Don't Believe The Hype

Avoiding The Herd Mentality In Forex

Careful analysis of the technicals along with a good dose of logic and common sense will help you become a more successful foreign exchange trader.

by Todd Gordon, CMT

There was some interesting price action in the last quarter of 2005 in USD/JPY, with foreign exchange traders anticipating a break of the important 115 level. They got it, but in a rather lackluster fashion. As it turned out, the real level to contend with was 116. Look at the candlestick lows, closes, and Fibonacci support levels from 2002 and 2003 that dictated price action in 2005. Armed with this knowledge, you might have prevented a costly short trade at 115.00 and been properly positioned for future price action.

2005 IN A NUTSHELL

October was a busy month in the forex markets. EUR/USD battled with 1.2000, while USD/JPY struggled with 115.00. Tradable volatility that allowed for outsized profits was not all that spectacular, but as it turned out, October's price action set the course for the rest of 2005. And what a finish to 2005 it turned out to be.

But first, let's go back to the end of August, when USD/JPY first broke through 110. This new high jump-started the largest USD/JPY runup in more than six years. Those momentous levels 110 through 114 came and went without much of a to-do, but as USD/JPY cleared the 114.50 level and approached 115, the hype began. Bank traders and market analysts could not talk about anything but 115.00. Their analysis showed that 115 was the breakeven point on hedges of Japanese exporters, who would certainly defend this level. Soon, the newspapers, magazines, and trader chatrooms got on board and before long, every trader in the crowd was ready to sell into 115.00.

THE HYPE HAD NO MEANING

Despite all the hype surrounding this massive resistance level, a close look at a USD/JPY chart in Figure 1 told another story.

In Figure 1, a weekly chart of USD/JPY shows the 38.2% Fibonacci retracement at 114.45. There appears to be a solid support level at 116.00, which repeatedly held in 2001, 2002, and most of 2003. In late 2003, the highlighted support level of 116.00 finally gave way in a blaze of glory, leading to a 15-cent implosion, ending in early 2005. The Fibonacci projection level of 0.618 from January 2005 lows up to July highs compared to the September lows put the target at 116.26. On a side note, the 1.0 Fibonacci projection level in the same series caught the high of the entire move. So 114.50, 116.00, and 116.25 appeared to be technically significant on the weekly chart, but what about 115.00?

During the second week of October 2005, the move to 115 seemed to be inevitable. Armed with the knowledge that 115 was not significant on the long-term charts, the next step was to look at an intraday chart to see if the 115.00 level made sense.

SOMETIMES THE CROWD IS RIGHT

On the 240-minute chart in Figure 2, there is a minor five-wave pattern beginning on September 4 that, after the completion of wave IV, projected the end of wave

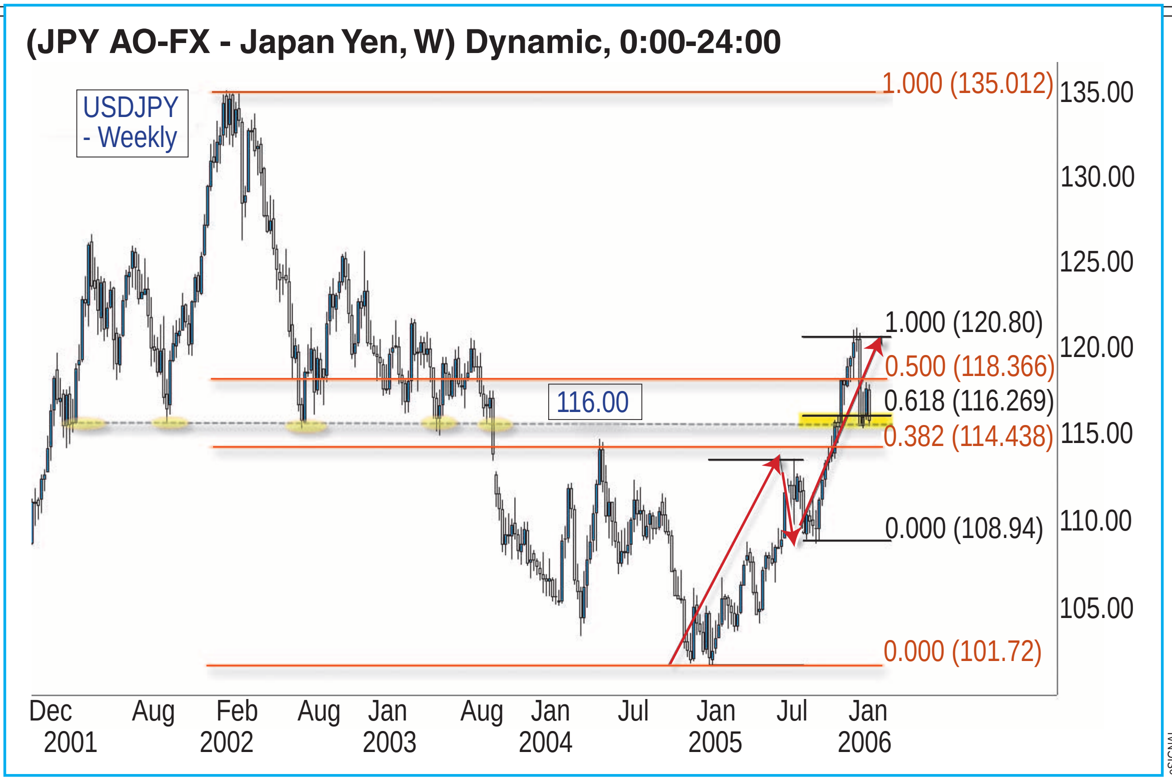

FIGURE 1: SUPPORT LEVELS. If you go back to 2001 you will see that 116.00 acts as a solid support level. But what about the 115 level that seemed to be an area of importance during October? You'll need to turn to an intraday chart.

V to be up at 115.07. This nice Fibonacci symmetry of waves I and IV, combined with the selling interest of the crowd at the 115 resistance level, was strong enough to reverse the USD/JPY uptrend back down to 114.00. This time, the masses were correct.

The bottom of the retracement (from the failure at 115) is at 113.75. From here, price reverses to head back up to 115.00 for another shot. Traders who were sure to see 115 fail the first time around considered another look at 115 to be their golden ticket. Sure enough, they sold into the 114 handle and considered themselves lucky as the price marched higher. And then the unthinkable happened — USD/JPY sailed clear through 115, landing at exactly 116.00, only to fail miserably. If you refer back to the analysis about the 116.00 level, you can take some amount of comfort in the fact that you had done your work and

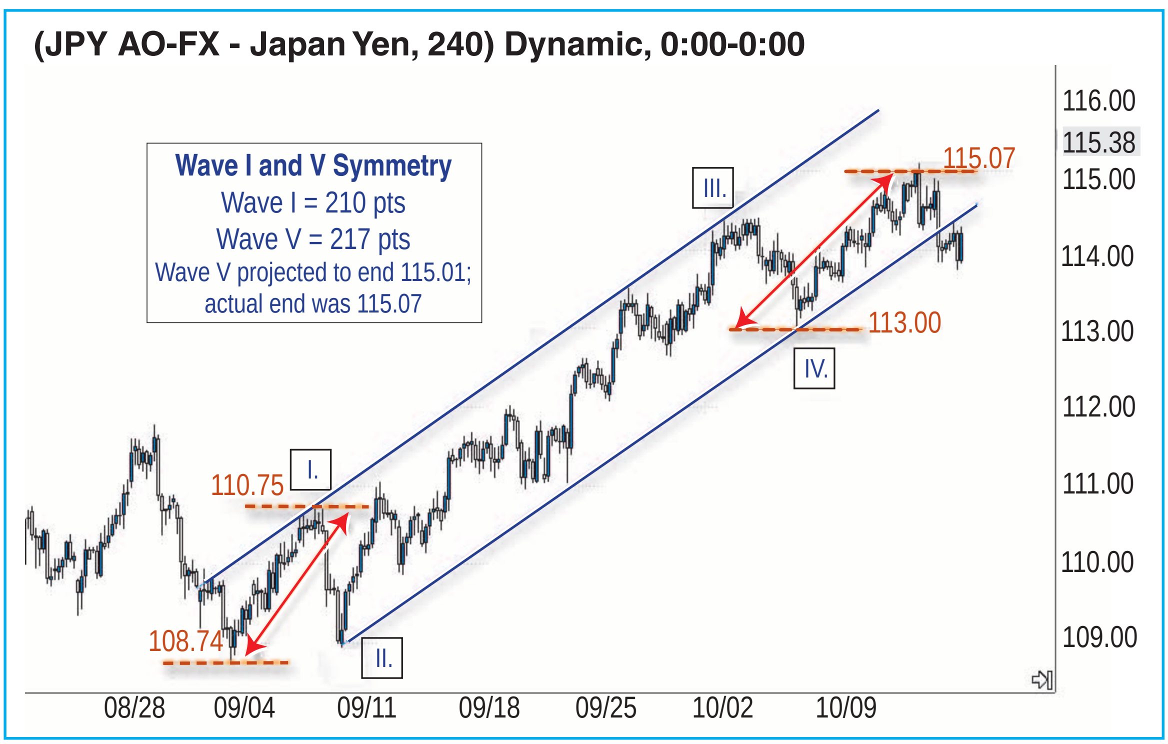

FIGURE 2: THE IMPORTANCE OF WAVES. Here you see that wave V ended at 115.07. The strong selling interest at this level reversed the uptrend and brought it to 114.00. Will it go lower or reverse?

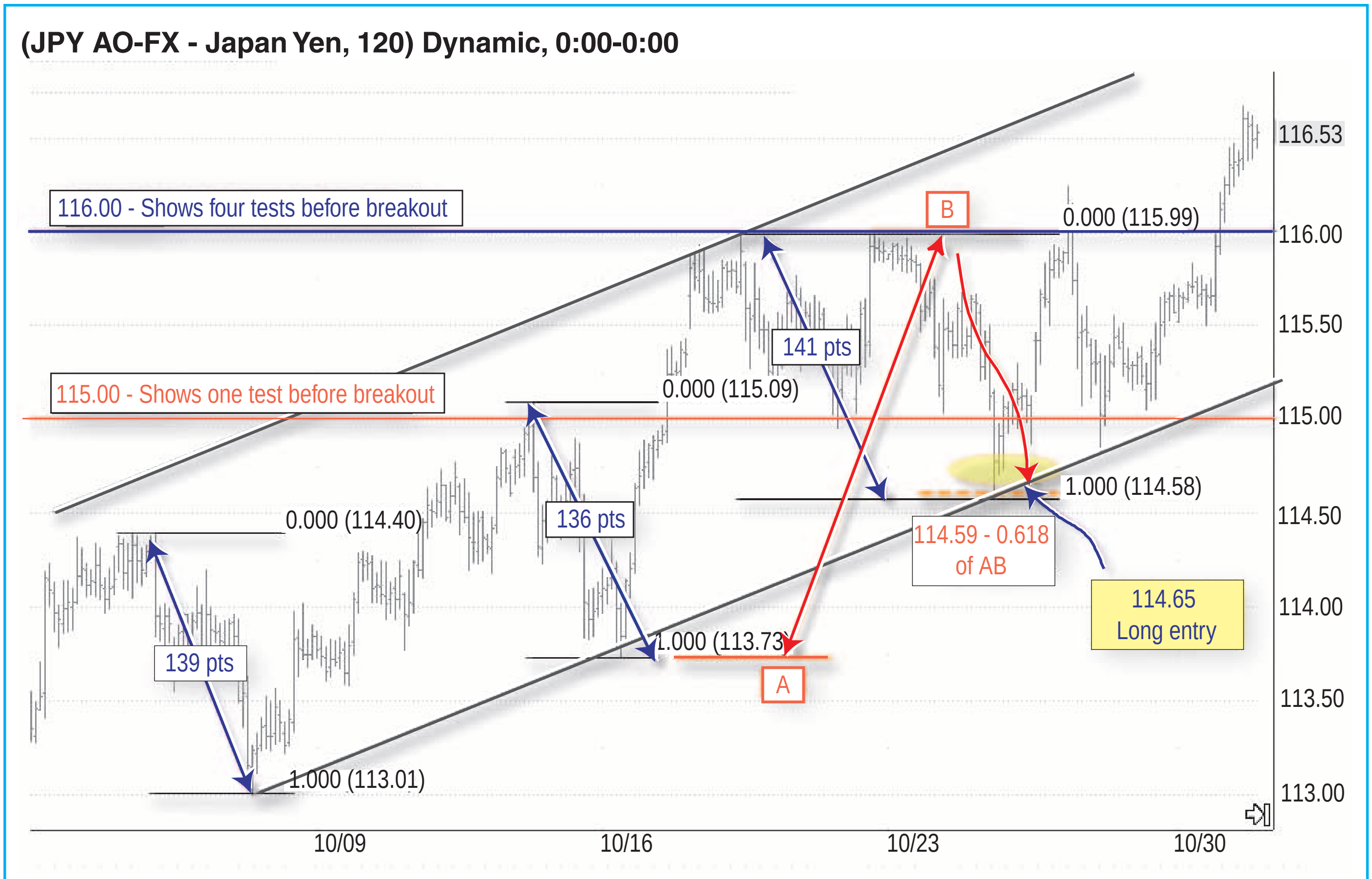

FIGURE 3: BATTLE BETWEEN BULLS AND BEARS. You can clearly see the price movements between the 115.00 and 116.00 levels. There were five attempts for the USD/JPY to push above 116.00. It finally did so, only to soar higher for the rest of the year.

were prepared for the ensuing battle at 116.00.

Take a look at the price action between 115.00 and 116.00 in Figure 3. There is a single test of 115.00 before a retracement to 114.00, followed by the reversal higher through 115.00 up to 116.00. Once prices reach 115.00, the battle ensues at 116.00. There are five attempts to achieve 116.00 on the topside, and just as many tests of former resistance turned support at 115.00. Thus, 115.00 served as minor resistance on the way up, but that turned out to be significant support. So many traders positioned themselves short ahead of 115.00 that any move back down toward this level was met with traders buying back their shorts closer to breakeven, creating the significant support level.

As if to toy with the 115-level believers one last time, USD/JPY dropped below 115 to lure the shorts who just witnessed the failed battle at 116.00 for another go-round. Then, in the last trading week of October, a tremendous long setup formed as price broke down through 115.00. Taking a second shot combined with stops just under 115.00 from existing longs, the shorts pushed price down to a beautiful technical support level at 114.60 (see Figure 3).

The two prior pullbacks contained within the trend channel equaled approximately 138 pips. If history were to repeat, the target for the third retracement is 114.62 (137 pips in length). Also found at 114.60 was the parallel trend channel support along with 0.618 Fibonacci retracement of the move from A to B. It was too sweet to pass up.

For the calm, yet decisive trader who did not get caught up in the noise, bids were waiting patiently at 114.65 for the emotional masses to push the market into the support level. Ultimately, USD/JPY did trade up to 116 for one more failure and retest of 115 before launching up and through 116, never to be seen again in 2005.

OBSERVE, THEN ACT

Without a doubt, technical analysis is important and useful when trading currencies. However, successful forex traders also carefully observe and take advantage of the herd mentality, a trap that too many traders invariably fall into. Indeed, as in the examples given in this article, the technicals were faded while more attention was paid to the expected reaction. Forex traders who employ a shrewd combination of technical analysis, tape reading, and simple logic will certainly reap the rewards.

Todd Gordon is a currency strategist and trader at GAIN Capital Group. A Level 2 Chartered Market Technician (CMT), he uses his expertise in technical analysis to produce GAIN's "Strategy of the Day" research report, which identifies price trends and trading opportunities for the major currencies and crosses. Prior to joining GAIN in 2004, Gordon was a director with Connors Capital, a hedge fund in Los Angeles. He began his professional career trading equities for Aspen Trading. To contact him, visit www.forex.com.

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