2 TRADERS

EP15: Contrarian Trading

Walter: The big payouts that the trend followers take home are due to the fact that they're still riding a trend that the majority of the market believe has fizzled out or has run its course.

Announcer: Two traders, Darren and Walter, pull back the curtain on profitable trading systems, consistent money management and profitable psychological triggers. Welcome to the Two Traders podcast.

Walter: Welcome to the Two Traders podcast, I'm Walter Peters, 2traderspodcast.com. On the line, I've got Darren. Hey Darren, how are you doing today?

Darren: Hi Walter, I'm very good, thanks.

Walter: Darren, we've been talking about this idea lately of contrarianism and how that fits into your trading. One thing that I believe, and you may or may not agree, but one thing that I believe about trading is that in essence, traders are going to get paid for being the contrarians. The amount that you get paid is inversely related to how contrarian you are behaving in terms of the market. What I mean by that is you have a much greater chance of hitting a large winner if you are part of a very, very tiny minority in terms of the over-all market.

For example, if 99.8% of the market is bullish and you're bearish and you enter a trade based on that then your payout is going to be much greater than if you are part of the 49% bearish and whereas the majority is the 51% bullish. I'm really interested to get your thoughts on this because I think you're going to have some interesting takes as usual. I also think that later on, I'd like to get into specifics that you can use to adopt a contrarian way of trading and how that can fit into your trading routine and in your strategies.

First of all, let me just start off by asking, Darren, what is it about contrarian trading? Is it something that you think about or that you incorporate into your trading? If so, why would you do that? Why would you go against the norm? Why would you go against what most people are doing?

Darren: Essentially, when we're being contrarian, we're going against the opinion of the masses. The idea is that if everyone is already bull and there's nobody else to buy then the opportunity to sell is really good. That's a great opportunity to make money because there's nobody else to buy so price can't go any higher so it's going to fall. But the problem is as people mix up being contrarian, they mix up expectations and fundamentals when they're trying to be contrarian. If the trend is long, and it's clearly long, and the fundamentals haven't changed, then trying to short the long trend, you are being contrarian but you're being contrarian to the fundamentals there rather than the expectations.

What you want to do really is find the, so say the trend is long and then it starts retracing, at this point everyone's thinking the trend is over so the expectation is that the trend is over and that's where you need to be contrarian. You've got to distinguish between fundamentals and expectations.

Walter: Explain that a little bit more, why is it important for me to... when you say expectations, is it my expectations? Your term, the expectations of the market, yes?

Darren: Yes. Because, if you try and go against the masses all the time, what the fundamentals would say the opinion is then, then you're going to get run over by a freight train all the time. To make money as traders, we need to buy at a price point where we believe people are going to be prepared to pay more in the future. That's how we make money as traders. If the trend is long and we try and short the trend at the high, we're going to be wrong a lot all the time because the fundamentals have not changed. There's no reason for the trend to end.

In those occasions, basically, we need to find the point where everyone believes the trend is finished and they're all starting to sell. At that point, nobody else is interested in selling because the long term traders are still holding on to the trend, that's where opportunity lies because we're still in line with the trend and the fundamentals but people are wrong with their expectations.

Walter: One thing that I've noticed Darren, and I know a lot of traders who follow the way that I trade know this but many of them out there probably don't know this, there's one thing that I've noticed when I'm looking for an exceptional opportunity in the markets is, I just pay attention to what the retail traders are doing. For example, all of the retail traders or 85% or more of the retail traders, you can look this up online and there's links underneath the show notes, underneath this podcast at twotraderspodcast.com, I'll know that when say 88% of the traders are going long gold and if I look at the gold chart and gold is clearly ready for a downside breakout, then it's time to short gold.

I guess what I'm saying is, it seems to me that this is not a perfect strategy because sometimes you mistime the entry, but I do believe that oftentimes, if you show a trader a chart, in fact I've done this and I've seen thousands of traders react to a chart where the chart's going up, up, up and up, and you ask them, what would you like to do, what kind of trade would you like to take on this chart? Almost all of the traders say that they would like to sell. They see a really strong bullish chart. Not all of them, but the vast majority of them would like to sell a bullish chart. The same thing with the bearish chart, if you show them, like I said, I've tested this, most traders are going to see a bearish chart and there's a clear downtrend and they're saying that they want to buy.

I don't know what it is about our psychology that means that we're essentially looking for these turning points in the market but I do know that when enough of us have all agreed that it's gone too far it is time to turn around, that's usually the spot where it goes even further, which is crazy in a way. I guess, to me, in a funny way, you are being the contrarian when you jump on a strong trend and everyone thinks that trend has gone too far. Does that make sense?

Darren: I think so, yeah. I think you really need to take into account whether that is, exceeding expectations or not. Let's use GU as an example right now. GU has been in a really strong downtrend for about, for most of the year. Then just recently, we've had a bit of a reverse and it started trending up. If everyone wants to short that now because they think it's going to go down back in line with the long term trend, you have to ask yourself, is it exceeding expectations that it's going to go up some more? No, it's not. All of the news and the fundamentals that have come out have agreed that the pound is getting stronger and it looks like the interest rates are going to go up, so that fundamental agrees with it as well. If we look at the charts, all of the charts are going up strongly as well.

You have to be sure whether it's exceeding the expectations of the move. It's a difficult thing to do. Just because price is going down, if you're going to go long then you're basically not using all of the information and you've got to take into account the fundamentals and ask yourself, is this exceeding expectations? Has it dropped a massive amount? Take the Swiss franc for instance, when that absolutely, I don't know what it did, 3000 pips in an hour or something, that's exceeding expectations there. The fundamentals didn't really back that up. It wasn't a great surprise when that didn't continue. If it continued dropping for another four weeks like that, then that's a different scenario.

I think you got to be really careful and this idea of just, "well, it's going up so I'm going to sell or it's going down so I'm going to buy", I think you have to think about the expectations and the fundamentals as well.

Walter: As I'm pretty much, I'm a clearly technical trader, just because I've had such a difficult time trying to adopt the correct interpretation of fundamental news, for me, the easiest way... I'm not saying that you can't interpret fundamentals and use them in your trading, I understand that you do and that's great. I guess, my concern is, how do you know that your read of the fundamentals is the correct one? Does that not even matter? Do you have to actually just go with the crowd and say, like for example, most people in terms of the pound as you say at the moment and this is going to change in the future, but at the moment there's expectations that the interest rate is going to raise. The pound is going to be worth more in essence than it is now because the interest rates going to be ratching it up. Likewise in the US they're saying, looks like they're probably going to raise interest rate over there as well, and in Australia perhaps, they might cut them. We have these expectations.

I guess, my question is, how do you know, for example, that's not already priced into the market. There was a recent rate cut in Australia and instead of the Aussie dollar falling, it actually rocketed up. To me, that doesn't really make sense. I suppose people would say that was already priced into the market and it wasn't really that the interest wasn't as important, the cut wasn't as important as what the Glenn Stevens, who's basically the head of the reserve bank of Australia, his comments suggested that that might be the end of the cuts and maybe they won't do anymore and maybe next year they'll start raising again or something like that. It was really more about what he didn't say than about what they did in terms of the cut.

I guess, for me Darren, the fundamentals have always been this mine field. It's almost like a "who done it". If she said this and he said that then who had opportunity to do the murder. It's this really tricky mind trap that, for me, I'm not clever enough to work my way out of so I just work off the charts. Is there a shortcut? Is there a way to know what the crowd is thinking? Is it just as simple as looking and seeing what all the economists think or something like that, the consensus?

Darren: I don't think it's the case of being clever, Walter. I think the problem again is the people, they try and predict so then they have an expectation of what the news is going to do. Talking about the expectation that the rate is going to go up in the UK. Really, what you need to ask yourself is if the technicals of the market, if the technicals of the chart say the market's going up and the fundamentals haven't changed, then there's no reason for it to turn around.

Really, you don't really need to know whether x number of jobs increase is going to make the market go up or down. What you need to know is have the fundamentals changed? Have the technicals changed? If they haven't, then there's no reason why that market should turn around. You need one of those to change, just simply change, before you start being a contrarian. It's more a case of change rather than expectation.

Walter: Got it. Okay, right. It's like fundamental calculus. You're basically looking and I've seen some really clever fundamental traders do this where they keep tabs on, for example, let's say that you're a fundamental trader and you follow the non-farm payrolls report in the US, they'll actually keep the spreadsheet of the trend. They'll actually almost like a moving average of the non-farm payroll. They keep tabs on is it trending up or is it down or is it flat, is it sideways, that thing. I think it's related to your idea which is that you don't really need to interpret it. You just need to know when there's a shift.

For example, let's say that in January or let's say, in February next year, which is essentially nine months from now or whatever, the reserve bank of Australia raises the cash rate. That's a change. That's what I'm looking for. I'm just looking for a difference in what's been happening. Is the status quo... the status quo keep going, chugging along, and then boom you get something new. That's really the catalyst for the fundamentals side.

What you're saying is you need both pieces. You need both the change in the fundamental and then you need the change on the chart, is that right?

Darren: Not necessarily both of them have to happen. If there is no change, you've got to question why you suddenly think that the market's going to turn around. You have to back it up with some data. Just because you've got a feeling, if you're going to act out that feeling and you don't then put it in some context and ask yourself, why is it going down? When you ask that why question, then I think a lot of the time you're going to be wrong.

It's just something simple like, if it closed up yesterday, if you're not going go long today, then you need to have some recent fallout, either be technical or fundamental. That can be, it closed up today but right above is a strong weekly S&R or something like that. I'm saying use some data rather than just trying to go against the trend.

Walter: This is something that I look at in terms of the price structure on a chart. I think this fits. Let me know what you think about this. When I'm looking at the chart and it's trending, what I should see on the chart is a bunch of really strong candles in one direction. That's the burst of the trend. Then there's a retracement which means that the candles usually get smaller, they'll have more wick and less body and then they'll often alternate in color. They'll be a bullish and bearish, and a bullish and a bearish and so forth and they don't really go anywhere. Whereas the trending candles, they close at the high or the low depending on if it's an uptrend or a downtrend. They're bigger and they over more ground and all that.

Here's my question for you, Darren. According to your strategy, what should happen is when the market's in a trend and then it goes into one of those consolidation/retracement phases, that's when all the suckers are getting in because they think the market's turning around. This is the swing point. This is the turning point. This is the end of the trend. I need to get in here. But what you're saying is, in those retracement spots on the chart, you wouldn't really have any fundamental reason why things have changed for this particular market. What that means is, this is just the natural ebb and flow of the market. All the suckers are getting in thinking this is the turning point. Does that make sense?

Darren: It does. The fact that you can distinguish the price action when it's moving with the trend and against the trend, you should be taking from that some data that, okay, people are trying to reverse this trend here, we're trying to go short in this long trend. Are the buyers giving up? No they're not because every time it goes short, it retraces all, almost all the way to the higher depth. It's doing that deep retraces indicative of a kind of trend movement you get really deep retraces in the kind of trend and it's really easy to spot.

Again, the expectation is that it's going short but the fundamentals and the technicals are telling you that although people are piling in short at the moment, the long term buyers are still hanging around and they're waiting for that chance to sort out to that position. It's just at that point where everyone's convinced that the uptrend is over. It's retraced too far. That's the excellent point price where you can add to your long and then build your trend results.

Walter: That's exactly right. Looking at the crowd, I guess, what you would expect thinking in terms of this framework that we built here, the same thing would be like if you're looking at percentages like I do, I look at percentages of traders, of retail traders, not the pros, that's an important distinction. If we're looking at retail forex traders and we see that during that little mini retrace against the trend, let's say we're in an uptrend, and then during that consolidation/retrace where the market goes against the trend, at that point we would have no fundamental change, really. All the policies and reports and everything is the same. We haven't seen any real big change there.

The other thing is, in theory, these would be the spots where I would see a large chunk of the crowd deciding to short. Maybe, my rule is 85% or higher, we would see 85% or higher retail traders looking to short at that stage. Contrast that to the actual turning point, in the actual turning point where the market is going to fizzle out and this uptrend is turning around and coming back down, at that point we would expect to see some fundamental change in the market and we would probably also see the crowd is no longer shorting. They've given up. We wouldn't see the majority of retail forex traders looking to short at that point. Instead, it might be more of a mix or even it could be in the other direction where most of them want to go long there.

Does that fit? Are we sort of building something here?

Darren: Yeah. I think what happens is we have this herdin mentality don't we? Basically, the ones last till the show are basically the least experienced traders. They basically, they see price drop in and on this amount, on this move, it's turned around. I'm going to miss it. Then at the last minute, they all pile in and you get a spike down and then it reverses strongly. I presume that's basically people like you waiting to see till all of the retail trader are in short and that's the moment to go long. But, I bet you when you're doing that, you're also relying in the up with your support and resistance level. Your technical, fundamental reason for buying as well. You get that kind of spike down to your S&R and then price reverses and goes in your direction.

You see it all the time. When we have a nice trend, you see a nice trending move throughout that say trade in and today you get a nice trending movement throughout the day and then you get that slow retrace movement back down. Then, in the morning London open, it spikes down and then it continues long. You get that kind of spike down to the S&R and see it all the time.

Walter: Yeah. I have students that trade that. The exact move which is... yeah, you've got that right. Then there are other people that like to trade the drifting bounces off the Asian session that can put you to sleep.

Darren: Yeah, that's good. You know it's going to retrace deeply so you wait until it retraces all the way to the top and you got a really nice tight entry there and put your table at the top and you trade that move all the way down. It's quite a predictable move.

Walter: Yeah, absolutely. You're talking about that retrace during when?

Darren: Usually during the Asian session basically overnight.

Walter: You're not talking about the morning retrace in London. You're talking about the Asian.

Darren: Yeah. I think for the Aussie and the Yen sometimes they're slightly different. I tend to trade this all European currencies and the US. Really, it's about being contrarian but you have to keep in mind data and fundamentals and market structure as well. Just looking for a strong downtrend to reverse in it is kind of missing the point. We still need to find somebody who's going to pay a higher price for something then you're paying for it. You got to ask yourself, what do I know other people are not going to be aware of? If you can't come up with anything, then you're essentially gambling. I think you're going to lose a lot of money that way.

Walter: Yeah, exactly. It's the old idea. If you're sitting there playing poker and you can't figure out who the sucker is, then the sucker is you. That's it. I used to have this idea in my head that I couldn't really make sense of the fact that I knew that you wanted to be contrarian in your trading to make money, but I couldn't really figure out how the trend followers are making money. Because to me, it seemed like they were following the herd. But actually, I've come to the conclusion that they're not. That the trend followers are, sure they lose a lot because they always think that any blip in the market is the beginning of a new strong trend.

However, I also believe that the big payouts that the trend followers take home are due to the fact that they're still riding a trend that the majority of the market believe has fizzled out or has run its course. Does that make sense?

Darren: Yeah. I think so, definitely. The key is getting those good prices. It's always about getting those good prices. If it is trending, I suppose you could just take a breakout of the high all of the time. But you're essentially increasing your risk there and reducing your reward. The secret is, like you say, wait till everyone else believes the market's turned and they've gone short and then add to your position and keep trading like that. You're being contrarian, you'll be right more than you're wrong because trends tend to go on much longer than we think they're going to go on.

Walter: Yeah. The other thing I've noticed about the trends as a price action trader, you will see these reversal signals in a trend and they'll just get blasted. You'll see, like for example, in a strong trend you may see 3 or 4 really typically solid reversal patterns on the charts. Those will fail. I'm not saying that they're good enough to take us trades because they often have some tell-tale signs of why they are trapped. But, I think that a lot of traders, especially traders who are just getting their feet wet in terms of price action trading, they get suckered into those. It's a good sign. Like if you're looking at a chart and you want to know is it trending, one way to know is to look back and see those reversal signals that have just been literally steamrolled. Then you know that you're looking at a chart that's definitely going to trend on there.

The other way of course, my favorite way to do it is just to ask a little kid if they turn it into a line chart and just ask a little kid if the chart's going mostly up or mostly down or if they don't know. I think that'll also work well.

Darren, let's say I'm a new trader. I've been trading forex for the last 6 months. I really want to be able to incorporate this contrarian idea into my trading because it makes sense. It makes sense that most people would be wrong. If I've got this summary here, I'd say something like, I know that if I'm going to get into the market where I think it's a reversal point, I need to really see something on the chart that tells me that. I also need to see that there's a change in the fundamentals. There's something going on there where things have shifted. That would make sense for why the market is going to turn here. I've got to have these without pieces.

I would add to that that you probably would want to look at the crowd and you'd probably want to see the percentages in terms of what is the crowd, most retail traders what are they looking to do here? They're looking to buy or sell because that can also put you on the right side of the equation. Is there anything else that we would suggest in terms of contrarian trading, what you should implement as a trader to get better at using this in your trading?

Darren: The important thing is to just because you're going to be contrarian, don't discard all other data. Look at the other data and perhaps have a checklist of when you're going to take a reversal entry, reverse current direction of the mood. Have some checklist where you check what is the long term trend. How are the smart money positioned, not the retail traders. Have some checklist where you can, like you say, work that out simply. If the trend is the same and the fundamentals haven't changed and they're both long and price is moving short and all the retailers are short, then, that's a pretty good checklist for finding entry... then be contrarian.

Walter: Excellent. That's great advice. Yeah, that's great advice. Remember, as a trader, I think it's probably likely that you're already somewhat contrarian. I think that trading is one of those things that a lot of people, they think about and they think, "Oh, that'd be cool to be a trader", but they don't really go for it. If you're listening to this podcast, you're probably someone who is a little bit different from the crowd anyway. It's probably going to be a little bit more natural to you than it would be for many others.

A lot of other people are going to say that what you're doing is gambling. But of course, the banks don't bet on horses or play the pokey machines. They do dabble in the markets though. I think this is something that a lot of traders out there can use, Darren. I really appreciate your time. I'm looking forward to our next session.

Darren: Yeah cheers. Nice talking to you.