Peter Panholzer on market sentiment

This top manager has been trading currencies professionally for nearly three decades, using systematic, statistical approaches as well as subjective, sentiment-driven techniques. Find out how he uses contrary opinion in the forex market.

BY MARK ETZKORN

With its 52.96-percent return last year, DynexCorp's Percival Market Sentiment program topped the Barclay Group's rankings of top currency managers ($1 million to $50 million under management) in 2005 (see "Top currency traders of 2005," *Currency Trader*, April 2006).

The last time *Currency Trader* spoke with DynexCorp (www.dynexcorp.com) head Peter Panholzer ("Peter Panholzer: Currency system architect," November 2004), much of the discussion revolved around his firm's TETRA strategy, which is systematically oriented and executed without discretion. (In addition to TETRA and Percival, DynexCorp trades three other programs — Ranger, Halley, and Interbanker — to diversify across different time horizons, currency portfolios, and approaches.)

By contrast, the Percival Market Sentiment program is a discretionary trading strategy that incorporates principles laid out in currency trader John Percival's book *The Way of the Dollar*, as well as many of the contrarian ideas and sentiment analysis tools Panholzer has used in one way or another for decades.

In fact, one of Panholzer's previous discretionary approaches — the Dynex Market Sentiment Strategy, which he traded from 1994 to 1998 — was based on a very specific type of contrarian market interpretation. It relied on the daily trade recommendations of a single analyst ("Mr. X") who worked at a large Chicago-based futures brokerage. Panholzer found the analyst was the source of nearly perfect trade signals — in reverse.

"We consistently used his entry price to go in the opposite direction, and used his stop-loss as a profit target," Panholzer says. "There was virtually no need to use a stop-loss of our own because the win rate was so high, but we would generally use his profit target as our stop-loss. If that was too far away, we used a one-percent equity protection stop."

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The trading program ran its course when the analyst got a different job and suddenly became less drastically wrong. Why this was the case can be explained in terms of at least one of the characteristics Panholzer says should be present in useful contrarian information:

1. It is provided gratuitously, which excludes paid advisories. This can include a volunteered opinion or a forecast in the press.

2. It is "unpunished" — for example, immune to the negative feedback of clients. Typically, this kind of information is provided by salaried employees of brokerage houses who are not involved in trading or managing client funds.

3. It is a buy or sell recommendation arrived at by a committee — for example, within the boardroom of a bank or brokerage house.

Ideally, Panholzer says, the contrarian input should come from participants who are unaware of the final use of their input.

Mr. X was one of several sources Panholzer monitored at the time.

"We had what we called a stable of contrarian horses, and he was the lead horse — the best," Panholzer says. "He didn't care if he was right or wrong, and people liked to read his little blurbs. We found him to be so persistently wrong we could make money off him. An advisory service that gets paid couldn't afford to lose on every trade — they typically break even."

When Mr. X left his position at the brokerage, Panholzer "begged him" to continue his service for a fee, which he did. But — per the preceding rules — Mr. X was no longer a reliable contrarian source: Most importantly, he was no longer providing free advice; he was a paid advisor.

Also, Panholzer notes, Mr. X was very excited about his new job, so his possible dissatisfaction at his former position had impacted his performance. Once his situation changed, he stopped losing, and Panholzer was forced to evict this "horse" from the contrarian stable.

Panholzer consults several well-known contrarian indicators, including Market Vane's Bullish Consensus report (www.marketvane.net), which measures the bullish or bearishness of market newsletters, and *Consensus* magazine (www.consensus-inc.com). However, he stresses, such data is just part of the contrarian market puzzle, and it must be interpreted judiciously.

"It might be a bad sign if too many market letters turn bullish, for example," he explains. "But it's not as simple as that. Most people don't realize that in a bull market you normally *do* have bullish consensus, so you can't simply go against it."

Another factor is the price level accompanying a sentiment reading, although Panholzer notes this applies to commodities, which have "real" prices attached to them.

"We always interpret bullish consensus percentages in context to relative historic price levels," he says. "If the bullish consensus was high when a market peaked at, say, $2, and it reached the same level when the market was subsequently at $2.50, it would be a meaningless signal because it was occurring at a higher price. But if the bullish consensus reading was as high with price now at $1.50, that would be very bearish, because price was lower."

As the rest of our conversation with Panholzer illustrates, interpreting and acting on sentiment data is challenging and subjective; it requires experience to understand it in the context of other market information.

CT: ***Can you explain the basics of using bullish consensus and other sentiment indicators?***

PP: We measure the extremes in the consensus — the historical extremes over the past five years — so we're monitoring readings between zero percent and 100 percent. Most of the time consensus hovers between historic extremes and thus indicates — at best — the market is not yet overheated. Twenty percent is a very low reading, but we've seen figures as low as seven percent when the market is moving only one way. And 80 percent is very high, but you might see figures go as high as 95 percent.

CT: ***Is a market's reaction to specific news events a useful sentiment gauge?***

PP: It's not good when the market does not maintain a positive reaction to a positive news item. For example, just recently there was a very bullish Consumer Price Index reading. The dollar rallied for a while and then faded.

CT: ***Do you also use Commitment of Traders (COT) data?***

PP: Yes, it's a standard tool, but you have to be careful with it. We only look at small traders. It might give you a clue only once or twice a year, but when it does, it's powerful.

But you cannot always rely on a particular indicator to provide a signal. When [many] indicators fall in line, you get a very strong tool, of course.

CT: ***So when you say the COT provides a useful signal once or twice a year, does that mean the small-trader reading is reaching a certain level in conjunction with other sentiment inputs? For example, the specific COT small-trader reading might occur frequently, but it only occurs in conjunction with the other signals at certain times.***

PP: Exactly. Another indicator is provided by Oanda. On their site (http://fxtrade.oanda.com) they show the open positions of their own traders, which are typically small traders. Through this, you get a perfect sample of small-trader opinion — which by the way, happened to be short the euro all along the recent up move. Oanda also shows, for example, how many short positions have been put on

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200 or 300 points below the market and long positions 200 or 300 points above the market (Figure 1).

CT: ***With the currency market becoming more mature and efficient, has it changed the way you trade?***

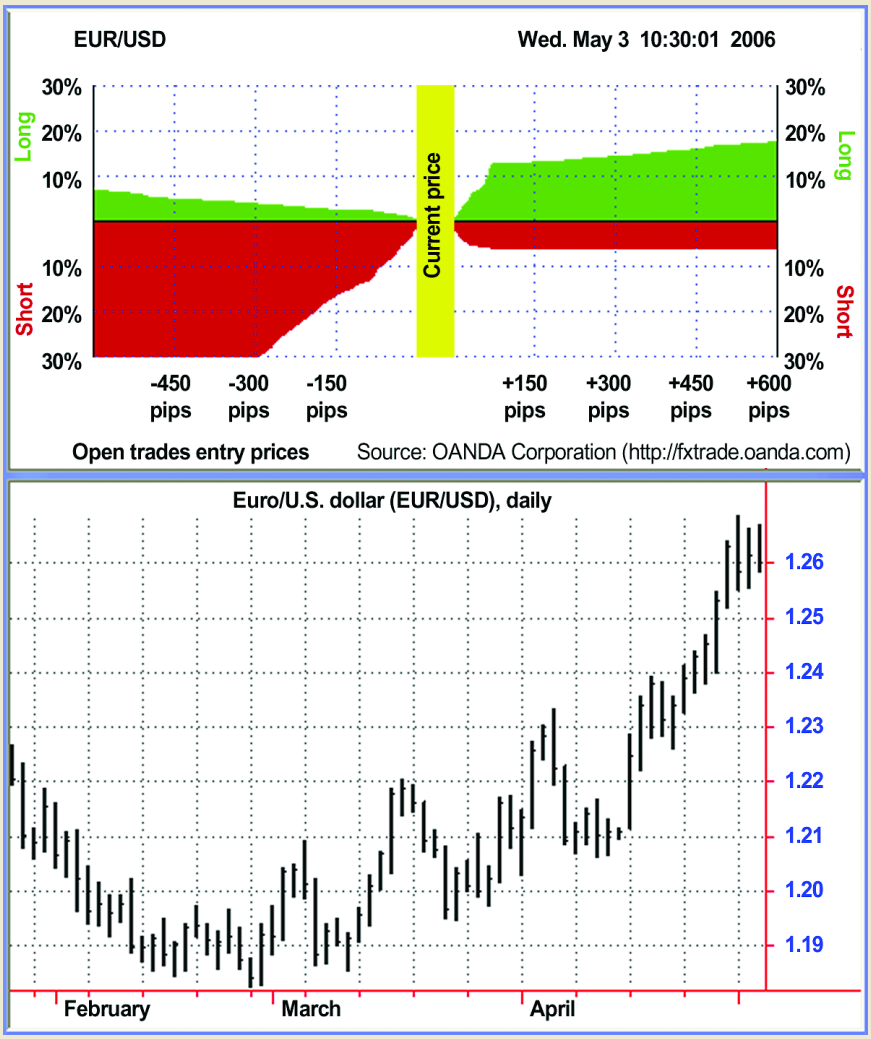
PP: Yes and no. With regard to market sentiment and contrarian opinion, nothing has changed. With regard to trendiness, things are different. "Baby" markets are trendy, but as they grow older they become more random and less trendy.

CT: ***But if that's the case, it would seem as if there's less directional movement to capture regardless of the approach you use — which would impact profits.***

PP: I would agree. If you took any trend-following program and measured it over the past 30 years, you would find continuous deterioration. Pierre Lequeux (www.cibef.com) created his own trend-following index because he believes peer-group benchmark indices tend to be inappropriate for comparison of single-advisor performance, since there have been some embedded covariance effects that make them underestimate the risk of the single advisor. So, why not create a standard trend-following system and make it an index? Currently he is disappointed by this project because the index is deteriorating so much.

FIGURE 1 — SMALL TRADERS SHORT THE UPTREND

Open trade data from Oanda Corporation (top) shows the greater number of shorts vs. longs in the EUR/USD rate despite the recent uptrend (bottom).



Source: TradeStation

CT: ***How useful do you think "media signals" are?***

PP: I remember waiting in the train station in Zurich in 1995 and seeing the cover of *Time* magazine, which had a headline about how high the yen might go. Next to it was *Newsweek*, which had a cartoon picture of Superman on it with the headline, "Superman Yen."

I shivered, but it wasn't because of the cold March wind. Both of the magazines appearing on the newsstand at the same time gave me an incredibly strong signal to sell the yen. It had been rising to 80 yen per dollar, and it subsequently fell very quickly to 100 cents per dollar by Labor Day 1995.

CT: ***Timing those kinds of signals can be very difficult, though, can't it? Do you have to be willing to take a lot of heat if you enter the market on something like that? The market can keep going in the same direction quite a while before it reverses.***

PP: You would use, obviously, some kind of a trend indicator to gauge price — for example the statistical tools we currently use in the TETRA program. The time frame might differ. I've used a four-hour interval since 1994 for all our price signals.

Also, contrarian or sentiment indicators don't really work with stops. Of course, there must be an equity stop of some kind, typically placed far enough away to be comfortable. Or — and this might be easier — you use an option.

Coincidentally, a good trading system seems to have a lifespan of four or five years before it falls to the wayside. That was the case with my Magnum trading program, which ran from 1979 to 1984 and was the first instance of currencies offered as an asset class of their own — it offered trading in nothing but currencies, which was a kind of a sacrilege in the diversified trend-following world that had emerged in the highly inflationary 1970s.

In 1991 I had the good luck to be invited for a chat with (*macro trader*) Bruce Kovner in his Park Avenue flat. He was

interested in systems, but he didn't trade them himself. He pointed out that systems tend to drop off every four or five years.

CT: ***Have you ever found systems to come back into phase? Or when something dies, is it dead forever?***
PP: I would think yes. The Magnum program, for example, never came back. It's amazing.

CT: ***That's interesting, because I can understand that a system would never perform as good as it initially did, but it seems like it might — eventually — go through another profitable phase. Did you ever check to see if a particular system might have a new life if applied to a different time frame?***
PP: We haven't found any good results. Also, every so often a single trading strategy may become out of sync with price behavior and sustain losses that are heavier than previously experienced. Basically, single strategies are subject to performance cycles whose depth and length are difficult to predict. Diversification into three or more strategies at the same time tends to reduce single-strategy portfolio risk.

Currency price scaling: Unique characteristics

Many years ago, Panholzer conducted a study and discovered that currencies are fundamentally different from other markets in that their price moves don't markedly change as they move from high prices to low price — they are "scale linear."

He analyzed the daily price moves in various commodities and currencies, measuring the shifts that occurred as prices moved higher and lower.

"During a huge bull market in anything — coffee, sugar, soybeans, gold — as you go higher, the daily price changes increase and become more volatile, which is normal," Panholzer explains. "When you go to extremely low prices, the opposite occurs.

"Those price moves had kind of a parabolic, logarithmic behavior, which made it more difficult for a commodity portfolio manager to balance, say, very low sugar prices with very high copper prices. How do you allocate the trade sizes?"

Panholzer discovered currencies didn't behave the same way — their daily price moves essentially stayed constant regardless of high or low price levels (Figure 2).

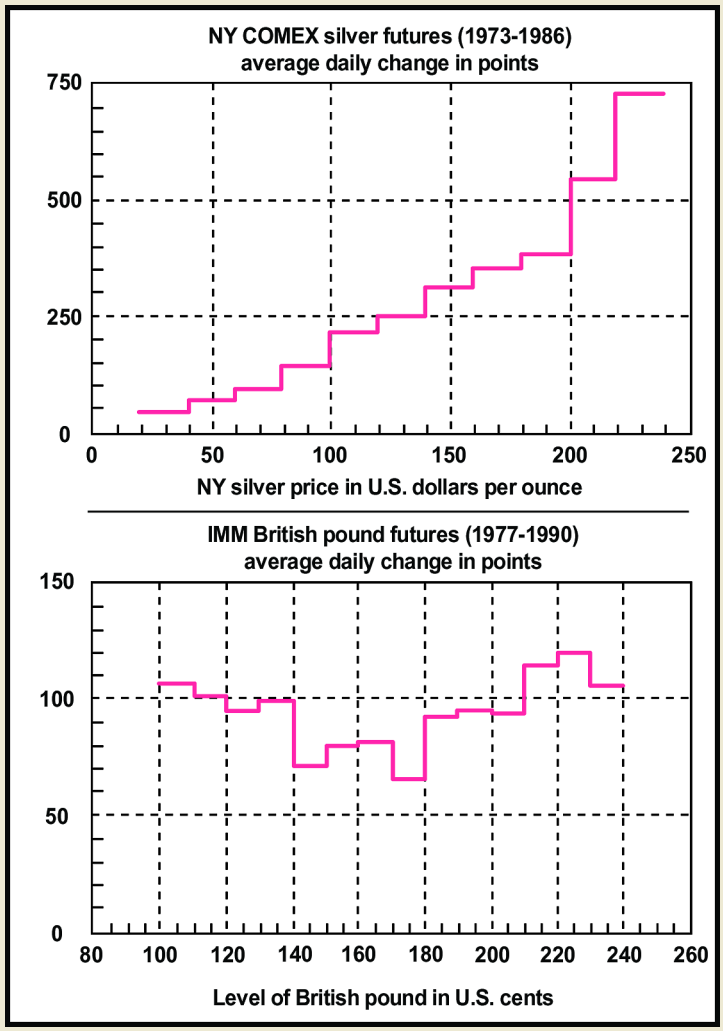
"You could use the same amount in each currency and it didn't matter if a currency was high or low," he says.

Why is this? Panholzer points out that because currencies are by definition "reciprocal" — if you're long one currency you're automatically short another. You can, legitimately, price the dollar in British pounds as well as price the British pound in dollars.

"They are both valid markets," he says. "If the pound was very high, you would expect larger price changes relative to the level. But that would mean the opposite would have to be occurring for the dollar — which simply wouldn't work."

FIGURE 2 — PRICE SCALING: CURRENCIES VS. COMMODITIES

As the price of silver (top) increased, the average daily ranges also increased, which is typical behavior in most markets. However, as the British pound (bottom) increased in price, its daily ranges remained relatively stable.



Source: Peter Panholzer/DynexCorp.