

A Crystal Ball Isn't Enough: The Importance Of Context

On September 18, 2024, the headlines read the Fed cut the Fed Funds rate by 50 basis points. At first blush, one would think that a trader with a crystal ball a couple of days before the Fed action would buy bonds and lick their chops over the money they would soon make. In this case, the crystal ball was a curse.

Bond yields rose following the rate cut despite what many investment professionals perceive to be a bullish event. If you scour the media, you will find rationales for the sell-off. Such includes the Fed stoking inflation or China's massive stimulus package. In our opinion, it's much more straightforward; it all comes down to context.

We were inspired to write this by a message asking us in disbelief if we had ever seen such an adverse bond market reaction to a rate cut.

To help answer the question, we share an article entitled [When A Crystal Ball Isn't Enough To Make You Rich](#) by Victor Haghani and James White, along with their Crystal Ball Challenge. **The article and challenge help us appreciate that context is often more valuable than a crystal ball.**



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Technicals Provide Context

On September 18, when the Fed cut interest rates by 50bps, ten-year note yields rose slightly from the opening yield of 3.68% to close the day at 3.69%. Five days later, the yield rose another .12% to 3.81%.

A crystal ball enlightening a trader about the rate cut headlines would have been costly. However, a trader with the crystal ball and proper context may have been more successful. In trading, context describes market conditions and recent trends. On a short-term basis, excellent context can be gleaned from technical analysis.

To contextualize the Fed rate cuts, investors had been expecting a rate cut at the September meeting for months. Furthermore, in the days leading up to the announcement, the odds of a 50bps rate cut increased markedly. The critical context was the 1% decline in ten-year note yields since April, and, equally importantly, bond prices were extremely overbought on a technical basis.

This potential for a bearish reaction to what should have been positive news from the Fed was not lost on us. On September 17, the day before the meeting, we wrote the following summary on bonds in our [Daily Commentary](#):

*Yesterday, we discussed the market's strong rally from the recent lows. However, the bond market has rallied just as strongly ahead of this week's highly anticipated Federal Reserve meeting and the expected rate cut. **As shown, Treasury bonds (as represented by TLT) are quite deviated from the 50-DMA and overbought on multiple levels.** While we remain bullish on bonds in the longer term, particularly as the economy slows, the current overbought conditions and "exuberance" into the bond trade over the last few months is a bit overdone.*

***With the Fed meeting this week, the current setup suggests that even if the Fed cuts rates as expected, this could be a "buy the rumor, sell the news" setup for bonds.** Of course, as is always the case, overbought conditions can remain overbought longer than most imagine, so trade accordingly.*

To subscribe to our Daily Commentary free of charge to your email every morning, click [HERE](#).

With that example of how context was more valuable than a crystal ball, we let you discover the value of a crystal ball without any context.

The Crystal Ball Challenge

The article noted in the introduction is based on information the authors gleaned by subjecting over 118 young adults schooled in finance to the Crystal Ball Challenge.

Before summarizing the article, click on the crystal ball below. Take the challenge and see what value, if any, a crystal ball with tomorrow's headlines is in predicting short-term price changes. ([LINK](#))



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Review: [When A Crystal Ball Isn't Enough To Make You Rich](#)

Per the whitepaper:

Was Taleb correct in his conjecture that "If you give an investor the next day's news 24 hours in advance, he would go bust in less than a year"? While our experiment didn't test his statement precisely ? we only gave players 15 days of front pages, players were risking just \$100 in the game, etc. ? by and large we think Taleb is right.

The 118 young finance professionals posted a meager positive return. Their results were not statistically different than flipping a coin. They attribute the poor results to two factors.

The first was not correctly guessing how stocks and bonds would perform with knowledge of the headlines 36 hours in advance.

Second, the authors claim the players didn't properly size their bets. We also presume that some traders made trades on headlines that did not affect the markets. In those cases, it was a 50/50 proposition.

Sizing is an important point the authors stress. Trade sizes should have been minimal, or trades should not have occurred when the trader had little confidence their guess was correct. Conversely, they should have had larger sizes when they had more confidence.

Experience Matters

The article shares a tweet from the very experienced Lloyd Blankfein, ex-Chair of Goldman Sachs. While he tweets about the market action concerning CPI on one specific day, we bet he would agree that, generally, having news before everyone else may not be all it's cracked up to be.



This is one of those trading days where if you had the news in advance (above-expected CPI), you REALLY would have lost a lot of money.

After testing the younger finance professionals, the authors wanted to see how experienced traders would do. They "invited five seasoned and successful macro traders" to take their test. **Once again, they found that advanced knowledge of headlines was not incredibly valuable.** The traders got 63% correct. However, they posted an average return of 130%.

*These players all finished with gains. On average, they grew their starting wealth by 130%, with a median gain of 60%. All of the players were selective and highly variable in their trade-sizing. **They did not bet at all on about 1/3 of the trading opportunities, but bet big on days when they presumably felt confident in the impact of the news on stock or bond prices.***

Guessing is a fool's errand when it comes to investing. However, investing with context and adequately sizing your trades/investments based on your confidence level is vital.

The study, in a roundabout way, shows that context matters. As we opined in the opening, technical analysis can provide significant context as to recent trends, the strength of said trends, and how momentum may change. Furthermore, volume and trade analysis can help us find market pain points and price levels where investors are more likely to buy or sell.

Macroeconomic analysis and appreciation for the liquidity situation of a market are also essential to help bolster your context. Along the same lines, given the importance of actual and perceived liquidity, a good appreciation for the Fed's current mindset and their current and likely stance on monetary policy is critical.

With proper context, a headline in your crystal ball may prove much more valuable.

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Summary

A crystal ball would be an excellent addition to our market analysis arsenal. Advanced knowledge of market, economic, political conditions, and other events would likely positively impact our performance. The impact, however, would be over the longer run, not in the returns immediately following the foreseen events. Trading on a short-term basis with no context can be hazardous to your wealth.

Furthermore, assumptions of a specific result due to particular news are often faulty. As the old saying goes- **buy the rumor, sell the news!**