

Between 2001 and 2004, volume in the foreign-exchange market increased more than 50%, illustrating the overall rise in popularity of currency trading. The advent of online trading following the technology boom has allowed many equity and futures traders to look beyond their more traditional trading instruments. Most short-term traders or speculators trade FX based on technical analysis, so equity and futures traders who use technical analysis have made the switch to FX fairly easily. However, one type of analysis that traders have not been able to transfer over to currencies is volume-based trading. Since the currency market is decentralized and there is no one exchange that tracks all trading activities, it is difficult to quantify volume traded at each price level. But in place of volume-based trading, many traders have turned to the Commodity Futures Trading Commission's Commitments of Traders (COT) report, which details positioning on the futures market, for more information on positioning and volume. Here we look at how historical trends of the COT report can help FX traders.

What is the COT Report?

The Commitments of Traders report was first published by the CFTC for 13 agricultural commodities in 1962 to inform the public about the current conditions in futures market operations (you can find the report on the CFTC website [here](#)). The data was originally released just once a month, but moved to once every week by 2000. Along with reporting more often, the COT report has become more extensive and - luckily for FX traders - it has now expanded to include information on foreign currency futures. If used wisely, the COT data can be a pretty strong gauge of price action. The caveat here is that examining the data can be tricky, and the data release is delayed as the numbers are published every Friday for the previous Tuesday's contracts, so the information comes out three [business](#) days after the actual transactions take place.

Reading the COT Report

Figure 1 is a sample euro FX weekly COT report for June 7, 2005, published by the CFTC. Here is a quick list of some of the items appearing in the report and what they mean:

- **Commercial** - describes an entity involved in the production, processing, or merchandising of a commodity, using futures contracts primarily for hedging.
- **Long report** - includes all of the information on the 'short report', along with the concentration of positions held by the largest traders.
- **Open interest** - the total number of futures or options contracts not yet offset by a transaction, by delivery or exercise .
- **Noncommercial (speculators)** - traders, such as individual traders, hedge funds & large institutions, who use futures market for speculative purposes and meet the reportable requirements set forth by the CFTC.
- **Non-reportable positions** - long & short open-interest positions that don't meet reportable requirements set forth by the CFTC.
- **Number of traders** - total number of traders who are required to report positions to the CFTC.
- **Reportable positions** - the futures and option positions that are held above specific reporting levels set by CFTC regulations.
- **Short Report** - shows open interest separately by reportable & non-reportable positions.
- **Spreading** - measures the extent to which a non-commercial trader holds equal long and short futures positions.

EURO FX - CHICAGO MERCANTILE EXCHANGE
Commitments of Traders - Futures Only, June 7, 2005

	Total	Reportable Positions						Nonreportable Positions	
	Open Interest	Non-Commercial			Commercial		Total	Positions	
		Long	Short	Spreading	Long	Short	Long	Short	
(Contracts of 125,000 Euros)									
All	193,707	22,939	40,710	629	125,244	105,308	148,812	146,647	44,895
Old	193,707	22,939	40,710	629	125,244	105,308	148,812	146,647	44,895
Other	0	0	0	0	0	0	0	0	0
Changes in Commitments from May 31, 2005									
	3,213	-1,272	-1811	-414	21,649	21,407	19,963	19,182	-16,750
Percent of Open Interest Represented by Each Category of Trader									
All	100	11.8	21.0	0.3	64.7	54.4	76.8	75.7	23.2
Old	100	11.8	21.0	0.3	64.7	54.4	76.8	75.7	23.2
Other	100	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of Traders in Each Category									
#Traders									
All	100	23	33	6	32	30	59	65	
Old	100	23	33	6	32	30	59	65	
Other	0	0	0	0	0	0	0	0	
Percent of Open Interest Held by the Indicated Number of Largest Traders									
By Gross Position									
By Net Position									
		4 or Less Traders		8 or Less Traders		4 or Less Traders		8 or Less Traders	
		Long	Short	Long	Short	Long	Short	Long	Short
All		36.8	35.3	50.6	45.3	34.0	26.3	43.9	33.8
Old		36.8	35.3	50.6	45.3	34.0	26.3	43.9	33.8
Other		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Figure 1

Taking a look at the sample report, we see that open interest on Tuesday June 7, 2005, was 193,707 contracts, an increase of 3,213 contracts from the previous week. Noncommercial traders or speculators were long 22,939 contracts and short 40,710 contracts - making them net short. Commercial traders, on the other hand, were net long, with 19,936 more long contracts than short contracts (125,244 - 105,308). The change in open interest was primarily caused by an increase in commercial positions as noncommercial or speculators reduced their net-short positions.

Using the COT Report

In using the COT report, commercial positioning is less relevant than noncommercial positioning because the majority of commercial currency trading is done in the spot currency market, so any commercial futures positions are highly unlikely to give an accurate representation of real market positioning. Noncommercial data, on the other hand, is more reliable as it captures traders' positions in a specific market. There are three primary premises on which to base trading with the COT data:

- Flips in market positioning may be accurate trending indicators.
- Extreme positioning in the currency futures market has historically been accurate in identifying important market reversals.
- Changes in open interest can be used to determine strength of trend.

Flips in Market Positioning

Before looking at the chart shown in Figure 2, we should mention that in the futures market all foreign currency exchange futures use the U.S. dollar as the base currency. For Figure 2, this means that net-

short open interest in the futures market for Swiss francs (CHF) shows bullish sentiment for USD/CHF. In other words, the futures market for CHF represents futures for CHF/USD, on which long and short positions will be the exact opposite of long and short positions on USD/CHF. For this reason, the axis on the left shows negative numbers above the center line and positive numbers below.

The chart below shows that trends of noncommercial futures traders tend to follow the trends very well for CHF. In fact, a study by the Federal Reserve shows that using open interest in CHF futures will allow the trader to correctly guess the direction of USD/CHF 73% of the time.

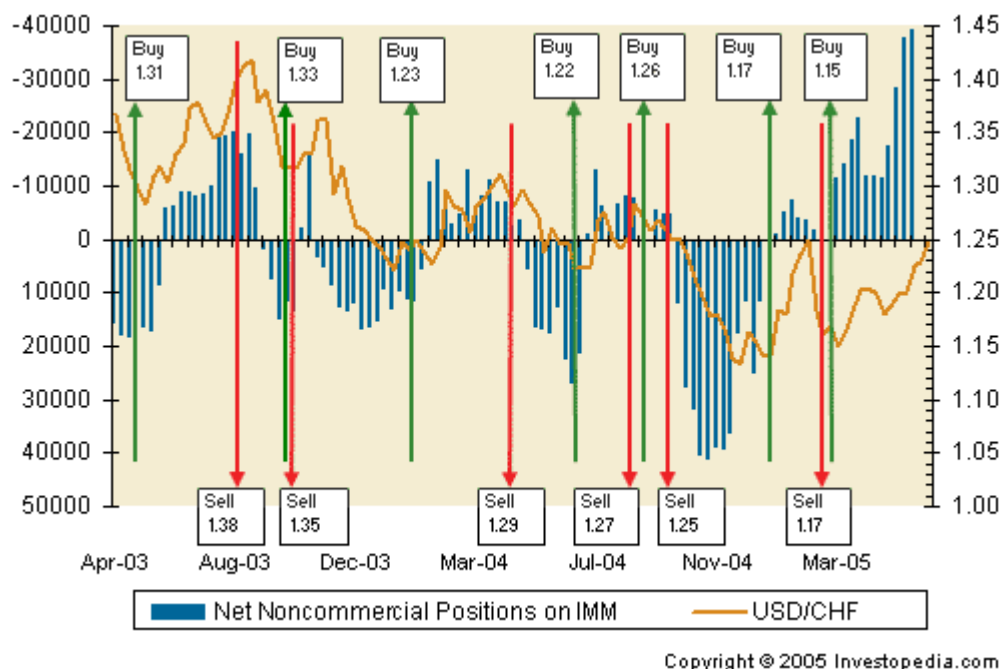


Figure 2 - Chart showing net positions of noncommercial traders in the futures for Swiss francs (corresponding axis is on the left-hand side) on the International Monetary Market (IMM) and price action of USD/CHF from Apr 2003 to May 2005 (corresponding axis is on the right-hand side). Each bar represents one week. Source: [Daily FX](#).

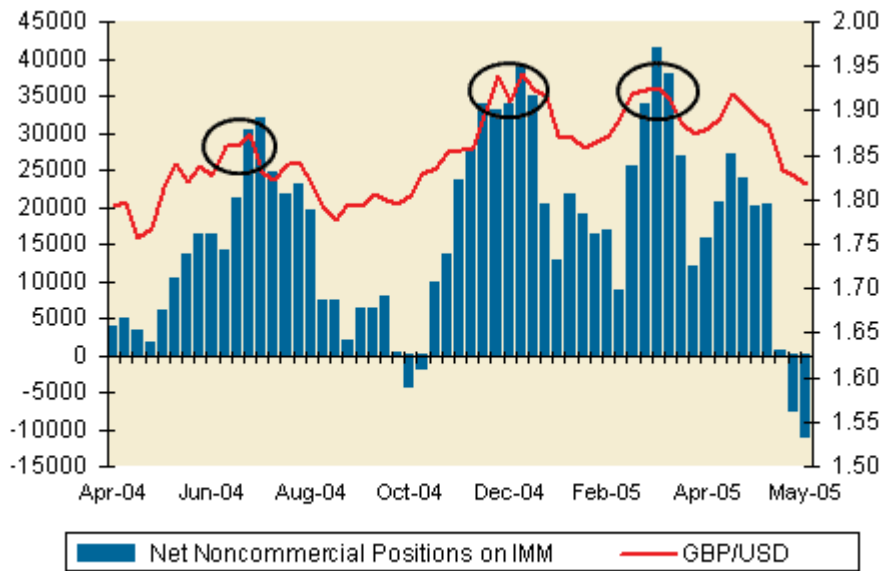
Flips - where net noncommercial open-interest positions cross the zero line - offer a particularly good way to use COT data for Swiss futures. Keeping important notation conventions in mind (that is, knowing which currency in a pair is the base currency), we see that when net futures positions flip above the line, price action tends to climb and vice versa.

In Figure 2, we see that noncommercial traders flip from net long to net short Swiss francs (and long dollars) in June 2003, coinciding with a break higher in USD/CHF. The next flip occurs in Sept 2003, when noncommercial traders become net long once again. Using only this data, we could have potentially traded a 700-pip gain in four months (the buy at 1.31 and the sell at 1.38). On the chart we continue to see various buy and sell signals, represented by points at which green (buy) and red (sell) arrows cross the price line.

Even though this strategy of relying on flips clearly works well for USD/CHF, the flip may not be a perfect indicator for all currency pairs. Each currency pair has different characteristics, especially the high-yielding ones, which rarely see flips since most positioning tends to be net long for extended periods as speculators take interest-earning positions.

Extreme Positioning

Extreme positioning in the currency futures market has historically also been accurate in identifying important market reversals. As indicated in Figure 3 below, abnormally large positions in futures for GBP/USD by noncommercial traders has coincided with tops in price action. (In this example, the left axis of the chart is reversed compared to Figure 2 because the GBP is the base currency.) The reason why these extreme positions are applicable is that they are points at which there are so many speculators weighted in one direction that there is no one left to buy or sell. In the cases of extreme positions illustrated by Figure 3, every one who wants to be long is already long. As a result, exhaustion ensues and prices begin reversing.



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Figure 3 - Chart showing net noncommercial positions in GBP futures on IMM (corresponding axis is on the left-hand side) and price action of GBP/USD (corresponding axis is on the right-hand side) from May 2004 to Apr 2005. Each bar represents one week. Source: Daily FX.

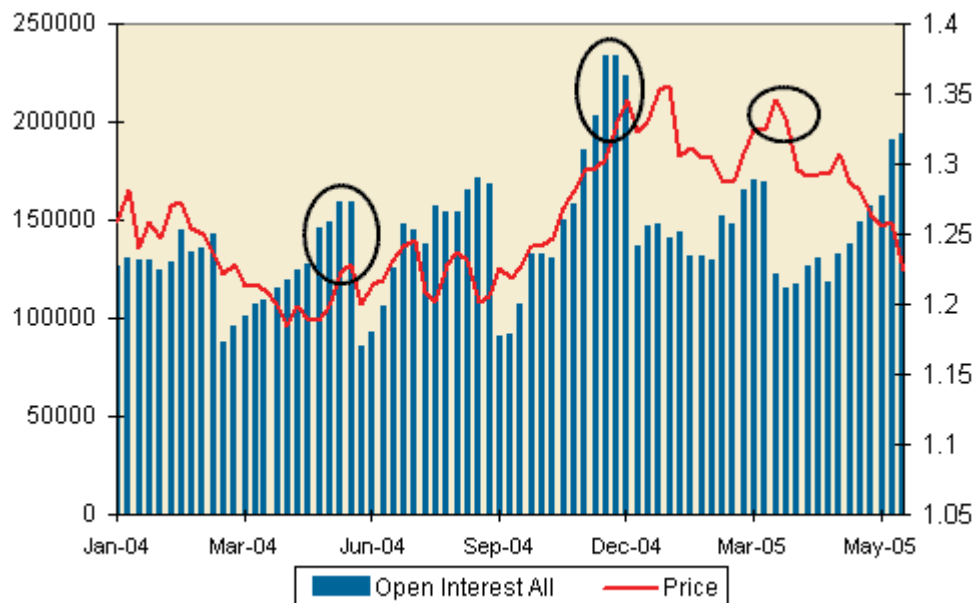
Changes in Open Interest

Open interest is a secondary trading tool that can be used to understand the price behavior of a particular market. The data is most useful for position traders and investors as they try to capitalize on a longer-term trend. Open interest can basically be used to gauge the overall health of a specific futures market; that is, rising and falling open interest levels help to measure the strength or weakness of a particular price trend.

For example, if a market has been in a long-lasting uptrend or downtrend with increasing levels of open interest, a leveling off or decrease in open interest can be a red flag, signaling that the trend may be nearing its end. Rising open interest generally indicates that the strength of the trend is increasing because new money or aggressive buyers are entering into the market. Declining open interest indicates that money is leaving the market and that the recent trend is running out of momentum. Trends accompanied by declining open interest and volume become suspect. Rising prices and falling open interest signals the recent trend may be nearing its end as fewer traders are participating in the rally.

The chart in Figure 4 displays open interest in the EUR/USD and price action. Notice that market trends tend to be confirmed when total open interest is on the rise. In early May 2004, we see that price

action starts moving higher, and overall open interest is also on the rise. However, once open interest dipped in a later week, we saw the rally topped out. The same sort of scenario was seen in late Nov and early Dec 2004, when the EUR/USD rallied significantly on rising open interest, but once open interest leveled off and then fell, the EUR/USD began to sell off.



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Figure 4 - Open interest in the EUR/USD (corresponding axis is on the left-hand side) and price action (corresponding axis on right-hand side) from Jan 2004 to May 2005. Each bar represents one week. Source: Daily FX.

Summary

One of the drawbacks of the FX spot market is the lack of volume data, but to compensate for this, many traders have turned to the futures market to gauge positioning. Every week, the CFTC publishes a Commitment of Traders report, detailing commercial and non-commercial positioning. Based upon empirical analysis, there are three different ways that futures positioning can be used to forecast price trends in the foreign-exchange spot market: flips in positioning, extreme levels and changes in open interest. It is important to keep in mind, however, that techniques using these premises work better for some currencies than others.

By Kathy Lien, Chief Strategist, FXCM