MOTIF: Price action and Thematic Filtering

Once the macro viewpoint has been established, we move to target identification. This process starts with two initial filters — **P&T**:

1. **P**rice action screen: We run a number of quant screens and look through hundreds of charts every week for possible high "R" setups (more on this in a bit) that deserve further exploration.
2. **T**heme: We spend a lot of time thinking about the state of the world, markets, and particular themes. If we think there's a large thematic mispricing, say in emerging market debt for instance, then we note that for further exploration.

Every target we identify must be able to pass muster on <u>both</u> P&T.

Often times price action will look good and we'll have to dig a bit to understand the possible theme. If the theme makes logical sense then it continues down our funnel of analysis.

Sometimes we'll really like a theme, but the price action at the time will be lacking, so we'll put alerts on the chart and file the trade away for another day.

Since price is king, let's start with the type of price action that warrants further investigation.

Price Action

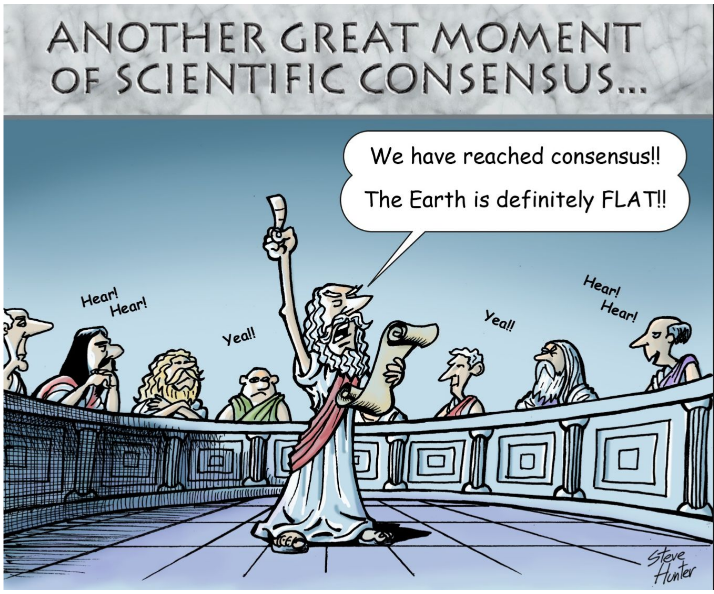
A price chart shows us a two dimensional representation of supply and demand. And in this supply and demand we can extract the following valuable insights:

- What type of players are in the market (momentum, value, steady/weak hands etc.)
- What the dominant and competing expectations/narratives are
- How much consensus there is around price

➢ How extreme the emotion and sentiment are in that market

Price action also serves as an invaluable risk management tool that helps us handle the complexity inherent to markets. It provides us with inflection points (IPs) or "danger points" as they were called at Commodities Corp. IPs are points on the chart where we can say our trade is a go or no go; where if price were to hit, would mean our thesis or timing are clearly wrong (we'll cover IPs in much greater detail in a follow up piece on trade management).

The number one thing we're looking for in price is "Consensus".



Consensus takes two different forms in price action — low activity and high activity.

Low activity consensus

When there's low activity consensus in the security you will see very little volatility or trend. The underlying will move sideways in a tight range for a long period of time.

This is the exact opposite of a trend. Think of what a trend means. Most traders mistakenly believe that a trending stock equates to a consensus that the stock should be higher or lower depending on the direction of its trend. This is incorrect.

A trend occurs when there is a narrative/consensus shift in an asset. A stock oscillates up and down as it moves higher because there's a level of disagreement of price. For others to buy, you need people to sell. And people don't sell a stock they think will go higher after the fact.

They sell because they think the issue is fairly priced, over priced, or just not that interesting all together.

If a stock is trading a $25 and the dominant consensus is that it should be $50, it doesn't slowly trend up to $50, it rockets without stopping to $50 because that's the dominant consensus point (CP).

A trend changes its slope or angle of attack as the narrative increases/decreases in adoption rate by market actors — simple supply and demand.

Trend equates to disagreement, not consensus.

When there’s little volatility or up and down movement it means that market actors (those who are buying and selling the underlying) are at general agreement over price. It also means those in disagreement with the dominant narrative have mostly been shaken out (ie, the stock acts like dead money).

When there’s price agreement it means the holders of the stock are steady hands. It would take a significant surprise of new information to shake them out. This provides the trader with a solid base to operate from because the consensus acts as a floor or ceiling to future movements.

Here’s a few charts of some trades we’ve hit which show a congestion period denoting low activity consensus. You want to see a lot of closes that are close together. It’s even better when they’re on the weeklies. Again, this just means there’s little fighting over price which equals consensus amongst holders.


MacroOps published on TradingView.com, August 11, 2016 17:36 EDT
BATS:CLF, W 6.62 −0.45 (−6.36%) O:8.17 H:8.42 L:6.61 C:6.62
ATR (30, RMA)
CLIFFS NAT RES INC, W, BATS
MA (200, close)
Large trend with violent swing denotes lots of fighting over price.
30 day ATR is high. There's no consensus in this stock at the moment.
Price bottoms in January of this year. Volatility disappears and goes through a slow basing and consolidation period. Volume generally dies down over this period and there's little action in the stock. This is what consensus looks like.
ATR collapsed to the lowest levels in years.
Vol (20, false)


MacroOps published on TradingView.com, August 11, 2016 17:40 EDT
BATS:CHK, D 5.03 +0.23 (+4.79%) O:5.09 H:5.10 L:4.82 C:5.03
ATR (30, RMA)
CHESAPEAKE ENERGY CORP, D, BATS
MA (200, close)
Indecision. No consensus!
Weeks of tight consolidation and low ATR = consensus!
Vol (20, false)

These are consensus points that happened to take place at potential bottoms. But congestion zones can happen anywhere; in the middle of a trend, at new highs… they can mark continuation points or areas of major reversal.

The key being, it's a notable period of time where the major players in the stock all seem to be in agreement. Like Kovner, we want to find the trades where the most people will be really wrong. And when there's general consensus amongst holders it means the situation is ripe for a lot of people to be caught on the wrong side and that equals potentially large moves.

High activity consensus

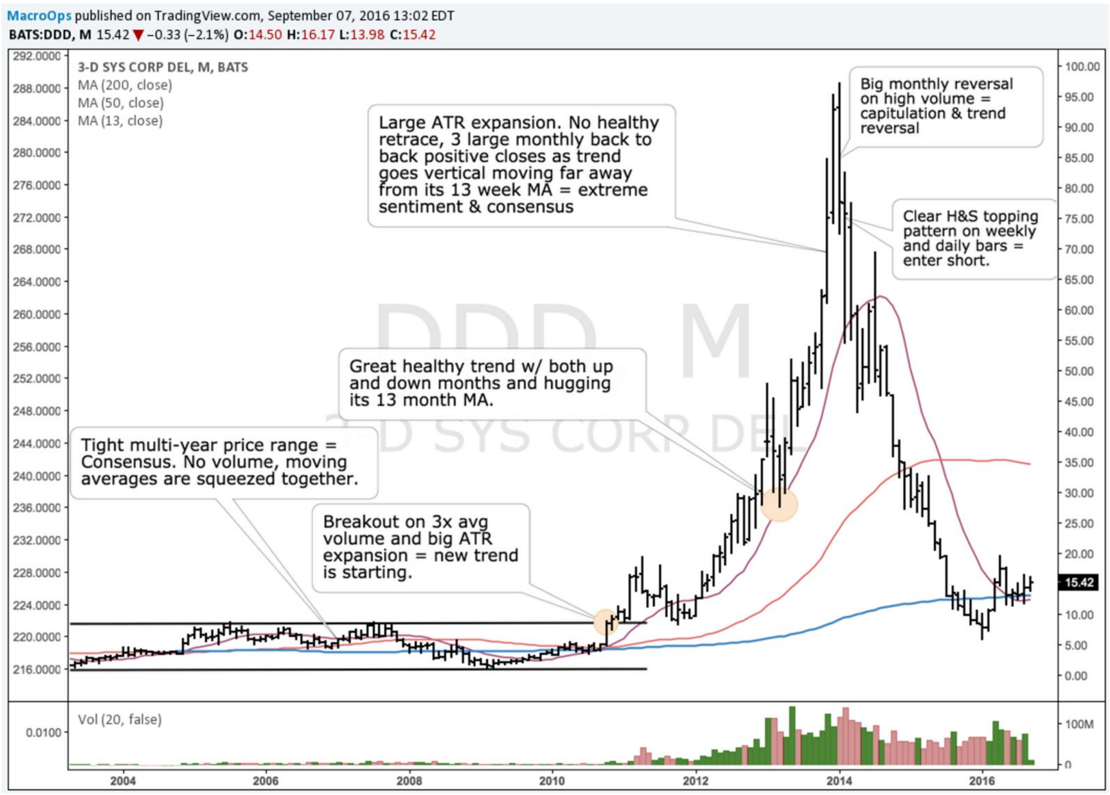
High activity consensus points are periods of extreme trend; both bullish and bearish. These differ from regular healthy trends in that they don't rest or retrace.

If it's a bull trend then all sellers and shorts have been knocked out of the market and price can't climb fast enough. A bear trend is comprised of excessive selling driving the stock straight down with no pullbacks. You'll also see vol expansion as the daily and weekly bars extend well above their average range as the trend picks up steam. Both bull and bear trends denote periods of extreme sentiment and consensus.

You never want to fade high activity consensus points. That's a shortcut to the poor house.

What you want to do is watch them for clear reversals and wait for the pattern to play out. These points provide excellent reward-to-risk entry points. It's here where the powerful forces of mean reversion tug on price like a magnet.

Here's an example of both low and high activity consensus points.



DDD starts with a low activity consensus point. Then a regime/narrative shift occurs with the breakout, offering a clear inflection point for a great risk-to-reward entry. The stock then takes a high angle of attack from $7 all the way up to near $100 per share over roughly a 3-year time period.

It enters a high activity consensus point at the top, producing a high-volume / high-volatility reversal. This provided another inflection point for a great R/R entry to the short side.

Going back to Soros' take that the "market is always wrong", when price action is showing signs of extreme low or high activity consensus, we should investigate, because the market is probably really wrong.

Go onto stocktwits and seeking alpha to see what the retail Joe Schmoes are saying about the stock. If the average punters all seem to be in agreement and their consensus is at odds with your initial assessment, then it's probably worth digging into. If the consensus is in line with your expectations then you should question your expectations — if everybody agrees a stock is going higher then why isn't it higher?

Read through old news clippings on the company or sector to get an idea of what market expectations and drivers were for past narrative shifts and breakouts from CPs.

Thematics

> *One of the jobs of a good trader is to imagine alternative scenarios. I try to form many different mental pictures of what the world should be like and wait for one of them to be confirmed. You keep trying them on one at at a time. Inevitably, most of these pictures will turn out to be wrong — that is, only a few elements of the picture may prove correct. But then, all of a sudden, you will find that in one picture, nine out of ten elements click. That scenario then becomes your image of the world reality.* ~ Bruce Kovner

Back to the P&T filter; I generally will not take a trade unless the price action provides a clear path of least resistance and is inline with a theme or narrative that I believe to be true.

To develop useful thematics you need to spend a lot of time thinking about the world. Particularly:

- ➢ What are the dominant narratives in the market?
- ➢ What are the dominant themes in financial news?
- ➢ Can you imagine a future that contrasts with these dominant narratives and themes?
- ➢ Is price action going against any of these dominant themes?

Similar to assessing price action, we're standing back to objectively look at the world, including the players in the market and the news, to identify thematics/narratives where there seems to be a strong consensus. We're always operating from the assumption that the market is wrong and price will move in the direction that will cause the most amount of actors to be wrong too.

Kovner said that his "...ability to imagine configurations of the world different from today and really believe it can happen", was one of the greatest reasons for his success.

The vast majority of market players are playing what's happening now. They think they're looking ahead but they're really just extrapolating the present into the future. Anchoring and recency bias are powerful forces on our judgement and this tendency is bolstered by the fact that everybody else is doing it. We find psychological comfort in agreeing with others.

And it's this fact about human nature that drives and sustains false themes and narratives. It goes something like this:

- Price action spawns a narrative.
- The longer price action confirms this narrative, the more dominant it becomes (more people believe in the narrative and it grows stronger).
- The news (which always lags price action) starts reporting on this narrative; picking information/data that support it and discarding what doesn't.

- This strengthens the narrative further until it eventually becomes accepted fact; other possible futures or competing narratives stop being considered. There is near total consensus.
- Price action begins to diverge from the dominant narrative but the change in trend is not acknowledged. Actors don't have the mental framework to accept the unfolding reality; cognitive dissonance occurs as investors perform mental gymnastics to confirm their belief in the dominant narrative.
- Eventually price action diverges so far that the narrative begins to crumble. Actors begin going through the five stages of acceptance until there's a violent price action and narrative shift. Suddenly a new narrative starts to be slowly adopted and the process begins again.

A perfect example of this process occurring and how P&T was used to trade it, is the oil price collapse that started in 2014.

Everybody remembers the bullish oil narrative that dominated prior to the collapse. It reigned for years. The consensus was that we were running out of oil and price could only go up.

Despite this strong thematic consensus, price action traded in a relatively tight range for nearly 5-years.

In September of 2014 I was in the final interview at a macro hedge fund. I had to write research pieces on two trade ideas of mine. For one of them I chose to do a bearish oil piece, and in it I said that oil is likely to fall to the $20/bbl range.

My reasoning was that there had been extreme consensus on both narrative and price for many years. The narrative was predicated on three important "facts" that were beginning to no longer be true. They were:

1. China (the largest source of new demand growth for oil) will continue to experience double digit GDP growth in perpetuity (China's growth had been slowing down for a long time by then).
2. We were running out of oil and the future would be marked by a large supply and demand imbalance (fracking had started and was rapidly disproving that theory).
3. The US dollar would continue to stay low for a long time (USD started strengthening at just that time due to a diverging set of monetary policies between the US and the rest of the world).

This was one of the highest conviction and highest R/R opportunities I had ever seen. In my experience, these only come around every few years.

I ended up getting the job but not because the fund manager agreed with my assessment — he had written a number of papers on $1,000 oil; he was fully devoted to the dominant theme.

And if you remember, market actors and financial news fought this narrative shift the entire way down — all the way from $100/bbl to the low of $25/bbl.

Livermore said that "a trader gets to play the game as a the professional billiard player does — that is, he looks far ahead instead of considering the particular shot before him."

Using thematics to generate and assess trade ideas is all about keeping an open mind and envisioning a whole range of possible future outcomes. And "all of a sudden, you will find that in one picture, nine out of ten elements click. That scenario then becomes your image of the world reality."

Search for consensus in price and narrative. Imagine different outcomes… and wait for price to confirm a different future.

Suggested reading list for this section:

- Lefevres' "Reminiscences of a Stock Operator"
- Edward and Magee's "Technical Analysis of Stock Trends"
- Loeb's "The Battle for Investment Survival"
- Stine's "Insider Buy Superstocks"