

ASK SLIM

I'll share a quick history of my trading career and let you decide. I've been a trader for 31 years. My trading career began in 1974, at 24 years of age, on the Chicago Board Options Exchange (CBOE). Over the 17 years I was a member of the CBOE, I traded in nearly every pit on that floor. Much of that time was spent in the chaotic OEX pit. Over the years I was a member of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). I have traded "off the floor" since 1984.

In this column, I will answer your questions on the technical and psychological aspects of trading and trading methodologies. Oh, and the next question would be, why the name "Slim?" My badge on the CBOE was "SLM" (Steven L. Miller). Other traders gave me that nickname on my first day of trading, back in 1974. So, ask Slim!



Dear Slim,

The Fed has been raising interest rates for the past year. Yet the rate on 10-year Treasury notes has actually gone down, and mortgages are up only a little. Can you explain how this can be happening? What am I missing here? Has this happened in the past? How much longer will Alan Greenspan continue to raise rates?

—Gary S., Cleveland, Ohio

Dear Gary,

The Federal Open Market Committee (FOMC) met last February at its semiannual two-day meeting, bringing the markets the expected sixth straight quarter-point rise in interest rates. Your question is valid. Are rates really going up? It depends at what part of the rate curve you are looking. The Fed certainly is raising short-term rates, with Fed funds moving from a low of one percent up to 2.5 percent. However, during this time, long-term rates held steady, with the rates on 30-year bonds hovering around 4.5 percent, a stone's throw from last year's low. So the yield curve has been flattening.

Historically, when the yield curve flattens, it means there is strong short-term demand for money due to high economic activity. The FOMC, doing their assumed job of fine-tuning, steps in and raises short-term rates. Their intent is to slow growth, so the economy doesn't overheat and inflation is controlled. At times, they raised rates so aggressively that the yield curve "inverted" or "humped." Long rates did rise, but not as much, anticipating the near surety of a coming recession. This is nothing like the conditions that have existed in recent months.

What we are seeing here is two markets. After the FOMC cut rates sharply in reaction to the bursting of the tech bubble, 9/11 and a deflationary scare, Greenspan and crew feared that with rates so low they had rendered themselves ineffective. Had there been more trouble, the Fed had little room left to react. With the economy stabilized, the FOMC correctly has been moving rates up in "measured fashion." As long as they see a growing economy, expect them to continue until they have reached a level of "neutrality." This may be 3 percent, 3.5 percent or higher.

The long-term market is a very different story. Though the Fed can control short-term rates, longer-term rates are more dictated by the economy. The FOMC cut the Fed fund rate from 6.5 percent in 2000 to one percent in 2003 because they feared the ravages of deflation. Are these forces gone? The long-term bond market doesn't think so. Proof comes when you look at the weak job-growth situation, with the manufacturing sector unable to create jobs. Additionally, the huge decline in the dollar has failed to provide the expected stimulus. And the buck remains a big risk, as South Korea has scarily indicated it will "diversify" out of dollar holdings. Furthermore, the spike in energy and basic materials prices may actually be deflationary, as money is sucked out of other sectors of the economy. Year over year, the core rate on the PPI is up only two percent, which means there is little pricing power in this economy. So the long-term Treasury market – in its resistance to the rise in short rates – may be reading more economic trouble ahead.

Greenspan, whose timing hasn't been the greatest – having raised rates sharply just before the tech bubble went – is acting very carefully. He's tiptoeing through this mine field and bringing interest rates up very cautiously because he does not want a tight credit situation with the aforementioned factors looming out there. And there still are bubbles out there left to pop in the area of real estate and related basic materials. If the Fed pushes rates up too far, we're going to see mortgage rates move up and the housing market really begin to struggle. The paradox is that once the Fed stops raising short rates, the long-term interest rate markets will see it as stimulative some months out. Then we'll finally get a push up in long rates. So it is a lose-lose situation caused by a rolling deflation that started in 2000.

My guess is that this rare situation will be resolved after rates all along the curve move up together for a while. It could bring joint disturbances in the real estate and stock markets, followed by another round of much lower interest rates over the next couple years.

Dear Slim,

What in your opinion is the strongest chart pattern? It seems to me that the head and shoulders works well. I really enjoy your articles.

-Jim O., via e-mail

Dear Jim,

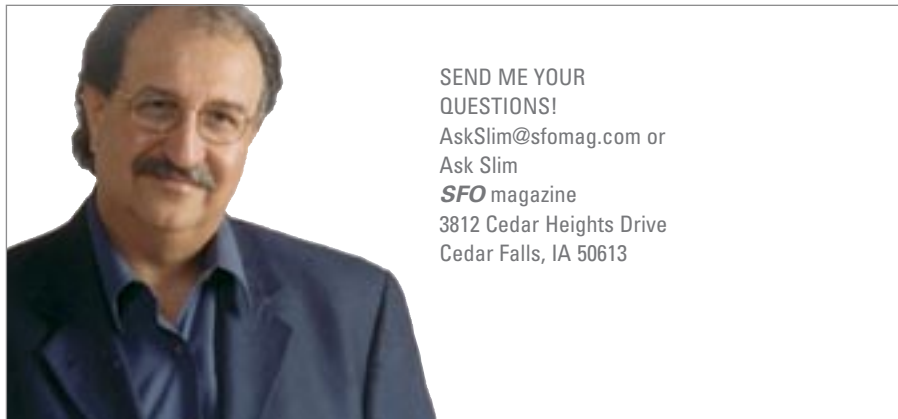
I think the best chart pattern is the "island reversal." It also is the rarest. In fact, while looking through the 300 daily charts of my stock trading universe, I only found a few that occurred over the past several months. An island reversal is formed when a stock gaps, making a new high or low for the move, trades in a range for a short period, then gaps in the reverse direction, leaving the "island."

Look at the daily candlestick chart of Amazon below. In December, the stock was in an up trend. It gapped up, nearing 46, and then traded there for five days. Then the stock gapped down at the beginning of January, leaving the island. It later tested the pattern; however, it was really the end for this stock, which saw a steep downtrend.

Though not shown here, two other examples of bearish island reversals are on the daily charts of Fannie Mae (FNM) and Gold Corp.

(GG), both occurring in December of '04. A very nice bullish island formed in January '05 in the daily chart of Nokia (NOK).

I look for island reversals all the time, as the pattern rarely misses. **SFO**



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