to analyze data, discover new metrics and respond to them in a timely manner. However, just as information needs filtering, markets need overseeing, and as central banks begin to unwind, the ‘new normal’ may well give way to a new type of order.

Stagflation, a combination of stagnation and inflation, is one possibility. Where there is sluggish growth but strong inflation, prompting a world where real assets become the best protectors of value. A world where rises in asset prices give the general populace the illusion of wealth but not the real thing.

In truth, no one knows what this world order may look like but if we have learned anything over the last few hundred years it is that while markets may change, the people who trade them rarely do. The fundamental skills needed to profit from the markets therefore are likely to stay much the same.

Combining them with the new breed of technology could become a winning formula for the next decade.

With such risk and opportunity looming, there has never been a better time to educate yourself about the way financial markets operate.

MY STORY

It's fair to say that Monday, September 15, 2008, was a pretty eventful day for me. Not only was it the day that Lehman Brothers declared bankruptcy after a weekend fraught with rumour but it was my first day in a new job as a futures trader in the City of London, England.

Six months of intense training and three months of live demo trading, alongside two other recent graduates, had all boiled down to this and we were eager to go.

We came in on that Monday morning to find that US stock markets were already down nearly 200 points before the market had even opened. We had heard the rumours about Lehman Brothers over the weekend but this was practically unheard of. We could only sit and watch as the market went on to decline further throughout the day, posting its biggest drop since 9/11.

By Wednesday, markets were reeling and the Dow Jones Industrial Average ended the day down by 500 points (over 4%). It was a pattern that was to be repeated frequently over the next few months as the credit crunch caused a perfect storm of events culminating in the Dow's largest ever one-day loss of more than 1,000 points and several months of severe volatility.

Back in the trading room, things were manic and even veteran traders had not seen anything like it before. We spent those first couple of days just watching, too scared to place a trade. At first, we couldn't believe our bad fortune that we had managed to start our trading careers during some of the toughest conditions in the last 100 years. However, looking back, it was probably the best thing that could have happened.

Although it was tough, surviving the crisis meant learning everything at breakneck speed and it has made me an infinitely better trader today.

It's for that reason I have put together this book containing all the knowledge and secrets I have learned over the last five years. I have consumed hundreds of books and articles and put in thousands of hours of trading; everything I have learned has been put into this book.

It's not supposed to be a trading bible, far from it. We will never stop learning in this business. But it does provide information that should be useful to beginners as well as more advanced traders.

There is a hell of a lot of information out there in the world, some good, but most of it bad, which is why I have kept everything in the book short and snappy, so you don't have to waste time getting to the good stuff. In fact, I have set it out almost like a series of blog posts so you can flick through to the bits that you're interested in, if you want. At the end of the book you'll also find a resources section which you can use to read up further on the topics addressed here.

I hope by passing on this knowledge, you are able to become a smarter, more informed trader.

All the best with beating the markets.

HOW IT ALL BEGAN

Trading is a fact of life and has been around since the beginning of civilization. In fact, the first futures exchange can be traced back to Ancient Greece where the Greek philosopher Thales developed a way of predicting olive harvests.

Thales was able to predict when a good harvest was around the corner and made agreements with local olive growers at fixed prices, depositing money with them in order to take advantage of the harvest when it came around.

The olive growers were happy to agree to the transaction since they did not know what the harvest would be like and were effectively hedging their future income in case of a poor harvest.

When the time came, the harvest was indeed excellent and Thales was able to sell back his stake for a substantial profit. Thus, the first futures contract was settled.

Today, the rules are a bit clearer and a futures contract is defined as a contract between two parties to buy or sell something at an agreed price today, with the delivery and payment occurring at a later date.

Futures thus provide risk insurance to producers and holders at a relatively low cost and are the perfect vehicles for trading.

Some products such as forex (foreign exchange market) can be traded on spot markets, but for all intents and purposes there is very little difference between the two. The only real difference is that futures products are settled at some time in the future, whereas spot products are settled daily. Whether you use futures or spot markets, the principles for trading them are the same.

Trading vs. investing

Throughout this book, we cover some aspects of trading and some of investing but in both we mainly deal with stocks, bonds, com-

modities, forex and ETFs (exchange-traded funds) – any product that lends itself to be freely traded on a central exchange.

For further clarification, we denote trading to be anytime that something is bought with the intention of selling it at a later date for a profit. Anything else shall be deemed as investing.

Getting started

A trader is someone who buys and sells goods, currencies or stocks and makes money by buying something at a low price and selling it a higher price, after taking into account the cost of commissions.

It's important to understand this and not get side-tracked as everything boils down to this one simple truth.

Anyone can become a successful trader if they put in the hours and these days there are plenty of ways to get started. All you need is a computer, an Internet connection and a bit of money. If you have those you can connect to a broker and be trading cotton futures, soybeans, gold futures, silver or Nasdaq stocks in a matter of seconds.

Becoming successful, however, is a different matter, and the game of trading has an immensely steep learning curve.

I can think of no other career quite like trading, where the risks are so great yet the opportunities are so vast. For an exceptional trader, there really is no limit to the amount of money that can be made.

In the end, it really doesn't matter who you are or where you come from. In the eyes of the markets', everyone is equal and if you put in the required effort you can succeed. Not everyone will of course; it is suggested that between 60-90% of retail traders will lose overall.

The majority of those are amateurs, gamblers who play the markets for excitement or out of curiosity. It is actually a very small group of traders who are responsible for 90% of profits in the markets. They are disciplined professionals and have worked hard to hone their craft over many years.

So you could be either one of those who wants to get rich quick, who plays the markets out of boredom and who wants to find the shortcuts to riches but never finds them. Or, you could be a disciplined professional, committed to becoming the best trader you can be.

I know which I would rather be.

Contained in this book are some of the secrets used by the small minority of traders that manage to win, time and time again.

But first we need to start at the beginning.

**CHAPTER 1:
TRADING FUNDAMENTALS**

TRADING PHILOSOPHIES

There are thousands, if not millions, of traders in the world and nearly all of them have their own unique strategy to profit from the markets. Some use technical indicators, some fundamental data and others look at news releases.

There are, however, two very broad philosophies that I believe most traders ascribe to: mean reversion or trend following.

Mean reversion

Mean reversion traders typically believe that market prices fluctuate around a certain level of equilibrium, be it the recent mean or something else like intrinsic value.

They therefore believe that when a security deviates from this level, it is an opportunity to make a trade in the opposite direction and profit when the price returns to equilibrium.

Since markets trade in ranges most of the time, mean reversion is a very popular method of trading the markets – particularly among day traders – where big trends tend to be less pronounced and there is more ‘noise’ in the markets.

It all depends on your own world view and how you see markets operating. If you believe mean reversion is true, there are plenty of ways to approach the markets (which we look at later in this book).

Trend following

‘The trend is your friend, until the end when it bends.’

This is a common saying among traders who believe in the other trading philosophy of trend following. Trend following basically describes the simple belief that markets move in trends.

In other words, the belief that if market prices move in one direction for long enough it is possible to trade in the direction of that movement and make a profit.

TRADING FUNDAMENTALS

Trend following is thus the polar opposite of mean reversion and many trend followers trade trends irrespective of fundamental events or news flow.

It is often said that markets range approximately 60% of the time and trend the rest. So trend followers may often encounter more losing trades than other traders, but this is generally compensated by bigger moves and therefore bigger wins. A win ratio of just 40% can be considered a good win ratio for trend followers.

Once again, we refer to trend following throughout this book and give many ways of putting this philosophy into practice.

Different opinions

As you may have noticed, these two philosophies are broad and many traders do not fit into either of these two categories definitively.

I am a fan of trend following strategies and prefer to use these in most of my trading. However, I also believe that mean reversion can work well and know many traders who take this approach.

Instead of worrying about which strategies work the best, it is more important to find out what works for you and what style suits your personality. Only by doing so will you be able to trade in a relaxed and confident way.

One thing I have certainly learned over the years is that there is more than one way for a trader to make a living from the market. Traders can hedge, speculate or make short-term bets and that's why traders can take several different forms.

DIFFERENT TYPES OF TRADERS

Quants

Starting with the fastest traders of all, quants are the high frequency traders who trade using quantitative methods and with complex

HOW TO BEAT WALL STREET

computer algorithms. They are sometimes given a bad name in the industry, after being blamed for the 1987 crash, but quants tend to be technically savvy individuals who are able to harness automated algorithms to find minute inefficiencies in the market.

Becoming a quant might be difficult, because to succeed quants need super fast connections (such as fibre optic lines straight to the exchange) and expensive computers. This is why they often work for big institutions such as the major banks. Their trades are often so fast, operating between the bid and the ask price, that they are not even noticed by the rest of the markets.

Scalpers

One up from the quants, scalpers also operate in the short-term, but they may do so manually or by using a computer program.

Scalpers look to profit from inefficiencies in markets and can hold trades for anything from a couple of seconds to a couple of hours. Scalpers have been in the markets since the beginning with the idea being that markets are forever fluctuating around.

Scalpers use this fact to profit from the 'noise' so that when a market spikes up or down, they will quickly enter and hope to pull one or two pips from a quick reversal. To be a scalper takes a lot of skill and practice and usually a lot of discipline but it can certainly be an interesting way to trade. Both scalpers and quants are very useful to financial markets since they enter lots of trades and provide liquidity to the markets.

Day traders (or technical traders)

Day traders enter and close their trades on a daily basis, rarely holding any positions overnight. Typically, they trade off charts using technical indicators such as pivot points or moving average lines to justify their trades.

They may also take into account fundamental factors and news releases – perhaps buying or selling a stock the moment an eco-

TRADING FUNDAMENTALS

conomic figure is released. Some day traders may also use strategies to hedge their trades as they go.

Swing traders

Swing traders typically hold positions for a couple of days, but not normally weeks. They are therefore less active than day traders but they do trade frequently enough to have to stay tuned to the markets at all times. They may use technical indicators such as trend lines or resistance channels to identify profit but are just as likely to look at fundamental news flow. They also look out for the possibility of reactions to upcoming news releases and events.

Position traders

Position traders take much longer-term positions and hold positions for weeks, months or years. They are therefore just slightly down from buy and hold investors in terms of time frames. Position traders study big macroeconomic trends in order to find the long-term moves that can often define a market for years. They are also likely to enter big short-position trades and use hedging strategies to build a successful and stable portfolio.

All of the above

It is also possible to be one, none, or many of these different trading styles combined. Some traders concentrate on one market and one style only, perfecting their technique as much as they can, while others take a bit of each style depending upon the situation. For example, a trader might take long-term positions but keep a little bit of capital in reserve, in order to profit from short-term opportunities when they arrive.

In general, the shorter the time frame you trade, the harder it is for you to make a profit. That's just one of the facts of life, so make sure to think carefully about what kind of trader you want to become.

A closer look at position trading

There are many options when it comes to trading the markets but position trading is one type that often steals the headlines. The main reason for this is that position trading allows longer-term positions to be built up over time and therefore facilitates some of the biggest profits.

In fact, some of the most famous traders in the world and biggest hedge funds can be described as position traders. George Soros, Warren Buffett, John Paulson – they are all famous for taking big, long-term positions according to their views on markets.

To sum up then, position trading is any trading style where trades are held open for a long period of time. Some may argue that any trade that is held for longer than a day constitutes position trading but it is generally accepted that position trading relates to trades being held for weeks, months or years.

Another view, is that position trading describes any trade that is placed according to fundamental analysis on the market and only closed once those fundamentals change. Although this is not always the case with position traders, it is certainly true that the majority of position traders use fundamental analysis to enter the markets.

Fundamental analysis

Fundamental analysis is best described as any analysis that looks at data relating to economics or the big picture numbers that operate behind the market. It is therefore not directly interested in the price and can also include top down or bottom up analysis.

As fundamental analysts, position traders study the market rigorously in order to find the big macroeconomic trends that enable them to make huge multi-month or multi-year profits. They study such factors as unemployment, GDP (gross domestic product), retail sales or the outlook for interest rates and they have a firm grasp of how global markets interact with each other.

Because of this, many position traders spend large amounts of time

TRADING FUNDAMENTALS

on the sidelines, often putting their money into cash or treasury bills (T-Bills) and waiting for the next big opportunity to emerge.

While some traders such as Warren Buffett waste no time in entering their full position when the opportunity comes, others, such as George Soros, prefer to drip their money into markets gradually, testing their hypothesis and targeting the best possible entry price.

Because of this long-term-ism position traders need a totally different approach to risk tolerance than short-term traders. While short-term traders place very tight stops in the markets to reduce their risk of losing money, this is a flawed strategy for position traders, since they are unconcerned about the minor fluctuations in the markets.

Rather, position traders look for the big trends and need to have a very strong tolerance for losses in order to be able to ride them out over time. In this way, they often need to keep trades relatively small at first, building them up as they progress, and they need to be supremely confident about their trades in order to not get dissuaded when the position is losing money.

Some people like to argue that there is more money to be made trading the markets in the short-term, but it is hard to argue against the effectiveness of position trading considering some of the most successful traders in the world are position traders. George Soros, Warren Buffett and Jim Rogers are just three good examples.

Famous position traders

George Soros

Born in Hungary in 1930, George Soros is one of the most famous position traders of all time, not least for his role in 'Black Wednesday' when he was dubbed the man who 'broke the Bank of England' and netted \$1bn in profits from a short position in the British pound.

Since then, Soros has continued to beat the market over several decades, through a combination of rigorous fundamental analysis and gut instinct. He is often said to close trades when he starts to

HOW TO BEAT WALL STREET

feel backache, an indication that something is not right. He also takes the view which he calls 'reflexivity,' – that the movements in markets can actually affect fundamental conditions just as much as the other way around. Soros has written about this theory in a number of books. (Several of which are included in the Resources and links section at the end of this book.)

As a trader, Soros is known for his bold predictions and courage to make big trades. In fact, Soros is quoted as saying that the biggest error a trader can make is not being bold enough. Soros likes to think deeply about markets and to come up with a thesis that he believes best reflects the world around him. Often he tests the thesis by opening a position in the markets and seeing how it goes, sometimes building it up over months or years. Other times, he likes cutting it quickly if there are losses or if his intuition tells him to sell.

Warren Buffett

Although some might regard the 'Oracle of Omaha' Warren Buffett as more like a buy and hold investor, there is no doubt that he is also a very astute position trader. He may have held stock in some of his favorite companies for several decades but he has also bought and sold many other hundreds of stocks at numerous times throughout his career.

In fact, what most people don't know about Buffett is that he also regularly takes big positions in the derivatives market. He has long held a negative view on gold and has also taken a number of big positions in the bond and forex markets. Indeed, Buffett made around \$2bn from a short position in the US dollar in 2005.

All of Warren Buffett's trades have one thing in common: they are all upheld with rigorous economic research and fundamental analysis, leading to macro trends that can span years.

Jim Rogers

Legendary investor, Jim Rogers, co-founded the Quantum Fund with George Soros during its most successful period and famously

TRADING FUNDAMENTALS

claims he is not much of a short-term trader, since his timing is always 'too early'. For that reason, Rogers studies markets and the fundamentals before taking positions that generally last anything from a couple of months to a number of years.

Amongst other wins, he successfully predicted the boom in commodities and the 2008 financial crisis even though, in the latter trade, he had to wait for a couple of years for his prediction to come to fruition. Rogers, as a true position trader, is quoted as saying he simply 'waits until there is money lying on the floor, and then goes over and picks it up'.

As Soros, Buffett and Rogers testify there is often far more money to be made in riding out the big trends than by trying to pick the bottoms and tops each day while day trading.

It is for that reason that position trading is good at facilitating big profits. Indeed, it is no wonder that many of the richest traders in the world are all position traders. Big, macroeconomic trends do not come around often but, when they do, they can often lead to huge moves in financial markets over months, years or even decades.

Another reason why position trading is so effective is that market timing becomes less of an issue.

Many traders in the financial world come up with good trading ideas but sometimes they are let down by getting into markets too early or too late. As a result, short-term traders such as day traders need to be watching their screens constantly, since they can lose big money in the space of a couple of minutes if markets turn against them.

Because of this, day traders use a plethora of different techniques in order to try and time markets perfectly.

However, for the position trader, this is much less of a problem. Although there are times when a position trader must react quickly, such as after an unexpected world event, often a position trader has a couple of days, even weeks to initiate or close a position. Big trends are often slow to get going and so a position trader has a lot

HOW TO BEAT WALL STREET

more flexibility in timing his or her trades. Because of this, position traders have the advantage of not having to watch their screens 24 hours a day, since they are not concerned with daily fluctuations in markets.

It's also easier for a position trader to enter a really big position in a market, and this is why most big funds choose position trading.

Usually, when a really big position is placed in a futures market, that market reacts instantly and in some cases the trade is not filled at the bid price. For a day trader, not hitting the required bid would be a big issue and could cause big losses, but a couple of pips is neither here nor there for a position trader. Thus, large positions are much more easily absorbed into markets over several hours or days. A method that lends itself best to longer-term trading.

There are of course disadvantages to position trading and the biggest is that it is a very long-term strategy. Trades typically take a long time to make any money and trends can last weeks, months or years. That means that a trader must wait a long time to cash in on his profits. They must also have the patience to wait for long periods on the sidelines without putting any money to work.

Which is why many traders choose day trading over longer forms of trading even though it is a much more risky profession.

It is very difficult for a trader with only a small amount of capital to get rich by position trading and would take several years to do so.

Another problem position traders face is the difficulty of manoeuvrability. Since they often have big positions built up in markets, they cannot always get out of them at the flick of a switch. Big positions in illiquid markets can cause problems, since trying to exit markets causes prices to move in an unfavorable direction. This means position traders can be sometimes left vulnerable to big market events and left scrambling to exit their big positions.

Such big events could come in the form of natural disasters or wars, but they may often be caused by the actions of politicians or

central banks – those that have big power over markets. It is the central banks that we turn our attention to next.

CENTRAL BANKS

One of the key lessons a trader must learn before attempting to trade is that central banks (such as the Federal Reserve, the Bank of England and the European Central Bank) can have a huge impact on stocks, bonds, commodities, forex and the global economy itself.

Indeed central banks have such power that their actions can cause markets to plummet or soar with just a few carefully worded statements. And, when central banks follow through on their statements with real policies, the price changes can be even more profound. Therefore, if you learn about one thing early on in your trading career, make it central banks.

Such is their importance, that traders must keep a close eye on central banks at all times. They must know when central bankers are due to meet and they must be ready to analyze every word that comes out of their mouths. Central bank meetings (in which bankers meet to discuss inflation expectations and set interest rates) are closely followed events in the investment world and can cause significant volatility in markets.

Just to indicate how important central banks are to financial markets, there are a number of people whose jobs are to solely follow the actions of a particular central bank.

While all central banks are different, most have been vested power by their incumbent nation and usually have the same, simple but important mandate: To promote economic growth while keeping control of inflation. They do this chiefly by controlling interest rates in the economy by purchasing government bonds and other open market securities.

HOW TO BEAT WALL STREET

By cutting interest rates central banks seek to make money cheaper to borrow, to increase consumption and, thus, to stimulate the economy, which they do if they think the economy is underperforming. By doing so, they increase the money supply and thereby also increase inflation.

Although it is not always so simple, cutting rates is usually bullish (positive) for the stock market and bearish (negative) for a country's currency, since stocks benefit from the increase in consumption and currency depreciates as a fact of there being a greater supply of that currency.

Similarly, raising rates is generally bearish for stocks and bullish for currency. By limiting the money supply, companies find it harder to borrow and the value of the currency is likely to go up.

Bullish describes the belief that markets will generally rise in price while bearish predicts that markets will fall. For a quick reference guide to financial terms used in this book take a look at the glossary section.

When it comes to central banks around the world the Federal Reserve (the Fed) stands out as the biggest and most influential banking system by a long way. As a provider of liquidity for the United States, the Fed and its chairman Ben Bernanke, control more than \$16 trillion dollars. It is the biggest mover of financial markets in the world. To trade successfully, therefore, a trader must know exactly how to respond, whenever the Fed makes its next move.

The characteristics of central banks

As I've said, central banks, particularly the Fed, have the most power in guiding the direction of nearly every asset class.

By cutting rates aggressively or by using strategies such as quantitative easing, central banks can inject liquidity into the economy, propelling stocks to new highs and depreciating the value of currencies. Similarly, by raising rates, they can curb inflation and cause currencies to go up in value.

TRADING FUNDAMENTALS

However, not all central banks have the same power and each one, as we shall find, has its own distinct personality.

Knowing the different characteristics of each bank is essential in order to predict what they might do next.

The Federal Reserve – The Speed Boat **Head: Ben Bernanke (soon to be Janet Yellen)**

As controller of the biggest economy in the world (the United States), the Fed is by far the most influential central bank and its policies are able to affect not just the US economy but the global economy as a whole. As such, Chairman of the Fed, Ben Bernanke, has one of the most powerful jobs in the world.

The best way to describe the Fed when compared to other central banks is by way of a speed boat. The Fed is always fast to act and quick to respond to changes in the economy. It sees itself as entrepreneurial, much like the American people, and it has little problem changing direction if the situation needs it.

For example, during the financial crisis in 2008, the Fed responded by cutting rates to near zero. The Fed is nearly always the first to act and be aggressive in its approach. This is good to remember whenever the Fed meets to talk or to set rates, (which it does once a month). As a trader, never bet against the Fed making another bold move and be prepared to react when it does.

European Central Bank – The Oil Tanker **Head: Mario Draghi**

Although the European economy as a whole is about as big as the United States economy, the European Central Bank (ECB) is not as big an influence on the world stage as the Fed.

The ECB typically has less control over its policies as a result of being responsible to so many different country nations (including Germany) and is therefore a lot slower in its policy moves. In fact, if we say that the Fed is a speed boat then we can refer to the ECB

HOW TO BEAT WALL STREET

as being an oil tanker. Big and cumbersome, the ECB has come under criticism at times for being too slow to respond to economic crises and for being behind the curve. This was partly seen in 2008 when it actually raised rates shortly before the global meltdown.

Unlike the Fed, the ECB's principle mandate is to control inflation and it sets its target at 2%. In many ways, the ECB's negativity towards inflation is a reaction to the dark days of Nazi Germany when hyperinflation caused so much damage making it almost understandable that the ECB continues this vigilance. All in all, the ECB is generally slow to act and unlikely to make any rash decisions when it comes to setting policy.

Although the ECB tends to not be as aggressive as the Fed, their lack of action can be just as important to future price moves as anything else, so it pays to always understand what is going on before the ECB meets or before one of the ECB's members speaks.

Bank of England – The Ocean Liner **Head: Mark Carney**

The Bank of England (BOE) is made up of the monetary policy committee (MPC) and is arguably the third most powerful central bank in the world. It is responsible for controlling liquidity and stimulating growth in the United Kingdom's economy and the MPC meets once a month to decide on policy action. Like the ECB, the BOE also has an inflation target of 2% but it is far less tied to it than the ECB. The BOE often lets inflation go a little higher than the target if it sees the economy struggling and it makes strong policy moves if it sees fit, such as cutting rates or expanding the balance sheet. Although it is not as aggressive as the Fed, the BOE is quicker to respond than the ECB and more willing to take risks.

People's Bank of China – The Hovercraft **Head: Zhou Xiaochaun**

As the country's central bank, the People's Bank of China (PBC) is becoming ever more important on a global stage. In fact, it is the

TRADING FUNDAMENTALS

biggest financial institution in the world when measured in terms of the financial assets it holds.

As China's economy has grown in recent years, the PBC has maintained a strong strategy of accumulating large quantities of US treasuries and precious metals such as gold and this is likely to see the bank in good stead for the future.

Although some of the bank's powers are spread to other offices, the PBC has shown itself to be quick to respond to market events and has made some smart policy measures such as those designed to cool China's property bubble. However, by not allowing its currency to be freely exchangeable, the bank is still a bit behind the times.

The rest

There are many other important central banks on the world stage including the Bank of Japan, the Reserve Bank of Australia and the Central Bank of Brazil, with the Bank of Japan in particular, becoming considerably more aggressive in recent months.

Although these are the most important banks it is worth remembering that the action of any central bank, no matter how small, can have a big effect on a market such as the national currency of that country. Their actions should always be considered.

KEYNES: MACROECONOMICS AND EXPECTATIONS

After following the financial markets for a short while, it will not be long before you begin to form judgements over the decisions made by various policy makers. Since the financial crisis in 2008, there has been mixed reaction (to say the least) at the decisions made by politicians and central bank officials.

Much of the commentary has been negative. Central banks have been criticised by many for bailing out failed financial institutions

HOW TO BEAT WALL STREET

and implementing the biggest program of monetary easing in recorded history.

To understand why central banks, such as the Fed, have cut rates to zero, instigated huge programs of quantitative easing and blown up the budget deficit to unprecedented levels, it is necessary to know a little bit about the late British economist, John Maynard Keynes.

Keynes

Keynes was a British economist whose ideas rose to significance during the 1930s Depression era, and again after the Second World War. He proposed that macroeconomics was fundamentally concerned with three things: the output of an economy, inflation, and expectations.

After the Second World War, the success of Keynesian economics caused the mainstream of American economists to adopt Keynesian ideas. This explains a great deal why the Fed has acted in the way it has in recent times. Knowing Keynesian economics also helps to predict how the Fed will act in the future.

The Great Depression

During the 1930s, the United States and much of the world entered a prolonged economic depression that saw the Dow Jones lose 89% of its value.

What is surprising, is that many economists and politicians at the time were at a loss as to why this was happening.

The States experienced no fall in labour or industrial resource that should have led to such a determined downward spiral in economic conditions.

At the time, President Roosevelt proclaimed, "Our distress comes from no failure of substance. We are stricken by no plague of locusts...Plenty is at our doorstep but a generous use of it languishes in the very sight of supply."

Keynes said that the reason for the downturn was not to do with

TRADING FUNDAMENTALS

supply (since America did not lack resource or economic will) but rather one of demand. Moreover, Keynes argued that negative expectations (or 'animal spirits' as he called them) had become self-fulfilling, so that demand had also plummeted.

He argued that if expectations of future growth were bad enough, employers and business owners would withhold investments, while consumers would put money aside instead of spending it.

The result would be a vicious cycle of reduced output and prolonged economic woe. A situation that, if bad enough, could not be resolved by even aggressive monetary loosening by central banks.

Keynes came to the conclusion that when expectations become so entrenched that they lead to severe economic recession or depression, policymakers should do everything in their power in order to bring output back to its potential level.

Central banks should drive interest rates down as far as possible (by controlling money supply) and governments should run large budget deficits in order to encourage further spending.

Keynes proposed a model known as an income 'multiplier' which explained why an increasing budget deficit would eventually lead to a more than proportionate rise in GDP.

Put simply, Keynes said that a rise in government spending would result in a bigger proportionate rise in national income as further consumer spending and investment went back into the economy. Keynes estimated that increased government spending could equate to an increase in national income, by a factor of five times as much.

In other words, if the government increased spending by \$100, the overall benefit to the economy would equate to a GDP of as much as \$500.

Taking these steps, Keynes said it should therefore be possible to reverse expectations enough so that markets become self-fulfilling once more. This time, by encouraging future investment and spend-

ing, leading to the resurgence of output within the economy and restarting the business cycle.

Overheating

As the economy recovers to its potential, Keynes suggested that inflation also ignites, as a result of the increase in money supply. When this occurs, officials should act quickly to control the inflation before the economy overheats. They should do so by reversing the methods used to ignite growth in the first place. In other words, by reducing spending and raising rates. If they don't, inflation has the potential to run away to unsustainable and dangerous levels.

The present day

Today, it is quite clear that central banks have taken a Keynesian approach to tackling the financial crisis. In 2008, what started as a housing bubble in America quickly led to severe contractions in output across the world. As negative expectations became entrenched, banks stopped lending to each other and sparked fears of bank runs and further crises.

The Fed responded by driving interest rates to near zero and buying up government bonds on a huge scale. By 2012, the US government was running a budget deficit of over \$1trillion dollars (6.3% of GDP).

Inflation is yet to really ignite in the States (as of November 2013, US inflation stood at around 1.6%). But when it does, you can be sure that the Fed will work quickly to turn off the printing presses and fulfil the next part of the Keynesian ideal. Savvy traders will be on the lookout for such an event, well before it occurs.

WHAT IS INFLATION?

Inflation is the rise in prices of goods and services in an economy and having an understanding of it is essential in order to trade

TRADING FUNDAMENTALS

financial markets effectively. Deflation on the other hand, occurs when prices experience an overall decline and normally occurs during periods of economic struggle.

Inflation has been practised throughout history as a tool that governments use to pay for its expenses, spur economic growth and control the populace of a country. Historically, governments would induce inflation by melting down gold coins and mixing them with other metals such as silver, copper or lead.

The government could thus issue more coins, at the same nominal value, effectively putting more coins into the money supply and diluting the real value of each coin. The effect of this is that the government can produce the same value money at a cheaper cost. The government is therefore able to gather more money to finance its expenses.

As the distribution of money increases, the populace feels more content as they believe (incorrectly) that they are becoming wealthier.

These days, governments are able to increase money supply much more easily by printing paper money, also known as fiat currency.

You need to know about inflation and deflation in order to understand what kinds of returns you should be targeting and what sort of returns may or may not be possible.

If inflation is high, then your returns need to be equally high or you are not making any money.

For example, let's say that inflation was 3% last year but your portfolio only returned 2%.

In other words, even though your portfolio made 2%, you still lost money in real terms, since the prices of everything around you has gone up more than your wealth has. Similarly, if your investment makes 3% and inflation is also at 3%, you are no better off.

Generally, economists favor a level of inflation that is low and steady, around 2%. Much lower than that and economists fear stagnation

while much higher and the implications from an economic slow-down become more severe. Central banks, therefore, use interest rates to try and keep inflation at around this 2% mark.

Any return you make must always be compared to the rate of inflation. Generally, when prices are dropping it is harder to make bigger returns so look for investments that are immune to low prices and benefit from lower interest rates. Investments such as banks and bonds, for example. Conversely, if prices are forecast to rise, look to investments that retain their value, such as property, gold or commodity stocks.

THE TYPICAL MARKET CYCLE

Good traders know that central banks have huge influence over the outcome of financial markets but it is the market cycle and real economics that ultimately drives prices. The stock market is a big influence, since it is arguably the market that is most clearly affected by changes in economic fundamentals.

Financial markets are always interconnected with one another, so no matter what asset you trade you must have a clear understanding of the outlook for the stock market. One way to do this is to have a sound understanding of a typical market cycle.

1. Coming to the end of the market cycle

During the latter stages of a bull market, such as experienced in 1999 and 2007, there is typically strong economic growth and high levels of optimism among market participants. It is during this time that the market cycle nears its peak. Consumer confidence is likely high, interest rates rise and cyclical stocks begin to outperform. It is not always the case, but these are the usual characteristics of a maturing market.

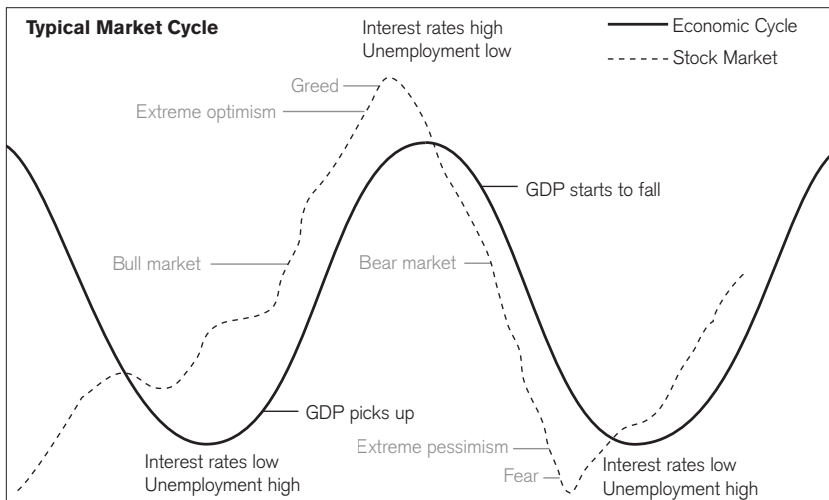
As markets move up, rising interest rates become an ever stronger

TRADING FUNDAMENTALS

threat to economic growth and markets begin to slow in momentum. Lending money becomes more expensive and thus risk taking begins to drop, leading to investors seeking more secure places to invest – such as utility and value stocks.

This in turn leads to sharp falls in the growth stocks that were previously in charge and mounting pessimism begins to set in as the main driver. As pessimism increases, economic growth begins to fall and small cap stocks and growth stocks bear most of the pain.

In order to address the decline in growth, interest rates start to fall and the stock market most likely enters a prolonged bear market. Traders begin to sell higher yielding investments and move into safer investments such as bonds, utility stocks or safe havens.



2. Restarting the market cycle

As interest rates fall and pessimism takes hold, markets keep dropping until they reach a selling climax, where optimism is at its lowest. It is at this point when markets are washed out and at their lowest ebb that the cycle can begin again. Fuelled by the prospect of now low interest rates, and improving economic growth, small

HOW TO BEAT WALL STREET

cap stocks and growth stocks take over and markets start to rise.

Since the stock market looks ahead, this rise is often happening well in advance of any corresponding uptick in GDP or unemployment. In this way, the stock market is the ultimate leading indicator into future economic growth.

It is important to understand the market cycle. Although no cycle is ever the same, it is generally the case that riskier assets and small cap stocks do better in the beginning stages of bull markets. Whereas in bear markets, bonds and defensive stocks do better. As do safe-haven currencies such as the US dollar, the Swiss franc and the Japanese yen.

ASSESSING MARKET CYCLES USING INDICATORS

Understanding current market cycles aids in timing markets. But since cycles can go on for a number of years and each one is different, it is not always easy to ascertain what stage we are at. Fortunately, a closer examination of various economic indicators can help form a top down view of which stage of the market cycle we are currently in.

Another reason why economic indicators should be given attention is that by understanding economic conditions you are in a much better place to anticipate future policy decisions by central banks such as the Fed.

Money supply and the yield curve

Money supply

Money supply, by and large, increases as an economy worsens and slows as a market cycle nears its peak. It is controlled by central banks and in the States the Fed can control the money supply by

TRADING FUNDAMENTALS

changing its reserve rate requirement.

The principle way it does this is by changing the Fed target rate, which it is able to keep in place by buying and selling US government securities in the open market at the required rate. This process is known as an open market operation and, while there are several other methods the bank uses to control money supply, this is the main one.

Generally, traders use the economic indicators M2 and M3 to measure money supply in the economy and these numbers are released regularly by the Fed. M1 used to be used but these days it is subject to too many distortions for accurate analysis. (I have included with this book a number of spreadsheets, including money supply data, which you can analyze at your convenience).

If you regularly keep track of money supply you should also be able to predict long-term shifts in interest rates.

When money supply is shooting up, inflation is likely to follow which then has to be controlled by higher interest rates. For traders, this means currency yields in the US increase while the US dollar itself likely depreciates. Stocks, in theory, should benefit from an increase in money supply, as do commodities, particularly precious metals.

Yield curve

We have seen how money supply can affect interest rates but we should also look closely at interest rates themselves – in particular the difference between long-term rates and shorter-term T-Bills (known as the yield curve).

The yield curve reacts to dynamics in cash markets and is an extremely useful guide to the future of the economy. You can view it in real time by logging on to any one of the main finance websites, such as Bloomberg.com, and calculate it for yourself using some of the spreadsheets provided within this book.

When long-term rates are much higher than short-term rates, the yield curve is steep and indicates an optimistic environment. The

HOW TO BEAT WALL STREET

Fed is typically accommodative, stock prices typically do well and markets expect an improving economy.

Conversely, the yield curve can be said to be flat, or inverted, when short-term rates are close to or above longer-term rates. This occurs when markets expect economic weakness, and longer-term rates are deemed too risky. It is a scenario often accompanied by a restrictive Fed and a certain level of fear and pessimism in the financial markets.

It makes sense to follow the yield curve as it can be a useful leading indicator in the state of the market. By and large, a steep yield curve means economic growth which should benefit riskier assets such as stocks, while a flat or inverted yield curve means traders should be prepared to shift into safer haven markets. The yield curve is one of the best leading indicators available to traders and contains brilliant insight into the functioning of the money markets.

INVESTING IN MONEY MARKETS

As we have seen, central banks are perhaps the biggest influence on financial markets. One of the reasons for this, is their ability to control money markets that financial institutions use to fund their daily activities.

In general, central banks aim to provide stability to markets and encourage lending between financial institutions. We saw in 2008 the problems that can occur when banks stop lending money to each other (for fear of losses) as the London Interbank Offered Rate (LIBOR) went up.

LIBOR is the estimated interest rate offered between leading banks in London and is a key component of the TED spread; a name formed from the merging of T-Bill and ED, the ticker symbol for the Eurodollar futures contract.

Essentially, the TED spread is the difference between the three-

TRADING FUNDAMENTALS

month LIBOR and the three-month risk-free T-Bill rate. This spread came to be a good indicator of fear during the financial crisis.

An increase in the TED is therefore a sign that the risk of default on loans between banks is increasing. If banks are fearful of lending to each other it means they are worried about their solvency and is a worrying prospect for the financial system.

The long-term average of the TED spread is a difference of around 30 basis points, but during the financial crisis the indicator ballooned to 457. The TED also jumped higher during the 1987 crash.

Money market funds

Investing in a money market fund is like putting your money in a big pool of secure, highly liquid short-term debt securities, the same pool of money as described above that the big institutions use to keep money overnight before deploying elsewhere.

It's important to note that money market funds differ from money market deposit accounts. Whereas money market funds are investment vehicles that the investor picks for his own investment, money market deposit accounts are investments where the bank receives the funds and can invest the cash at its own discretion.

The whole point of a money market fund is to be a secure place to store money so that the value of the fund never drops below the net asset value (NAV) of \$1. As such, money market funds generally offer safe returns at rates a little bit higher than checking accounts.

Nevertheless, money market funds can lose money on rare occasions and are not insured by the Federal Deposit Insurance Company (FDIC).

Breaking the buck

Money market funds rarely lose investors' money but when they do, it is referred to as breaking the buck, as the fund drops below the NAV of \$1. Prior to 2008, there was only one instance of a money market fund breaking the buck and that was an institutional fund

HOW TO BEAT WALL STREET

that paid out at 96 cents for every dollar invested.

In 2008, after Lehman Brothers went bankrupt, another money market fund broke the buck with its value falling to 97 cents per share. The amount of money invested in money market funds at the time meant that a single fund breaking the buck could have led to ripple effects and cause a potential run on banks. Because of this, the Fed stepped in and guaranteed funding to protect public money market funds from slipping below \$1.

The Fed came to the rescue in 2008 but it may not always do so going forward. Therefore, it's still important for the investor to do their due diligence before investing.

On the whole though, money market funds are secure and there are several factors that make them safe places to store money:

1. Money market funds typically only invest in high quality AAA grade debt;
2. They're not allowed to invest more than 5% of the fund in one issuer (except the government), which means the risk is spread across several firms;
3. Money market funds have an average weighted portfolio maturity of less than 90 days. This means managers have a lot of room to manage the risks of certain securities.

The biggest risk with money market funds typically comes from extraordinary long tail events where credit conditions change dramatically in a short space of time. Rapid shifts in overnight lending rates between banks or sudden movements in interest rates can put pressure on some money market funds that are concentrated in the wrong areas. It is therefore important for the investor to seek out the details of a money market fund before committing any investment.

Particular attention should be paid to the current macro-economic environment and the health of the banking sector. In general, money

TRADING FUNDAMENTALS

market funds from the bigger institutions provide lower risk as they are more heavily capitalized and better able to ride out extreme market volatility.

Like money market funds, bonds also react directly to changes in money supply. Although not as secure as money market funds, they are among the safest investments in the financial community. Because of their perceived security, bonds take up a huge role in the financial system.

INVESTING IN BONDS

Bonds, in their myriad of forms, are among the least understood investments but they can provide a steady, reliable stream of income as well as being secure places to park one's money – particularly when expected returns on riskier assets such as stocks is uncertain.

Bonds are essentially IOUs. You lend money to a company or institution for a certain amount of time; in return, you receive interest and the money you lent in full at the end of the loan, called the maturity date. You can also sell your bond early. If the value of the bond goes up, you can bank the capital gained on your investment.

The key thing to remember is that bonds move in the opposite direction of interest rates. When rates fall, bonds rise and vice versa.

All bonds have a par price of 100 and go up or down depending on interest rates. So if you buy a bond at 100 with a yield of 3% and rates go down enough so that your bond goes up in value to 105, you earn 3% per year in interest as well as bank 5% capital gain if you sell it. If rates go up, you still get the 3% but receive your money back in full at the end of the term without any gain.

There are essentially three different types of bonds.

The first two are both investment grade bonds and are provided by governments, agencies, cities, corporations or states.

HOW TO BEAT WALL STREET

Government bonds provide possibly the safest investments available and, because of this, garner much lower rates of return. The reason why they are so safe is that governments are much less likely to go bankrupt than other entities such as companies. (If they do get into trouble they can always raise taxes from their citizens to pay back the debt.)

That is not to say governments never default on their debt of course and explains why certain countries (for example Greece and Argentina) offer much higher yields than other countries like Germany.

Corporate bonds provide higher yearly returns but there is always a chance of the company going into liquidation and defaulting on the debt.

The other types of bonds are referred to as Junk bonds. These riskier bonds are below investment grade. As such, they generate yet higher returns on investment.

An easy way to see the level of risk associated with a certain bond is by looking at the ratings provided by rating agencies such as Fitch and Moody's. Bonds are rated from AAA down to D where D denotes an imminent default is likely.

Such ratings, however, must be taken with a pinch of salt. The rating agencies came under intense pressure in 2008 for their part in the financial crisis as they maintained AAA ratings of bonds that were ultimately worthless. Ratings agencies often have a conflict of interest in that the companies that pay for their services are the same companies that the agencies must rate and they are often much slower than the markets to downgrade risky bonds.

When investing in bonds, an investor therefore needs to consider a number of different scenarios.

If capital preservation and reliable income is all that is needed then secure bonds such as US Treasuries can provide that answer.

For more risk adverse investors looking to secure not only income but also gains on their capital, an opinion on the outlook for interest

TRADING FUNDAMENTALS

rates and the future implications for inflation is needed.

With interest rates at historic lows and central banks seemingly doing everything in their favor to stoke economic growth, long-term investment in bonds is not the best investment at the present time. Bonds may perform adequately for a short period of time but there is a danger of them becoming the next bubble.

If you are worried over inflation but like the security of a bond, treasury inflation protected securities (TIPS) are a good buy as they improve when interest rates rise – the opposite of normal bonds.

Bonds are also good instruments to trade with due to their high liquidity and many traders specialize in day trading US 10-year bonds and German Bunds. The skills needed for trading bonds are just the same as for trading stocks or commodities. The same principles exist across different markets, however, bond traders need to pay extra attention to interest rates and inflation of course. Bond auctions can also be good indicators of the demand for a particular bond.

HOW THE TRADE BALANCE AFFECTS CURRENCY PRICES

Predicting the direction of forex markets is notoriously difficult. In fact, there are many people in the academic world who believe it to be almost impossible – at least on a short-term basis.

On longer time frames, there is more agreement. Many of those who study macroeconomics believe that the trick to predicting where a currency might go is to look at a country's current account balance.

The current account balance is the sum of the balance of trade, factor income and cash transfers – where factor income means earnings on foreign investments minus payments to foreign investors. It basically describes the flow of money between two countries.

Supply and demand

Macroeconomic theory dictates that a country's currency is subject to the same laws of supply and demand as any other asset. If a currency is in greater demand it becomes worth more, whereas if it is greater in supply, it depreciates.

To understand this, consider a country whose inhabitants develop a strong urge to buy products from a foreign country. In this situation, the act of buying foreign goods increases the demand for the foreign currency, since that is what the goods are priced in. At the same time, the current account balance of the country deteriorates, as more imports are coming in compared to exports.

The result is a trade deficit and a depreciation of the native currency since it is in much less demand.

However, there are other scenarios too.

Consider for example, a country whose financial products, such as bonds, become wanted by foreign investors. In this case, the current account balance also deteriorates (as a result of negative cash transfers), but the currency goes up in value instead of down. Since the increase in demand for the country's financial assets means an increase in demand for its currency.

Longer term outlook

Economists tend to disagree on just how easily the current account balance can be used to predict foreign exchange prices. However, it is generally thought that sustained current account deficits lead to a depreciation in a country's currency, while prolonged current account surpluses lead to appreciation. It is thought too, that a current account deficit larger than 5 (as a percentage of GDP) is unsustainable and a potential warning sign for a country.

Take a look at the current account deficits for various countries and you see that for the majority of developed countries, the current account deficit is lower than 5.

TRADING FUNDAMENTALS

While it would be extremely difficult to use such data to trade forex markets in the short-term the current account balance can provide some use for predicting markets over longer term horizons.

The data can be freely found online and it is also released monthly by governments. One idea is to use the current account balance as one factor in the development of an indicator. Such an indicator can be used to decide which side of the market to trade on; long or short.

Interest rates and forex

Interest rates, or more importantly – the expectations of future interest rates – are probably the most significant factors that influence forex markets in the short to medium term.

The reason for this, is that market participants naturally move their money towards those currencies with the highest yields, as those yields give the best return for their money. Therefore, those countries with the higher interest rates see much larger inflows of money coming into their currencies.

As a general rule then, countries with higher rates should see their currency appreciate while those countries with lower rates should see their currency weaken.

However, as noted above, the real key to predicting forex markets is identifying where interest rates are headed before they go there. Since, by the time a country has raised interest rates, that decision is likely already priced into the markets (and that country's currency has already become stronger).

It's important therefore, to recognize market expectations as a key driver for all forex pairs.

For example, if interest rates drop for a while and traders suddenly decide that they have hit bottom, they begin to buy up the currency, well in advance of interest rates going up. In fact, sometimes the very act of traders changing their market views can alter the economic environment enough to influence future outcomes.

HOW TO BEAT WALL STREET

It is, therefore, important to understand news releases and economic reports as they can change the sentiment among traders, even if the opinion among central banks remains the same. Equally, it is just as likely for markets to price in events that do not end up transpiring in real life.

Let's look at the most recent FOMC policy meeting whereby the Fed's governor Ben Bernanke went against market expectations and kept current levels of QE unchanged at \$85bn per month.

Running up to the event, markets had become convinced that Bernanke would 'taper' asset purchases, so much so that traders sold down stocks and bought up the US dollar. (Since tapering reduces money supply this act would in theory be bullish, and deflationary, for the US dollar.)

However, Bernanke surprised the markets and did not taper. The result saw stocks advance and the US dollar give up most of its gains in a short time, as traders reacted once more to the change in expectations.

The funny thing is, Bernanke had not actually given any indication that he would taper in the last meeting, but a series of positive economic releases had convinced traders that he would. As you can see, most of the time it pays to move with market sentiment. However, in certain instances, like the example above, it can pay even more to go against market sentiment, when there is enough risk/reward in doing so.

GETTING STARTED IN BONDS, STOCKS, FOREX AND COMMODITIES

Bonds

Getting started in bonds depends on the type of bond you want to buy, where you live and how much money you have.

TRADING FUNDAMENTALS

Government bonds can be bought from any of the big brokerages and banks. Some can also be bought direct from the US Treasury or from a regional Federal Reserve Bank. Their prices and ratings can be easily accessed through financial news websites, such as the Financial Times and the Wall Street Journal, or through one of the rating agency websites.

It is also possible to invest in bonds by buying bond futures through a broker or through an ETF that tracks bonds prices, such as the iShares 1-3 Year Treasury Bond ETF, for example.

For short-term trading, US 10-year notes, UK Gilts (United Kingdom government bonds) and German Bunds are all highly liquid government bonds that can be traded as futures via a stockbroker, a contract for difference (CFD) provider or using a respectable spread betting firm if in the UK.

Stocks

Stocks can be bought via any stockbroker with many investment banks and online brokers offering this service. The Internet has brought down the costs of investing in stocks with many brokers such as E*Trade Financial, TradeMonster and Scottrade offering fixed commissions of around \$10 per trade for stocks and \$4 for futures. TradeMonster also offers an unlimited demo period to try out your trading ideas.

You can also trade stocks via a CFD provider or spread betting firm with similarly low commissions, or you can buy an ETF that tracks stock prices.

Short-term trading in stocks is better suited to the main indices, since the costs are even lower. The most popular stock indices to trade are as follows:

United States:

Dow Jones Industrial Average

S&P 500

HOW TO BEAT WALL STREET

Nasdaq (Technology)

Europe:

FTSE 100 (UK)

DAX (Germany)

CAC (France)

Asia/Australasia:

Nikkei (Japan)

Hang Seng (Hong Kong)

ASX (Australia)

Commodities, forex and ETFs

Most brokerages these days cater for the whole gamut of investment products so the same brokers that sell you stocks usually sell you commodities futures, currencies and ETFs too. A list of ETFs can be found at www.Bloomberg.com under 'Market Data', 'ETFs'.

In terms of coverage, Interactive Brokers is a well-respected brokerage site that pretty much does it all.

The Internet has really brought down much of the cost of investing in all of these products, so deciding on which broker to use usually comes down to a matter of time frames.

Typically, stock brokers are more aligned to investing and suit longer time frames whereas for shorter-term trading it's cheaper to use a futures broker, CFD provider or spread bettor. A full list of brokers and trading platforms can be found in the Resources section.

CHAPTER 2: TIMING

METHODS TO TIME THE MARKET

The 1980s and '90s were such good times for stocks that many people became wealthy without having to know a thing about investing. A simple buy and hold strategy, with no thought towards market timing was all that was needed to reap the rewards that came with being invested in the world's largest economy.

However, the same strategy implemented over the last 13 years, would not have performed so well with the Dow Jones industrial average currently sitting only slightly higher than where it was at the turn of the century.

Professional investors know that to navigate the markets effectively it is essential to have more than one strategy to time the market.

The famous Wall Street adage, 'buy low and sell high' may well be a favorite among stock brokers and commentators, but just what does constitute as low, and what as high?

The correct answer is that there are more than a couple of ways to ascertain whether something is cheap or not. As we shall see, there is an art to investing as well as a science.

1. Financial ratios

Financial ratios are generally used to provide bottom up analysis of individual stocks and the various statistics can be found on any good finance website, such as Yahoo! or Google Finance.

Price/earnings

The price/earnings ratio (P/E) is probably the most popular method traders use to value a stock. P/E is the price of a stock divided by its earnings over the last year. So if a company is priced at \$30 and has earnings last year of \$3, the company has a P/E of 10.

Historically, companies have averaged a P/E of around 15, so in theory, stocks with P/Es lower than this can be considered cheap.

However, buying a company because of a low P/E is a flawed strategy since it takes no account of future earnings. Indeed, many companies with high P/E's go on to be great investments. Google, for instance, has a P/E of 24.6. Likewise, stocks with low P/Es can often be in stale industries and not make much progress either.

A better strategy is to use the ratio and combine it with other factors such as projected growth, debt to equity, earnings per share or statistics from other areas of the company's finances – such as its balance sheet. But projected growth is the real key, since trading in a stock is all about what it will deliver in the future, not what it has done in the past.

Earnings per share

Earnings per share (EPS) describes the profit of a company allocated to each outstanding stock and is calculated as:

$$\text{EPS} = \frac{\text{net income} - \text{dividends on preferred stock}}{\text{average outstanding shares}}$$

It is an important indicator and is useful for comparing companies. If two companies have the same EPS but one has a lower level of equity or investment, it can be said that that company is more efficient. However, the problem with EPS is that it can easily be manipulated by cunning accountants so it is important to use it in conjunction with other metrics.

Price/earnings to growth

Price/earnings to growth (PEG) is calculated by dividing the P/E ratio by annual EPS growth. It therefore aims to improve on the P/E ratio by taking into account future earnings. A PEG below 1 is preferable although it is also important to consider what has been used to measure the growth. It is also important to take into account the P/E ratios that exist across that specific industry.

HOW TO BEAT WALL STREET

Debt to equity

The debt to equity ratio is measured by dividing total liabilities by shareholders equity and is a good indicator of leverage. Generally a high debt to equity ratio means a company has been aggressive in financing which could lead to volatile earnings. However, debt to equity levels generally differ across markets and industries so this needs to be taken into account. Not all debt is bad, but too much debt can be dangerous.

Price to book ratio

Value investors often use the price to book ratio as it compares the share price to an estimate of the value of the company. It is calculated as:

Price to book ratio = Share price / total assets–intangible assets and liabilities.

Generally, this ratio tells you how much the company would be worth if it was sold off as-is. A lower number is therefore preferable. However, a low number could also indicate something fundamentally wrong with the company so it should be combined with other factors too.

Current ratio

Current ratio is measured by dividing current assets by current liabilities, and is a good indicator of liquidity. Generally, the higher liquidity within the company the better, as it means a company is in a better position to pay off debts. However, a current ratio that is too high could indicate that a company is hoarding cash and not reinvesting in the business. Although this is not necessarily an issue if market conditions are deteriorating sufficiently.

There are plenty of different ratios that investors use to analyze stocks and these are just a handful of the most important ones. Not all ratios are useful and many depend on the stock itself or the industry it operates in. One way around this is to form a composite

indicator to combine ratios. This method can greatly help in screening for the best value stocks.

I have provided with this book a useful Excel Spreadsheet from www.investexcel.net that can be used to calculate how cheap a stock is.

Shiller CAPE ratio

Another method which is useful for overall market timing is to use the Shiller CAPE ratio which measures valuation for the broader market and stands for the cyclically-adjusted P/E ratio. It is a better measure for P/E valuation, as it measures the previous 10 years of earnings of S&P 500 companies adjusted for inflation using the consumer price index.

Values below historical norms such as 14 indicate markets are cheap and these are generally good times to buy. Since many stocks move in-line with the indices most of the time, this can be a nice method for timing investments, and the Shiller P/E stands up against data going back to the early 1900s. As of October 2013, the Shiller P/E ratio sits above 23 so the stock market is considered expensive on this measure.

To see a live recording of the Shiller P/E, visit GuruFocus' site, www.gurufocus.com/shiller-PE.php

2. Balance sheet

A company's balance sheet, like its cash flow, offers a snapshot into the health of a company at a given point in time and is a good tool to measure a company's value. The balance sheet essentially measures what a company has or expects to get (assets) and what it owes to others (liabilities). Companies with high levels of debt tend to be the most volatile investments.

As a shareholder or investor, this ratio between assets and liabilities is key, since it is the value of all those assets when liquidated that provides the ultimate value of the business. A company that gener-

ates more cash than it needs to fund its operations is going to add value to its stock and is likely to climb. Additionally, such a company would likely give some of its excess cash back to shareholders in the form of share buybacks or dividends.

With careful analysis it is possible to find some real surprises in balance sheets that can lead to big stock moves. Sometimes those surprises can lead to a company going under or even being investigated for fraud, such as what happened with Enron. For a good book that deals with finding accounting irregularities, check out *The Art of Short Selling* by Kathryn Stanley.

3. Market cycle

We looked briefly at the market cycle in the last chapter and basic economics teaches us that when something is very cheap people buy it. In turn that reduces the supply and therefore increases the price of whatever the thing is. Subsequently, new suppliers come to market in order to take advantage of the high prices which, in turn, increases the supply, eventually causing prices to fall back again. This is especially true for commodities but also works for stocks.

All markets work like this and operate in cycles spanning from a few years to long 20 to 30-year bull and bear runs. This means that major 20 to 30-year bull or bear markets are actually a typical occurrence as it can take long periods of time for new suppliers to come to markets.

Historically, it is rare for a major bull or bear market to last longer than that, so if you find a market that has been going down for 20-30 years and has finally started to stabilize, it may indicate the market is very cheap and ready for a new bull cycle.

4. Scan a chart

While a market's cycle can be measured relatively objectively, there is also value in scanning the historical price chart of a security. It is a fast and easy way to quickly tell whether something is depressed (or not) and if it can be the starting ground for further research.

Look for charts where the price has been hovering at historically low prices for a couple of years or more; it is a fair bet that a decent bottom has formed. Once you've found a stock that looks like it may have bottomed do some more research into the company. Have a look at its finances. If it has something to offer from a fundamental point of view, it can be an even stronger trade.

5. Relative Graham Value

Benjamin Graham, author of *Security Analysis*, formulated the relative Graham value (RGV) – a measure which has been modified to great affect by famous value investors such as Warren Buffet. The strategy states that stocks fluctuate around their intrinsic value over time with the original formula for intrinsic value described as:

$$IV = [EPS \times (8.5 + 2G)] \times (4.4 / Y)$$

Where:

IV = Intrinsic value

EPS = Projected 12-month earnings per share

8.5 = appropriate P/E for a no growth company according to Benjamin Graham

G = company's 5-year earnings growth estimate

4.4 = average yield of high-grade corporate bonds

Y = current yield on AAA 30 year corporate bonds

All of these statistics can be easily found online at a site like [Yahoo! Finance](#) or [Finviz.com](#)

The theory states that when a stock trades below its intrinsic value it is cheap and when it trades above it is expensive. The formula is noted for its simplicity but it is a good first level check to see whether a stock is cheap or not.

Graham goes on to state that a 25% margin of safety is a good rule of thumb when investing in a business that is below its intrinsic value. The greater the margin of safety the better the investment.

Try your own

RGV is one example of a valuation method that, when combined with some extra criteria, has worked to great affect for several notable investors, including Warren Buffett. But there is nothing to stop you from coming up with your own investment criteria.

You can get creative here and come up with a strategy of your choice, using the metrics you discern. Balance sheet calculations, earnings ratios and even qualitative methods can be used. By forming your own composite metrics you may be able to get away from the crowd and make even stronger investment decisions. Decisions that are unlikely to have been copied elsewhere.

Try back-testing your ideas on historical stock market data and you might be able to come up with a winning strategy of your own.

ADVANCED TIMING METHODS

The methods discussed so far are pretty standard ways to time the markets and work well over medium to long-term time frames using freely available economic data.

But what if your focus is on other metrics and different time frames? In such situations it may be necessary to look at more advanced methods to sharpen your timing skills.

Volatility

Volatility is one method professionals use to make market timing a little bit easier. Without exception, the best time to buy stocks is when volatility is at its peak in the stock market.

High levels of volatility have coincided with all the major bear market troughs such as in 1930, 1987 and 2008. Find a period of high volatility and you also find a major bottom.

Professionals often use a measure called the VIX – a trademarked

ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure to estimate the volatility in markets. High levels of volatility typically signal good buying points and low levels are often good places to sell.

While it is not always easy to tell when a market becomes more volatile, a good rule of thumb is to become more aggressive when volatility increases above its historical 2-year average. Historically, this has been a good guide, but always be aware that periods of high or low volatility can persist for longer than you would think.

Dow theory

Dow Theory, developed by Charles H. Dow in the late 19th century, is also a popular strategy to find peaks and troughs in markets; and amazingly, is still used by professionals today. The basic principle cites that markets go through a number of phases.

First, investors latch on to the fact that markets are cheap and start accumulating stocks. This in turn causes the stock market to go up and continues on until nearly everyone in the market is aware of it. It is at this point that rampant speculation takes over, resulting in rapid price change. Once this period of speculation is exhausted, astute investors realize the speculation is overdone and begin to dissolve their holdings, which itself often leads to rapid selling.

While it isn't the purpose of this book to go into the details of the Dow Theory, knowing these different market phases can offer a good introduction into the way markets operate and how to take advantage of them. The essence of the Dow Theory, which is to try and buy when people are unaware of something and sell before rampant speculation is exhausted, remains sound.

Sentiment indicators

As well as using time-old methods such as Dow Theory, professionals look at sentiment indicators. In fact, consumer sentiment and investor sentiment surveys are given a lot of consideration by some investors. So much so, the results of such surveys are often sold for

HOW TO BEAT WALL STREET

thousands of dollars to banks and hedge funds.

The reason for this is that professional traders like to buy stocks when there is fear and sell when people are greedy. By monitoring the sentiment of market participants, as well as the general public, they are better able to analyze this information in a quantitative way.

Indicators provided by advisory services, such as Investors Intelligence or Barrons, are excellent measures of public opinion and gauge the number of bulls or bears in markets. When there is extreme pessimism, it is often a great time to buy stocks. Similarly, when optimism abounds, the best thing to do is to sell. Increasingly, savvy investors are looking to newer ways to gauge sentiment such as with social networks.

Interest rates

Another much more simple but still effective strategy to time markets is to take a look at the current and future prospects for interest rates.

The Fed often lowers interest rates going into a bear market as the economy gets progressively worse and starts to raise them only when the economy has started to pick up. We saw this in early 2008 before one of the more severe bear markets of the century.

A good strategy, therefore, is to buy stocks when rates are low and are about to turn up and to sell stocks when rates are high. Many traders try to tell you the opposite, that cutting rates boosts stocks. This is true over the short-term but over the longer term, interest rate cuts actually indicate a worsening economic environment. Timing the market like this would have paid big dividends over most of the last century.

Getting the edge with open position data

As we have seen, it is market participants who ultimately drive prices through the act of buying and selling various futures – so it's fair to say that knowledge of who is buying what, and how much,

would be extremely useful information for predicting and timing future price moves.

Well, the good news is that by using a few different reports it is possible to do just that.

Commitment of Traders report

The Commitment of Traders (COT) report is published by the Commodity Futures Trading Commission every Friday at around 2:30pm EST. It is the best available source for gauging what market participants are doing.

The data itself is split between three groups: Commercial traders, non-commercial traders and retail traders. Generally, the commercial traders are the big corporations and banks that use markets to hedge their exposure, while the non-commercial traders are the large speculators and fund traders. The retail traders are the small guys that make up the rest of the market.

Identifying extremes

The best way to use this data, then, is to look for market extremes, as it is at these times markets are most likely to hit a top or a bottom.

Generally, when most traders move to one side of the trade it is a clear signal that markets are reaching a peak. If everyone is long, for example, then there is no one left to buy, so in theory, markets will start to fall back. Conversely, if nearly everyone is short, then there is no one left to sell.

By looking for these moments, it is possible to find times when markets spring back, like an elastic band, and when combined with other fundamental factors, a useful strategy can be developed.

Commercial and non-commercial traders

Another thing to look out for is the fact that commercial and non-commercial traders diverge as a market's peak or trough is reached. Since commercial traders are mainly looking to hedge, they tend

HOW TO BEAT WALL STREET

to buy as markets hit a bottom and sell as markets reach a top. Conversely, non-commercial traders like to follow trends, so tend to be more bearish at market bottoms and bullish at market tops.

If you see a market extreme whereby a large proportion of traders are positioned on one side of the trade and this is accompanied with divergence between the positions of commercial and non-commercial traders, this is a strong sign that a market extreme is near.

Short interest data

In stocks, one way to see what traders are doing in a particular company is to look at the short interest data. This data can be extracted from the central exchange and shows the number of shares that have been sold short in a stock divided by its daily volume.

The ratio therefore indicates the proportion of investors who are bearish on a stock and can be used to decide whether to go long or short. If a stock has a high number of short sellers, then it stands to reason that it could decline in the near future. Although if the stock has a high number of short sellers and does not move, then it could be bullish – since when bulls do join the market, stocks are likely to go up.

Short interest data can also be calculated for the entire exchange.

Oanda data

Like the COT report, there are other places where traders can find data on currency positions, such as from forex broker Oanda. The company releases details of the net long and short positions for currencies for most of its customers and lists them via its website. Although it is relatively untested, this data could be another way to gauge market sentiment. Oanda also shows data on much shorter time frames than the COT report and it is generally shown that whenever a market is over 75% net long or net short, a reversal is usually near.

HOW TO TRADE LONG-TERM TRENDS IN THE STOCK MARKET

Learning to time markets effectively is a valuable skill, it is only one component of a successful strategy.

Indeed, there are many traders who make their money fretting over the smallest daily movements but they sometimes forget to look at the bigger picture. If they only took a step back, they might realize that the major trend is perhaps more important than anything.

While timing is essential for entries and exits, it's important to concentrate on markets with the most profit potential, since the big money is saved for those investors who are able to catch the big trends and capture those 500%+ investments.

Supply and demand underpins all macro analysis

When it comes to finding long-term trends there is no substitute for doing some macro analysis into the big picture issues affecting the markets – the outlook for interest rates, for example, or the potential influence of big market players such as central banks or the International Monetary Fund. These are critical issues that have widespread implications for markets, implications that can shape markets for several years at a time.

Supply and demand is the underlying principle affecting all markets, although analyzing it accurately is a tricky task. For commodities traders, there are statistics for global supply and consumption (the Commodity Yearbook is an excellent resource for this), while seasonal variations also come into play. In bonds, demand can be measured through auctions and in stocks, the value of a business determines its demand, relative to price.

It's also useful to consider world history when assessing the current environment. Has this situation ever occurred before in the past? What happened then that could happen now and what makes this situation different to that time?

HOW TO BEAT WALL STREET

Are we headed for a period of inflation like the 1970s and '80s? If so, perhaps precious metals will soar like they did then. Or, is there a chance of war? If so, will stocks go down and oil go up? These are patterns that can be found if you spend enough time looking through the history of markets.

It's also important to consider cycles, since these are grounding principles of economics. Unemployment, recessions, economic growth – in fact, most things – tend to run in cycles. It's a similar thing with markets, so identifying current cycles makes it easier to project what might happen next. Recessions typically occur every 4-6 years – something to keep in mind when considering the current valuation of the stock market and whether to invest or wait.

Another way to get on board a long-term trend is to get into the stock market when it is distressed and extremely cheap on a valuation basis. As already suggested, the best time to invest is often when there is 'blood on the streets' and panic rules. The stock market nadir of March 2009 was one such time when seemingly no one wanted to invest, yet it set in motion a 4-year bull market.

While macro analysis and fundamental data can provide effective insight into markets, sometimes you cannot beat reading straight off of a chart. After all, we are trying to make money off of price moves not economic predictions.

It's the same reason why traders use trend lines and then developed indicators such as moving averages – now popular among technical traders and trend followers.

Anyone can draw a trend line on to a chart and say where a market is headed next but moving averages offer a calculated way to see when a market is trending. When a faster moving average crosses over a slower one, it signals that an upward trend has formed and these signals can be used to join long-term trends in any market. In this way, you can largely forget about the fundamental picture and just focus on price and making a profit.

A popular combination used by some professionals is to buy markets

when the 50-day exponential moving average (EMA) crosses the 200-day EMA, known as a 'golden cross'. Buying markets on a golden cross gets you on board most long-term trends – such as the big bull market in the Dow during the '90s, for example, and the 10-year run-up in gold. You won't catch it right at the bottom or get out at the top but you can catch a big chunk of the middle, which is what good trend following is all about.

HOW TO DEVELOP YOUR OWN INDICATORS

It is important to develop your own view as to where you think markets may be headed and there are plenty of indicators out there for you to use. You can do this using fundamental indicators or technical indicators. Whatever works as a means of predicting future price moves should be judged on its own merit.

However, there is an inherent flaw in using a well-known indicator, you are likely getting the same trading signals as everyone else who uses it.

The solution of course is to develop your own indicators and it isn't as difficult as it seems.

Technical indicators

Indicators do not have to be particularly complex but they do need to make sense. The best way to approach designing a technical indicator, therefore, is to first scour several different price charts looking for patterns in the data.

By scanning lots of different situations over various time horizons, you should be able to come up with a unique idea that you think may lead to profitable trading opportunities.

Once you have an idea, it is simply a matter of getting that idea on paper in the form of programming code, since nearly anything that

you can see on a price chart can be distilled down into mathematical code.

Most trading platforms allow coding and if you are not too keen on doing it yourself, you can get a programmer to do it for you.

Once you have your own personal indicator written down in code, you can start adding buy and sell arguments, and go about testing how effective it is trading on historical price data.

Fundamental indicators

Many traders forget that indicators can be designed to use fundamental data, not just price data alone.

It's possible to download economic data from many of the freely available sources on the Internet and incorporate it into your investment decisions. (Several spreadsheets of economic data have been included in the download pack that accompanies this book.)

There are plenty of options around which can be combined into a composite indicator or simply used on their own.

You could, for example, create a composite indicator that measures the spreads between bond yields and takes into account the price earnings of stocks in the S&P 500. Or one that keeps track of M3 money supplies in the economy and the price of oil.

By doing so, you could limit your account to only trade when certain fundamental conditions line up. This way, you can use fundamental data as a type of filter for your trades.

As another example, let's say that the spread between interbank rates and T-Bills is higher than 1 (also known as the TED spread, an indicator which signifies credit risk and thus fear in the market). You could use this information as a filter and only buy safe-haven assets such as gold or the Swiss franc. Similarly, if the TED spread is lower than 1, the market is more optimistic so you might choose to only buy riskier assets like stocks. (An example of this strategy is provided in the Trading Systems chapter.)

Thank-you

Thank-you for downloading and taking the time to read this free preview. To read the remainder of the book, it can be purchased on Amazon or via jbmarwood.com.

I look forward to connecting with you in the near future.

Best Regards,

JB Marwood