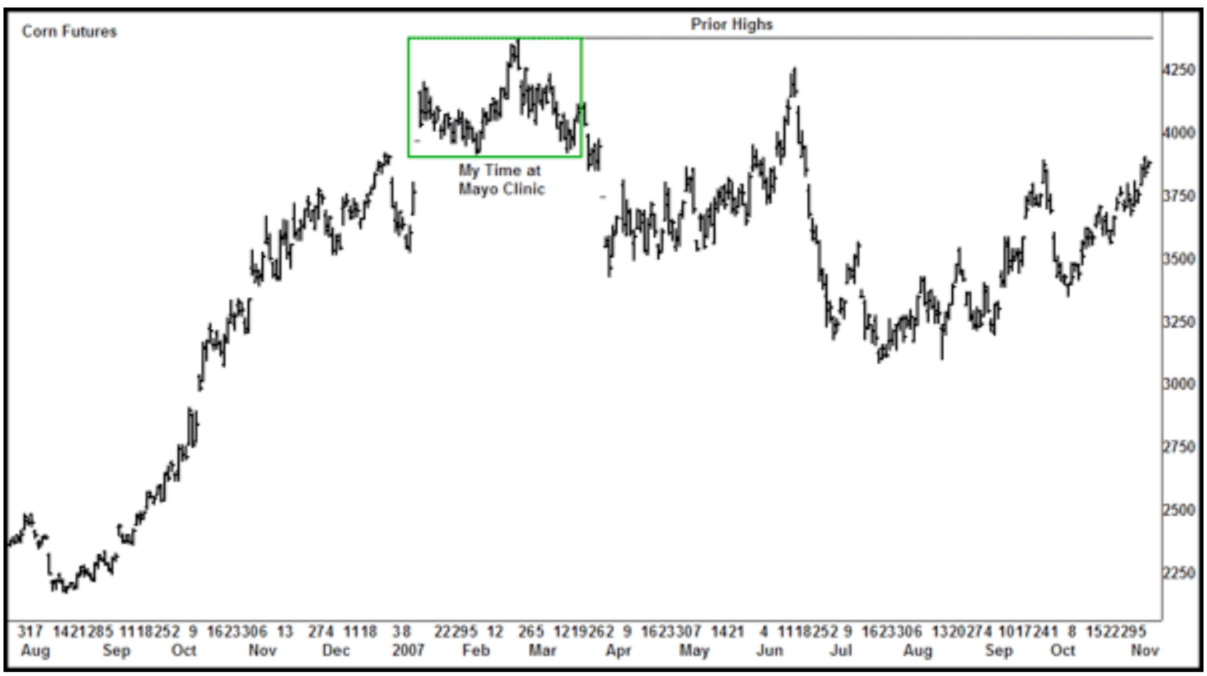
Tips for Traders | 11/12/2007

Trading: Planning with a Perspective Will Increase Your Profits!

How many times have you heard the saying, "trees don't grow to reach the sky!" It may not be as popular a saying as it once was, but it is just as appropriate now as it ever was. But in trading and investing, one of the most dangerous pitfalls involves greed. Gold got to $800 an ounce only to fall spectacularly in the early 1980's simply because everyone that was long gold believed the move would continue forever. On the other side, folks laughed at T. Boone Pickens when he continued to add to his oil properties when oil slipped from well over $30 a barrel to roughly $10 a barrel. In their minds, the days of expensive oil was over and he was an old man that couldn't deal with the 'new' reality of cheaper oil. And of course, oil went on a rally that has it approaching $100 a barrel as I write this article. I believe T. Boone was investing with perspective in mind: the price of oil was unlikely to go to zero and once the economies of the world began to grow again, oil at $10 a barrel would be a thing of the past.

Was T. Boone Pickens using trading and investing skills that you and I don't have? Not really. He was just using perspective when making his trading and investing decisions and the ability to add perspective to your own decision-making is there for you if you take the time to use it. Let me see if a current example makes this concept a bit clearer:



This is a daily chart of CBOT corn futures that ranges from August 2006 until the present. You can see the tremendous run up in corn prices that occurred in the fall of 2006. Everyone was talking about the potential of ethanol and how at least 1/3 of the world's corn production would go directly to producing ethanol as the price of oil stayed at or near record highs [at that time, oil was trading in a range from $50 to $70 a barrel]. New ethanol plants were being financed and built and farmers were dancing over the prices they were getting paid as they harvested their crops in late 2006. Did you know that on average, a farmer in the United States got paid $2.26 a bushel for his corn over the past fifteen years? Many farmers made more in the fall of 2006 than they had in the past three or four years combined.

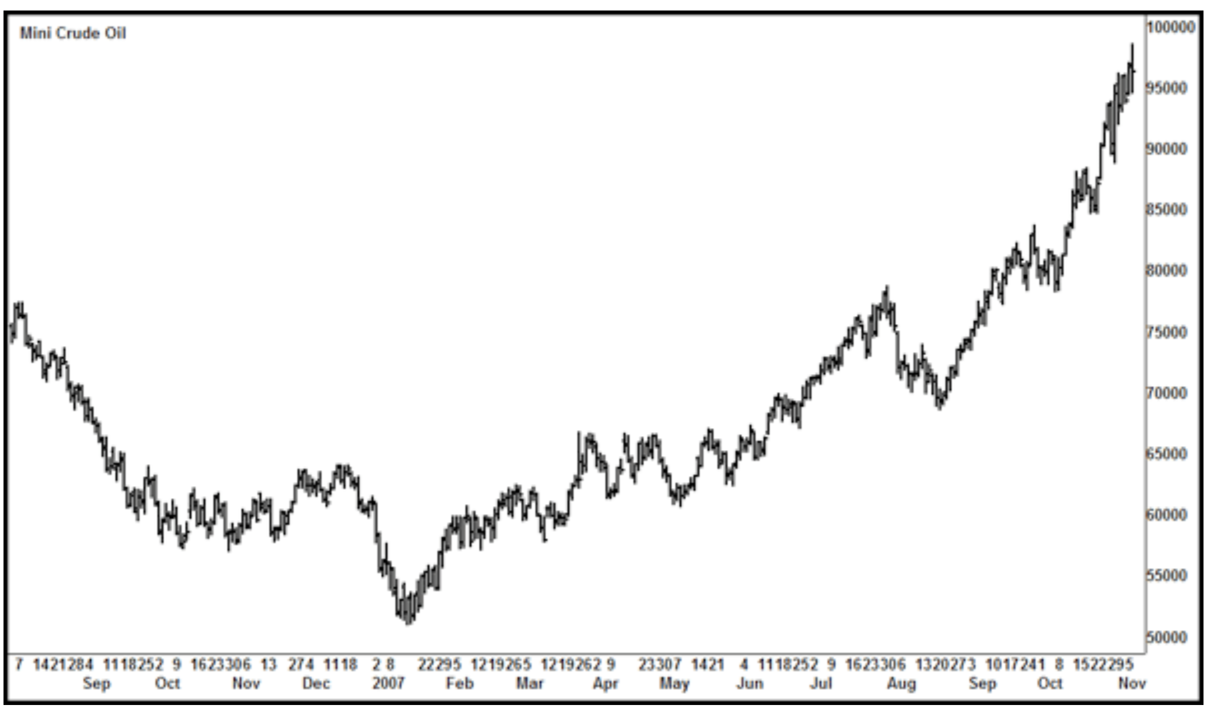
As 2006 ended, I had the misfortune of being diagnosed with a rare major fungal infection in my lungs and sinuses and was sent to Mayo Clinic in Minnesota for long-term treatment. I spent a great deal of time at that fine institution getting treatments from late 2006 until late June of 2007. And because I spent so much time there, I got to know the people of Rochester quite well, especially the nurses I saw day in and day out that administered the treatments I needed. Most of them lived on farms and after work, went home to help with the farm chores. And once they learned I was a commodity speculator, they all wanted to know what I thought about the price of corn and what I thought about investing in ethanol plants [two were being planned in the area at that time and the general partners were soliciting investors].

I remember one conversation quite vividly: a nurse asked me where I thought the price of corn was going in 2007, because she and her husband were planning how many acres of corn to plant and how many acres of soy beans to plant. I responded by asking if she could lock in delivery prices [that is, hedge her 2007 crop in advance] and if she could, what rate could she do it at currently. She told me the local grain elevator would pay them $4.12 a bushel for fall 2007 delivery as of that day. And because of that very high price, they were considering two things: planting an additional 700 acres of corn and also investing in a new ethanol plant that was being built.

I asked her if she remembered what they had gotten for their crop in 2005 and she told me about $2.30 a bushel, which was about what they normally got each year. I pointed out to her that at $4.12 a bushel, she was being offered almost twice as much as they normally got each year and she could take that rate risk free. My advice to her was to immediately lock in this rate. And as for the ethanol plant, I asked her if they had invested in the ten year old ethanol plant down the road. She told me that when it was built, they had the opportunity to buy in at $7 a share, but at the time they decided ethanol was a fad. Those shares were now worth roughly $110 per share. I told her the money to be made in investing in a corn to ethanol conversion plant came and went over the past ten years-in my opinion, the move had already occurred and they would be better served doing what they knew: farming. I told her I would bring her some charts when I came to the clinic the next day and we'd talk again.

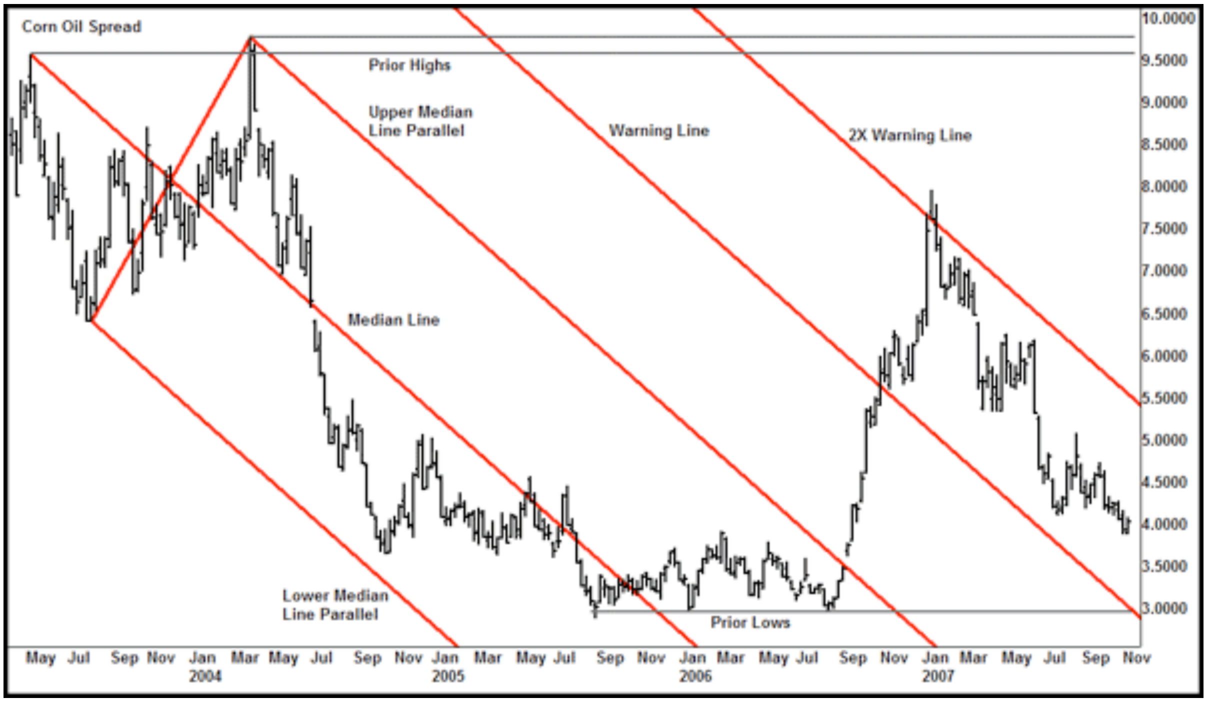
First I showed her the corn futures chart and pointed out the steep rise that corn had already made. I commented that corn prices had stalled and were trading in congestion and that in general, prices tended to trend lower in the spring once planting began, so I was not terribly excited about being long corn above $4.10 a bushel going into planting season. You can see I marked the period I was visiting Mayo with a green box, to give perspective of when this conversation took place.

Then I showed her a chart of mini crude oil:



Note that from late 2006 through June of 2007, oil prices traded in a $20 range, between $50 and $70 a barrel.

Then I showed her the following chart:



This chart plots the price of a bushel of corn relative to a barrel of oil. Corn has been grown and oil has been drilled for a very long time, so these charts are available and it is easy to study the relationship between corn and oil. And by looking at the price of corn divided by the price of oil, you take the currency exposure out of the relationship, because they are both priced in US dollars. There are three things to pay attention to on this chart: the prior highs in this spread just above 9.5, the set of lows in this spread at three and the resistance area at the two-times warning line price was hitting in early 2007, while I was visiting Mayo and literally showing this chart to the nurse. A warning line carries the same slope and therefore frequency that the median line carries and therefore, one of the warning lines often act as an area where prices run out of directional energy-so they are areas to be very cautious if you are carrying a position. As I read this chart and spoke with this nurse, it concerned me that the ratio was at eight, nearing long-term resistance of the prior tops at 9.5 and was also right at a warning line, where price might run out of up side directional energy. In my opinion, as a farmer, this was a great time to lock in their profits and focus on farming. And my opinion on the ethanol plant investment was that 'the horse was out of the barn', meaning the large gains had already been made. I think significant alternative fuel profits will be made but not from investing in ethanol plants.

She thanked me for my views and told me that she and her husband had made a significant investment in the plant the night before. And she told me she liked my charts but as farmers, they felt corn would probably go to $7 a bushel this summer [the summer of 2007], so locking in a delivery price of $4.12 a bushel didn't make sense to them. I smiled and she began my treatment and that was the end of my commodity advisory service at Mayo Clinic.

Looking at all three charts now that time has passed, you can see that the perspective of the past relationship between the price of corn and oil gave a good feel for where to be cautious on the up side and it also gave a good feel for where the price of corn relative to oil was probably bottoming out [when it congested at a ratio of three].

And what is it telling us now? The ratio is down just below four as I write this article in mid-November 2007. The ratio is not going to stay this low for too long, though it may go a bit lower to test the prior lows in the three area. But does that mean the price of corn is going to rocket higher? Or does it mean the price of oil, now at almost $100 a barrel, will sell off? I don't have the answers to all the questions, but I'd eye the beginnings of a move in either corn to the up side or oil to the down side with the perspective of this spread chart in the back of my head.

As much as people think the world has changed, things tend to remain the same. We tend to forget history and then tend to repeat it. Using perspective when planning and evaluating your trading and investing will greatly increase your profitability. Trees never grow to the sky and there are no free lunches.

I wish you all good trading!

Timothy Morge

www.medianline.com

www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
Web sites: www.marketgeometry.com or www.medianline.com