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Fishing for "Home Run" Trading Profits

"In the spring a young man's fancy lightly turns to thoughts of love"

Alfred, Lord Tennyson

In the spring, my mind turns to two things: baseball and fishing! I am a born and bred Chicago White Sox fan and I have been an avid fisherman as long as I can remember. Don't get me wrong—love is fine with me, too—but in the spring, I think of baseball and fishing.

When I recently reviewed the portfolio trading I do for myself and my investors, I noticed a pattern: I tend to "fish" (or look aggressively for) large profit or "Home Run" type trades. I can give you a few reasons why they may be easier to find in the spring:

1. Grains tend to begin major moves before the beginning of the planting season
2. Energy prices, especially gasoline, have a tendency to move higher in early spring

The cyclical nature of grain prices is easily understood. In early spring, the crop the farmers are going to grow is still sitting in seed bags. Traders watch the weather patterns as planting season gets nearer and nearer for clues as to whether the crops will get planted on time and whether they'll get a good or poor start once they are in the ground.

The cyclical nature of gasoline prices is more difficult to understand (or maybe I am just naive). My wife Jeanne always tells me in late January or early February, "Start keeping the gas tank at least half full, because you know they are going to raise rates for spring break and keep them high for Memorial Day." She never tells me to get long crude oil futures, but that subtle hint about gas prices (and she's usually right, by the way) always has me checking the charts to see if I should be getting long crude oil futures.

It always seems that once I start fishing for grain and energy positions, fishing season is open and I generally watch all the commodities and currencies I hand chart for signs of potential portfolio trades. And these aren't my "normal" portfolio trades-meaning trades I plan on keeping for weeks or months. This is spring, and baseball is in the air! In the spring, I find I am eyeing the charts for trade opportunities that will give me home run type profits.

I used to think it was a coincidence that I entered these types of trades more often in the spring. But after reviewing over 20 years of my portfolio trades, I have to admit to myself that I must be looking for these home run types of trades in the spring. Now that I've admitted it to myself, let me show you my current portfolio trades and hopefully you'll be able to see what I am looking for when fishing for these types of trades. All of these trades are marked to the market as of the close of trading Friday afternoon on April 3, 2009. As each part of this article comes out, you'll be able to see whether my stop loss, stop profit, and/or profit orders were useful, prudent, or poorly chosen.

Let's start out with the grain complex, since I always stalk trades in the grains in late winter or early spring:

This is a daily bar chart of the December 2009 corn futures on the CBOT. If you are not familiar with the grain markets, speculative traders think of the different delivery months as being either "old crop" or "new crop." Simply put, old crop has been harvested and is in storage, while new crop is either waiting to be planted or is in the fields growing.

Many traders simply take their grain positions in the front month contract, not realizing that there can be an extremely important distinction in price action between old and new crop futures. I think of it this way: If I am speculating that there is going to be a shortage of supply (the Mississippi river freezes, halting grain barge movement for several weeks, for example), I would be taking my position in old crop futures. If I am speculating that weather conditions are going to hamper planting or hinder germination of seeds just planted, I would take a position in new crop futures. The reason behind the price move dictates which will move further, faster. That being said, when I take a spring position in corn futures, I am generally buying or selling the upcoming December corn futures. The December corn futures is the contract where the large speculators load up, long or short, when the grains start to move (unless there is a supply situation, which would cause them to buy or sell the nearest old crop futures).

Prior to 2003, the "normal" trading range for corn futures was just over 200 to just over 300. The averaged hedging price at grain elevators during that period was $2.26 a bushel, which is the price on which a farmer would base his crop production and profitability. But grain prices, like oil and metal prices, exploded over the past three to five years and they reached an incredible climax last summer. After trading well over 700 in July of 2008, corn traded back down to 350 by early December 2008!

Looking at the December corn futures chart above, you can see that after corn reached its December lows, it began to climb higher, making it to 475 in early January before heading lower. There was an orderly decline in prices that ended just below 375 in early March. Then corn futures began to make higher highs and higher lows, signaling a change in behavior. When prices broke above a prior swing high at 411, I added a blue, up-sloping Median Line set to show me the probable path of price.

There are two key elements on this chart (besides it being spring) that make me interested in fishing for a long corn futures position:

1. The March 2009 swing low is higher than the prior major swing low in early December 2008
2. Price broke above the prior swing high at 411 and began making higher highs and higher lows

Both lead me to believe a change in behavior has taken place in the corn futures market, and so I begin looking for a high probability trade entry set up.

From my past experience, I know that the grain markets often pull back, but when the pullback reaches its top or bottom, it is often a 'V' formation-meaning prices reach their highs or lows on one bar and then close a good distance away in the opposite direction. And price seldom comes back to re-test this new high or low. That means I am generally unable to use my favorite set up, a test and re-test of an up- or down-sloping line, to enter these portfolio positions. Once I have determined what I believe to be the probable path of price, I identify an area for an entry and begin working a limit buy or sell order in that area. If I am trying to enter against a sloping line, that means I have to move the order at the end of each day to match the slope of the line.

In this case, I begin working orders to buy December corn futures where price will intersect with the blue, up-sloping lower Median Line parallel. On Monday, March 30, my limit buy order gets filled at 413 1/2. My initial stop loss order on this position is below the last prior swing low, at 391 1/2. My first profit target is just below the highs made earlier this year, at 467 1/4. My second profit target is just below an area of congestion, at 497 1/4.

Corn prices spiked higher on Tuesday, closing above 435. After the close, I cancelled my initial stop loss order and moved it higher to 404 1/2, five cents below the low made on Monday. On Thursday, corn prices made a new high for the move and corn closed on its highs Friday, April 4, at 435 1/2. After the market closed on Friday, I cancelled my stop loss order and entered a stop profit order at 418 1/2. My intuition tells me this order is a bit close to the current price action and I might get washed and rinsed out of this position, but I don't see a quality area to hide a stop profit order. If prices plunge lower from this current leg up, I prefer to lock in some profits and come back to fish another day.

Tomorrow, we will take a look at the soybean market!

Yesterday, we looked at the corn market. Today, let's take a look at the soybean market!

Like corn, soybeans had an incredible run higher that ended in July 2008 with an equally incredible selloff. Soybeans topped out above $15 a bushel last year. Prior to 2003, the general trading range was $4.75 a bushel to just over $7 a bushel.

In early March, new crop November 2009 soybean futures made a low of 784 and then began an orderly climb higher. When soybean prices broke above a prior swing high at 855 ½ on March 16th, I added a blue, up-sloping Median Line set to show me the probable path of price and the fishing expedition was on!

Here are the two key ingredients that lead me to believe a change in behavior had begun:

1. Prices went from making lower highs and lower lows to making higher highs and higher lows
2. Price broke above the last prior swing high of the leg down at 855 ½

I began entering limit buy orders where price would intersect with the blue, up-sloping lower Median Line parallel. I entered the first limit buy order in November 2009 soybean futures on March 17th at 815 ¼. Looking at the chart, you can see that I kept moving the limit buy order higher along the sloped line until my order was finally filled on Monday March 30th at 843 ½. My initial stop loss order was under the prior swing low, at 808 ½.

Soybean prices spiked higher on Tuesday, closing at 892. After the close, I cancelled my initial stop loss order and entered a new stop loss order at 829 ¼, underneath Monday's low. Since soybean prices had rallied hard, I wanted to move my stop closer to the action, but not so close that I risked being washed and rinsed out of my position because of market noise.

On Thursday, April 2, November soybeans closed at 915 ½. The 72 cents of potential profit at that point was worth $3600 a contract, so after the close on Thursday, I cancelled my stop loss order and entered a stop profit order at 872 ½. If prices plunged from this move up, I would prefer to take some money off the table and go fishing another day. You can see that soybeans closed on their highs Friday.

Now, let's look at the validity of my wife's intuition: the crude oil futures markets!

Like the grain markets, crude oil futures had an amazing rally that ended with an equally amazing vertical selloff that began in July of 2008. Depending on the contract month you were watching, crude oil futures made it up to just about $148 a barrel. By the middle of January, crude oil futures broke below $33.50!

Most traders no longer trade off of the weekly or monthly charts. Markets move fast and traders are generally drawn to smaller timeframes. I still hand draw daily, weekly, and monthly charts for 27 different commodities and currencies, and honestly, I find that some of my best "catches" when fishing for large moves come off of my hand-drawn charts. There is something about the time spent drawing in a daily bar, then waiting for another day's trading to end before adding to the chart. I can't tell you exactly what it is, but that pause between adding each bar and then the actual physical drawing of the bar, with its open, high, low and close, gives me a feel for that market that I cannot duplicate when watching a computer-generated chart paint daily bars on a screen. The weekly and monthly charts also have their own unique rhythm. The act of adding that next bar after spending an entire week or month pondering the formation building in front of you on the hand-drawn charts has some mystical quality that gives me a much better feel for what has already happened, what is happening currently, and what may happen next.

On my monthly charts of crude oil futures, the rally above $35 a barrel and the subsequent fall back below it take up a very small portion of the chart, perhaps 5% of the entire chart, while 95% of the chart is filled with price action above $10 a barrel and below $35 a barrel.

Picture in your mind drawing in a long bar as price spikes above $40 a barrel, followed by another long bar that ends higher as price runs above $60 a barrel, and then $80 a barrel. There's a pause of three or four bars as price consolidates and drops back to test $50 a barrel. Then you are drawing in wider bars again, each making new highs for the move as crude oil tops $100 a barrel, $120 a barrel, and then finally hits $143 a barrel!

You sit down to draw in the bar at the end of the next month. It opens at $140 a barrel, and like the prior bars, it continues higher, finally getting to $148 a barrel. But then your pencil does something it hasn't done the entire run up: It heads lower, down past $140 a barrel, past $130 a barrel, all the way to $120 a barrel! This bar is nearly $30 from top to bottom, an amazingly long monthly bar—and it closes on its lows.

But this won't be the last long bar that closes much lower that you draw. The next five monthly bars are all very long and they all close near their lows. You draw six bars that erase the entire move up from $35 a barrel to $148, and suddenly, price is right back where it started!

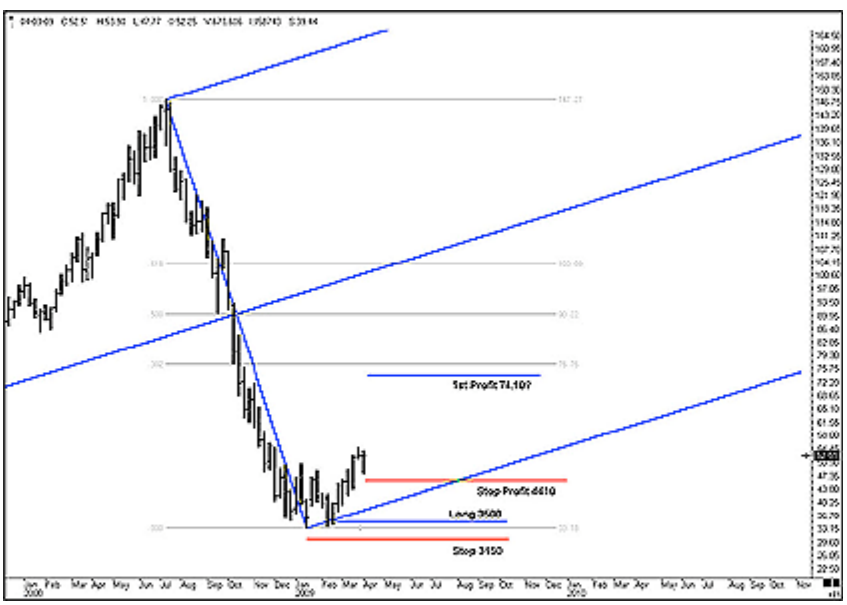
Each bar I added headed back towards the long-term "normal" range of $10 to $35 a barrel and one thought kept going through my mind: "*What was resistance is now support.*" If crude oil prices showed any sign of congesting and then gave me any clues of a potential change in behavior, I'd have to be fishing in the $30 to $35 area. My words probably don't do justice to the story of the monthly crude oil chart, so let me show you the actual monthly chart of crude oil futures. As you look at the following chart, imagine drawing the long bars up and then drawing the long bars down. And look at the 240 or more bars to the left that all fall between $10 and $35 a barrel!

Now that I've shown you the "big picture" that I kept seeing at the end of every month as I updated each bar on my paper charts, you should be able to see that price may be at an area where it may start to congest or show signs of a change in behavior. But remember: Just because it may be in an area where it may shows signs of a behavioral change, it still may simply continue to head lower. The market is always right, and it goes where it wants to go!

Before I can fish, I have to see some encouraging signs from the market. Tomorrow, let's move on to the weekly crude oil futures and see if we see any signs that price is congesting, or better, if we see any signs of changes of behavior.

We now move on to oil. Crude oil futures made a low of 33.20 and then began to rally, spending four weeks higher and then coming back down to approach the prior low—but note that price failed to make a new low.

Remember, $35 per barrel had acted as resistance for hundreds of monthly bars before price made the huge but short-lived run to $148 a barrel. Now price was re-testing this area from above, and it may find that this $30 to $35 area is now support.



The higher weekly highs are a minor clue, but I would have been much more comfortable if price had broken above one of the prior swing highs from the plunge lower. But if you look at the plunge lower on the weekly chart, price would need to trade above $50 a barrel to trade above the first prior swing high—and that's a huge edge to give up when fishing!

I put in an order to buy crude oil futures at 3500, and my initial stop is at 3150, just under $2 per barrel below the low for the move. If price makes a new low for the move, I'd prefer to be stopped out and I'll go fishing again when I see more evidence that a bottom may be in.

I have no trouble getting filled on my limit buy order at 3500—in fact, I put the order in on Monday, February 17th and I was filled that same day. Price didn't move a great deal against me. The position was at a slight loss the first two days, but then rallied hard on the third day, closing at 3948. Crude oil futures closed the week on their highs, at 4003.

I have been in this long crude oil futures position for seven weeks now. Price closed this past Friday at 5247, and I am now working a stop profit order at 4410. There is very little structure for me to use in hiding my stops, so this stop profit order protects the profits reaped from the risk to which I exposed my capital, now that it is profitable.

In the scheme of things, this may still be a bearish market, and one marker of a bearish market is its inability to rally above the 38.2 percent retracement area. You can see I placed my first profit target just below the 38.2 percent retracement area, at 74.10. If price manages to climb that high, where will my second profit target be? I will be moving my stop profit orders higher as price climbs, and hopefully, I'll be able to find some quality market structure for effectively hiding my profit stop. For the moment, I prefer to let the position run and if the first profit target is hit, the picture will me much more clear depending on how price deals with the 38.2 percent retracement level.

Finally, let's look at a related position in one of my favorite currency pairs:
The Japanese yen against the Canadian dollar.

This is a 240-minute chart of the Japanese yen against the Canadian dollar. In many ways, this chart kept nudging me to fish for a long position in crude oil futures. You'll have to look closely (click chart to enlarge) because I wanted you to be able to see all the structure on the chart, so it is not a zoomed in look. This currency pair made three drives to the top, and it's easy to see that between the second and third drive to the top, price congested and then had a hard selloff. Price did manage to climb back high enough to make a marginal new high for the move, but once again, it came under selling pressure, and in fact, the bar immediately following the high that formed the third drive to the top was a wide range lower bar that broke below a prior swing low. At this point, I added in a red, down-sloping Median Line and its set of parallels.

Price congested at a lower level and then tried to make a new high but failed after testing the red, down-sloping upper Median Line parallel. When this bar closed, I entered an order to sell yen against Canadian dollars, just inside where price would intersect with the red, down-sloping upper Median Line parallel, at 1.4415, with an initial stop loss order 50 pips above the high for the move, at 1.4507. If I was filled on my limit order, my plan was to take half my position off at a test of the Median Line, while trailing stop profits if the market left me swing highs to hide my orders above. My ultimate profit target was a test of the multiple lows at 1.1520-which would be one heck of a catch!

I was filled on the next 240-minute bar and price quickly moved lower, making it below 1.3500 before leaving a major swing high for me to hide my stop profit order behind at 1.4030. It's easy to watch me ratchet down my stop profit orders as price made lower and lower swings. And in late February, price hit my limit buy order for one-half the position at 1.2635.

By now, crude had started to turn higher, so let's review the relationship between this currency pair. Canada produces three times as much energy as it consumes on a per capita basis. Japan is the fourth largest consumer of energy, and yet produces literally no energy. This currency pair is a wonderful proxy for the price of crude oil, though the timing of the turns does not always match exactly.

Once I was out of half of my position, the yen rallied hard against the Canadian dollar and I briefly attempted to sell out the half of the position I had taken profits on as the currency pair got closer and closer to the down-sloping red upper Median Line parallel-at the 1.3525 level. But the rally never approached the upper parallel, and once price began to break below swing lows, I cancelled the limit sell orders and went back to focusing on managing the portion of the position that I still had on.

With crude oil trading at or above the $50 a barrel area, the yen has again sold off against the Canadian dollar, and I have been able to lower my stop profit orders several times recently. My current stop profit order is at 1.3095 and my profit target on the remaining half of the position is at 1.1966, where price intersects with the down-sloping Median Line.

I hope you have enjoyed watching me fish for large, longer-term profits. Please do not be fooled into thinking that these trades always work! This is an unusual market and I have been extremely lucky this spring. I currently have seven positions on in the portfolio (I am fairly close to my maximum risk) and I have taken partial profits on three of these positions. And all seven are now being protected with stop profit orders, so barring a disastrous gap open against me in one or more of these markets, all seven will reap some profits. Because these trades carry such a high risk/reward ratio (I generally look for a minimum of five-to-one, and they often have a risk reward of 15 or more to one), I am quite happy if my win to loss ratio is better than about 50%.

But sometimes, the fishing is good and the White Sox play decent baseball!

I wish you all good trading and my heart goes out to all of you struggling in these difficult times.

Take care.

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