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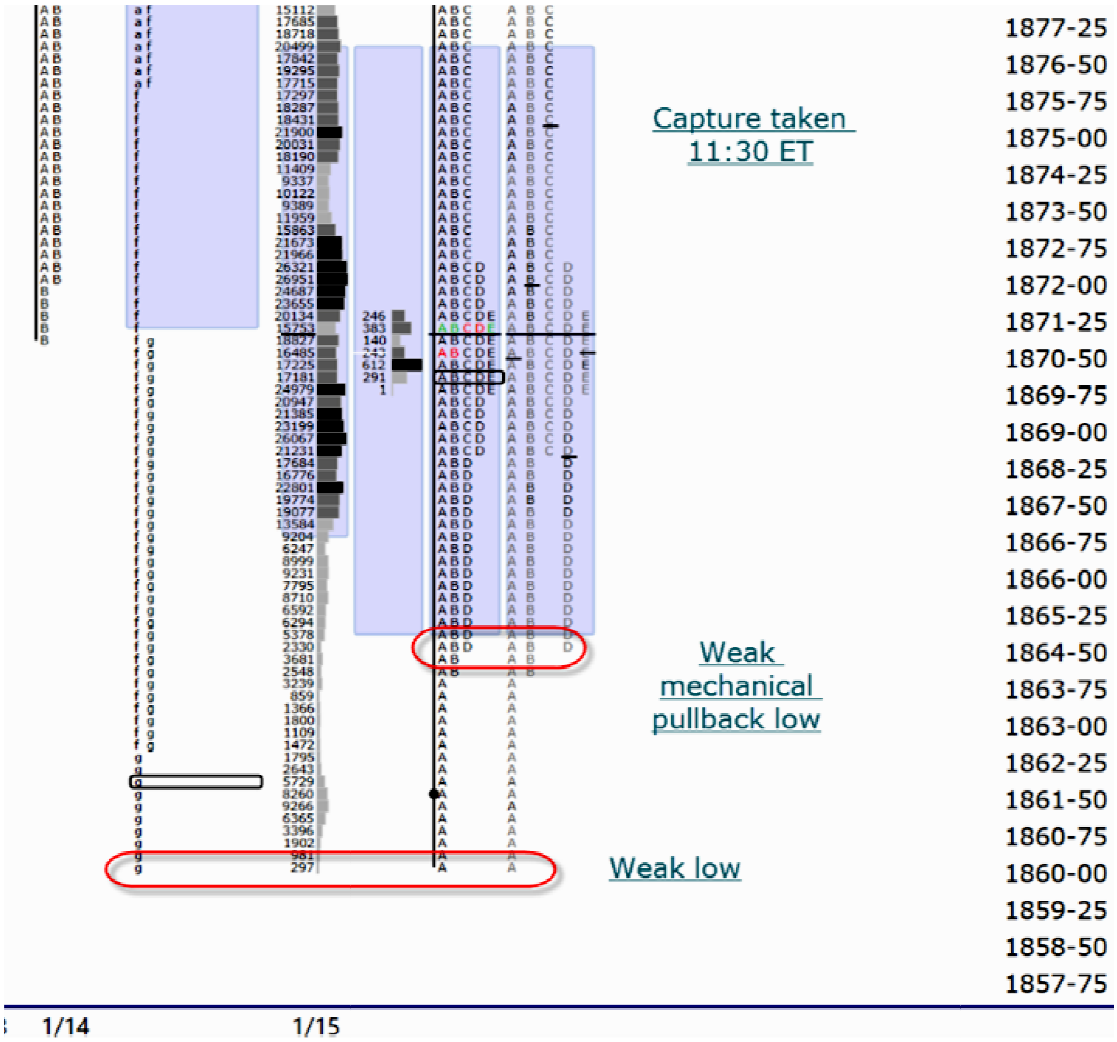
S&P 500 Daily Report for 1-19-2016

Friday's Recap



Ruling reason Ruling reason isn't always clear, however, on Friday morning I saw ruling reason as being the weak first 30 minute period low.

I first began to employ the term ruling reason when, as an additional assignment, while I was working for UBS, I was conducting hiring interviews at Yale, Harvard, and the University of Rochester. When I was very green at recruiting, I would meticulously make a list of all the positives and negatives that I identified in each candidate. A brief write-up was completed and presented to a review committee. As I became more experienced I quickly realized that there could easily be ten positive attributes and only one negative. I realized that the one negative became the ruling reason and overrode all of the ten positive attributes. When applying the term "ruling reason" to trading it is the one thing that overshadows everything else.

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Weak low Numerous times, over our short time together, I have employed the term "weak reference". A reference is considered weak when it mechanically matches or comes within a tick or so of a very visual, prior reference. Friday's early morning low, at exactly the overnight low, clearly met the definition of a "weak low".

Other circumstances Our saying is, '*everything is a series of facts surrounded by other circumstances*'. The other circumstances allow us to view the weak reference contextually. No real learning takes place until you have contextual understanding. Let me provide two examples.

1. The first example occurred on Friday. The intermediate-term auction was down with a clearly negative tone around the world. The overall tone in the US was negative as this was one of the weakest starts to a new year on record.
2. A couple of years ago Julia and I were conducting an Intensive when the market also gapped lower in the morning immediately rallying from the exact overnight low. The circumstances were quite different, the long-term auction was up, the intermediate-term auction was up, along with a strong short-term auction. At the time I commented that I didn't like the exact low. That gave me cognitive dissonance never allowing me to get in touch with the strong auction that day. It was because of that misstep that I began to reemphasize the importance of context.

Friday's opening rally The initial A period rally (you can see it in the above capture) could easily have taken your breath away. Without understanding context it would've been very easy to have been misled by this rally. The context, besides what was described earlier, saw overnight inventory extremely short. Once the short covering began it would go until inventory was brought back into balance. Price following momentum traders or systems would likely be now looking to buy all breaks. In fact, this is exactly what happened on the B period break. Short-term traders, with an appreciation for this mentality, could also have bought this break. Now let's separate out two separate traders.

1. The first trader is the one described above that believes momentum has shifted to the upside.
2. The second trader, who is a little more circumspect, appreciates the behavior of the first trader, however, this trader understands that the intermediate-term trend remains down, and that, under these circumstances, the weak low is unlikely to be lasting.

The mentally-trying period on Friday morning was C period. Four or five times during this 30 minute segment each pullback was bought. I had bought puts on the initial A period rally, as was described during Julia's intensive orientation on Friday. (I came on during halfway through the orientation to update traders). As I explained, I must admit

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that I initially began to doubt myself, however, I held on. As this process continued I became more and more comfortable as I realized there was no real upside follow-through or lift. I added to my put position. C period began to give ground. (Carry the above discussion forward as it will come into play later. What I recognized was that had the market been as weak as I had anticipated, C period would not have been as stubborn to go lower.)

Value area You should have been noting on your trade worksheet (if you have misplaced the worksheet it is an invaluable tool) that value had very little chance of even entering Thursday's value area unless there was meaningful upside continuation relative to the C period high. Remember, we trade value not price. Understanding value allows you to sift out a lot of superfluous price action.

Commercial It is often difficult for me to 'toot our own horn', however, one of the things that adds substance to our program is that Julia is forgoing her full-time, profitable trading in order to provide you with continuing logistical support. This frees me up to trade full-time, which allows us to give you a detailed report of how I saw the market. We are sharing some very complex thinking developed over the last 40 years.

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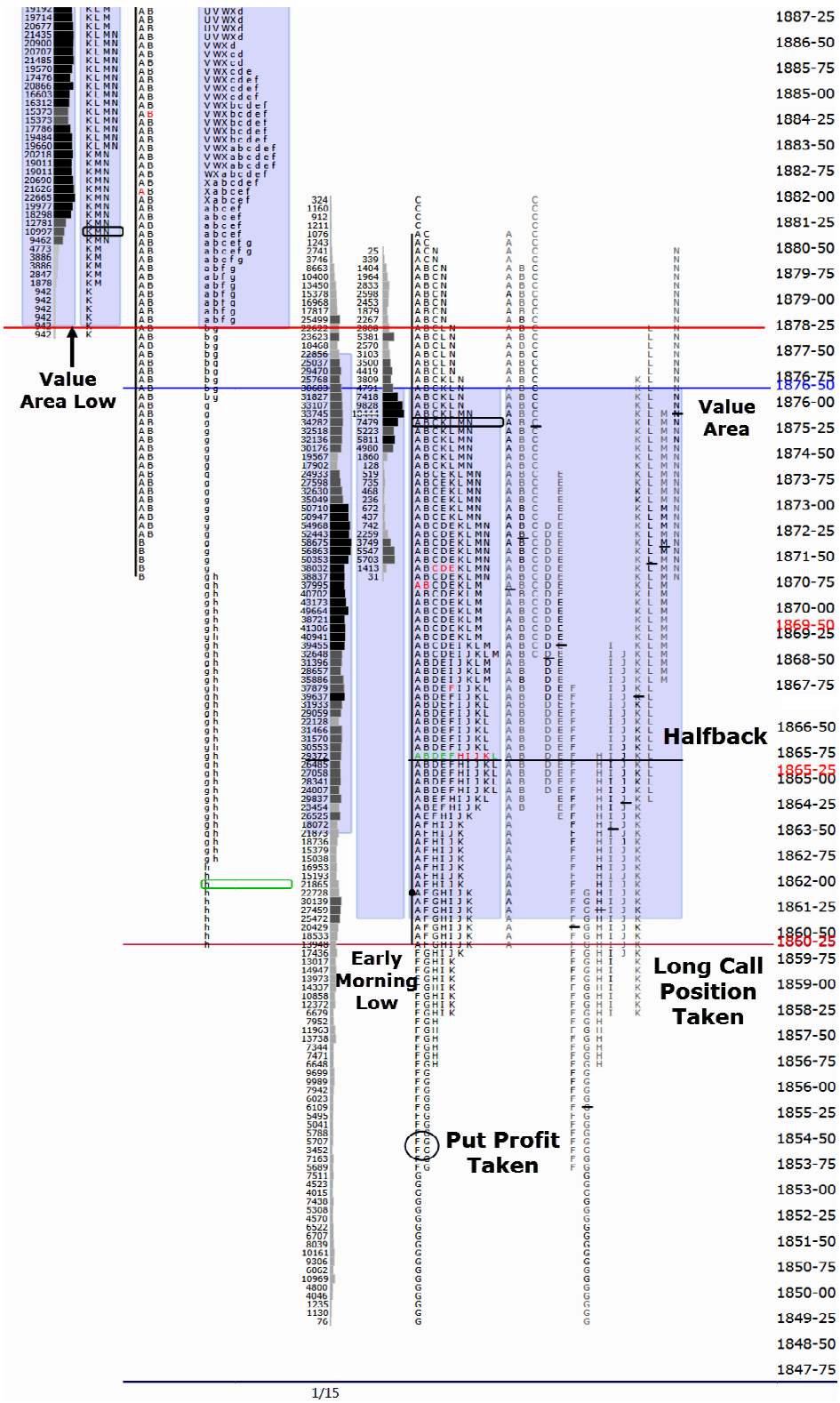

The above graphic allows you to see continuation to the downside as the early-morning, weak low was taken out but the market had a very difficult time taking out the early-

morning low. This was the second piece of important information, which lowered the odds of substantial downside continuation. The first was the stubbornness in C period.

When the market finally took out the early-morning low, hitting the stops both from overnight and early-morning, I use the downward spike to exit my put positions. On Wednesday in the webinar I talked about doing just the opposite which was buying puts as Tuesday's low was taken out. Let's examine the different thinking.

1. I exited Friday's position on the downward extension based upon the C period stubbornness along with the difficulty or stubbornness the market had taking out the early-morning low.
2. On Wednesday I bought puts for the downward extension as there was no stubbornness or hesitation as the low was taken out. There was no bounce or lift off of the prior pit low.

Many of you, who have been with us before, know that I am hesitant to talk about my own trades unless it is clear that I evidenced that trade at the time. We don't want the suspicion that we cherry picked a trade.

During the last portion of Julia's orientation session yesterday, when I was updating the market, I pointed out that I was buying 1865 calls as the market reentered the early morning range. The reasons for this trade:

1. The above described stubbornness as the market was trading lower.
2. Good rejection off of the low, or Profile excess. Remember excess and balance are the two most important concepts we trade from. And,
3. The reentry of the early-morning range.

As you can see from the afternoon settle at 1875.50 there was upside continuation, however, the upside continuation was not smooth. I'll use this opportunity to point out one last nuance.

On the above graphic you will see the label for halfback. Selling at halfback created another weak reference at this level. Once again it is a weak reference because price went exactly to the reference. Let's look at what happened relative to halfback.

1. Short-term and day timeframe mechanical traders aggressively sold at halfback.
2. Following that selloff, the market, once again, came back through the weak halfback reference and traded higher. There are several ways you can take advantage of this information:
    a. You could take profits on an existing long as this is the area that would likely exhibit a setback if one were to occur.

b. You could short with a very tight stop above halfback. If the trade is to work it should work very quickly. What I want to point out here is the trader personality that should and should not engage in this trade.

   i. The short-term and day trader that has great mental agility and realizes that this is a "quick pick" lottery trade is perfect for this opportunity.

   ii. The ponder-er, who, when he or she experiences the decline begins to envision a larger profit or, is slow to take a profit because they want to 'wait and see what happens' should not engage in this trade. With regard to this same trade not working, this same contemplative personality can leave him or herself vulnerable as the market goes above halfback and begins to escape. A 'wait and see' attitude can be very emotionally and potentially financially damaging in this scenario.

Tuesday's opening

Friday was a balancing day. We will update you on Tuesday morning following the long weekend.

A final few comments before the intensive starts on Tuesday

The markets we've seen for the past several weeks are quite different from what we have seen for the past few years. I have always suggested that you do away with looking at 1 minute, 5 minute, or any bar that is less than 30 minutes in duration. I believe that the shorter time periods get you too focused on insignificant information blinding you to what is really going on in the market. With the increased volatility, in my opinion, it is even more important that you jettison these habits.

A lot of good trade ideas are not profitable because traders place their stops too tight with the belief that they are taking less risk by having a tight stop. In truth, they are likely taking more risk. Think 'death by a thousand cuts'. Not only is one taking small losses, but this trader is also not participating in a position that could have been positive in their account.

Most traders who have unsatisfactory results over trade. **The best way to control overtrading is by concentrating on trade location.** Trade location is not necessarily relative to where your trade is placed within the daily range but rather how close is there a structural place for your stop. Good trade location comes through patience.

You can control risk, however, you have no control over reward. Once you place a trade, monitor for continuation. The observations you are recording will be elongation, taking out the prior 30-minute high or low, and how price acts around prior static (←pre-identified) references. Not all references are static. Some references are dynamic

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(←develop during the session) such as halfback, the opening high or low, prior 30-minute bar high and low, and poor and weak highs and lows.

You want to quickly assess if the market is opening within or outside of the previous day's range. The biggest opportunities occur when the market is outside of the previous day's range (out of balance). The smallest opportunities occur when the market opens within the previous day's range. When the market opens within range (in balance) I generally want to give the market time to set up before I make my first trade. There are of course exceptions, two most notable:

1. A high confidence directional move right off the opening. And,
2. An immediate trade to a reference, such as the overnight high or low, with no follow through.

Exactness kills. Missing an entry or exit by one or two ticks is no fun. Looking at exact references instead of appreciating price action around certain levels has the potential to detract from your market logic. Similarly, using exacting stops that do not respect current volatility can drain emotional and financial capital as well. Focus on trade location and asymmetric opportunities. These considerations do not require exactness; in fact, demanding exactness will only hinder trade decision-making.

Finally, we have spent the last week trying to precondition you to **quickly assess market confidence.** High confidence suggests a directional day, while low confidence suggests a rotational trading day. Markets can go from high confidence to low confidence or vice versa, however there will usually be a transition.

Good luck to all of you and we will see you Tuesday morning at 9 am ET.