Dollar direction signals hard to decipher

Much of the action remains in the undocumented over-the-counter trade

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Every week the Commodity Futures Trading Commission (CFTC) releases its Commitments of Traders (COT) report.

But just how committed are the traders shown in those trading activity reports? When you look at what traders can also do in the cash, over-thecounter and physical markets associated with those futures contracts, it's difficult to say for sure.

This is especially true of the currency markets given the vast size of the cash and over-the-counter (OTC) market across the global banking system. This makes tracking and analyzing Canadian dollar futures activity even more challenging.

As a refresher on the subject, the CFTC publishes the COT reports to help the public understand market dynamics. It does so by categorizing the long and short positions of different market participants to help market participants understand who is doing what.

In general, the two most important classifications are large commercial hedgers or large speculators.

When it comes to financial futures like the Canadian dollar, stock indexes or interest rates, compared to physical commodity futures like canola, wheat or cattle, the CFTC also provides a detailed Traders in Financial Futures report with the following four subcategories:

• Dealer/intermediary;

• Asset manager/institutional;

• Leveraged funds; and

• Other reportables.

Dealer/intermediary participants are what are typically described as the "sell side" of the market. Though they may not predominantly sell futures, they do design and sell various financial assets to clients. They tend to have matched books or offset their risk across markets and clients.

Futures contracts are part of the pricing and balancing of risk associated with the products they sell and their activities. These include large banks (U.S. and non-U.S.) and dealers in securities, swaps and other derivatives.

The rest of the market comprises the "buy side," which is divided into three separate categories: Asset manager/institutional are institutional investors, including pension funds, endowments, insurance companies, mutual funds and those portfolio/investment managers whose clients are predominantly institutional.

Leveraged funds are typically hedge funds and various types of money managers, including registered commodity trading advisers (CTAs); registered commodity pool operators (CPOs) or unregistered funds identified by CFTC.

The strategies may involve taking outright positions or arbitrage within and across markets. The traders may be engaged in managing and conducting proprietary futures trading and trading on behalf of speculative clients.

Other reportables are traders that are not placed into one of the first three categories. The traders in this category mostly are using markets to hedge business risk, whether that risk is related to foreign exchange, equities or interest rates. This category includes corporate treasuries, central banks, smaller banks, mortgage originators, credit unions and any other reportable traders not assigned to the other three categories.

Typically, when the big commercial entities like dealers and banks are long, the large funds are usually short, and vice versa. Think of the banks and dealers as the house in Vegas or a sports betting site; they don't necessarily take an outright position but continually adjust the odds and payouts to balance their book while facilitating the wagers of others.

So if a lot of traders want to be long, the dealers take an opposite short position to accommodate those speculative trades.

When a market gets too stretched to the long or short side, the dealers will take the offsetting position and look to profit from those trade flows.

The “funds,” defined as large investment managers, mutual funds and hedge funds, are often considered the big smart money.

We often hear about the funds’ long or short futures positions being at record levels as a reason for the market to go higher or lower, respectively. But if we analyze those extreme futures positions over time, does it really show any insightful pattern worthwhile following? Looking back at 20 years of CFTC COT data for the Canadian dollar, there have been about 20 significant scenarios of extreme long or short positions held by funds in the past 20 years, or about once per year.

Crunching this data shows that if you bought every time the funds had an extreme long position or then sold when funds were heavily short, you would have actually lost four cents on average on each of those trade signals. So I guess it is good to watch what the funds are doing, but not how you think or have been taught. In fact, it is better to do the opposite of what the funds are shown to be doing in the report.

Keep in mind though you don’t know what the funds are doing on the opposite side of their trading in the over-the-counter (OTC) market. If funds are long futures, they may be short in the OTC market and are just accommodating speculators or facilitating hedges to companies by providing liquidity to the system.

Another practical aspect to consider is that the OTC market is much larger than the exchange traded futures markets. For instance, based on Bank for International Settlements (BIS) data, there were US$4.25 trillion outstanding notional Canadian dollar currency positions at the end of 2018. This compares to only US$14.3 billion worth of outstanding Canadian dollar futures on the CME Group futures exchange at the end of 2018.

The Canadian dollar futures market represents only 0.33 per cent of the outstanding global market for Canadian dollar positions.

Likewise, the daily trading turnover in the OTC market averaged US$260 billion in 2016.

Meanwhile, CME Canadian dollar futures contracts were about US$5.5 billion, or only two per cent of the global trading volume.

While futures are transparent, regulated and efficient, they are often a small portion of the overall marketplace. If you are tracking the COT reports for insights into where the market may go, you have to keep this in mind. You don’t know what they are doing on the other side of their trading ledger in the cash and OTC derivatives markets.

Bottom line — I’ve researched this issue for other futures markets and the conclusion seems to be the same. The commercial players tend to be the ones with a bigger-picture outlook and longerterm view so their actions may better represent what’s truly going on in the marketplace.

Market efficiency has the view that all public information is properly discounted in markets and cannot be exploited. While that public information may be discounted, it doesn’t mean it is always done correctly. So, don’t invest too much time or capital in these reports since you don’t know what these traders may be doing on the other side in the cash or over-the-counter markets.

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