TRADING FOREX

Think Tactically

Discounting Sentiment In The Euro

Excess returns from trading sentiment are only seen in the short run … or are they? Here's a look at a sentiment trading tactic using a contrarian, indirect sentiment indicator applied to the euro ETF that shows how over the long term, you can use a sentiment trading strategy.

Sentiment can have an impact on the markets, directly and indirectly. This is the reason why sentiment indicators are differentiated between two categories, direct and indirect. In this article, I will look at the closed-end-fund discount indicator, which is an indirect sentiment indicator similar to the traditional put-call ratio and other modified put-call ratios such as the options sentiment indicator (OSI), which I described in an article in this magazine in the November 2016 issue.

CONTRARIAN VS. COINCIDING

There is a major difference between my approach in this article versus the approach discussed in my November 2016 article. The benchmark indicator in this article, the closed-end-fund discount, serves as a contrarian indicator, whereas the OSI trading indicator is a coinciding indicator. With that said, this approach can be seen as more of a trading tactic to your overall sentiment trading strategy, unless you are a contrarian.

In academia and in practice, it's generally understood that investors have a greater expectation for investment returns by discounting such factors as the price-earnings ratio, price-book ratio, and, in this case, a sentiment factor. I will calculate a daily closed-end-fund discount (CEFD) to serve as a proxy for sentiment.

JOSE CRUZ

In Figure 1 you see a graph from the last 10 years plotting daily returns of the euro ETF (FXE) versus its closed-end-fund discount, which is my sentiment proxy. Notice a slightly negative linear relationship. The regression results (see Figure 2) show a convincingly negative slope for this linear relationship at the 95% confidence level.

This negative linear relationship falls in line with my previous research, which says markets will discount the sentiment factor in the long run.

Following this logic, I was able to fairly easily backtest the daily mid-price and closed-end-fund discount (CEFD) with a few data points. By discounting sentiment in this way, you would simply buy the euro ETF when the previous day's mid-price (average of open and close) was trading at a discount to the net asset value; and sell the ETF when it was trading at

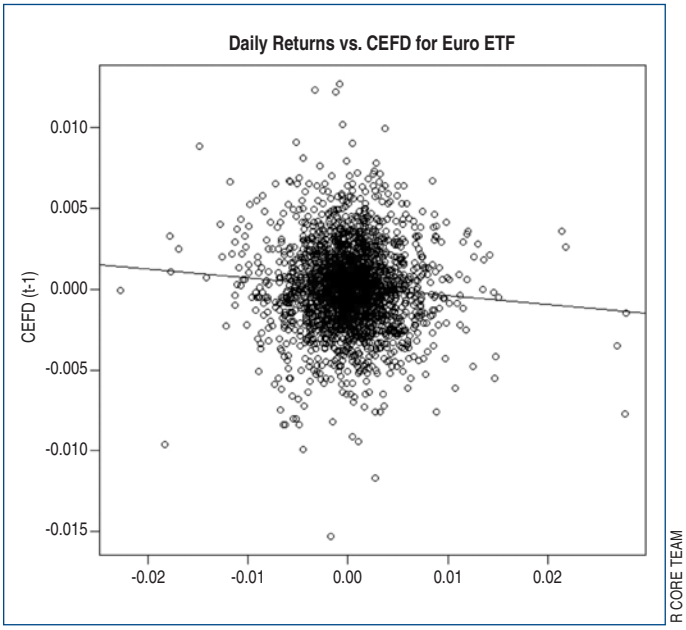

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FIGURE 1: DAILY RETURNS. Here you see a scatter plot of daily returns and previous day's closed-end-fund-discount.

by Philipe Saroyan

REGRESSION RESULTS

SUMMARY OUTPUT

Regression statistics	
Multiple R	0.036
R-squared	0.001
Adjusted R-squared	0.001
Std. error	0.003
Observations	2518

ANOVA

	df	SS	MS	F	Significance F
Regression	1.000	0.000	0.000	3.180	0.075
Residual	2516.000	0.016	0.000		
Total	2517.000	0.016			

	Coefficients	Std. error	T-stat	P-value	Lower 95%	Upper 95%	Lower 95%	Upper 95%
Intercept	0.000	0.000	1.430	0.153	0.000	0.000	0.000	0.000
Daily returns	-0.023	0.013	-1.783	0.075	-0.049	0.002	-0.049	0.002

FIGURE 2: REGRESSION RESULTS. There's a negative slope for this linear relationship at the 95% confidence level.

Traders and investors should discount sentiment when it is at its peak, especially when it is "noisy."

$$\text{CEFD}(\%) = \text{LN}\left(\frac{\text{Midpoint price}_{t-1}}{\text{NAV}_{t-1}}\right)$$

a premium. In this way, the strategy is contrarian, and falls in line with the tenets of prevailing research, supporting positive long-term results.

CALCULATING THE INDICATOR

To calculate the indicator, first you'll need the previous day's mid-price, which is simply the average of the open and close prices. Then you would need the previous day's net asset value (NAV), which is calculated and published by the ETF company each day. Both data points are fairly easy to compile. Finally, you would take the natural log of the two to compute a daily CEFD percentage, as in this equation:

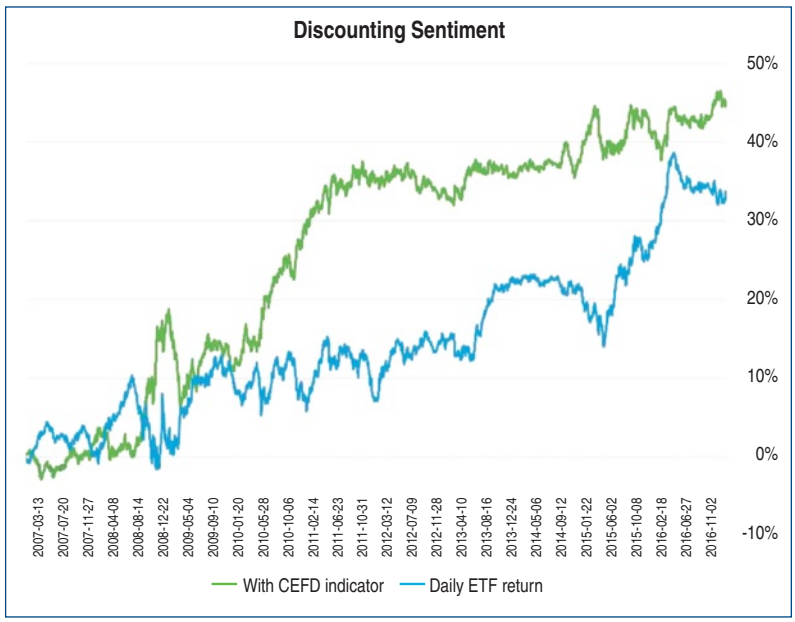

FIGURE 3: DISCOUNTING SENTIMENT. Here, the euro ETF (FXE) is shown with and without the sentiment indicator.

The CEFD indicator gives clear buy or sell signals each day to discount the prevailing sentiment when the ETF is trading at a premium, and to buy when it is trading at a discount. Figure 3 shows the backtested results from the last 10 years when trading this strategy on the euro ETF.

PRICES PREDICT SENTIMENT

The reason I use daily returns to predict sentiment is that prevailing research does not substantiate sentiment being able to predict prices when testing for these two variables. Although stock returns and sentiment have a covariant relationship, especially in the case of consumer sentiment, the research only shows evidence of prices being able to predict sentiment and not the other way around. Results suggest that there is a feedback loop from the stock market to general confidence/sentiment levels but that relationship doesn't necessarily go in reverse. Increased sentiment levels don't necessarily affect price levels.

Based on this logic, I can stay sound in my sentiment trading strategy over the long term by initiating this tactic of discounting sentiment. The backtest results show the strategy boasts an impressive hit rate of 52.17%. Although it is possible to easily transpose the *y*-variable—the daily CEFD(%)—making it the predictor variable, it would be invalid based on this premise.

TO FOLLOW SENTIMENT OR NOT

The strategic trader should be aware that ever-increasing prices should not make sentiment investors more bullish. This merely suggests a crowding-in effect will eventually be discounted.

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FURTHER READING

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