How to know it’s time to leave the party

Remember the bull market?

Green candles, profits, not having to think about which kidney to sell to cover the tax bill.

That was the stuff.

I know it is but a distant memory, but try and recall.

Remember when, sometimes, the market would just go into a riotous party? Altcoins would pop left and right. You could throw a dart and catch a rally. Hell, it felt like you would have to actually make an effort not to make money. You probably could not help but tell everyone around you just how easy this crypto stuff was.

Those good times inevitably ended with a pullback though. A nasty one. You know, the kind of pullback that makes your heart skip a bit when you check TradingView. It also probably ended with you probably giving back to the market some of those sweet profits. I know I have.

The markets are tricky, you know? When things feel easiest and you let your guard down, that’s when you should be eyeing the exit door. You never want to be the last one at the party.

How to know when to leave though?

One simple trick is to track the correlation between Bitcoin and altcoins. Like the clock tolling midnight for Cinderella, altcoins moving without papa Bitcoin tells us that it’s high time we went home. Let me show you.

When two variables really like each other

Correlation is a measure of how much the behaviour of two variables influences one another.

Things that are correlated in real life: height and weight. Someone that stands over 2 metres tall will usually weigh more than someone 1.5 metres tall. And yes, I will keep using the International System of Units. Sorry not sorry, freedom lovers.

Things that are not correlated: intelligence and the number of samosas you eat in a given month. Great, now I’m thinking of samosas. A samosa! A samosa! My kingdom for a samosa! Don’t ever sit down to write an article when hungry, kids. But I digress.

We can measure correlation in various ways. But maths is boring. You can check out here the formula we used if you like.

What is important is that using this formula gives us a handy-dandy scale from -1 to 1 on how much two variables are correlated. -1 for negatively correlated, 0 for not correlated at all, and 1 for positively correlated.

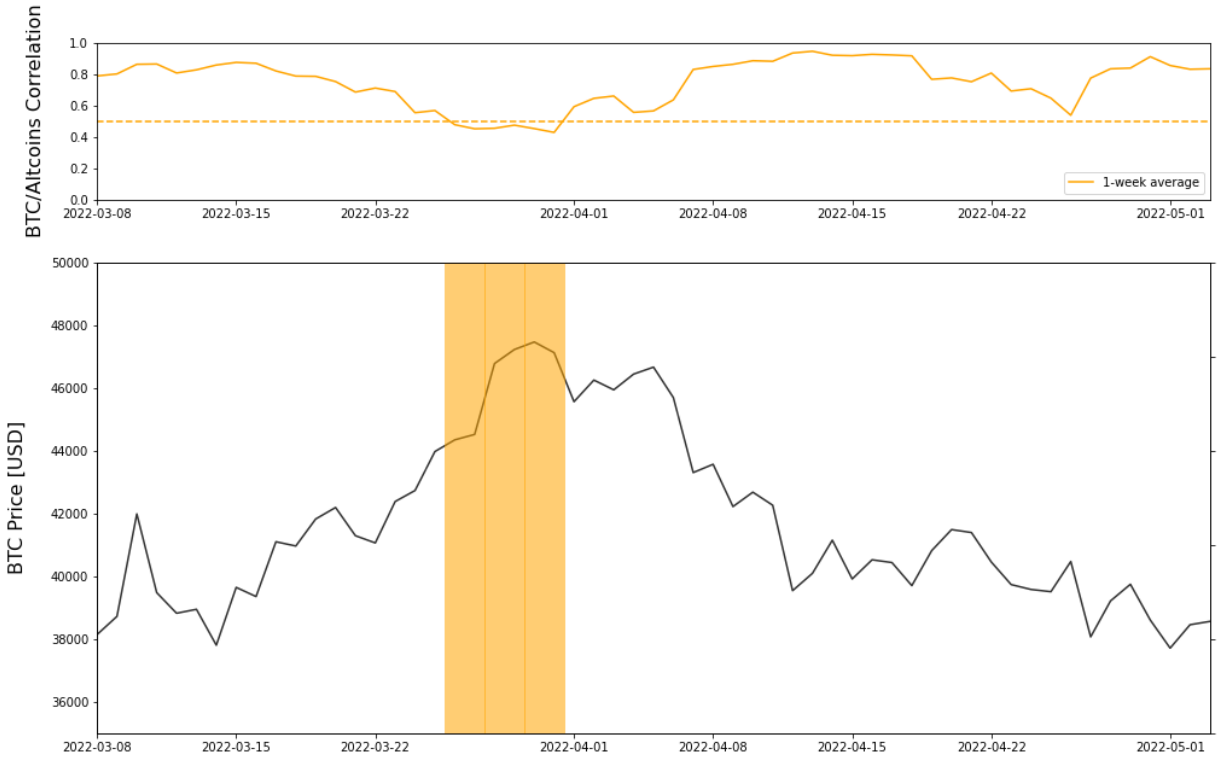
In crypto, BTC and altcoins are usually highly positively correlated.

This is so because Bitcoin is the OG. The big daddy. As much as it pains dot.eths, Lunatics or Solana bros, Bitcoin is the most important crypto asset. There is no second best. And, as anyone who has been trading the crypto markets for a while can tell you, BTC needs to move first before the rest of the market follows.

It's a simple process, really. BTC rallies, then "Blue-Chip" altcoins rally, then riskier altcoins, then bottom of the barrel shitcoins that you've never heard of, and, finally, you get a correction.

Traders like to go further and further out into the risk curve until they fall out of a cliff. This is why this indicator works. It tells you when traders are getting closer and closer to that cliff.

As an example, let's take a look at what happened in the last rally we had back in March.



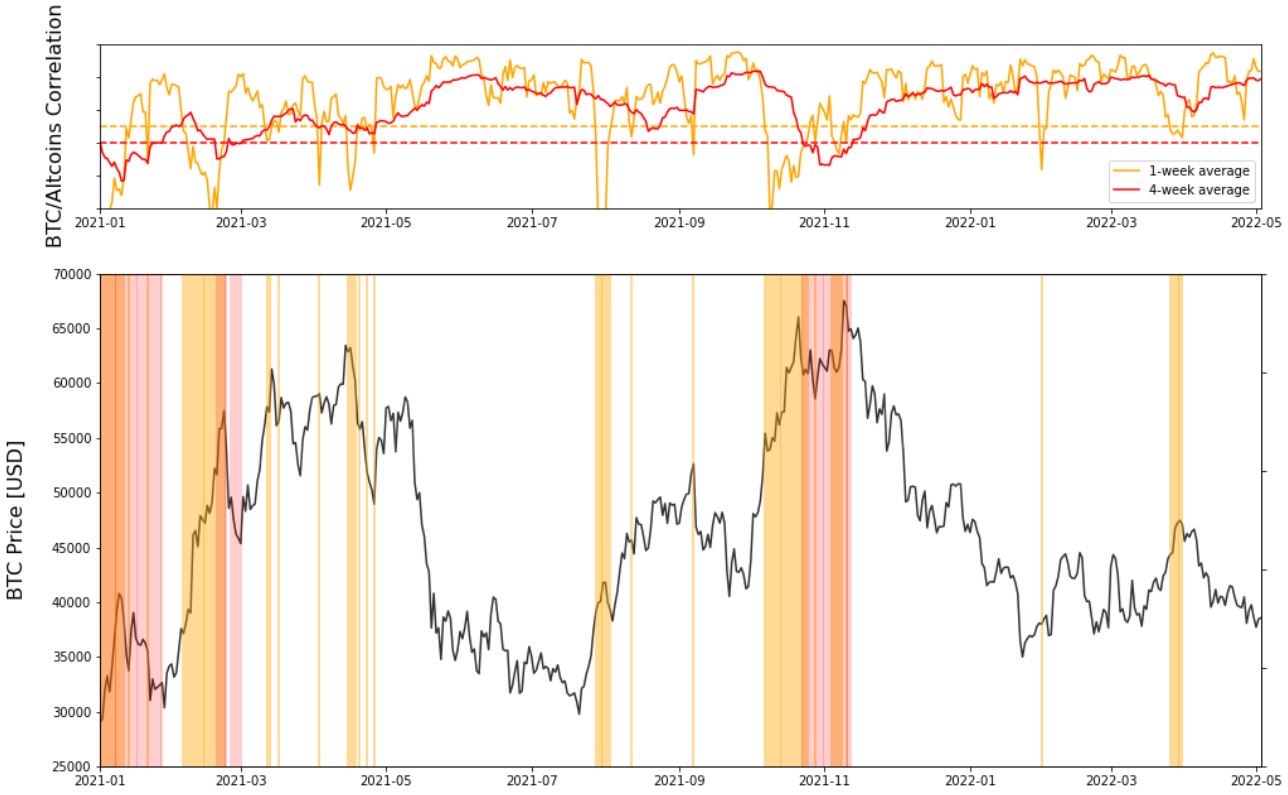
Note that we do not take the correlation at a specific time. Rather, we use the rolling mean of the last 7 days, to smooth out the results and to clean out the noise. We have also selected a level for when things are getting too hot. This is purely discretionary. For the 1 week moving average, 0.5 seems to be a good threshold historically. We have coloured in orange the dates when the 1-week average is below this threshold.

Back to the chart. In mid-march, after months of underperformance, Bitcoin started to rally. Soon, the rally turned into a riot. Stocks were flying. Terra was buying BTC hand over fist. It almost looked as if the bull market might be coming back. Almost.

Things started to peter out at around $46k though. BTC started declining soon after, taking the whole market with it.

This indicator was telling you already on March 26th that things were a little iffy. If only you had listened to it, rather than the bull chanting of crypto Twitter, you might have saved some dollars.

Now that we got the mechanics of how this indicator works, let's look at how it performed in 2021.



In this case, we have taken two rolling means, the 1-week and 4-week. A "fast" or 1-week average will tell you when it's time to start thinking of going home. The "slow" average is

meant to tell you that the sun has already risen, respectable people are already going to work and only lost souls remain at the party.

This dynamic duo seems to be great at picking tops, doesn't it? The 4-week average would have told you to pack it up at the January, March, and November tops. The 1-week average works great to time local minor tops and would have saved your skin too many times to count.

When does it not work? During major sell-offs, for instance. During a time of crisis, correlations go to 1. Think of the Covid-19 March 2020 crash. Everything went down. This is also true for the crypto markets. During the May sell-off, correlations actually rose. No cryptos escaped the wrath of the liquidation engines.

So, this does not work in a crisis. But it works great to time tops in bull markets. I'd say that is quite useful, wouldn't you agree?

If you do agree, and want to incorporate this in your trading, you have two options:

- Option 1: check out the suit of indicators by @Mtrl_Scientist. They offer a product with a similar chart and the idea for this article was taken from them.
- Option2: DIY! Follow this notebook, using data from CoinMetrics.

And that's all folks! Hopefully, you can use this when the bull market comes back to keep some more of your profits. I know I will.