Gauging trader commitment

Analyzing the euro with Commitment of Traders data sheds light on the strength or weakness of price moves.

BY BARBARA ROCKEFELLER

You can be the best chart reader on the planet and still lose money trading. Losses are generally a function of bad money management, such as setting a profit target unreasonably high or a stop too low.

But losses can also be a function of not having the "feel" of the market. Let's define feel as a grasp of what the main players are thinking and doing. You may think that other traders are in buying mode, but are they? You know only if you can see the actual buying volume.

As technical analyst and author Joe Granville and others have noted, a real rally is accompanied by rising volume. If prices are rising but volume is flat or falling, watch out. New buyers — fresh blood — are not joining the rally, and it may not last.

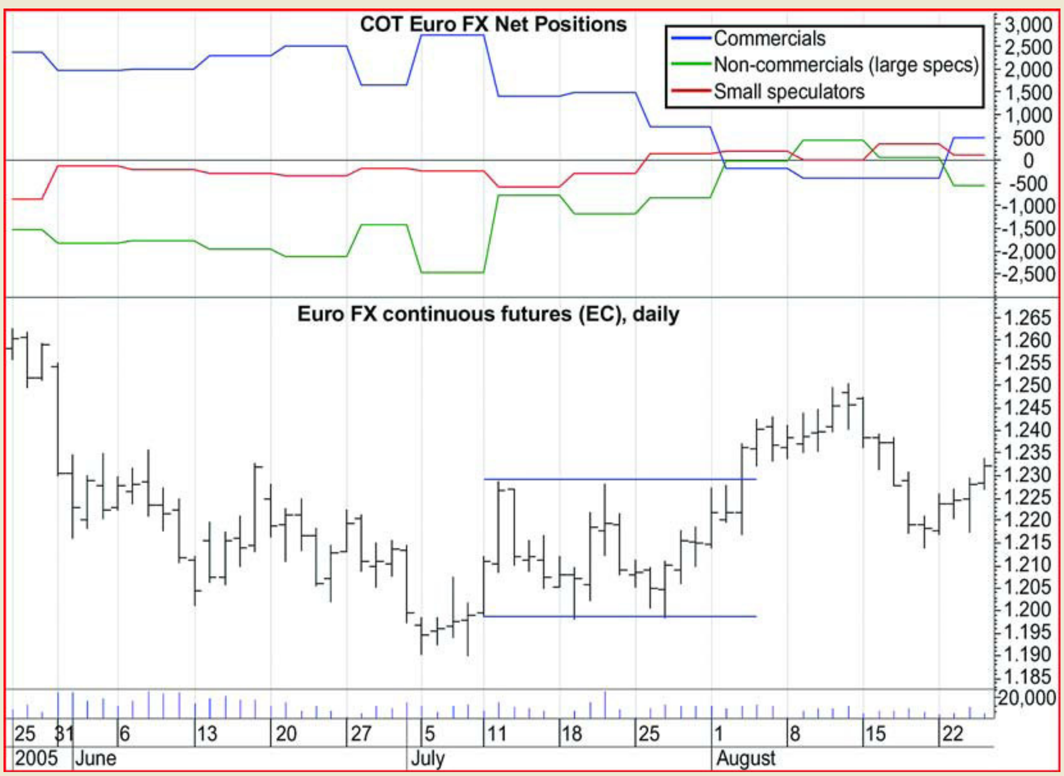
Very high volume at a market high may mean the top is in. If volume is extremely high and price is making new record highs, many traders have a lot at stake — and any significant price drop can cause a stampede of covering. As in price analysis, an extreme often precedes a reversal.

Finally, if volume is building during a consolidating or sideways period, we expect a breakout — but we don't necessarily know in which direction.

Volume changes are a dandy supplement to technical indicators and fundamentals. Forex traders are severely handicapped by not having good volume information, as stock traders have. In the spot market, there is *no* volume information, because every trade is a private transaction between customer and bank. Wire service reports tell us that "volume is heavy" or "the market is thin," but that's not very specific and does us little good.

FIGURE 1 — AWAITING A BREAKOUT, EURO JULY 2005

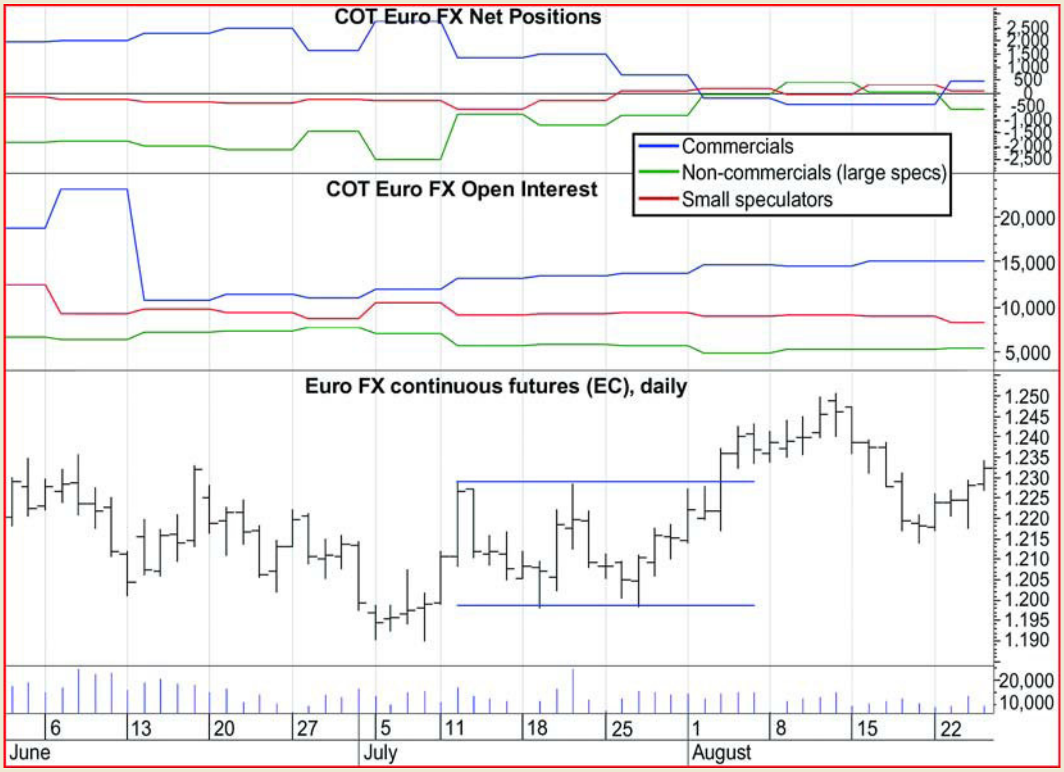
Traders from all groups downsized their positions prior to the trading-range breakout in early August. Commercial traders (blue), who had been net long, changed to net short by the time the breakout occurred. The breakout rally quickly failed.



Source: chart — MetaStock; data — Reuters

FIGURE 2 — JUDGING THE BREAKOUT

Open interest was flat throughout the entire period. The new high on Aug. 12 is suspect because a big upside move that is not accompanied by higher volume and an increase in open interest lacks real support.



Source: chart — MetaStock; data — Reuters

In futures, the exchange doesn't publish volume until after the close. For real-time analysis, all that's available is tick volume, which is less than ideal. You get a change in the tick whether the new trade was one contract or a hundred, and while you can check "Time & Sales" to see the actual volume, it's a cumbersome process. If you are trading in an intraday time frame, by the time you see big volume developing, it's probably too late.

What traders are really doing

Instead of looking at raw volume, though, you can look at the Commitment of Traders (COT) report and make some educated guesses about how to trade certain situations. You won't get a price forecast, but you will get information that is directly relevant to your trading.

Take, for example, the period in July 2005 when the euro futures (EC) were trading sideways in a range from 1.1980 to 1.2290 (Figure 1). Every three to five days, the price reversed. In the first week of August the euro rose above the range's resistance line. Breakouts must always be respected, and a long trade executed in the next six days probably produced a profit, since the euro put in a new high at 1.2505 on Aug. 12.

But look at the top window of the chart. This shows the net long or short positions held by three types of traders defined by the Commodity Futures Trading Commission (CFTC): the "commercials" (blue); the large "non-commercials" (green), otherwise known as large speculators; and the small non-commercials (red), who are mostly small speculators (i.e., retail traders).

The green non-commercials are net short 24,842 contracts the first week of July, while the red small speculators are net short 2,522 contracts. Offsetting the two short groups are the blue commercials, who are net long 27,394 contracts.

Now look at the next week. Everyone has downsized their positions, and they continue to do so until the first week of August, when the total number of contracts is only 2008, or 10 percent of the level the month before.

Yes, breakouts must be respected, but in this case we see they can't always be trusted. If the green speculators really thought the euro rally was going to continue, they would have bought more contracts. They did go from net short to net long, but only for one week as price was peaking, and then they went short again. Accordingly, the "feel" of the market is not really all that bullish. In fact, nobody seems to have much sentiment at all. Also, liquidity is low, meaning if you make an off-market bid or offer, it will probably just sit there and not get filled, whereas in a highly liquid market, there is always somebody who will shoot at anything that moves.

Market activity

Futures volume is a little tricky. Because every buyer has a counterpart on the short side, the two together constitute a single contract. Total contract volume in the example above is 27,394. Volume is not the same thing as liquidity, which is better measured by "open interest."

Open interest is the total number of contracts still outstanding — i.e., open positions that have not yet been offset. If a new buyer is creating a fresh long position and buys a contract, and the seller is also opening a fresh short position, open interest increases by one contract. However, if the buyer is just replacing a different long party who is selling, no new long position is being created; rather a change of ownership of an existing position is occurring. Open inter-

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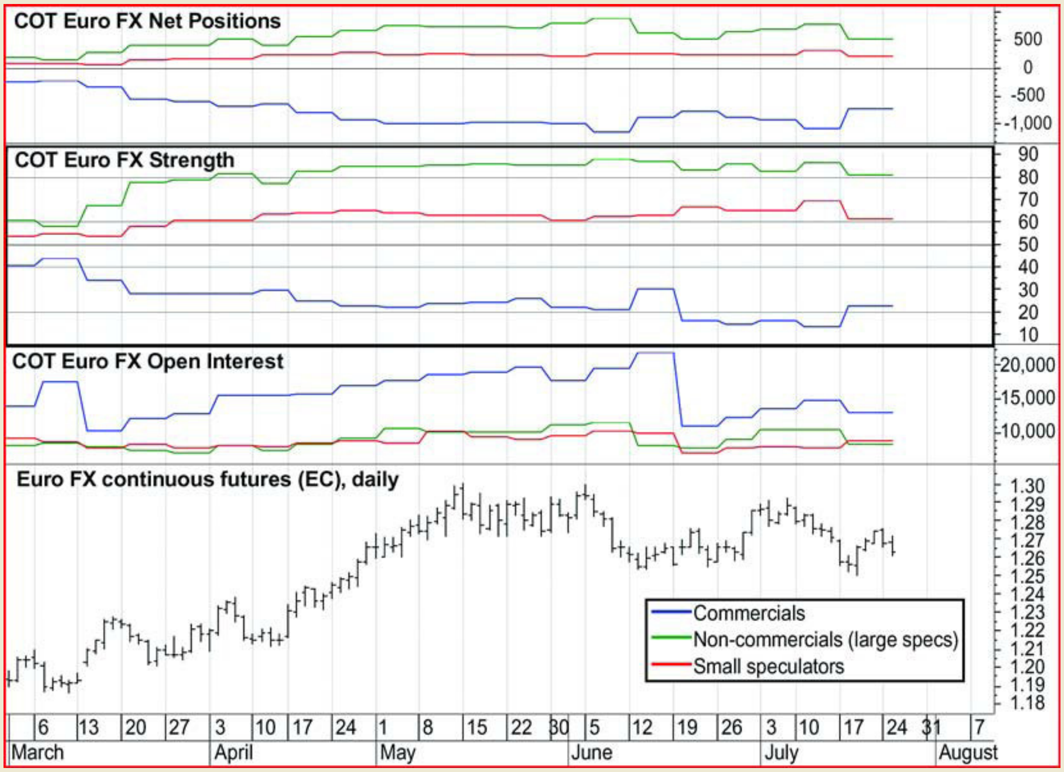
FIGURE 3 — EVALUATING STRENGTH

The highlighted middle window shows the percentage of traders in each category that are long. Eighty percent of large specs were long euro futures as of the latest available reading in July, while 78 percent (100 minus the 22-percent long position shown here) of commercials were short.



Source: chart — MetaStock; data — Reuters

est is still one because the number of open contracts remains the same.

Now look at Figure 2, which contains the same information as Figure 1, plus open interest in the center window. Open interest was flat through the entire period, at levels around 150,000. The new high on Aug. 12 is fishy, as it is not confirmed by a rise in open interest. A big upside move that is not accompanied by higher volume and an increase in open interest lacks real support; a significant amount of new money is not flowing into the market.

As a rule, when volume and open interest are rising, a price move will probably continue in the same direction. When they are flat or declining, the trend is probably going to end.

Understanding the COT report

The COT report is issued late every Friday afternoon by the CFTC for trading during the week ending the previous Tuesday. That means the data is stale by three business days, but don't let that bother you — you can still get powerful information from it.

You can bet that a lot of others are studying it over the weekend, too. Interest in the COT report has risen since the publication last fall of Larry Williams' book, *Trade Stocks & Commodities with the Insiders: Secrets of the COT Report* (Wiley, 2005) and stepped-up reporting by the financial press.

The COT report breaks down open interest by the categories of commercial and non-commercial, with commercials defined as market participants having an underlying cash business for which their futures positions provide a hedge. In other words, if Company X sells Blue Widgets to Germany, it expects to be long euros by the amount of quarterly sales, and will take a short position to offset or hedge the upcoming receipt of euros. Firms registered as commercials get somewhat better margin rates because they tend to be less active traders and thus take less risk.

Non-commercials are mostly large speculators such as commodity funds and pools, and sometimes banks and brokers.

The balance of open interest is derived and assumed to consist of both small speculators and small commercial hedgers, which do not have to register with the CFTC.

One of the reasons the COT report is neglected by many traders is that it's hard to read and to use. Take a look at www.cftc.gov/cftc/cftccotreports.htm. The CFTC has improved the report's formatting (and speeded up its release to every week and for data covering the most recent week), but the information is still presented in a raw format. You'd at least have to download it to a spreadsheet to conduct any analysis.

Fortunately, an outfit named Shatterfield (www.shatterfield.com) makes it easy to capture the data and analyze it in graphic form. For a small fee, you can get their downloader and display charts like the ones shown here (in MetaStock), or in Excel, TradeStation, and other charting packages. A number of other services are also available, but Shatterfield's program contains a special proprietary strength indicator that shows the long/short percentage of each trader category. Figure 3 shows the most recent COT data in July this year.

The highlighted middle window shows the strength indicator, which is scaled in percentage points. The number represents the percentage of traders in each category that are long. Eighty percent of large speculators are long euros, while 78 percent (100 minus 22 percent) of blue commercials account for the offsetting shorts. The high large-spec position denotes a real commitment to the trend, while the high participation rate by the blue commercials indicates a similar commitment.

Now check out open interest in the window below that. During the second week of June, the large specs reduced their outstanding contracts, meaning they cashed in net long positions. A week later the small specs cashed in, and a week after that, the blue commercials. Because the June contract had already rolled to the September contract by the time the commercials reduced their holdings, it's likely some of this is profit-taking. Notice that the week before, price fell quite a bit —from 1.2992 to 1.2534 — before rising again somewhat. Commercials are supposed to be hedgers and immune to the lure of profit-taking, so this may not be the correct interpretation.

The real point is that total open interest fell and the strength indicator contracted a little in each trader category, but total net positions (top window) remained at near-record high levels — 76,569 contracts the week of June 20 after the all-time high of 88,196 the week before. (The record high number of contracts that week made all the press reports.)

Uh-oh, here we go again — a very high volume figure that is not accompanied by higher price highs, with open interest falling and the percentage of participants in each category on the "consensus" side of the trade being reduced. This is "extreme" volume not being confirmed and validated by higher prices, and with commercials removing about half their previous level of interest, as shown in the open-interest drop from 217,570 contracts the week of June 20 to 112,183 the next week. Commercial interest rose a little in each of the following weeks, but they basically cleared out of the market.

As in July last year, we can't really expect a higher high unless the commercials come back. What can we deduce from this about price direction? First, there are a lot of speculators who are long euros in a falling market. At some point, they may hit stops or otherwise decide to bail out. The euro is thus at risk of a "technical" correction, only this time it's market-action technical and not the charting kind. Or, the commercials could come back, providing the engine for additional opposing trades by the specs — assuming the commercials do not switch sides.

The commercials do switch sides from time to time, which offers a tremendous opportunity for small traders. The commercials are not always right in terms of making profit from their long or short positions, but they should always be watched for their behavior.

Related reading

"Volume: The ultimate guide to sentiment,"
by Barbara Rockefeller
(*Currency Trader*, January 2006).
A previous discussion on interpreting volume and using the COT report in forex.

"Larry Williams looks inside futures"
(*Active Trader*, January 2006).
Larry Williams discusses his book on the COT report and his techniques for using COT data in futures and stocks.

"Floyd Upperman: Digging into COT data"
(*Active Trader*, February 2006).
A commodity trading advisor shares his insights on interpreting the COT report and the methods he outlines in his book on the subject.

"Barbara Rockefeller 'Big Picture' Collection, Vol. 1: 2004-2005."
This 11-article collection contains forex market analysis and commentary Barbara Rockefeller wrote for *Currency Trader* between October 2004 and December 2005. (This article set is available at a 30-percent discount.)

You can purchase and download past articles at www.activetradermag.com/purchase_articles.htm.

For information on the author *see p. 6.* *You can get a free 2-week free trial of Barbara Rockefeller's daily forex commentary at www.rts-forex.com.*