Psychology of Trading - Part I: Two views by FX Solutions

The Market as Mass Mind

What is the purpose of the foreign exchange market, or any market for that matter? It seems like a simple question with a simple answer, to permit participants to sell and buy commodities, equities or futures and to exchange one currency for another. But such a simple statement covers a world of complexity. If two parties wish to conduct an exchange, of one currency for another or of an equity or bond for a sum of cash the first question that arises is at what rate or price should the transaction take place? In a retail environment the price is predetermined by the seller and is rarely changed. The purchaser measures his need for the item against the price asked and makes his decision to buy or not. There is little or no discussion or bargaining over the price. The consumer does not usually say to himself, the price will be lower in a few days or hours; I will wait until then to make my purchase. Likewise the seller does not normally remove the item from sale expecting a price rise in a few hours or weeks. A market transaction is essentially different because both the seller and the buyer continually adjust their expectations to information flowing out from the market to participants and into the market from outside sources.

Market participants, in theory, incorporate all available information into the prices at which they buy and sell. This is referred to by economists as the perfect information assumption of efficient markets theory. Each participant in the market acts as an independent decision maker and influences the overall market and price level by its decision much as a single neuron affects the decision of the brain or a single binary choice node affects the response of a computer. The market or to be more precise, the price level of a market traded item, is, at any time, the amalgamation of all the price decisions made by all market participants. On this one topic, what should the market price be, the market reflects the will of all its decision making nodes, its participants, in foreign exchange markets, its traders. But how do 100 or 1,000 or 10,000 individual decisions become a market price, the product of a mass decision. How do we know that the price accurately reflects the wishes of 10,000 people?

If at any one instance three market participants want to buy a commodity and 50 want to sell, the market price for that commodity will fall. Bu what actually happens? The three bids in the market are filled, no others enter and the sellers displaying prices react to the lack of bids by dropping their selling prices until lower bids are encountered. The market is said to have fallen, but the market is not an entity producing a decision, it is only a method for reflecting the decisions of its participants. What occurred is that each participant in the market reacted to the changing information coming to them from the market and their combined reaction is the movement in price. The new price level reflects the aggregate decisions of the traders. It appears to an observer that the ‘market?traded lower, only because the thousands of individual decisions that comprise the movement are not given separate life, only the mass decision, ‘the price? is represented. This sense of the decision making power of the market and the ‘market?as almost a living entity in itself is reflected in the terms we use to describe the price action. We often say?‘the market reacted badly to the news?or ‘the market took profit

today. We personify the market and its behavior. Of course we all know that there is no “market?entity somewhere below the pavement on Wall Street, making the decisions for the stock exchange floor. But the common use of this ‘market ‘shorthand tends to obscure what is most important psychological point in under standing market behavior. Namely, that the ‘market?is a picture of the thoughts of its participants, the market is a snapshot of our minds.

We Have Met the Market and He is Us,

One of my main purposes today is to remove the sense of mystery from the term, “the market? We have all heard it so many times and from the lips of so many commentators, ‘the market went up, down, sideways, topsy turvey?and the thousand other clichés used in financial reporting. Whenever I heard this I used to ask myself, just who or what is this “market? Well the answer is plain enough, in the words of the immortal Pogo, “we have met the market and he is us?

When analyzing any aspect of market behavior or when puzzling as to why the market did not move as we expected, it behooves us to keep this very simple fact in mind. The market is a very focused mass mind; it is the product of the total opinions of its participants on one topic ‘price. If the market is a reflection of the minds of its participants and it did not move as we had anticipated there are only two possibilities, our assumption about market behavior was wrong or our facts were wrong. If our facts were wrong that is the easier case; it can be corrected with better information. Market participants do not, of course, possess ‘perfect information?nbsp; Even the best news source can miss something and rumors, a particularly volatile type of information, are rarely reported in the media. But most of the time the information in the currency markets is evenly spread. We all know when the next Non-Farm number will be released; we all know the expected range and so forth. Over the long run information disparity is not a major factor in trading. However, if it was our assumptions that misled us, if we expected the market to do one thing at a particular point or in reaction to a particular piece of news and it did not do so, then we need examine our assumptions. Or to put it another way, we need to examine ‘why we put on the trade in the first place? Whatever our logic, we were probably not alone, but, we were in the minority. If we had been in the majority the market would have performed as we anticipated. The market decision process is that simple. It is a matter of putting our assumptions in line with the majority as often as we can. The market does not reward iconoclasts.

The Psychological Utility of Technical Analysis

Technical analysis is often treated s if it contains some grain of secret knowledge or portrays an intrinsic truth about a currency. Often it is said that a specific chart formation will produce a specific price movement. Technical analysis does nothing of the sort. A chart is a reflection of past prices; in itself it does nothing to predict future movement. A currency does not move up of down because of a formation on a chart. It moves because the market participants, you and I, make basic assumptions about future behavior based on past behavior and a record of that past behavior is the information contained in a chart. It is very important to remember that the

translation mechanism runs from the information contained in a chart, through the analysis of market participants to the behavior of market participants.

Another way to approach this idea is to ask, just who is the 'market?and what is it trying to accomplish every day. Over 90% of the 1.9 trillion daily volume in the FX market is speculative. That means that everyone in the market, the hedge fund trader with 100 million under management, the market maker on the Deutsche Bank interbank desk and the retail trader in her kitchen, is trying to do exactly the same thing, take home daily trading profits. Interestingly, this daily volume figure from the latest BIS report (Bank for International Settlements in Basel) is up from 1.3 trillion daily in the prior report. That is almost a 50% increase.

The BIS report does not provide a breakdown of the volume other than between spot and forwards and futures but it is my suspicion that a good portion of this volume is driven by the explosion in retail currency trading. To return to my previous point, if every market participant is attempting to do the same thing, namely wring trading profits from the day's activities how do they all go about it? The first thing every trader does, in Switzerland, in Hong Kong, in Tokyo, in Topeka, in Birmingham, in Katmandu, everywhere, the first thing I did every day I sat on an interbank desk, was to pull up my charts and look for trading opportunities.

Remember, every trader looking for profit opportunities is looking at the same charts, everyone sees the same price history, and everyone identifies the same chart formations. And, and this is key, the majority of traders will come to the same conclusion based on these factors. If euro has been in an up channel for two weeks and is approaching the bottom of the channel most traders looking for an opportunity in euro will bet on the continuance of the up trend and the maintenance of the channel.

They will place buy orders just above the floor of the channel. And much of the time the charts will have been proven correct, the euro will indeed bounce from the floor of the channel. But it bounces not because, for instance, the ECB is expected to raise rates at some future date, but because of the fit between the goals, information and assumptions of the market's traders. Traders need profits, all charts contain the same information and all traders operate with similar assumptions about market behavior based on chart formations. If enough traders place their buy orders above the bottom of the channel it becomes likely that the euro will bounce off the floor of the channel and continue the upward channel formation, barring external events of course. There is powerful self-fulfilling logic in technical analysis, it works, because everyone trading believes it will work and makes their trading decisions accordingly. For a retail trader that is the most accessible and effective trading strategy that exists.