NEWSLETTERS & RECOMMENDATIONS - May 10, 2010

Dear Friends and Fellow Traders,

Over a year ago I was hearing and reading about high frequency trading (HFT), flash orders, predatory algorithms and other such terms but it's only in the last few months that I begun to fully understand what weapons of mass destruction (WMD) these trading programs truly were. Sure regulatory government agencies knew about these programs but the SEC was sold a bill of goods that these programs "provided liquidity" to the markets and were absolutely necessary. So the SEC drank the "Kool Aide" supplied by Wall Street and the hedge funds. Can these guys (SEC) really beat GS in a trial? I don't think it will come down to that. GS is under tremendous pressure to settle. Too bad!

Let's try to understand what really happened this past week especially Thursday. First let me tell you there was no trading error according to the CME exchange!! There was no "fat finger" as "They" would like you to believe. Our market can handle Billion $ buy and sell programs. I've been talking for months now in the Chat Room about this low volume rally. I exited all my equity holdings over 3 months ago to concentrate on E-mini, weekly expirations, option/S&P hedging strategies and BTIM. The returns have been quite adequate. For example, BTIM is up over 60%. Stocks were no longer attractively priced.

By now you've all heard about the "Shadow Banking System" I've talked about for years and how it totally fooled the Regulators. Remember B.B. saying sub-prime was not a problem? I told you it was a serious problem for the markets way back in early '07. Now say hello to "Shadow Liquidity"! So long as there is nothing wrong in US markets, the depth of liquidity that is, the amount of stock, currency, futures, etc. you can trade without materially moving the price is impressive almost certainly the best in the world.

Largely unnoticed and least known among nonprofessional investors, liquidity has changed immensely in recent years because traditional providers of liquidity in the past market makers and other participants are not standing so ready to make the other side of the trade. Today, the machines (computers) are in control! Today, in the snap of your fingers, a computer can complete over 20,000 trades. So now fewer market makers are prepared to make a market for the sake of market health. Potential market makers find that others, such as HFT traders, are jumping in and out in front for pennies and thus frustrating many of these former market participants.

For the first time we have a lot of providers of the shadow liquidity algorithms (there are more learning and entering the game weekly) and high frequency trading accounting for as much as 70% of daily activity. However, it is now very apparent that in market crisis when liquidity was always the hardest to find liquidity now doesn't just become hard to find, it disappears altogether. Market makers now stand aside as panicking orders pour in. The machines can turn-off or even become sellers with a push of a button. Viola! Down 700 DOW points in a flash!

The recent gapping of the market is a symptom that our markets are not functioning correctly. It's a wake-up call that the renowned liquidity of our markets can still disappear in a crisis. I'm now awake and aware just what can happen. I truly believe now that what happened Thursday was nothing more than computers all selling at the same time. The crash was caused by a little boy standing in the crowd shouting out that this rally actually had no clothes or was that an emperor I read about back in my youth.

The sell off came "because there were no real buyers." The Quants had the ability to manipulate the market higher. These HFT-type traders worship at the altar of momentum. When the momentum changed so did the machine’s program. If the SEC, Congress or whoever cannot fix the problem the next 1,500 DOW points will be down and that decline could occur in a day.

You all can't say I didn't warn you recently:
The VIX was 16. Over 90% of all NYSE issues were over their 40 DMAs. China was down 13% YTD last week and is now 18% down. China led the last decline. I told you the Greek crisis was a potential market killer, could last for years and prompts investors to sell risk assets and buy bonds. Providing more debt to Greece doesn't solve the problem. It's like pouring gasoline on a fire to put it out. The strong dollar is killing commodities and those stocks that pushed the market to new highs. We were approaching 1225-50 the last real target for this move up. The market was selling good news and earnings. US taxes are going higher and growth will slow down across the globe. I could go on. I've seen the movie. I know how it ends.

The present:
Today, all good assumptions about the market's solid footing and the enduring economic recovery were most likely swept away. More selling into what seemed to be a great job’s number Friday reinforced that feeling of unease. If nothing else it's a slap in the face reminding us that risk (or uncertainty) remains in the system. Tomorrow, ECB President Trichet could address the debt crisis when he speaks after a meeting of Central Bankers. He blew his first opportunity punish the speculators with his hedging comments last week.

The good news heading into Monday is that EU leaders agreed to setup an emergency fund to halt the spread of Greece's fiscal woes. The size was not specified. Only time will tell if this statement is enough to satisfy the "market vigilantes". To get ahead of this crisis the fund must approach $1 Billion. This amount is needed to buy Greek debt and support the Euro. If the EU cannot punish the "speculators" all bets are off.

This crisis is a serious deflationary event for Europe and will lower U.S. growth. The major problem ahead is whether the financial system gets frozen once again. The banks are in better shape this time. Be alert there are very strong cyclical tailwinds that will collide with very substantial headwinds in the second half of ‘10.

In summary:
The stark choices before the Greek government are not now in America's immediate future, However, a US fiscal deficit (one year debt) at 11% of the GDP and the overall federal debt level is rapidly climbing toward 100% of GDP are testing the risk tolerance of domestic and international markets. A WSJ editorial on May 8th noted, "…all of this ought to be a cautionary tale for politicians in Europe's other high spending slow growth states -- and for those in Sacramento, Albany and Washington, D.C., too. Greece shows that the welfare state model of development, dominated by public unions, onerous regulations, high taxes and other political allocation of capital has hit the wall. Down the road lies more Greek tragedy." So taking for granted Uncle Sam can indefinitely borrow at reasonable rates is a very risky proposition.

Trade of the week in review:
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. I setup a long call/short S&P hedge in the Chart Room earlier but I was trading the hedged side so poorly I exited the trade. I was leaving too much on the table and not letting the short side work better. Hindsight is 20/20 if I stayed in the trade. I could have lost $200 per call option and earned $2,000+ per option with the E-mini hedge. That's a 10 bagger in a few hours. Yes, you did equally well with long puts but you had to pay between $4-$6 depending whether you wanted to buy OTM or ATM and you had to be right about the direction which doesn't matter when hedging. The risk was much higher if you were wrong. OTM calls were less than $2.00. Besides, I was already positioned with the put spread from 2 weeks ago which are now fully paid for I might add. I'll tell you I was kind of frozen in disbelief as the decline started. I tried to sell the reminder (10%) of my long spread puts (paid $3.75 originally) for $45 worth $46-$48 at the time but were too deep ITM. The bid/ask spread was over 10 points with a $6.00 discount bid.
The puts did trade at $40!

I did something right in the Chat Room, I bought over 10,000 BTIM for less than $6.10 and sold out over Thurs/Fri for better than $7.10. Nice work if you could get it.

Over the last month I started to highlight why (see above remarks) I was becoming more and more negative on the market. The best way to protect and/or make my students money was to create an OTM put spread just far enough OTM to mitigate the risk yet receive maximum return if the market declined to the 200 DMA.

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As of last Friday the OEX closed in the 506 area where a 9X return would have been possible if Friday were the May Expiration. My recommended long put trade is a 6 bagger at this point. It's always up to you when to take some profits. Given the current market situation I see the need for more of these type trades not less. You can use the leveraged ETFs but the put trades define your risk better with more substantial returns like 7-9Xs if I'm correct.

As I predicted, Mister Toad's wild ride went off the rails last week. Lucky we had our put spread seat belts on. Keep them fastened. We ain't seen nothing yet.

Keep those cards, letters and calls coming. I read every one.

Good trading,

Stan Moore
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Kill the Quants or the next 1,500 points will be down

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