Chapter 20

LEARNING BY INSPECTION

What is a volatility blow-off?

A volatility blow-off comes when prices which have been strongly moving in one direction suddenly discontinue moving in that direction and begin to congest. In a moment we'll be showing you charts depicting this situation. During a blow-off, the range from top to bottom of the price bars diminish in size and trading quiets down considerably, leaving the market much less volatile than it previously was.

Can you make money from a blow-off? If so, how?

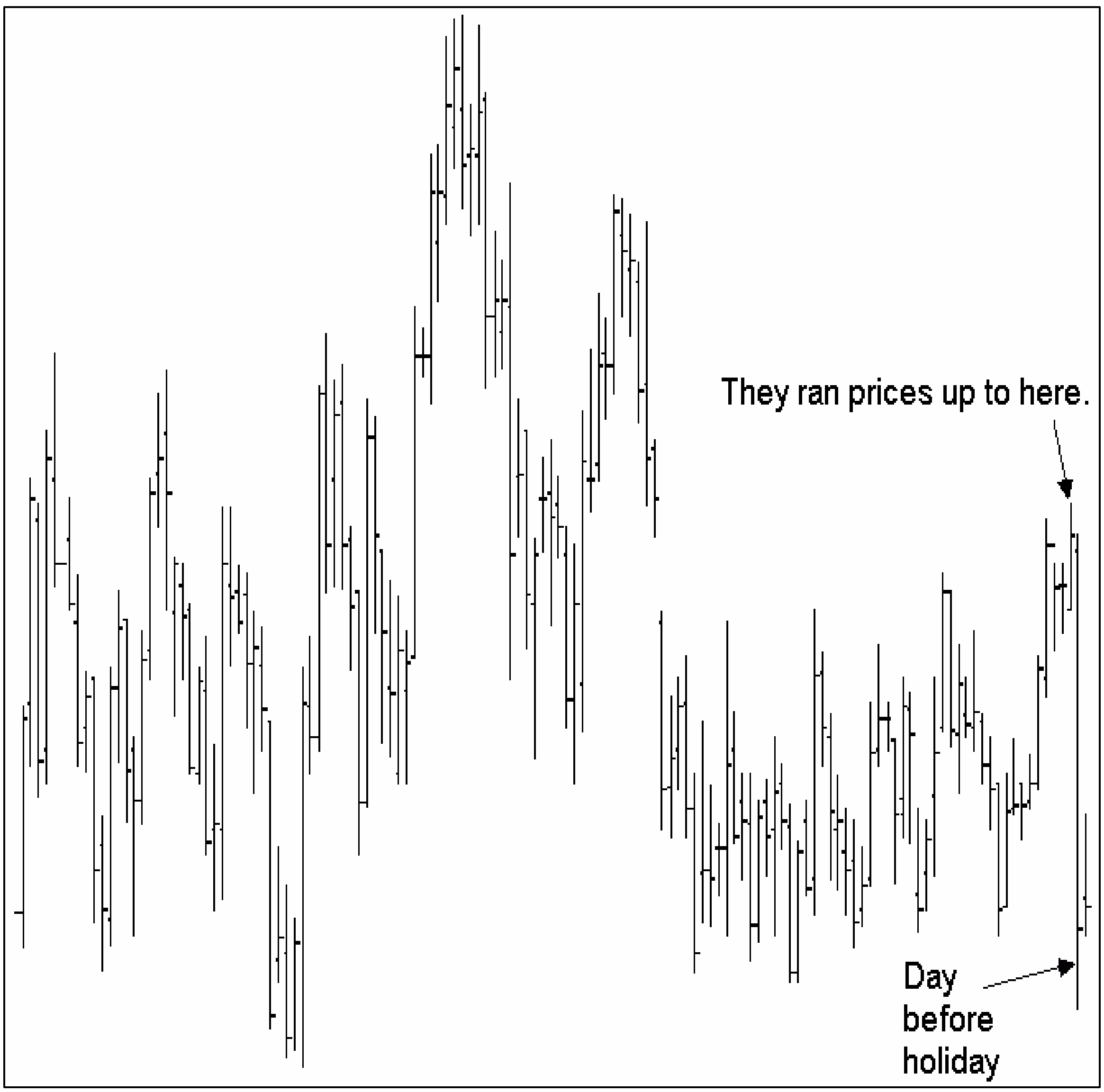
Volatility blow-offs are not created by the strong hands, but at times are used by them because they frighten the weak hands out of the market. By so doing, the strong players get to pick up the marbles the weak players leave behind. This often happens in thinly traded markets, and in all markets around holiday times. Blow-offs can be made more pronounced by those having control of a market. Volatility blow-offs are the reason you must learn to avoid trading just before a holiday. It is during those periods of time that the market movers can give themselves a holiday present at the expense of the foolish weak players who do not have enough sense to avoid trading then.

There are actually cases where market movers make most of their entire year's profits just before holidays, when the markets are sufficiently thin and they can run prices first one way and then another, virtually to their hearts' content.

To the casual trader, the price chart of a thinly traded futures looks no different from that of a heavily traded one. At the end of the day an open, high, low, and close are all in place regardless of liquidity. But during the trading day of the thinly traded futures, the insiders have had a picnic. They have cleaned the stops both above and below the market. That money is in their pocket and out of your account.

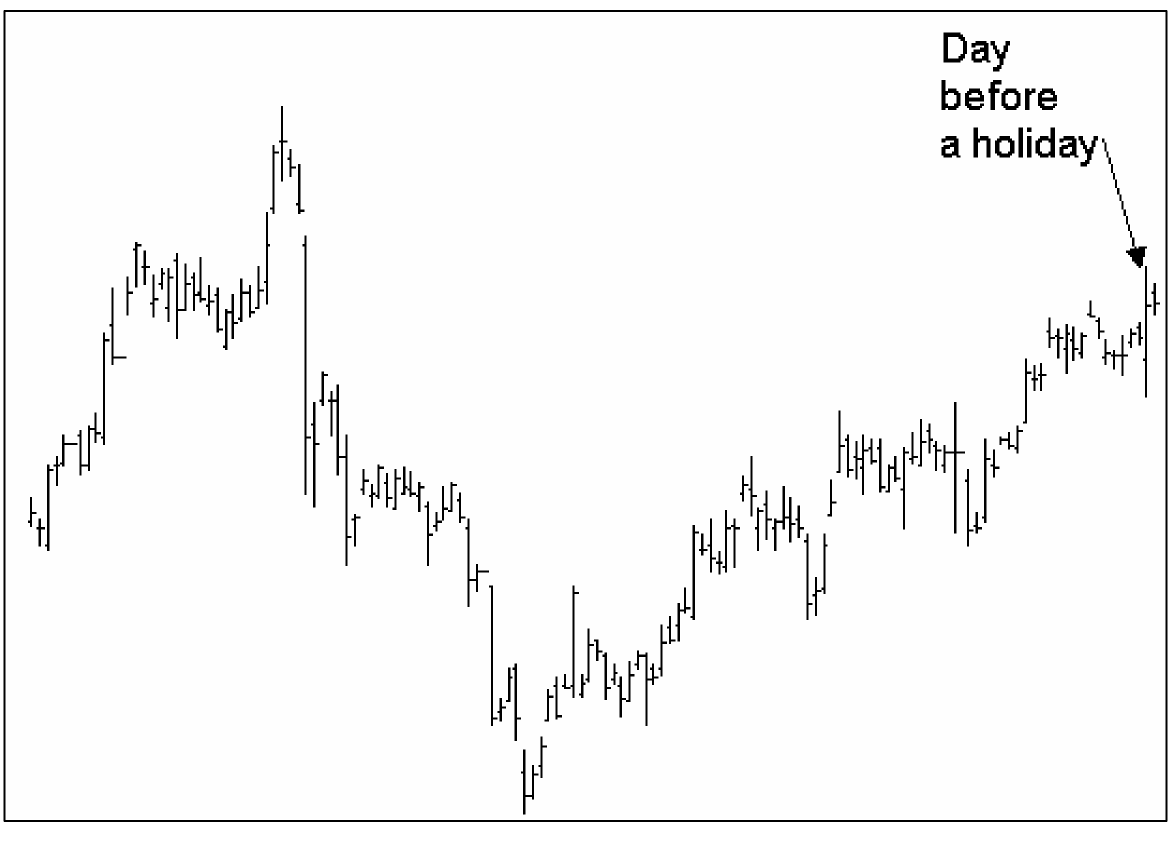
A close examination of some charts will show you how the insiders do it, and what you must look for. It may be that you, too, will want to play this game. The astute trader/business person will stand aside during these low liquidity times, but will seek to take advantage of the same action during times when liquidity is high.

Let's take a look at some charts to see what we mean. We'll start with a market which is usually thinly traded, and like many markets can become even more thin when Christmas and the New Year roll around. What you will be seeing is a minor volatility blow-off, otherwise known as a melt-down or sudden collapse.



First the market movers took the market higher. They made it look as though prices were going to breakout to the upside. Indeed, it did momentarily break the top of the Trading Range one day, and then broke out once more two days before a holiday. This was done in order to create a bull trap and pick off any buy stops lurking above the Trading Range. The intent of the market movers was to lure as many as possible into thinking they were truly taking the market up. Their real intent, however, was to take the market up so that they could take it down from a higher level, thereby snatching victory for themselves and handing unwary traders a defeat. If you don't think that such antics in the market are intentional and purposeful, then you have no business trading. You need to attend one of our seminars where we teach you about such things. Now, let's look at another sucker play, and then we'll look at some true volatility blow-offs, ones in which even the outside traders can make money.

This next one happened in another thinly traded market. You must always be aware of thin markets and the ever present danger of bad fills, sudden reversals, and treachery designed to part you from your hard-earned cash.



How about that? They ran the market and filled the orders above so-called resistance, and below so-called support. What a nice day these folks had for themselves.

It goes back to the old saying, "When the cat's away, the mice will play." Unless there are lots of orders (liquidity) and stronger hands (perhaps in the form of large trading funds) to stop these kinds of shenanigans, the market movers can have a field day running stops in the market. They can see them, they know where they are. Many of them are open orders they're holding in their hands, or which can be seen on their trading screens.

Sometimes it is the strongest players in the market who run the market for their own purposes.

They often do this just prior to running a market one way or the other. For instance, if they want to take a market up, they may squeeze it down first, scale buying into it just before they make their real move, which is to take the market up. At other times they will take a market up strongly so they can sell at higher prices, dumping parts of their position steadily as they go, buying back at lower prices than what they originally sold for.

Such action may be seen as an upward explosion or a downward collapse. Is there a way for us to play these situations and make money? Yes, there is! It can be done, and to a certain extent you can control the amount of risk you are willing to take when doing it.

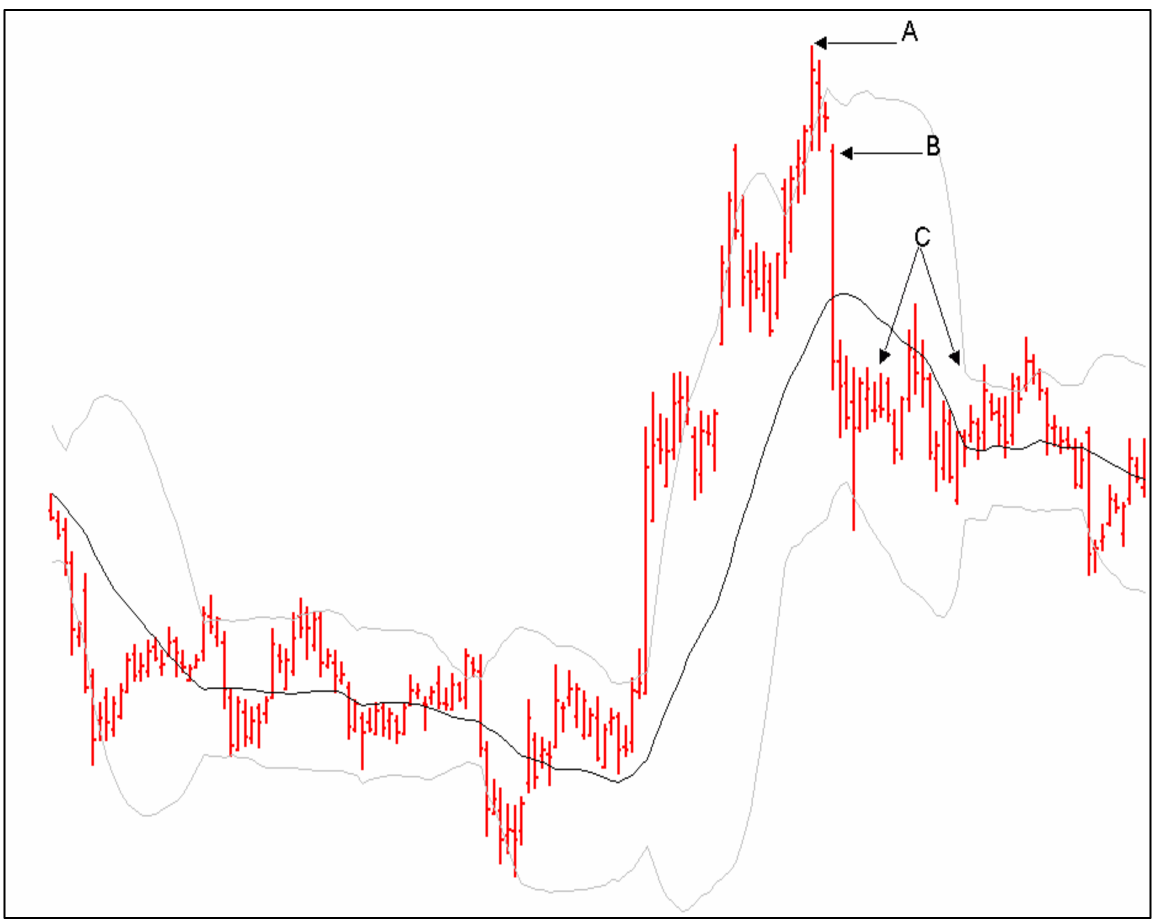
Let's look at how to do it. First we'll show it as a pure futures play. Then we'll look at it as a pure options play, and finally how to do it combining futures and options. Then you can make your choice as to how you would like to attempt such a trade, should you care to try one at all.

What's that, you don't do options? If you don't, then you may want to look into them. If your desire is to become a complete trader you will need to some day. Although options are for the most part beyond the scope of this book, perhaps we can tickle your imagination a bit and get you to look into them as a way to greatly improve your futures trading. Our purpose is not to encourage you to trade the options just yet, but to show you how it might be done should you care to try.

A volatility blow-off occurs just after a sudden explosion or collapse in prices. Prices may explode upward and appear to be running away, or they may collapse into what appears to be a melt-down. In either case, volatility will be very high and the volatility deemed to be quite dangerous, to say the least. Such price action is best left alone by most traders. But the situation may be one of great opportunity to those traders who have a plan in mind for this very situation. We'll now look at a volatility blow-off.

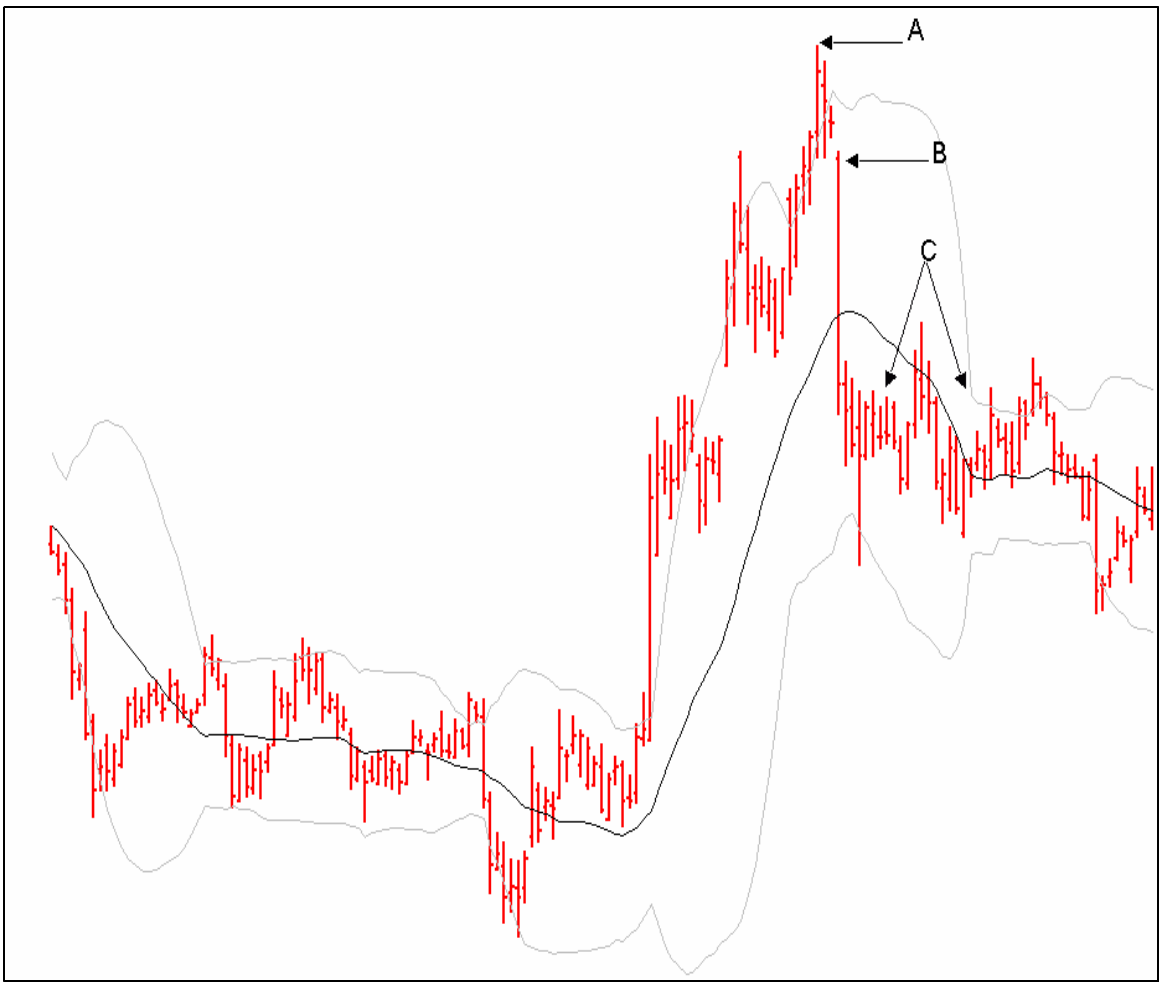
Notice carefully that prior to the big drop, prices had been volatile as they moved up. The price action even included closes outside the upper band (Bollinger Bands using 20 bar simple moving average and set at 2 Standard Deviations) on a few of the days before making the highest high on the chart "A". As prices rose, a great many profit protecting stops would have been accumulating at various places that traders holding long positions might have considered as support. Call premiums would have been quite high as investors not willing to be long the futures themselves would have placed a high level of demand in the market for Call options. Two days after the highest high was made, there was an inside doji day. Such price action would have caused a flurry of orders in the market as traders were now seeing two days in a row in which prices failed to make higher highs.

The day following the doji day, the market movers happily obliged those traders who had stops just under the double low created by the bar that made the highest high, "A," and the reversal bar immediately following it. The next day, the big down day, "B," the market makers took care of the rest of the stops, partly catching those traders who

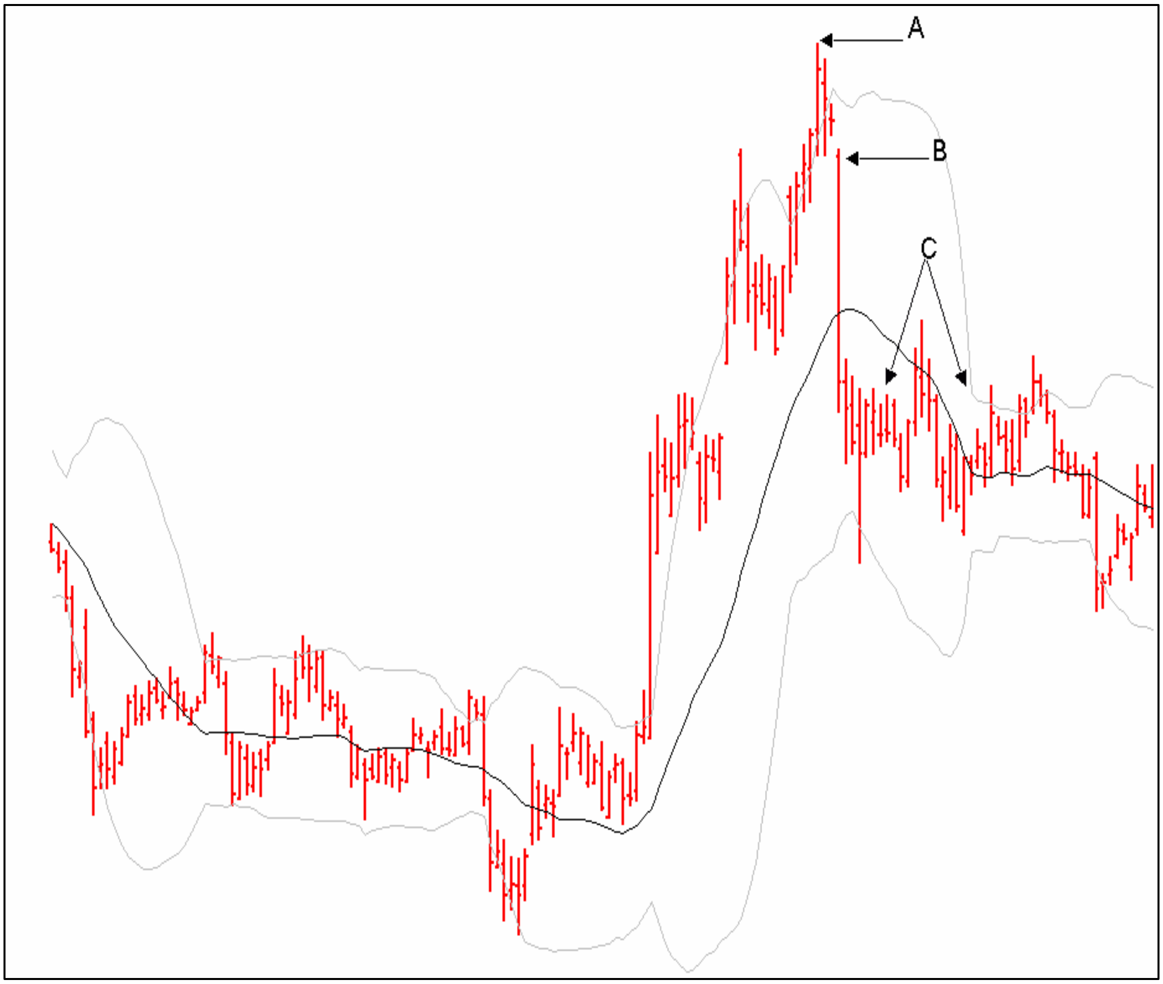


had stops at the top, bottom, and in the middle of the upward gap made a couple of weeks earlier. They did it without mercy. They opened the market with a gap down, and then ran a ton of stops that were in the market. Was this because suddenly no one wanted this market, or was it because the market movers were manipulating the market? The answer lies in the fact that once they had the bulk of the stops, which they did get in the next few days, most of the volatility in prices for this market disappeared and prices congested as pointed out by “C.”

We'll look at the chart again to see ways in which this market could have been traded.



Notice that the day after “A”, the price action resulted in a reversal bar at the upper band. There had been a similar reversal bar 12 days prior to “A” that yielded a small win or breakeven trade, depending on how the trade was protected (if entered at all). When prices are drastically volatile, and become almost vertical (parabolic) in their ascent, it is definitely worthwhile to enter on reversal bars at the upper band using a tight stop. The reversal bar following “A” was an excellent pure-futures sell short situation.



Pure-options traders could have written Calls above the market one or two days after “A” if they were aware of the price action being extremely volatile. That prices were extremely volatile is seen by the fact that on numerous occasions dating back several weeks, prices had repeatedly violated the upper band. Even if Calls were not written until after “B,” exceptionally high Call premium would have been available, and Calls far out of the money would have brought extremely high prices.

But once prices began to congest as they did at “C,” Call premiums would have shrunk dramatically, leaving the Call seller with some fat premiums in his account and prices far away from the Call's Strike Price.

Call prices would have fallen apart when it became obvious that there was practically no chance of an immediate recovery back to the previous highs. You could literally bank any premium received for those Calls. The volatility blow-off occurs by virtue of the fact that a Trading Range will typically reduce the market's perception of volatility, and thereby the price of options themselves. Volatility blow-off literally means that volatility has collapsed. Writing Calls above a melt down or writing Puts below an explosion is virtually a sure-thing options trade. Please recall that writing naked options may require a sizable margin account and many brokers will advise you to not write them at all. The concept behind this kind of trade and many others are taught at our private tutoring sessions to those having a desire to learn about them. Y'all come!

Of course, it was also possible to have the best of both worlds by combining the sale of Calls with the selling short of the futures while the meltdown was occurring. By doing that, you would have taken a wonderful opportunity to dramatically increase profits from the volatility blow-off situation.

PERTINENT POINTS

- The trader who knows what to do with high volatility is in a better position to make money than the trader who does not know what to do.

- Beware of thinly traded futures. The volatility in those markets may be entirely caused by market mover manipulations.

- Beware of trading any market the day before a holiday

- Protect yourself against fake moves by market movers and other strong hands who deal in the market you are trading.

- Be very cautious of price movement as prices approach areas of so-called support and resistance. Tighten stops, take profits, or simply exit.

- Be aware that most of the time the intraday price action has virtually nothing to do with supply and demand. True supply and demand are seen in trending prices on longer term charts. A monthly uptrend is much more indicative of short supply than is a weekly uptrend, and a weekly uptrend is more indicative than a daily chart uptrend. A monthly downtrend is much more indicative of over supply than is a weekly downtrend, and a weekly downtrend is more indicative than a daily chart downtrend.