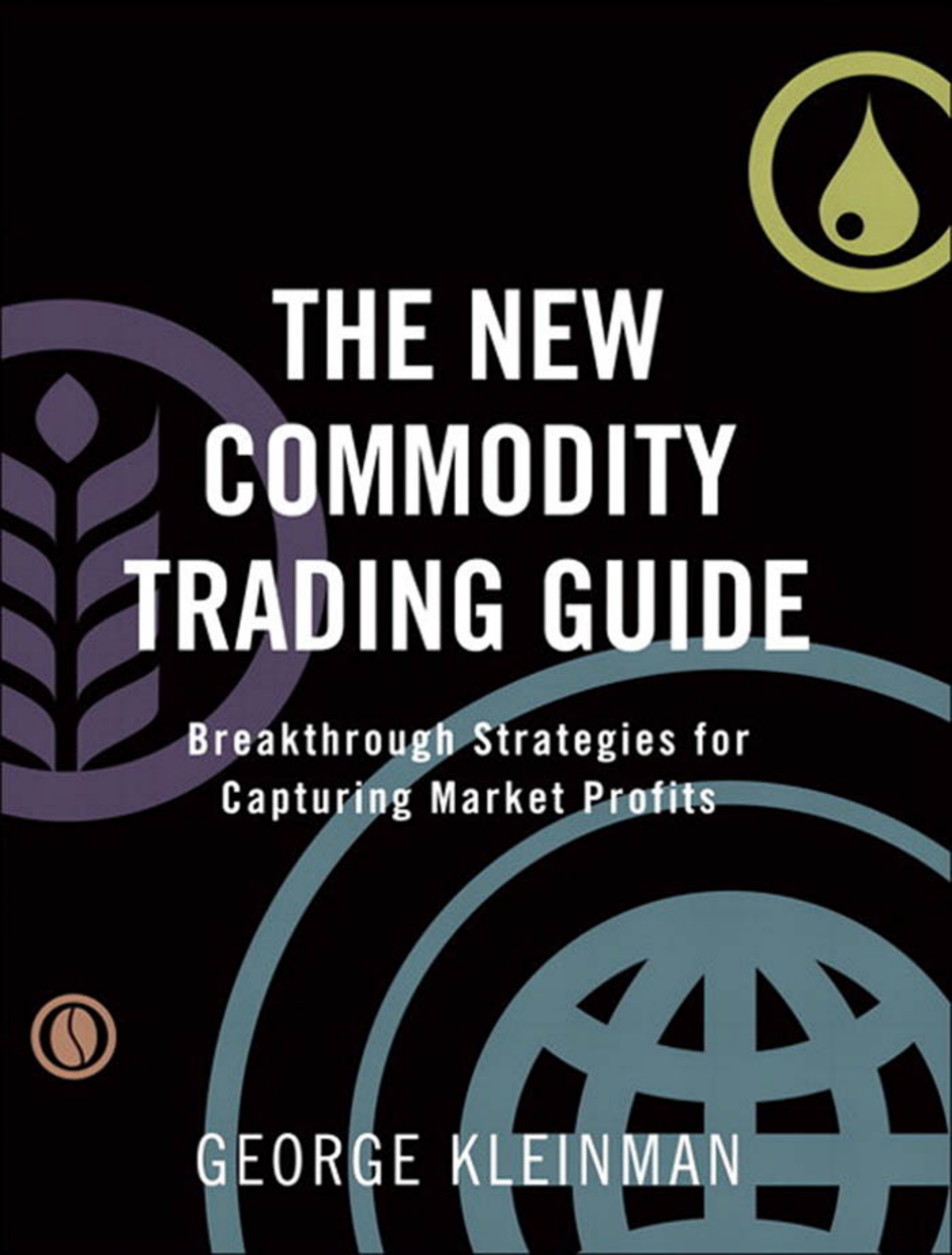
THE NEW
COMMODITY
TRADING GUIDE
Breakthrough Strategies for
Capturing Market Profits
GEORGE KLEINMAN

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Publishing as FT Press
Upper Saddle River, New Jersey 07458

Printed in the United States of America

First Printing March 2009

ISBN-10: 0-13-714529-2
ISBN-13: 978-0-13-714529-4

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education North Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educatión de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data

Kleinman, George.

The new commodity trading guide : breakthrough strategies for capturing market profits / George Kleinman.

p. cm.

ISBN 0-13-714529-2 (hardback : alk. paper) 1. Commodity futures. 2. Commodity exchanges. 3. Investment analysis. I. Title. II. Title: Commodity trading guide.

HG6046.K53 2009

332.64'4—dc22

2008039902

Going the Way of the Dodo

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."
—Charles Mackay, 1841, *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds*

The dodo, a flightless bird, has been extinct since the 17th century.

According to Wikipedia, the verb phrase to "go the way of the dodo" means to become obsolete, to fall out of common usage, or to become a thing of the past. The dodo is considered the poster child for an extinct species because its demise was directly attributable to human activity. (They were good to eat and easy to catch.)

Have you ever wondered whether the last dodo bird was aware of being the very last one?

On the first trading day of 2008, the price of crude oil easily exceeded $99 per barrel, due to a Nigerian rebel attack on oil-producing facilities. The rumor circulating trading desks globally was that this would be *the* day—the first day in history that oil prices would trade at that psychological stratospheric barrier of $100 per barrel.

I was watching the oil market that day and saw it approach $100, but it never quite reached it. The market traded at a new all-time high of approximately $99.80 but then ran out of steam and rolled over. Oil prices continued trading lower just as I received a "Breaking News" e-mail from *Marketwatch* that read: "Oil trades at $100 for the first time ever." I turned to my assistant and asked her what she showed as the high crude oil price. "It's $99.81," Nancy told me. "Last print, $99.50." So I looked at the other delivery months, but they were all trading at a discount—not even close to $100. I thought to myself, they just got it wrong this time.

That night, I was watching the evening news on NBC and the anchor reported: "Oil in New York traded today, for the first time ever, at $100 per barrel." "How could they all get this so wrong?" I thought. Then it dawned on

me. Like most traders, I was watching the electronic oil market where more than 99% of all trades take place. I didn't think to check the pit market that hardly anyone traded on or looked at anymore. Sure enough, "the pit" had recorded a different high than "the screen"—exactly $100 per barrel. The wire services had picked up on this feat and reported it as headline news around the world. Of course, this raised the question, why would anyone pay more than the market when they could have easily bought at the screen price? The pit trade is fast disappearing because it's slower than electronic trading. Was this merely an aberration?

The next day, the full story came out. On January 2, 2008, 747,748 one-thousand-barrel contracts changed hands, with 99% of them trading on the screen and just one of those contracts trading at the price of $100. This lone contract changed hands (as we had already discovered) in the pit. I really wouldn't call this a "legitimate" trade, even though an exchange spokesman called it just that in a press release the following day. The man behind this record-high price was an anonymous professional pit trader. Did he make a mistake?

No, he knew exactly what he was doing. This guy was willing to lose $300 for bragging rights. The BBC subsequently termed this a "vanity trade." He absolutely overpaid for the right to tell his grandkids, "I was the first person in history to buy $100 oil."

This "achievement" will no doubt turn out to be one of the last hurrahs of the pit trader. Electronic trading is faster, cheaper, more efficient, and, in certain ways, more honest than having market makers take the other side of a trade. These are the reasons why the pit trader is fast "going the way of the dodo," and as with that tasty flightless bird, the pit trader's demise is directly attributable to human activity.

It's Different This Time?

As you read *The New Commodity Trading Guide,* be aware that "New" will always be in the title whenever you read this. So at what point does this book become similar to the pit trader—obsolete and no longer "new"?

The book presents commodity trading in a new light because I believe the commodity markets perform differently today than any time before. During most of my career, which spans more than 30 years, futures trading was viewed as a casino. Now many financial planners treat commodities as an asset class, and they allocate a portion of their portfolios to commodities alongside traditional stocks and bonds. Then consider the electronic factor that has dramatically changed the way the markets behave. Add in increased demand from the

emerging economies, the hedge funds and the index funds, and you've planted the seeds for change. Because the commodity markets act differently now, new techniques are required for trading success. Still, it's important to remember that these four words—"it's different this time"—have collectively resulted in more lost money for more traders than any others.

A few years after the 1929 stock market crash, the great trader and philanthropist Bernard Baruch wrote a foreword to a reprint of Charles Mackay's classic *Extraordinary Popular Delusions and the Madness of Crowds.* Originally published in 1841, Mackay's book chronicled various investment manias from the 1500s through the 1800s. From the tulip craze to the Mississippi and South Sea Bubbles, the basic underlying premise was that manias (economic and otherwise) are a condition of the human species. They will come and go over time but never disappear. My reprinted edition of *Popular Delusions* was published in October 1932, right in the thick of the Great Depression. In this quote from the foreword, Baruch refers to that most recent mania he termed the "1929 market madness in America": "I have often thought that if, in the lamentable era of the 'New Economics,' culminating in 1929, even in the presence of dizzily spiraling prices, we had all continuously repeated, 'two and two still make four,' much of the evil might have been averted." Those very words could be used today; just substitute the dates.

The 1929 panic and eventual recovery from the Great Depression that followed were not firsts for America. Crashes and market panics occurred in 1837, 1857, 1861, 1873, 1893, 1901, and one could make a case for 2008 as well. The 1857 panic was preceded by the California gold rush. The 1873 panic was preceded by a speculatively induced bubble in railroad stocks. The panic of 2008 was preceded by a speculative boom in housing prices that created the subprime debacle. Still, more has been written about the 1929 crash than any other crash in history because more people in the newly minted middle and upper classes were affected, and also because few people saw it coming. People held a widespread belief at that time in the "new economics": A period of permanent prosperity had arrived. Certainly, the 1920s was an unprecedented period of prosperity, with new wealth created from the automobile industry and the accompanying boom in road building and travel. A plethora of new technologies and new household electronic appliances, such as the radio, were born. To top it all off, the 1920s saw the creation and widespread use of installment credit products. Perhaps this was one of the main unsung underlying causes of the crash. Looking at modern history, we can point to the dotcom mania of the late 1990s. In recent years, examples include the condo mania in Florida and Las Vegas and the subprime housing crisis in California and many

other places. Obscure manias also pop up nearly every year but fail to reach the mainstream media because they affect only a few of those directly involved. (I chronicle one of these, with the accompanying valuable lessons, in Chapter 2, "Capturing a 5,000% Return," a recent commodity bubble that ended with the inevitable burst.)

One shared trait of all manias is that the majority of players never see the collapse coming. If you read the financial press from 1929 to 1931, all during the period the market was falling, respected analysts continually considered it a correction that would soon be over. When stocks finally did hit bottom in 1933, more than 80% of all value had been lost. Will this be how the current commodity boom ends? Will today's commodity bubble burst? The answer to this question is, yes, it certainly will end badly because the history of mankind is that all economic bubbles eventually burst. The only question is, when? It will take place after any bull market move in a particular commodity market morphs into a mania. This will be the time when the general public is totally immersed in the story of the day. It's never "different this time": It always ends the same way—badly for the general public. However, as this is being written, I question the premise that, in a macro sense, this commodity bull run is anything close to a mania or a bubble. It's more similar to a balloon, inflating and deflating but overall somewhere at the half inflation point. Before the 1929 stock market crash, shares in shell companies were being manufactured without economic justification, and only because people would buy them. In contrast, commodities have intrinsic value and are being consumed by those who buy them.

So how will we know the final top is in for commodities as an asset class?

When analyzing any market move for a top, ask yourself whether the market you're looking at is currently spiraling. Does it look similar to a flagpole growing up to the sky (which the laws of physics tell us cannot last indefinitely), or has it recently been cleansed and purged via a healthy correction? In the middle of a move, some of the air (the buying) that was pumped in flows out before new air is pumped in. One of my goals for this book is to teach you how to recognize the early signs of a new bull run, and also how to recognize the end of the run.

One type of top is the blow-off top, a formation that occurs at the end a sustained bull market run. How can you tell if a market is in a blow-off top? Close to the end of the move, during the top formation, the market surges higher, with only shallow corrections. Compared to the norm, volumes are huge. Technical indicators such as the RSI (an oscillator) run up to extremely high (overbought) readings, but although these readings appear to be in unsustainable territory, the market continues moving higher than anyone believed

possible. Then you'll hear outlandish price predictions in the mainstream media, and talk of shortages will be rampant. The talk will be that the world is going to run out of this or that. In many cases, the last 48 hours of a major move can be the most feverish—and the most lucrative for the bulls. This final surge that forms the actual blow-off is the most painful for the bears. Their capitulation (short covering) creates the final high prices. Nobody I know of is able to pick the exact top in a situation such as this. However, in markets that show these signs, if you have been fortunate enough to be on for some of the ride, it's time to be vigilant because the end is near. The top price will come when nobody is looking and generally when the news is as bullish as it can get.

Most people will see the first break from the top price as a normal correction, just a temporary break within a bull that is nowhere close to being over yet. The market might have a secondary rally after the first break, but then it will be unable to register new highs. Without most of the players realizing it's happening, the air will be let out of the bubble. Then one day it will whoosh. Bullish news might continue during much of the move back down. At some point, the bull turns into a bear, the decline accelerates, and ultimately there's *blood in the streets.* This is the time when the news will turn very bearish, there will be a multiyear surplus of this or that, and it will appear that the bear has settled in for the long pull. In reality, as only the smart money will see during blood in the streets, the bear is losing the game and will soon be replaced by a young bull.

As this is being written, the macro forces of a continuing global commodity bull trend appear to remain in force. The balloon is inflating, not deflating. Sure, there have been, and will continue to be, plenty of healthy corrections along the way, but consider these merely temporary tops.

Let's briefly discuss the fundamentals that lead me to believe this current commodity bull will be running for quite some time yet. We know explosive demand growth exists in the developing world, with no easy way to turn this train around. More than a billion consumers are moving up to a higher level of consumption, demanding the comforts the West has enjoyed since the third Industrial Revolution that began in the early 1900s. For many decades, one billion of Earth's human inhabitants have consumed two-thirds of Earth's developed resources. The other six billion got by on the remaining third. Now, led by China and India, the developing world is eating better and living better, and this requires massive commodity consumption. These people are transitioning from being mainly producers to a combination of producers and consumers. From a macro sense, this places upward pressure on commodity prices.

The magnitude of this unprecedented demand shock is difficult to comprehend, as these people drive more cars and consume more protein and electric power. Heating, lighting, air conditioning, and appliances require power plants. New buildings, roads, ships, ports, trains, trucks, and buses—the list goes on. Energy needs, food requirements, textiles, copper to build new electrical grids, corn and soybean meal to feed growing populations of pigs, chicken, and cattle. Soybeans, cotton, rice, sugar, and corn for food and fuel, with more fertilizer needed to grow these crops.

The global population is growing at 80 million people annually. This is the equivalent of adding one Mexico to the world every year. The areas of the world with the greatest population percentage increases are moving toward the consumption patterns of the developed world. And while all this is taking place, the developed world continues to consume. And it's not just India and China that are players in this industrial revolution. Other rapidly emerging Asian nations, Eastern Europeans, Russians, and South Americans (with Brazil in the forefront) are all creating massive new consumer middle classes. But let's concentrate on China for a few paragraphs.

As we go to press, the average American is using approximately 25 barrels' worth of oil annually. To put this number in perspective, at the conclusion of World War II when the Japanese economy was in ruins, the Japanese consumed the equivalent of one barrel per capita annually. Now that Japan has become a modern industrialized power, the average Japanese person consumes approximately 17 barrels of oil annually. A decade ago, the average Chinese person consumed about one barrel annually, and now this number is rapidly approaching two. What happens when this number doubles again and then quadruples? On a daily basis, the world is using all the oil it can produce. For example, we have about 900 cars for every 1,000 people in the United States. By comparison (and this number is constantly growing and will be outdated by the time you read it), only 45 people per 1,000 own cars in China. If vehicle ownership there doubles to 90, how will this affect the demand for aluminum and rubber in auto manufacturing? China recently surpassed the United States as the world's largest copper consumer. And what about oil? As we know, a large percentage of global oil supplies are produced in volatile places. China is an oil importer, and as its oil consumption grows, what happens every time a disruption occurs due to an outage, pipeline problem, hurricane, war, or some political event in a producing country? Chinese per-capita income has risen from less than $500 in 1990 to $3,000 in 2008, and Indian per-capita income has risen from less than $500 in 1990 to more than $1,000 in 2008. This stimulates energy demand, not to mention demand for more and better food.

North American farmers have experienced great growing weather for most of the past 100 years. This benefit, combined with improvements in agriculture, has resulted in abundant crops. You have to go back 800 years to find a period of such favorable weather for such a long time. Yet as 2008 has shown, we know what can happen to the price of wheat, for example, if a few crop failures occur around the world—prices can easily triple. Considering how good weather has generally been during the past two decades; food stocks in corn, wheat, soybeans, and rice seem to remain dangerously low year after year. With another Mexico being added to the world's population each year, the demand side of the equation will not solve this problem. With global warming an impending dilemma for crops, can the world continue to rely on the supply side growing? When the world again experiences a year of bad weather (whether too much rain or too little, temperatures too hot or too cold), food prices are set to surge again.

Fundamentals are important because they set the tone for commodity price moves. However, increasingly in this new electronic age, fundamental analyses will not help you in your trading. The fundamentals for many of the markets we trade are complex and often conflicting. I've designed this book to help the individual trader. With that in mind, realize that it's virtually impossible for an individual to sort through the thousands of statistics that comprise the European economy to accurately determine the direction the Euro will be moving today. Many traders have wondered why something like this happens: On the day it was announced that the supplies of crude oil went down an extremely bullish five million barrels in the weekly report (and the traders were looking for an increase), how could the market close lower? Apparently, some hidden evil fundamental must have been lurking ("evil" because we were long that day) that caused that crash. As with the European currency, the fundamentals for oil (and all the other commodities, for that matter) are complex. During any particular trading session, assembling all the supply and demand data bits into a trading strategy is impossible. However, you can analyze one dominant fundamental to achieve profitability.

George Soros wrote, "The most important fundamental is credit flow"—or to put this more simply, *money*. *Money flows* move markets, and this is the most important determinant of price action. My premise is that you need to correctly analyze only this one fundamental to be successful: which direction the money is flowing. How do we do this? This book addresses that very question. As we go to press, the time is still ripe to capitalize on the continuing macro bull trend in commodities. However, when it does finally come to an end, the book won't

be obsolete. My plan is to also help you capitalize on the bear trend, and I explore techniques and methodologies—for both scenarios.

Our topic is as old as the hills. Commodities are necessary for life and comfort, and will continue to be traded as long as the human race exists. Every economy has experienced long periods of negative growth when commodity prices were depressed (as some are today). Then the bull cycles occur. Today the current global bull commodity cycle is about a decade old. Mini cycles, such as the commodity decade of the 1970s, lasted about ten years. However, long-term charts beginning in the 1700s tell us that major bull cycles in commodities generally range from 18 to 23 years. For example, as humankind entered the twentieth century, the last (the third great) Industrial Revolution lasted nearly 30 years. How long will this one last? I am a good enough student of mass psychology to know that this book will remain popular only as long as commodities are in a bull cycle. The public is not interested in bear cycles. So perhaps one way to determine whether the globe is still experiencing a bull commodity cycle is to ask where you bought (and I do hope you bought) *The New Commodity Trading Guide*? Did you buy it new at full price, or used at a discount? The latter might be an indication that this cycle has run its course.

In my current time frame, as this is being written, America, and by contagion much of the globe, is going through a colossal financial crisis. The major investments banks of Bear Stearns and Lehman Brothers, both in business for more than 100 years, are now both gone. The U.S. government has bailed out Freddie Mac and Fannie Mae and taken over AIG, and there will be additional bailouts and more money printing ahead of us. It's a real financial mess, with countless paper assets plummeting in value. Although liquidity problems can bleed over into commodity values at times, unlike the stock or bond of a failed financial entity, commodity prices will always rebound because they are necessary to sustain and enhance life.

I anticipate that commodities will continue to be hot for years to come because the world has entered a period of tightening commodity supplies with increasing demand. The planet's resources are limited, and commodities can play a role in your asset-allocation decisions. However, if the cycle has run its course, realize that bear cycles can be as profitable as their counterpart, and they can move much faster. Just follow the money flows.

Perhaps as you read this, oil use will have been replaced by some alternative energy source, but the macro trend of accelerating commodity consumption will likely continue unabated. More important, the trend of accelerating power usage will continue, and the new challenge will be avoiding power shortages. No quick solution exists for electricity shortages, and I anticipate that this will

become a growing problem as global power demand accelerates. Many of the best trading opportunities lie ahead of us, but be aware of ebb and flow to all of this. There's a time for all things, and one day the bull will lose control and then the bear will take over. As you read this, I have no way of knowing whether the bull or the bear is winning the race you choose to join this week.

Baruch began his 1932 foreword to *Popular Delusions* by telling us that "all economic movements, by their very nature, are motivated by crowd psychology." This is a truism, but it's magnified today because the crowd has grown much bigger than at any time in the history of the human species. When Baruch wrote his foreword, it was during the depths of the Great Depression. This must have been a time of deep and total despair for many, yet humankind always seems to muddle through the bad times, as he so sagely concluded we would at that time: "Similarly, even in this general moment of gloom in which this foreword is written, when many begin to wonder if declines will never halt, the appropriate abracadabra may be: 'They always did.'"

George Kleinman
Lake Tahoe, Nevada
September 2008

chapter 1

Eliminating People

"Most of the world's ills would be cured with one three-day open season on people."
–Ernest Hemingway

"They're not just getting rich…they're getting even."
–*Trading Places* (1983)

An electric tension fills the air as Louis Winthorpe, III and Billy Ray Valentine muscle their way through the crowd of traders lining the New York Board of Trade's frozen concentrated orange juice (FCOJ) trading pit. The traders are sweating from the heat generated by more than 100 tightly packed bodies, nervous with the anticipation of what's to come. The clerks manning the phones surrounding the pit are on high alert.

The crop report will be released in just minutes. When those numbers are out, the market will move big time, creating and destroying fortunes in the process.

Winthorpe and Valentine are now standing shoulder to shoulder with other traders eyeing their arch nemesis—the ultimate slime ball, Clarence Beeks. Beeks believes he already knows the actual crop report numbers. He illegally obtained an advance copy of the report in his quest to corner the orange juice market on behalf of the infamous Duke Brothers. However, our heroes learned of Beeks's plan: They managed to steal the real crop report back from Beeks and secretly delivered him a fake version.

The "real" crop report will show a record-large orange harvest, resulting in huge supplies that will ultimately cause the traders to yell "Sell!" Beeks believes the numbers in his false report and will be looking for the orange crop numbers to be sharply lower. He is planning to "Buy!" in his quest to corner the orange juice market for the Dukes.

Futures are traded on margin, with only a small deposit required to purchase a large amount of an asset. It's just as easy to short—to sell first and then buy back later (hopefully lower)—as it is to be a buyer. Commodities can be very volatile, particularly on crop report day.

The opening bell rings and immediately the decibel level explodes. All trades in the pit are made by the "open outcry" process where the traders yell out their bids and offers. Beeks starts hitting all offers, screaming "Buy, buy, buy!" Most of the traders in the pit are merely sheep looking to hop on for the ride. Seeing Beeks bidding the market up, they believe he knows something and join in his buying frenzy. The rumors have started to fly: "The Duke Brothers (with Beeks as their agent) are looking to corner the market!"

FCOJ prices are now on a tear, rising as high as $1.45 per pound. Until now, Winthorpe and Valentine have been lying in the weeds and with perfect timing begin to scream "Sell, sell, sell!" right at the top of the market. The true crop report numbers are then revealed, and the market begins to crash and, once again, at the optimal low point of 29¢ per pound, our boys reverse course and start screaming "Buy, buy, buy!" They are now covering their short sales. The majority of these sales were made—well above $1 per pound, so they are covering from 25¢ to 46¢ and netting millions in the process. The Dukes, having bought near the top, are left holding the bag.

The classic 1983 comedy *Trading Places* is one of my all-time favorites. Winthorpe is beautifully portrayed by Dan Aykroyd as a rich commodity broker turned homeless, with Valentine played by the comic genius Eddie Murphy as a homeless man transformed into a rich commodity broker. Many people believe that the story was inspired by the silver market's incredible rise and ultimate fall in 1980 when the Hunt brothers of Texas tried unsuccessfully to corner that market. Silver prices crashed in March of that year when the brothers were unable to meet their last $100 million margin call.

The unsung star of *Trading Places* was the trading pit itself—the actual pit at the New York Board of Trade (NYBOT) where real traders played themselves in the movie. The climactic scene (in most viewers' minds) is the chaotic buying frenzy that took place in the pit (although some male viewers might argue the climactic scene was when Jamie Lee Curtis took her sweater off). In any case, the movie would not have been as visually exciting or nearly as suspenseful

without the trading pit. It's hard to imagine any excitement if our heroes were just clicking a mouse in front of a computer screen.

Trading Places is now more than 25 years old. The NYBOT—the exchange where coffee, cocoa, sugar, and, yes, FCOJ is traded—was established in 1870. Here comes the sad part: On December 13, 2007, the NYBOT board of directors voted unanimously to permanently close the trading floor, moving 100% of the commodities trading to the computer screen. Open-outcry trading, the backbone of the Exchange for more than 100 years, was permanently silenced in February 2008. It was progress, but the pit closing put 1,000 traders and support staff out of work. One veteran pit trader told a *New York Post* reporter, "Most of these people really don't know how to do anything else, and now we will all have to find our place in the world." However, other than these folks, the closing had little to no effect on the dealings in these key global commodities. That's because more than 90% of the volume had already moved to the computer screen by this time. In the rest of the world, electronic trading for commodities had been the norm for years. Although small pockets of pit traders remain in certain commodities, the writing's on the wall. The computer will ultimately totally eliminate the pit trader. Why? Pure economics—it's cheaper. No need for traders to leave their homes in the morning. No need to maintain a downtown facility with the associated high rents and utility costs. No need to hire runners, phone clerks, and trading clerks. And above all, no need for the pit trader. I used to pay a good pit trader an extra $2–$5 per contract (above normal clearing fees) to execute my trades, and I was glad to do so. If the guy was louder or bigger or quicker than my competitor's floor broker, I would often get the better price.

The cost savings of computerized trading is obvious, but another advantage emerges: a level playing field. Ernest Hemingway once said, "The best way to find out if you can trust somebody is to trust them." In the olden days, you really had to trust your pit broker. Let me share a true story with you. Years ago, I was using a floor broker in the New York silver pit to execute my trades there. All was going well until one day I placed an order to buy 50 silver contracts at a price that should have been easily filled. After some time had elapsed, the market surged higher, netting me a tidy profit—or, at least, that's what I thought. I had been waiting for the pit broker's phone clerk to call me back with the fill. He hadn't called yet, so I called the floor. The broker got on the phone and denied I had ever placed the order. To this day, I have little doubt that he filled the order and pocketed my profit for himself. Because the phone call wasn't recorded at that time, my only recourse was to never use this guy again, and subsequently I did find a pit broker I could trust. This kind of problem doesn't occur with electronic trading—the computer can't lie.

Other than the substantial cost savings of eliminating people, electronic trading offers additional benefits. You can place orders faster, as fast as a mouse click. During a fast-moving market in the olden days, it was entirely possible to miss our price by the time the runner delivered our order to the pit broker. Even with using a market order (required to be filled at the next available price) during a wild pit session, we might not have known for hours what price we were filled at. In erratic market conditions, a good fill was often the luck of the draw. Today these doubts are gone—fills return to the trader instantaneously. The computer can also manage multiple orders and price fills more efficiently than a human. Clearing firms like computerized trading as well because credit and risk management is automated. The computer can cut off an out-of-control trader before the trader's account ever moves into an unsecured debit position.

Reduced cost, speed, enhanced information management, the expansion of markets globally with 24-hour trading…isn't technology terrific? Other than the loss of a few jobs and the romanticism of the bygone era of the pits, are there any downsides?

The legendary trader Jesse Livermore once said something to the effect that technology might change, but the markets never will because markets are made by human beings and human nature doesn't change. Traders today still make the same mistakes made by traders 50 or 100 years ago. This is true. Markets will continue to trend up and trend down.

"The trend is your friend" was a basic theme of my previous books. This truism has not changed and will remain a primary theme for successful trading in this book. I can cite literally thousands of examples of markets that have trended long and far and, in the process, made some people rich and wiped out many others. You might have heard about the poor soul who lost his farm. I can almost guarantee that guy was bull-headed and fought the prevailing trend of the market until he finally ran out of money.

In the 1920s, the New Haven railroad was the premier blue-chip stock of the day and sold as high as $279 per share. In those days, you could trade stocks on 5% margin as we trade futures today. When New Haven sold 50 points off the top, it must have looked cheap at the time. How many would have had the guts to sell it short when it crossed below 179, 100 points from the top? Better yet, who would have had the guts, or the vision, to sell this investment-grade security short at 79, or 200 points from the top? It must have looked extremely cheap at 79—remember, this was the Apple or GE of its day. Yet the trend was down, and after the crash of 1929, it traded as low as 12. In 2000, a friend of mine bought a "new technology" stock at the offering price of $66. He added to his position at $150 a share, again at $200, and then again at $300. I suggested he

use stops to lock in his profit, but he "knew" this company was only going up (his daughter worked there), and he told me it would ultimately trade at $1,000. It did keep going up beyond what I imagined it ever could, and he added to his position at $450 and $500. It actually traded as high as $600. Today it has ceased trading, going off the board at $0.

Remember Enron? This was a "blue-chip" energy company and the largest contributor to the 2000 Bush presidential campaign. At that time, the stock was trading at $90 a share. Today it no longer exists. If you still own the stock, you can use your certificate as wallpaper. *The trend is your friend—do not fight it.* Electronic trading will not eliminate trends or eliminate future Enrons or silver crashes. The keys to successful trading are still, and always will be, successfully identifying the trend and practicing good money management, combined with the essential qualities of patience and discipline.

I have long subscribed to Livermore's belief that markets do not change because human nature does not change. In many ways, this is a truism, but not in one major way. Eliminating people from the middle of the equation *has* made a big difference. Electronic trading *has* changed the markets—hence the reason for this book. As a trader, I've had to adjust to new market realities. And if you trade commodities, you absolutely will need to adjust your methods as well. One of the objectives of this book is to help guide you through these uncharted waters.

What are the consequences of eliminating people? The answer, in one word, is *volatility*. As a result, new trading skills are required for success. Speed and volume have combined to make the markets more volatile. Volatility can lead to trader anxiety; however, an anxious trader will not be a successful trader. Succeeding in trading today requires the ability to cope with exploding volatility. Think I exaggerate here? At times the markets have always been volatile, right?

Are you old enough to remember the good old days when gasoline was less than $1 a gallon? Consider Chart 1.1.

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Chart 1.1 Crude oil 1994–1995

This is a daily chart of the oil market for the 1994–1995 trading period. Each vertical line represents one full day of trading. You are looking at nearly one full year of oil futures trading. The chart appears to illustrate a volatile market with big ups and downs throughout this period. However, it all depends on how the chart is scaled.

The price range during this ten-month period was an extreme high of $19.07 per barrel in August, with an extreme low of $17 in December. This is a $2.07-per-barrel range from high to low within this entire period. The size of one oil futures contract is 1,000 barrels; therefore, every $1-per-barrel move equals $1,000 profit or loss per contract traded. During this 12-month period, we saw approximately a $2,000-per-contract range in price movement between the two extremes—not an atypical year for that period.

Today the oil contract size is exactly the same; however, volatility has exploded. Consider this recent example in Chart 1.2.

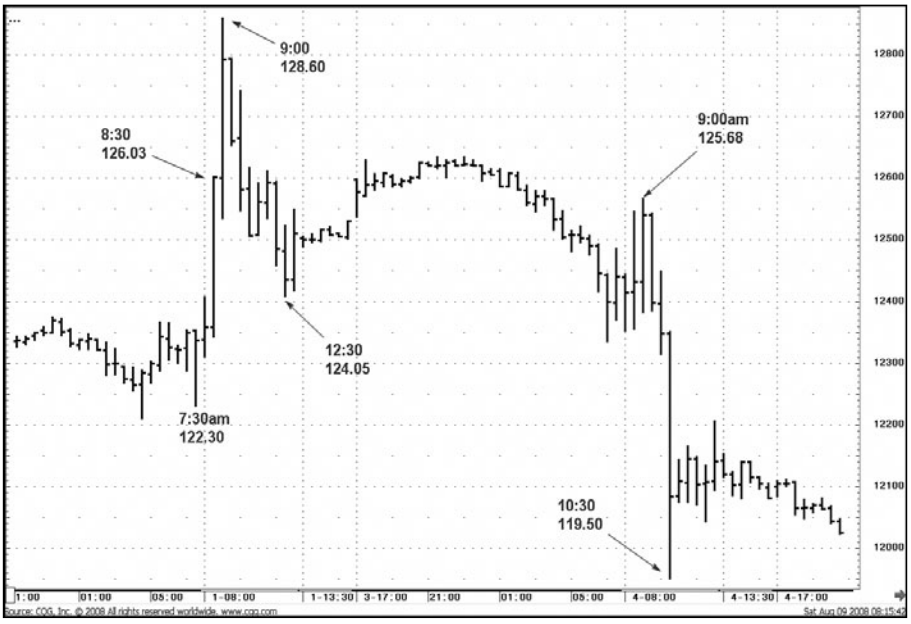

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Chart 1.2 Two days of oil trading

You're now looking at a 30-minute chart of the oil market that covers just two days in August 2008. Each vertical line represents 30 minutes of trading (versus one day per line in the previous chart). During the first highlighted one-hour period (two 30-minute bars), the price ranged from $122.30 per barrel to $126.03 per barrel, and *in just one additional 30-minute period* (from 8:30 a.m. to 9:30 a.m. CST), oil ran up an additional $2.57. Within just this 1 1/2-hour period, the range was $6.30, or $6,300 per contract traded. In only 90 minutes this day, the price range was triple of the entire 1994–1995 trading year. The next day, a similar dollar move *in the exact opposite direction* occurred. This is not atypical for the current market environment.

How about this? Chart 1.3 is a one-minute chart of the soybean market. Each vertical bar represents one minute of trading.

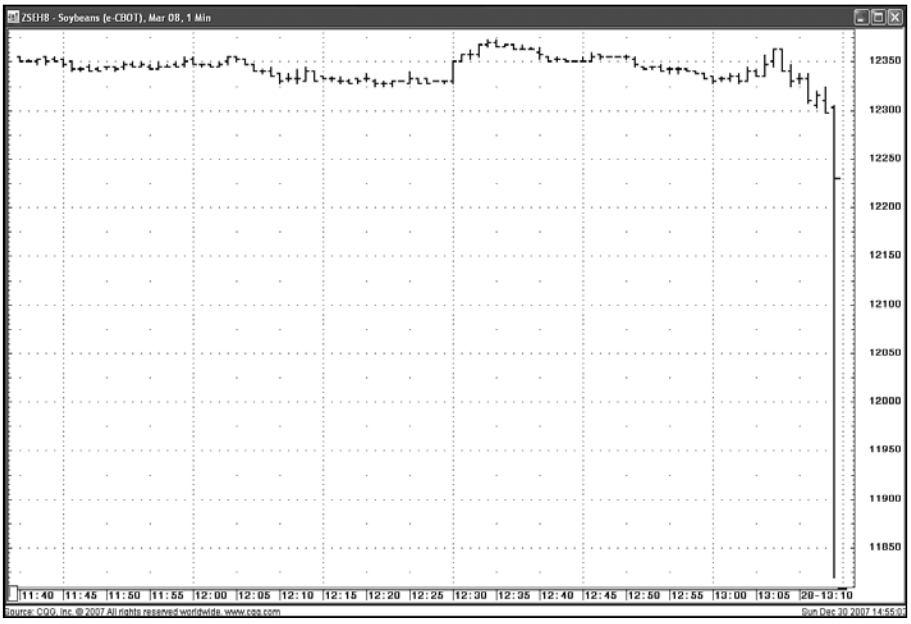

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Chart 1.3 One-minute soybean chart

Seemingly out of nowhere in a quiet market, the beans collapsed 50¢ a bushel and then immediately recovered, all in less than one minute. This is equivalent to a $2,500 move per contract *down and back up in less than a minute*. Today, action such as this is unfortunately (or fortunately) quite common.

Why this dramatic rise in volatility? Screen trading is the major culprit; however, reasons other than electronic trading are to blame, too. Commodity demand has multiplied in recent years due to the dramatic industrial revolution in a number of countries, notably China. This demand increase (with a dose of inflation) has resulted in higher prices. Higher prices lead to larger ranges for the same percentage moves. For $19 oil, a 10% move equals $1.90, but for $90 oil, a 10% move equals $9. So this is part of it, but it doesn't fully explain the velocity and ferocity of today's market movements (let alone the volatility).

Remember the old days when you heard a song on the radio and wanted to buy the album? The process involved physically going to the record store, finding what you were looking for, and returning home to play it. This process took time. Now you can find and download music in seconds over the Internet.

The main reason for the increased speed of market movements is the Internet—a direct result of the dramatic shift during the past few years away from nearly 100% pit trading to nearly 100% electronic trading.

Until recently, this is the way I would place an order in the commodity markets: I would pick up the phone and dial a trading floor. Hopefully, the clerk would pick up the phone call in a timely manner, but in a fast-moving market, sometimes it would ring forever, and this could be maddening. When the clerk did pick up the call, I would read my order, and the clerk would write it on an order ticket and then time-stamp the ticket. Good procedure required the clerk to read back my order to me for confirmation and consistency before he or she sent it off. The clerk would then pass my order to a runner (hopefully the runner was near the phone clerk and not out having a cigarette), who then physically walked it to my broker in the trading pit (or, at times, the broker's clerk adjacent to him in the pit). The pit broker would cue the order, and when the market approached my price, he or she would yell out the buy or sell into the trading pit, looking for an offsetting trade via the open-outcry process. After it was filled, the process would reverse from runner to clerk, with more time stamps, and eventually it would be phoned back to me. This all took time. Looking back, it is amazing we operated this way, in most cases efficiently, for the bulk of my trading career.

Now with electronic trading, orders are disseminated and received instantly over the Internet. Orders of all sizes from around the globe are now entered instantly with a mouse click, eliminating this entire human-based process.

This volatility enables many opportunities, but it also increases the risk geometrically compared to the old days. So how does a trader cope with this rise in volatility? The answer lies in computing power. We used to keep charts by hand, but now the computer draws the charts for us. A computer also calculates those same market studies in real time that we used to do at night by hand after the market closed.

As an example, in Chart 1.4, I've reproduced the 30-minute oil chart and superimposed a 60-period simple moving average. By monitoring where the market is in relation to this average (particularly on a close for each period), the computer can help a trader identify the true internal trend of a market. Today a trader needs to compress his time parameters and use computing power over shorter time spans. The computer cannot eliminate the volatility and speed of today's markets—these factors are here to stay. But computing power in today's market environment is a necessity to analyze the markets at a speed the human brain is incapable of doing.

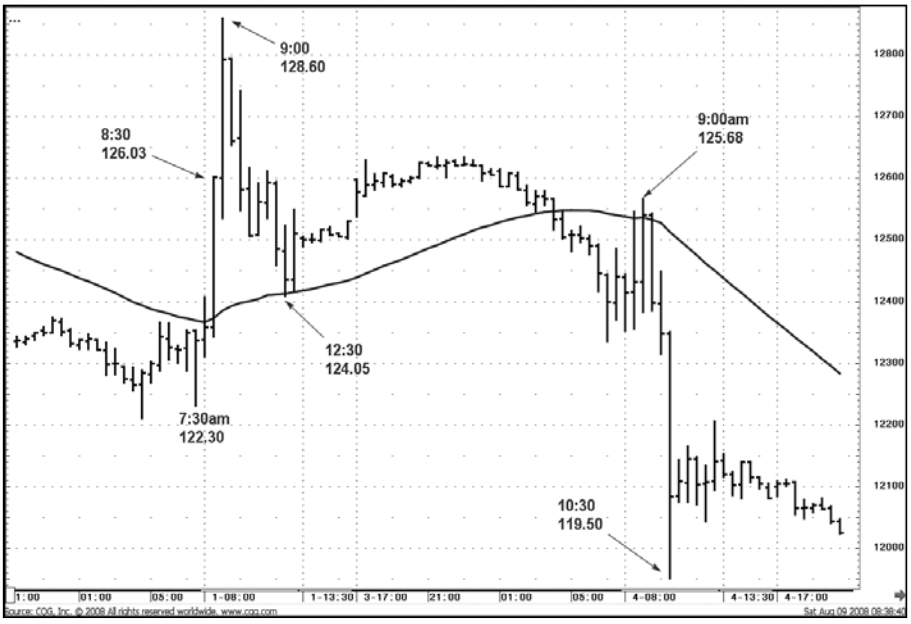

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Chart 1.4 Thirty-minute chart (with moving average)

The bottom line of the market change is that electronics speed up the process, resulting in greater volatility. This means that, as traders, we also need to change and use technology while maintaining those time-tested methods that work.

The objective of this book is to meld the necessary adjustments for the current market environment while maintaining those timeless methodologies that have worked in the past and will continue to work in the future because of human nature. Fear and greed ultimately move markets. And no matter what machines we utilize, these human traits will never go away. Speed can be our friend or our enemy. As the legendary trader W. D. Gann once wrote, "Most people are in too big a hurry to get rich and as a result they go broke."

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