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CALLING THE COMMITMENT OF TRADERS BLUFF

BY CRAIG GAUTHIER

GETTING ACQUAINTED WITH THE DIVERSITY OF THE DOLLAR INDEX

BY CARLEY GARNER OF DECARLEY TRADING

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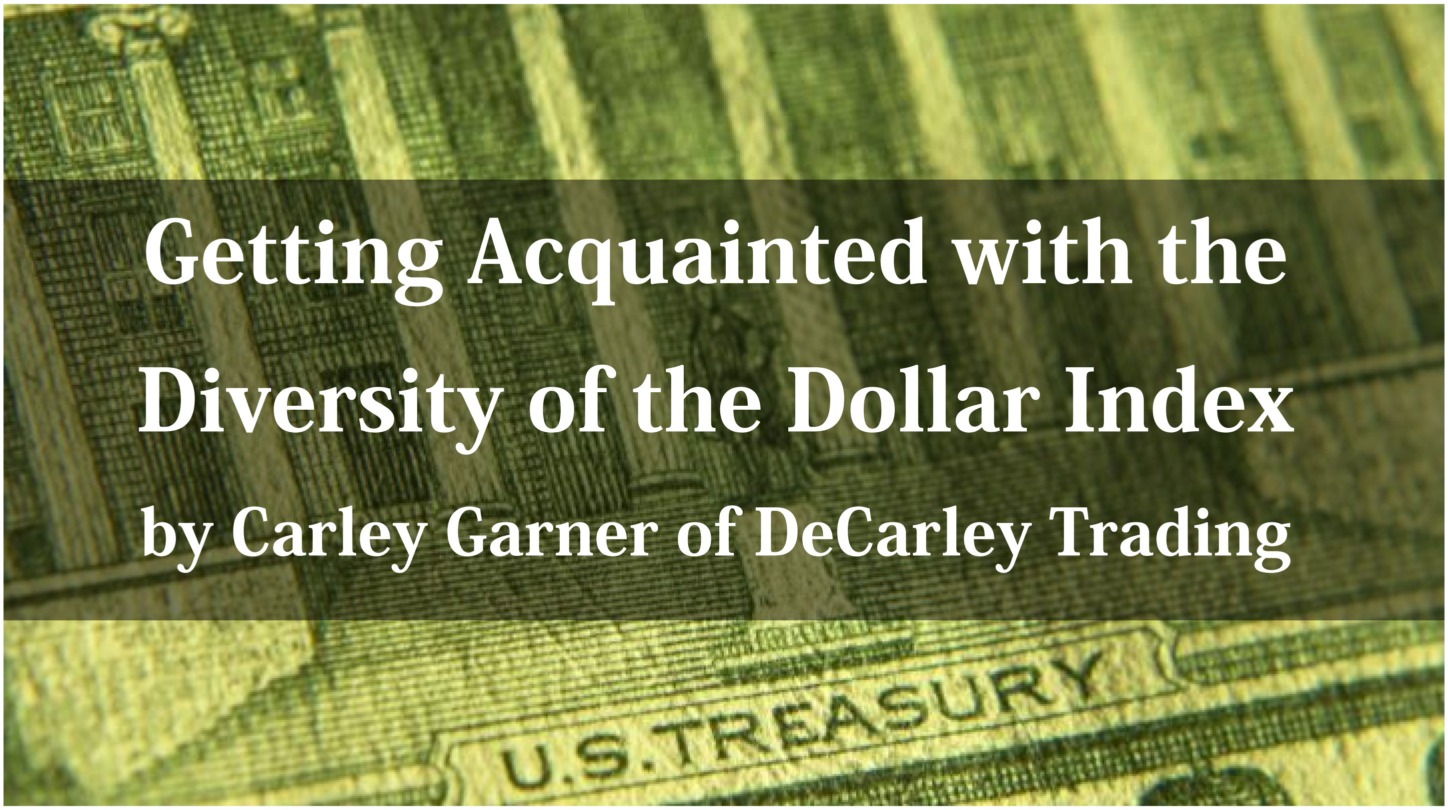


Getting Acquainted with the Diversity of the Dollar Index

by Carley Garner of DeCarley Trading

Currency traders in the futures and FX markets are often overwhelmed by the complexity of dealing with multiple assets paired against one another. For instance, factors that cause the U.S. dollar to appear bullish against the euro might not be evident, or valid, against another currency such as the yen. Accordingly, trading currency pairs outright poses challenges.

Similar to stock traders that are exposed to individual company risk in addition to market risk, currency traders are exposed to country specific event and political risk. For instance, traders that were bearish the yen vs. the U.S. dollar in early 2011 discovered that unforeseen natural disasters, in this case the infamous earthquake and tsunami, could quickly make the fundamental and technical analysis that led them into the trade obsolete.

Traders can diversify currency risk by establishing positions in multiple currencies but the most efficient means of managing exposure might be with the U.S. Dollar Index futures contract. The Dollar Index, sometimes referred to as the DX, is similar to a stock index ETF in that it enables traders to buy or sell a basket of assets with a single transaction. Specifically, the U.S. Dollar Index represents the value of the dollar against a handful of global currencies such as the euro, the yen, and the British pound. Because the euro represents multiple countries and is the most commonly traded currency against the U.S. dollar, it makes up 57.6% of the dollar index. The second largest represented currency in the index is the Japanese yen at 13.6%.

Ironically, while speculators in the equity markets are flocking to the convenience of index trading in the form of ETFs, the futures market counterpart to such a product, the U.S. Dollar Index, has yet to garner a loyal following. Although the Dollar Index is certainly liquid enough to trade, the volume and open interest stats are a fraction of the outright currency futures such as the yen, British pound and the euro which are all paired against the dollar in American terms (meaning the foreign currency price is quoted in terms of the U.S. dollar).

Contract Specs & Math

The Dollar Index futures contract is listed on the Intercontinental Exchange, known simply as ICE, and is perhaps the world's most widely-recognized traded currency index. In fact, it is often used as a benchmark by business news television and print outlets as a gauge of the greenback's health.

Setting Dollar Index futures apart from other currency futures contracts is the manner in which contract size is recognized. Other foreign currency futures have a pre-determined and constant quantity based contract size. For instance, the standard euro futures on the CME has a contract size of 125,000 euro, but the Canadian dollar futures trade in a size of 100,000. As we now know, the DX is an index; therefore, the size is indentified by the value of the index not a quantity of units. This is similar to other futures contracts, such as the S&P 500 or the Dow Jones, that represent an index rather than a single underlying asset with a specified quantity.

Unlike standard sized currency futures contract, the size of the Dollar Index futures is determined by multiplying $1,000 times the index value. You might also hear this referred to as "nominal value" which is the total value of the contract. For example, if the June DX is trading at 76.00 the contract size would be $76,000 ($1,000 x 76.00), similarly if the dollar index is trading at 82.45 the contract size is $82,450 ($1,000 x 82.45).

As previously mentioned, the contract size is figured by multiplying $1,000 by the index value. With this knowledge, we can also determine how to calculate profit and loss. The DX is typically quoted in four digits, with two digits to the right of a decimal and two to the left such as 78.50. We now know that 1.00 in the DX is worth $1,000 to a trader, so we can easily determine that a single tick (00.01) represents $10 of profit or loss ($1,000 x 00.01). In my opinion, the easiest way to calculate in the Dollar Index is to move the decimal place in the quote to the last digit that represents a whole integer and do the math from there (multiply the result by $10). In a nutshell, this means shifting the decimal in the quote two places to the right. Simply put, if a trader goes long the index at 78.65 and sells it at 79.75 she has profited by 110 (7865 - 7975) ticks or $100 (10 x $10).

As if the dollar index wasn't unique enough, in recent years the Dollar Index contract has begun trading in half-ticks. As a result, instead of the minimum price movement being .01 it is now .005. For instance, if the index is trading at 81.500 the price can go up by 0.005 to 81.505 or down to 81.495. Because the 0.005 represents a half tick, it is valued at $5 rather than the $10 tick value previously calculated. The additional digit often causes confusion when it comes to calculating profit, loss, and risk because simply looking at the quote board it is impossible to determine that the last digit of the quote is actually a fraction of a tick; specifically a half of a tick.

Let's take a look at an example. A trader that purchases the December DX futures at 81.255 (81.25 and a half) and places a limit order to take a profit at 83.150 and a stop order at 80.000, has a profit target of $1,895 ((8315.0 - 8125.5) x $10) and is attempting to limit losses on the trade to $1,255 ((8125.5 - 8000) x $10). As shown in the calculations, by shifting the decimal two digits to the right the sum of the entry and exit price simply needs to be multiplied by $10 (the multiplier).

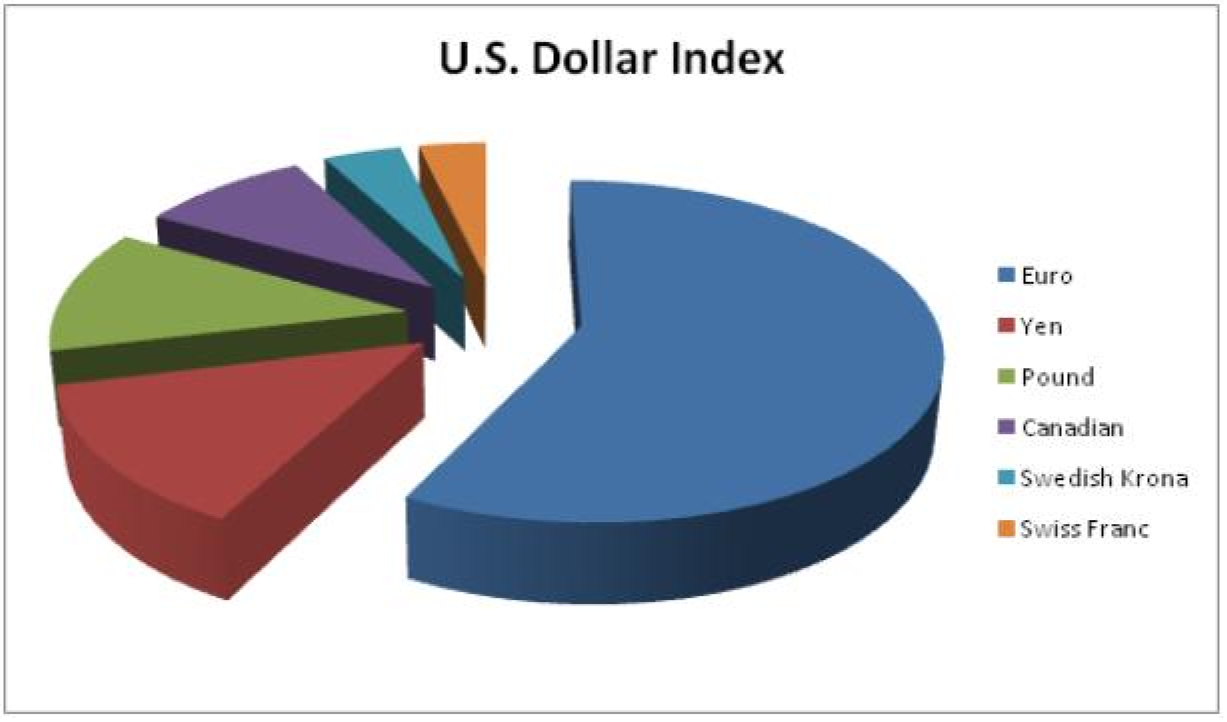


Figure 1: The U.S. Dollar Index traded via the Intercontinental Exchange offers traders a diversified trading product.

Eliminate Individual Country Risk

It is possible for Dollar Index traders to express their overall bullish or bearish bias in the U.S. dollar without excessive exposure to individual country risk. In other words, this futures contract enables traders to speculate on the value of the dollar in general as opposed to against a specific currency. The DX contract might also be used to hedge risk of changes in valuation in the greenback within an international stock and bond portfolio, and perhaps even commodity risk.

Reduce Volatility

The inherent diversity built into the DX future helps to mitigate the overall volatility that comes with trading currencies. For example, on days in which the dollar is higher the yen, euro, pound, Canadian dollar, and other futures typically trade lower to various degrees, but this isn't always the case. In recent years, there have been numerous occasions in which the euro and the yen futures (paired against the greenback) moved in the opposite direction. Similarly, even if they are moving together, some foreign currencies might only see moderate price changes while others are experiencing much larger moves. To reiterate, the index itself eliminates some of the country specific event risk, and works toward smoothing out market volatility that traders choosing undiversified products such as the euro or yen futures contract or even the EUR/USD and USD/JPY FX pairs are exposed to.

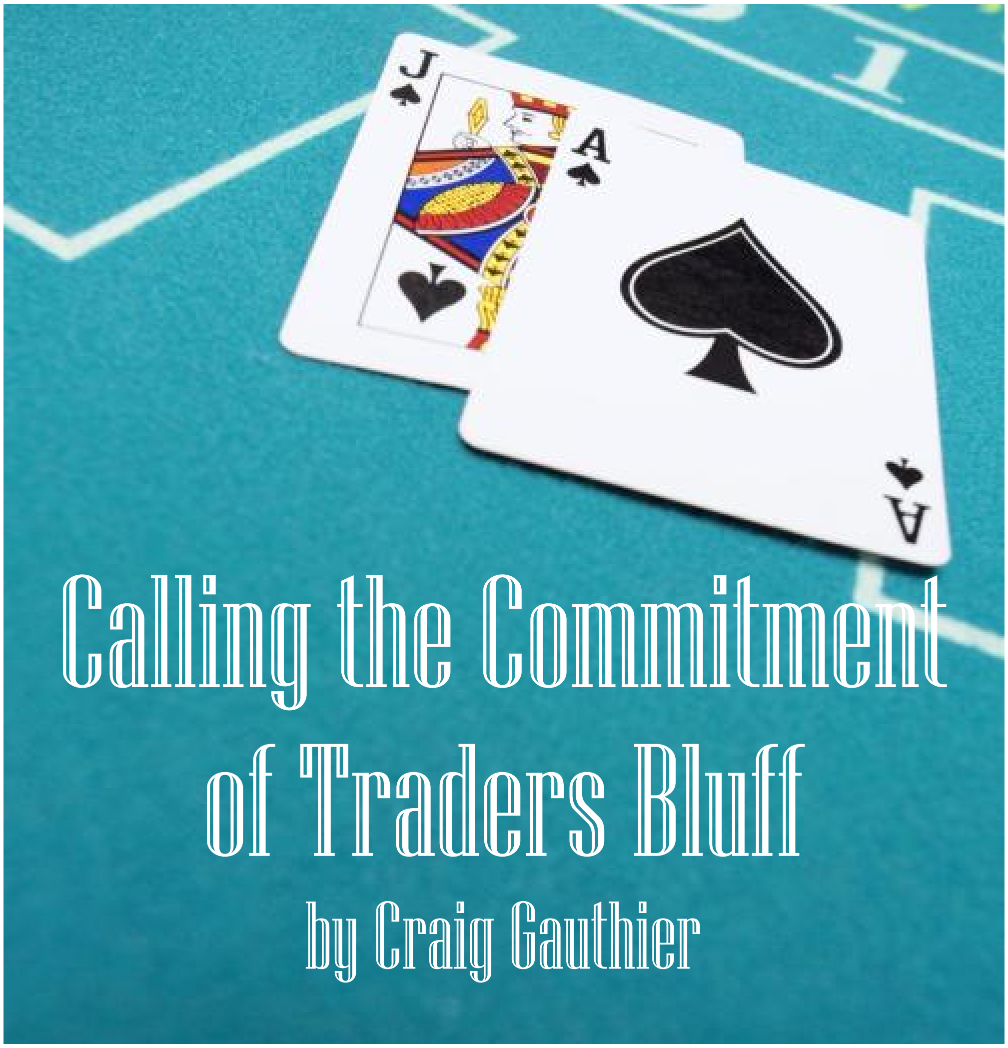
Compliments of diversification and the corresponding mitigated volatility relative to most other currency futures or FX pairs, the Dollar Index requires a moderate amount of margin to hold a position overnight. At the time of this writing, ICE required traders holding overnight positions (non-day traders) to have $1,980 on deposit (initial margin) and only $1,800 to maintain the position (maintenance margin). To put this into perspective, the initial margin on the standard -sized Euro and Yen futures were near $5,000 and the Canadian Dollar was the Canadian Dollar was $2,700.

In addition to a value benchmark and a method of diversifying currency speculation, I feel as though the U.S. Dollar Index futures contract should be seen as an alternative vehicle to the highly volatile metals complex. For instance, in 2011 silver and gold

Figure 2: Dollar bulls and bears often turn to the metals market for speculation, but perhaps a more efficient and less volatile venue is the U.S. Dollar Index futures traded on the ICE exchange.

traders were of the opinion that a declining dollar value offers strong incentives to own currency alternatives such as precious metals. However, as many such investors have discovered, or abruptly learned the hard way, the metals trading arena can be treacherous due to high leverage and volatile price swings. Even in the seemingly most bullish market environments, corrections can be swift and fierce. For instance, in May of 2011 silver futures fell nearly 30% in a matter of a few trading days after reaching a fresh multi-decade high. Rather than pushing your luck in metals, perhaps a more efficient, and possibly tamer, trade would simply be to take the inverse action DX futures contract.

**There is substantial risk in trading options and futures. It is not suitable for everyone.*
Carley Garner is the Senior Analyst for DeCarley Trading LLC where she also works as a broker. She authors widely distributed e-newsletters; for your free subscription visit www.DeCarleyTrading.com. Her books, "Currency Trading in the FOREX and Futures Markets", "A Trader's First Book on Commodities" and "Commodity Options," were published by FT Press.



Calling the Commitment of Traders Bluff

by Craig Gauthier

When I was in college we played a popular card game called Blind Man's Bluff. It is an unconventional game of poker in that each person sees the cards of all players except his own. Each player gets dealt one card which is displayed to all other players by placing on the forehead facing outwards. Players bet based on the distribution of visible cards and how other players are betting to see if they have the highest card.

In futures trading the CFTC (Commodities Futures Trading Commission) publishes a report http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm, called the Commitment of Traders report that is based around the same premise of Blind Man's Bluff. Only instead of seeing your opponents' playing cards, you get to see who is trading what. The report comes out once a week and classifies traders into 3 categories:

1. Non-Commercial - Large speculators, such as fund traders and professional traders who carry large positions.

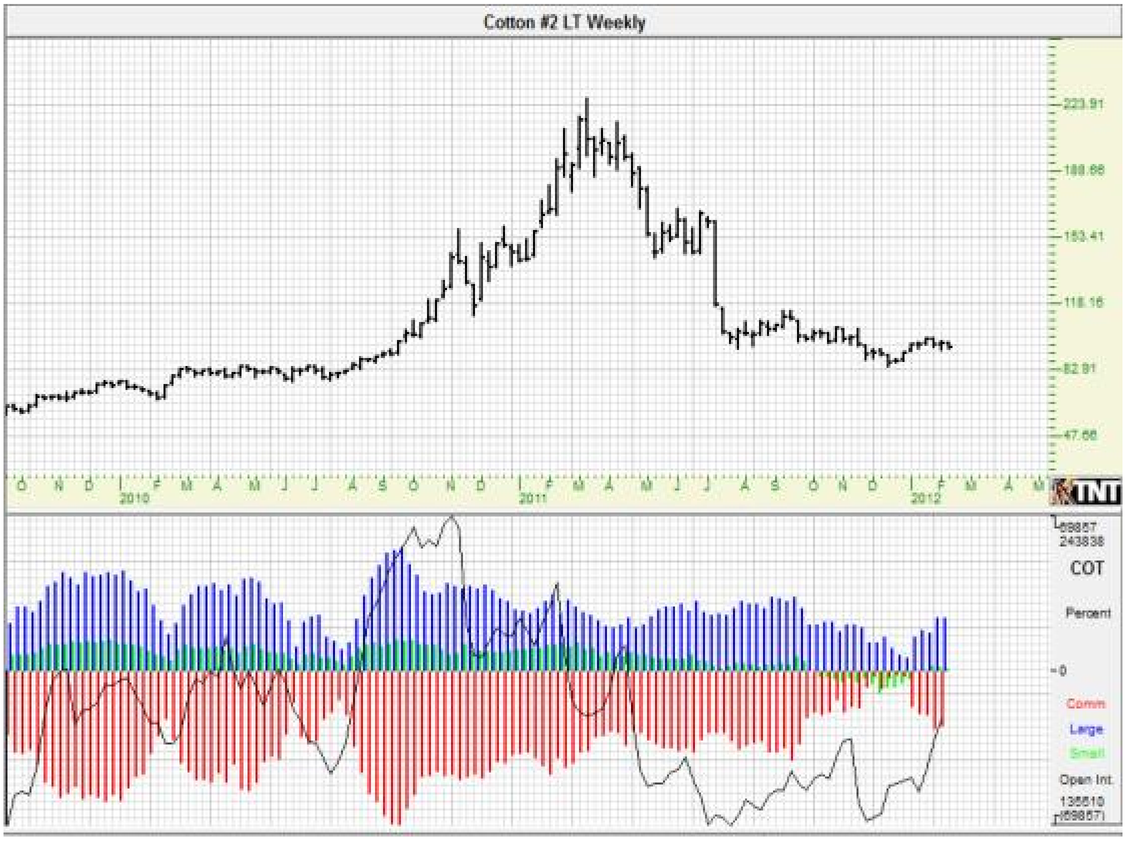
2. Commercial - A trader that uses future contracts to hedge a position.

3. Non-Reporting - Small trader who only trades small positions. What Track 'n Trade does is take the numbers from the CFTC and graphs the data in the form of either a line graph or a histogram to illustrate the net positions of all three categories.

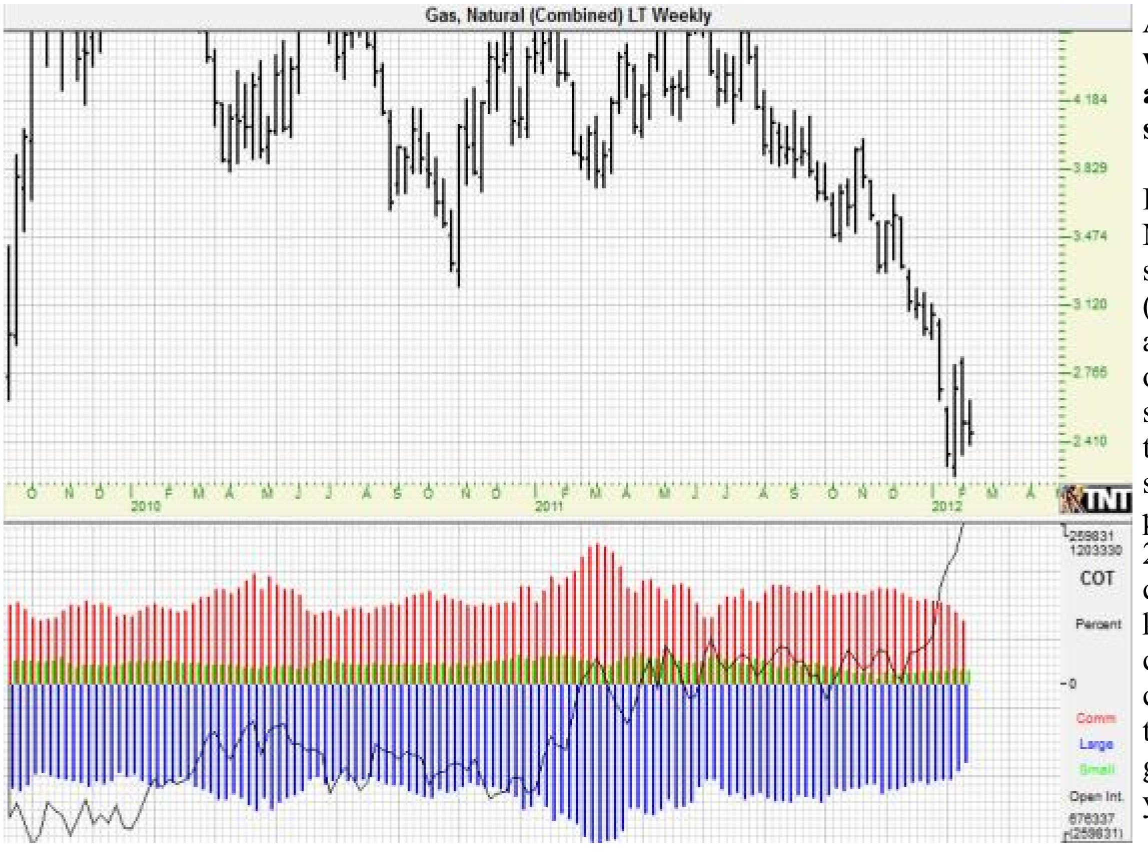
If we take a look at the weekly chart below for Cotton the blue lines indicate non-commercial activity, the red lines indicate commercial activity, and the green lines indicate non-reporting activity. The base number for the histogram is set at zero in the right hand column. Everything above zero indicates net bullishness and anything below zero indicates net bearishness.

How can we use the COT to form a bias in our trading decisions?

Out of the three categories of traders we want to keep an eye on the commercial activity. The main reason is because they're the biggest player in the game. We want to watch for clues when Commercial activity reaching extreme net bullishness or bearishness relating to levels of the past. If commercial activity is at extremes it usually indicates that a major move or a trend change is coming. The downside to the COT indicator is that it doesn't tell us precisely when either of these things will happen. So it should be used as a guide only to favor the side of heavy commercial activity and not a timing mechanism for entering a position.



If we revisit the weekly Cotton chart to the right we can see that near the end of 2010 the commercials were short. Open interest was increasing as the market price went up in August of 2010, at the same time commercials were bearish and large specs were bullish. Prices settled back to previous range as open interest declined.



Are there any markets where the Commercials are forming a bias to either side right now?

If we look at the weekly Natural Gas chart, we can see that the Commercials (Red lines) have been accumulating long positions over the past year and steadily increasing them throughout the price decline since July. Could this possibly lead to a rally in 2012? No one can be certain. But one thing is known for sure - the playing cards on the foreheads of the commercials are telling us they're buying - I'm not going to call their bluff. Are you?

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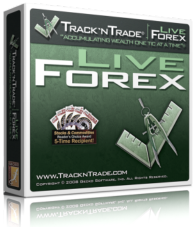

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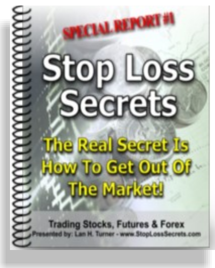

It seems that we spend 90% of our time studying and trying to figure out the best timing techniques for market entry, but we spend very little time actually learning the techniques of exiting the market. Getting into a market is easy, but getting out of the market, with a profit, is the true test of a traders skill.

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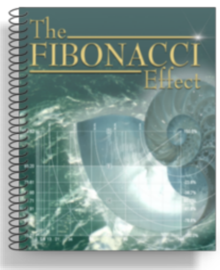

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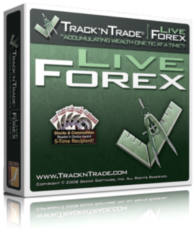

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