Technical Analysis for Options Traders

By Doc Severson
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Building an Edge with Technical Analysis

If you’re reading this eBook, then chances are good that you got some type of training in Technical Analysis. I’m not going to rehash all the “oldies but goodies” here, as you probably already know about oversold Stochastics, Moving Averages, MACD crosses and so forth. Those indicators do an excellent job of telling you what has already happened; they are trailing indicators.

But do you know how to read between the lines?

If you know what you’re looking for, then several garden-variety technical indicators can be used to look for leading signals, which are clues about what might happen in the future.

This is important, because if you have an increased likelihood of something happening in the future, then you can use that knowledge to help increase your edge in how you place your options trades. And as we know, this “edge” is necessary to initiate a trade, so that we’re not just gambling.

For example, there are leading signals in the chart below that gave me information that there was an increased likelihood of the rally failing:

Figure 1

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Did you see them? The MACD Histogram was showing “lower highs” as the price made “higher highs”. That is a classic Bearish Divergence on the MACD Histogram indicator, a great leading signal, and tipped us off that the price would soon take a pause from its upward assault.

The other piece of leading information was in the price itself; the price had been in an ascending wedge price pattern for over two months; those patterns always break to the downside - eventually.

How could you use these pieces of forward-looking knowledge to help you increase your edge on options trades? In this case, as the divergences continued to pile up in an ascending wedge pattern, you might get a bit more aggressive with placing your call spreads.

Don’t get me wrong; these leading signals are not meant to “predict” the future. Notice in this example that you started to see the first of these leading signals in early April, yet the eventual breakdown did not occur until the latter part of May. Keep in mind that all technical indicators are generally based on Price and Volume, and this inherently makes most studies lagging...telling you what’s already happened. To me, that’s like reading the sports page from two days ago, it’s yesterday’s news. Looking between the lines of these indicators is what gives us leading signals, which are inherently much more useful to us.

**How does identifying these leading signals give us an edge?**

Improving your edge depends on what your goals are, and what you’re trying to improve through your “edge”.

For some, it’s improving one’s monthly returns. In the previous example, if you felt that the Market was about to turn over, then you could place your overhead Call Vertical (Bear Call Spread) closer to the money than you normally do, in order to receive more initial credit and a higher potential profit.

If you’re like me and find sleep more important than returns, then using that leading signal allows me to get more distance on my Call spread when it finally rolls over. In simple terms, I can gain an edge by “widening” the legs of my Iron Condor trade; there are few things in life more beautiful to me than watching the price fade away from one of my short Options positions.
The Basic Premise

Here’s all that I’m trying to do when I use Technical Analysis to spot leading signals to help me gain a stronger edge when trading options...in my case, specifically the Iron Condor:

• I am trying to identify leading signals which indicate that price has an increased probability of dropping or going sideways in the near future, allowing me to sell a topside Bear Call Spread at the maximum possible distance from the current price, and...

• I am trying to identify leading signals which indicate that price has an increased probability of bouncing up or going sideways in the near future, allowing me to sell a Bottom Side Bull Put Spread at the maximum possible distance from the current price.

That’s it - it’s that simple. Remember, when we establish our credit spreads to build the Iron Condor, we don’t necessarily need to be correct about our forecast for the Market....we just need to be in the ballpark.

So now that we’ve laid out the basic premise of how we’re going to use Technical Analysis to help improve our entries, let’s look at some very specific signals that we’ll use to help increase our edge as we enter the trade.
Price Action

We’ll discuss price first, as Price is King. What the price action on the chart tells you will override any other signal or indicator that you place on a chart. Remember, all indicators are derived from price and volume to begin with, so it wouldn’t make sense to have a Derivative Indicator veto a Price Action signal. It would be like having a Son tell a Father that he’s made a mistake, and everyone knows that Fathers are always correct, right?

If I did not have any indicators on my chart at all, I could still establish high-probability Iron Condor trades if I just had price charts available to me.

There are several ways that we can use price action as a “leading signal” to help with our entries:

**Horizontal Support and Resistance Levels**

One of the most basic - and effective - methods for placing good Iron Condor spread trades is to use Support and resistance levels to help “slingshot” trades as far out of the money as possible, and then watch the price repel or bounce away from that support or resistance level. Figure 2 shows this concept nicely; note how there is a strong resistance level at about the 760 level on the chart, and a strong support level at about 650.

In practice, you can see that once the overhead resistance value of 760 was established in early June, on the next bounce up to re-test that level in mid-August, you would have an excellent opportunity to sell a very distant Bear Call Spread to the topside, and then watch as the price fell away from the trade, making it quickly profitable. Similarly, once the 650 level was established as support in January and March dips, the next test of support in mid-July would present another opportunity to sell a Put spread to the downside at a great distance, which would also become quickly profitable as the price runs away and implied volatility is crushed.
What’s the one problem with this method? Signals are powerful, yet infrequent. We’re frequently bound by time restrictions when trading spreads on a monthly basis. Fortunately there are many more price-based leading signals to help out our entries.

**Price Channels**

If you spend as much time as I do following one or two charts, then you’ll notice very quickly that Price tends to run in Channels. Price will never go in one direction forever; it tends to move in “waves”. (covered shortly in the Elliott Wave section) These waves tend to create a “back and forth” motion as the price moves on a net basis in one direction or another.

These channels give us several “leading signals” to trade off of:

- Once the channel is established, then Bear Call Spreads can be sold as the channel approaches the top trendline of a channel.
- Bull Put Spreads can be sold as the price comes back down to the lower trendline of a channel.
• Once the price “falls out” of a channel, the price will frequently jump back to “backtest” the old channel before falling away.

In Figure 3, you can see how the price ran in two very distinct ascending channels, offering multiple entries to the top and bottom, and how each channel was “backtested” from underneath once the price fell out of the ascending channel.

These “backtest” entries can be very high probability trades, as the odds usually favor the price not being able to climb back into the channel once it falls out. You can spot the backtests in Figure 3 in mid-June and early September.

With respect to price channels, I have found ascending channels to be much more useful for these types of entries than descending channels. Ascending channels tend to be slower, more grinding affairs vs. downtrending channels that tend to be short and sharp.

As we get into other leading signals, you’ll see that it can be somewhat risky to continue taking downside entries near the top of an ascending channel.

Figure 3
Chart Patterns

Chart Patterns - I’m sure you’ve heard of a lot of them by this point in your trading career. Bull Flags, Cup with Handles, Rounded Bottoms, Descending Triangles, etc etc. Believe me, I love spotting chart patterns because they can be an excellent leading signal from Price Action telling us that the odds favor the resolution of that pattern.

The trouble with learning chart patterns, however, is that you’ll start seeing all kinds of obscure patterns in your charts, many of which will conflict with each other, so you’re left groping in the dark trying to figure out which ones are correct.

So let’s not overcomplicate the matter. Let’s boil it down to two simple rules as it relates to price action:

• **Ascending patterns tend to break to the downside.**
• **Descending patterns tend to break to the upside**

Huh? That’s it? Surely there must be something more difficult than that!

Nope. In fact, many chart patterns are based on this rule; Ascending Wedge patterns break to the downside, Bull Flags break to the upside, Bear Flags break to the downside, etc.

Take another look at Figure 3; notice how the descending patterns break to the upside, and how the ascending patterns eventually break to the upside. Nothing runs forever in one direction. If you apply those two simple rules above, then you’ll add yet another edge in your favor.

There are two specific applications of “leading signals” that I look for on ascending/descending pattern breaks that help increase my edge:

• On a descending channel breakout, look for a re-test of that upper channel line as a possible downside Bull Put Spread entry (yellow marker on Figure 4)
• On an ascending channel breakdown, look for a re-test of that lower channel line as a possible topside Bear Call Spread entry (green marker on Figure 4)

Again, let me state that there is always an application for identifying and using the classic chart patterns. I frequently see Head/Shoulders patterns (regular and inverted), Bull/Bear Flag patterns, Pennants, Symmetrical Triangles, and many more. Yet, if you will just apply the two rules above concerning ascending and descending channels, you’ll cover 80% of what you’ll need.
Fibonacci Retracements

Without going into too much theory about Fibonacci retracements and why they work, just understand that they reflect tendencies of Herd behavior, which is why I expect them to continue to work going forward.

Once again, my goal here is not to overwhelm you with too many tools, but to give you a few sharp ones that can give us an edge in terms of spotting what price might do going forward.

Here’s how we’ll apply Fibonacci Retracements, or “Fibs”:

• First off, we’ll identify an extended trend that appears to have reversed.
• We're looking to find out just how far this reversal might go
• We’ll draw the Fib retracement tool from the very beginning of the trend to the very end.
• Now we’ll look for where the 38.2%, 50%, and 61.8% Fib retracements are. Price will likely “bounce” at one of those levels. (For the purists, 50% is not an actual “Fib” retracement but it’s still an important level)
• If the price retraces all the way past the 61.8% retracement, then it is much more likely to retrace ALL of the entire move.

Let’s see how this applies with the example in Figure 5. First, we’re interested in the downtrend from early June to mid-July; where are some possible price levels at which it could bounce back down again? After drawing the Fib retracements, we see that there the three levels that we’re interested in are at the 691 level (38.2% retracement), the 705 level (50% retracement) and finally the 719 level (61.8% retracement).

Figure 5
After the July bottom is put in, we now have three “leading indicator” price levels at which we expect the price to find resistance at: 691, 705, and 719. If the price gets beyond the 719 level, then we have a pretty good idea that it will go all the way back up to the 763 level.

What did it do? It found no resistance at the 38.2% Fib, in fact it found support there. It found no resistance at the 50% Fib. Finally, it encountered strong resistance at the 61.8% Fib level at 719, and after consolidating and breaking out above that Fib level, it did indeed retrace 100% of the trend all the way back to the 763 level.

Using Fibonacci retracements in this manner can help you “frame” the price in, so that you can prepare yourself to be more bullish if it breaks above a specific level, or bearish if it stays below that level, in this case.

This technique works just as well for uptrends as well as downtrends.

**Elliott Wave Counts**

Before I get started with this section, let me confess that I’m not really an Elliottician, however I understand the basic theory and how to apply just enough of it to give me an additional edge in terms of identifying price behavior and what it’s more likely to do next. For those of you that are interested, I would recommend linking to [http://www.elliottwave.com](http://www.elliottwave.com) and download some of their excellent guides under the “Free Stuff” tab.

What is the Elliott Wave principle? Markets move in “waves” instead of one-way moves. Prices will advance and retreat just like waves on a beach, and if the advancing or “impulse” waves are stronger than the retreating or “corrective” waves, then you have an uptrend. In fact, the wave theory goes into specifics that every major trend in the Market is comprised of 5 main waves, before a “corrective” pattern emerges.

You can see the basic layout of this wave pattern in Figure 6. The main “impulse” pattern is comprised of 3 impulse waves (waves 1, 3, and 5) and 2 corrective waves (waves 2 and 4). After the five-wave pattern plays out, then if the chart is to remain in a primary uptrend, a 3-wave corrective pattern plays out (waves A, B, and C), after which the wave series is “reset” and the primary uptrend is ready to resume.

Very important to the application of this theory, is to understand that Wave 3 is the main “impulse” wave, the strongest of the waves here. And Wave 5, which is the finishing or “exhaustion” wave, sometimes can be the shortest, and in the case of an uptrend, might produce a “lower high”, a bearish signal.
How do we use the “Elliott Wave” theory to help improve our entries?

- As a bottom is made, I will typically look for the bottom of Wave 2 to place my Bull Put Spread. This trade quickly becomes profitable as the main impulse wave (Wave 3) kicks in and accelerates up and away.
- As it becomes evident that the wave series has matured, I will look to enter my Bear Call Spread as Wave “B” peaks out at a lower high from wave 5.

Note how Wave “B” effectively turns into a “backtest” of the ascending trendline that connects the bottom of waves 2 and 4. Elliott Wave theory is just putting some structure around our earlier assertion that “descending channels fail to the downside, and often backtest their former ascending trendlines”.

Elliott Wave theory works equally well to the downside if you flip the examples upside down. And in my experience of watching the wave counts, there are many examples where the counts don’t quite match up...perhaps there are seven waves instead of five. This is why it’s important that counting wave structures is just part of the analysis that I do.
Trend Strength Indicators - ADX

Along with the Wave structure of Markets, there’s also a “rhythm” to charts. Price charts are always in the process of Expansion (trending) or Contraction (consolidation). Wouldn’t it be great to enter an Iron Condor trade just as the charts were about to go sideways, or contract for a period of time? And wouldn’t you want to be careful when entering trades...if you felt that a new trend or expansion phase was about to start? (that’s a big YES on both counts!)

Figure 7 shows this concept in action. The yellow areas are consolidation/contraction zones, where the price wanders sideways for a period of time. And the purple areas are trending/expansion zones, where the range of the price will expand via a trend. Notice how every purple zone (expansion) leads to a yellow zone (contraction) that lasts at least a couple of months.
This is where our Average Directional Index, or ADX indicator comes in. It measures the strength of a trend and tells us whether we’re expanding or contracting. Let’s see that same chart with the ADX indicator attached:

**Figure 8**

The heavy pink line is the actual ADX line that we want to watch. (the smaller red and green lines measure the strength of the downtrends and uptrends, respectively) Here are the characteristics of this indicator:

- If the ADX line is sloping down, the trend is weakening, and if the ADX line is sloping up, the trend is strengthening.
- If the ADX is below the “20” value it’s considered non-trending.
- A rising ADX line above “20” is considered the start of a trend.

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• ADX values above 30 are considered strong trends.

How can we use this indicator to help us trade the Iron Condor? Remember what we’re trying to do: spot the end of a trend, when we’re more likely to encounter sideways conditions. We’re also going to use this indicator to know when to be cautious, such as those times when the ADX is showing a very low value. Let’s translate these goals into rules for the ADX indicator:

• If the ADX is below 20 and falling, be cautious for the next trend/expansion phase. This means that the chart has been consolidating for some time and is about ready to trend again. This would be confirmed when the ADX rises above the “20” level again.
• If the ADX is above 30, then the chart is in a strong trend. Be on the lookout for a dip of at least 4 ADX points from the peak, which would signify that the trend is coming to an end and you can be more aggressive when entering Iron Condor trades.

By using the ADX in this manner, you now have a “leading indicator” that can tell you what’s more likely to happen next. Planning around these expansion and contraction moves can give you an edge, knowing when to be more cautious vs. knowing when you can be more aggressive.
Sentiment Indicators

Who’s winning the tug of war? The Bulls or the Bears? Is the Market overbought or oversold? One of the first things that any chartist is taught is to add an oscillator like Stochastics to their chart to be able to spot those “undervalued” areas when a stock has been beaten down and is more likely to rise.

Well, Stochastics indicators are great, however I don’t find much value from them other than to tell me what’s already happened. What I’m looking for, again, are Leading Indicators….reading between the lines of an indicator to give me a signal to expect something in the future. To that end, I’ll present a couple of tools that have worked well for me in the past.

A word of caution on these indicators; as oscillators, they are not meant for strongly trending markets, especially uptrends. They “saturate” and can remain in overbought states for a long time, giving off false signals. They do work better on strong downtrends because the trends are usually short and sharp. The best market to use oscillators on is a range-bound, choppy market.

The Market Forecast

The Market Forecast has gained in popularity over the years, at one time achieving cult status as an extremely accurate indicator with signals that were to be followed and not questioned. The only sources that I had for this tool a few years back were from an online educational subscription site, or from www.themarketforecast.com . It bothered me that they only covered the Dow and the Nasdaq charts - I traded the SPX. So over the course of about a month I finally cracked the logic for the “3 magic lines” and was able to get it to work on an Excel spreadsheet. Well, these days you can bring up a chart of the Market Forecast on some broker’s free charting packages. The cat’s out of the bag!

The Market Forecast is simply an indicator with three different stochastic lines on it, each representing a different timeframe. The Green line is the “Intermediate” line, representing the longest timeframe. The blue “Near Term” line represents a shorter timeframe, and the Red “Momentum” line represents the shortest timeframe. The idea here is to look for situations when at least two of the timeframes line up with similar signals. Figure 9 shows these as a lower “study” set up in ProphetCharts.
There are two different types of signals that we’ll look for on the Market Forecast:

• Clusters
• Divergences

A “Cluster” occurs when you have more than one timeframe in a “Reversal Zone” which is either 80-100 (Upper Reversal Zone) or 0-20 (Lower Reversal Zone). To that end, I came up with some terminology that I use to describe the three different combinations of signals:

• **Weak Cluster** - occurs when you have the two weakest timeframes (Near Term and Momentum lines) in a Reversal zone. This signal means that you’re overbought or oversold on a short-term basis.
• **Strong Cluster** - occurs when you have the two strongest timeframes (Intermediate and Near Term) in a Reversal zone. This is a stronger signal than the Weak cluster.

• **Full Cluster** - all three timeframes are in a Reversal zone. This is the strongest leading signal that this tool produces and these signals only occur a few times a year.

We can expect to see several Weak clusters during a month, each one usually causing some type of opposite reaction; i.e. on a Weak Bearish cluster, you’ll usually see the price retrace within a day or two of spotting the signal.

Strong Clusters show up less frequently, and usually cause a decent “reaction” within a day or two.

Full Clusters usually precede a full trend change, or at least a healthy retracement/bounce.

One more signal that the Market Forecast produces is Divergence signals. You will use the blue “Near Term” line to look for divergences against the price action.

![Figure 10](image)

**Relative Strength Index - RSI(14)**

The reason why I like the RSI(14) indicator is because it’s an accepted institutional tool. Institutions will often start to accumulate as the RSI drops below the “30” level. This is not an indicator that I use every day but I do find that it provides value when a trend has been moving in one direction and the question is: “when is this trend going to stop?!” I have found this indicator much more useful on the downside than the topside; in other words, spotting bottoms vs. tops. This is because bottom reversals are usually so much sharper than complex tops.
A good leading indicator for spotting a sustainable bottom, as measured by the RSI(14), is to see it dip under the “30” level, while at the same time showing Bullish Divergences. I have marked dips below “30” in Figure 11 with a yellow dot, and have marked the divergence patterns. As you can see, these provided nice bottoming signals. Judging a bottom can be very difficult as some sell-offs seem to go on for far longer than seems sustainable, so that’s where a good objective tool like the RSI(14) helps us identify a potential turning point.

Figure 11

![TradeStation Chart Analysis - SSPX.X Daily (CBOE S&P 500 Index)](chart)

**Relative Strength - RSI(2)**

During strong uptrends, I will set another chart with a period of “2” for the RSI, and look for the value of the chart in question to drop below an RSI(2) value of 2 on the indicator. This follows a strategy from [www.tradingmarkets.com](http://www.tradingmarkets.com) called their “R2
Strategy” which does a nice job of spotting sharp, high-probability pullbacks in the middle of an uptrend.

In simple terms, when the RSI(2) goes below the 2.0 value, the chart is extraordinarily oversold and creates some good risk/reward conditions to enter a downside Put spread. It’s rare when a day will close with a value below 2.0; many times the signal will show up intraday as a morning sell-off pushes the value below 2.0, only to recover in the late afternoon. In Figure 12, you can see several of these “dips” on this oscillator that pushed the signal below 2.0 intraday, with the green marker showing a day where it closed below 2.0, and the resulting rally.

Figure 12

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Momentum Indicators - MACD Histogram

As price moves expand, it’s important to know whether or not the Momentum of the move is being sustained. If prices continue to rise on decreasing Momentum, it signals what famed trading author Alexander Elder calls “the strongest signal in Technical Analysis” – the MACD Histogram Divergence.

The MACD Histogram offers a significant advantage to other “line-based” divergence indicators - they’re easier to see.

- In mid-July, you can see that the momentum of the downtrend is slowing as judged by the MACD histogram printing a “higher low” while price is still putting in a “lower low”.
- Throughout the July-August rally, momentum is seriously waning by the end of August, as evidenced by very strong Bearish Divergence signals as the MACD Histogram put in “lower highs” on “higher highs” in price.

Figure 13
What I’ve found in spotting these divergences through the MACD is that signals will often come very early, far before the actual trend change...especially during long, grinding uptrends. MACD divergence signals on downtrends will be very short and sharp. The MACD Histogram Divergence signal is really an “early warning radar” for a full trend change, although it will take patience on your part to wait for the true reversal.

Seeing divergences on our MACD histogram tells us to start getting ready to enter an Iron Condor spread in that direction, because it’s going to reverse soon, or at the very least, the former trend will lead to consolidation as described earlier.
Volatility Indicators

In discussing “Volatility” I’ll first discuss how we can measure potential leading signals based on the volatility of the underlying price chart itself, after which we’ll get into viewing how we can look for leading signals on the Implied Volatility index.

Bollinger Bands on the Price Chart

A somewhat “canned” indicator that I will use on a daily basis are Bollinger Bands. The Upper Band is two standard deviations from the center moving average, as is the Lower Band. What this means is that price is going to be inside the Bollinger Bands 95% of the time.

Of what use are these when trading the Iron Condor?

• If the price closes outside of the Bands, then I know that within a day or two the price will be back INSIDE the Bands again. This is helpful when evaluating my defense for a current position.
• If the price is pressing up against one set of Bands from the inside, then anything inside of the Bands is “free range” and the price can roam wherever it wants to inside of them. Anything outside of the Bands is unsustainable.

In Figure 14, you can see how the price generally stays within the Bands. If the price closes outside of the Bands, then it’s a leading signal for me that the price will very likely be back inside the Bands shortly. The price has come too far, too fast and will quickly need to slow down to keep the former trend sustainable.

You can also see how the price moves very fluidly and quickly inside of the Bands, where it is not subject to the same statistical rules of probability. I very often think of the Bollinger Bands as the ropes surrounding a boxing ring; the fighters can beat each other senseless while inside the ring, yet if one of them gets knocked outside the ring, they usually come charging right back inside.
The VIX Chart

The VIX, or Volatility Index, can tell us many things about what’s more likely to happen next. If you’re reading this then you probably know of the VIX as the “fear gauge” which shows high levels when investors are concerned, and low levels when investors are complacent. In just the past couple of years we’ve seen every VIX level possible, from single digits in early 2007 to high 80's in 2008. What can we read from this chart that will tell us leading signals for what’s coming next, and how can we position our Iron Condor trades from this information?

Let’s look at a chart of the VIX first; just like in price charts, I’ll put Bollinger Bands on the VIX chart to understand when the VIX has made an unsustainable move that puts the “price” outside of the Bands. If I see the VIX shoot outside of the Bands, that
tells me that the next move is likely to put the VIX back inside the Bands again, as Figure 15 shows.

**Figure 15**

Note how all of the “spikes” that placed the VIX well above the upper Bollinger Band were quickly faded down, putting the VIX back inside the Bollinger Bands again. Note also the heavy green line, which is the 200 day simple moving average; see how the VIX tends to stay “centered” on that indicator. More on that in a minute.

Based on our chart, we can derive some Iron Condor trading guidelines:

- A VIX spike outside of the Bollinger Bands to the topside is a signal to place Bull Put Spread positions; there is a strong likelihood of a bounce.
• Low VIX values below “20” mean that caution is warranted, especially on downside trades. This means that the price is likely in a rally and the next move could be to the downside, very sharply. Markets have gotten complacent and low VIX values show that there is now a positive Market sentiment extreme.

The VIX Ratio

Markets move opposite to their sentiment value, when sentiment has reached an extreme. When traders are too bullish and Market sentiment is too complacent, *(Everything is going up! It’s a Bull Market!)* strong moves to the downside appear. When traders are too bearish and Market sentiment is totally negative, *(This is the worst Market that I’ve ever seen! We’re going much lower!)* strong rallies appear. The chart of the VIX shows us that this is true.

So how do we know when the sentiment is too far “out of whack” and that an extreme reading has been reached? The VIX Ratio can help us here. What is the VIX Ratio? It’s simply the current value of the VIX, divided by the value of the 200 day moving average. The thought behind this ratio is simple; the VIX has a tendency to consider the 200 day moving average as “home”, and any strong move in either direction will eventually stretch that move too far, and it will “return to the mean” of the 200 day moving average. The VIX Ratio is just an objective way to determine this.

As an example, if the current value of the VIX is 25.0 and the 200 day moving average is reading 20.0, then the VIX ratio is then 25/20 = 1.25.

Let’s put some framework around how to use this ratio:

• During a “normal” Market the VIX Ratio will be close to 1.0
• During times where Market sentiment is good, the VIX Ratio will drop. We have seen VIX ratio signals as low as .5 during the March 2009 rally, showing that sentiment had reached an extreme divergence from the “mean”.
• During times where Market sentiment is poor, the VIX Ratio will rise. During the Bear Market that started in 2007, several VIX Ratio “spikes” of 1.8 to 2.0 were seen; in each case these high values led to a short-term reversal. Any value above 1.5 is considered a leading indicator for a potential reversal.

How can we use the VIX Ratio to help with our Iron Condor trades? Look for low values of the VIX Ratio (.8 and lower) to give you extra confirmation to sell Bear Call Spreads, and look for high values of the VIX Ratio (1.5 and higher) to give you extra confirmation to sell Bull Put Spreads.

In addition, the VIX Ratio can help keep you out of trouble from getting trades “stepped on”. When the VIX Ratio is very low, then do not be aggressive when placing downside Put spreads; a strong move to the downside might be approaching. Similarly,
if the VIX Ratio is very high, then the probabilities have increased for a strong relief rally, which might run over your Call spreads.

**A Final Word on the VIX as a Leading Indicator**

Before you start selling any positions based on a VIX signal, please keep in mind that the VIX was an extraordinarily accurate leading indicator prior to the 2008 crash - any VIX spike > 30 could be immediately sold with put spreads in the face of that “fear spike” that would no doubt reverse. That worked until the crash in September/October 2008, where anyone taking that signal unilaterally was rolled over by the plunging prices. The VIX has been a relatively poor leading indicator since that point. With the exception of identifying some spikes outside of the Bollinger Bands which led to some good short-term entries, the value of the VIX itself as well as the VIX Ratio have been essentially useless leading signals.

Markets are always changing and adapting, so there’s every reason to believe that once the Markets finally shake off the “Great Recession” that the VIX will start functioning as a true leading indicator once again as Markets once again do what they do best, which is chop around. Until that point, use the VIX signals with extreme caution and skepticism.
Putting it All Together - Technical Indicators

I realize that as you go through the previous pages on technical indicators, that it might seem overwhelming at first. "How am I going to keep track of all of those indicators and how will I know when to push the button?!" Trust me that it gets easier with time. Everything that I’ve listed in the preceding pages is what I look at every day, but it only takes me about 10-15 minutes to evaluate because I’m looking at the same one or two charts every day, looking for the same leading signals.

And this is exactly what will lead to your improved performance over time - consistency! It becomes very exciting when you can look at the price chart and say: “We’ve seen this movie before!”

Simplification leads to competence, competence leads to confidence, confidence leads to execution, and execution leads to consistent profits. I believe that it’s important to come up with a simple set of tools that you can watch every day until they “speak” to you; far too many traders stick dozens of indicators on their chart until they can hardly see the price action, thinking that adding “one last indicator” is the possible key separating them from ultimate profitability. It would surprise them that most professionals employ simple, crude systems that they know extremely well.

Notice how everything that we’ve talked about so far has been about Entering spread trades. That’s what technical analysis is for, to help give us an edge in the trade even before we send our order to the broker.

Once the trade executes, however....then it’s time to put away your technical analyst hat and focus on Risk Management! And in my mind, there are no better tools for managing risk on an Options trade than the Options Greeks.

I wish you all the success in the world and I hope that this guide helps get you there faster!

Doc Severson
Selected Resources

There are thousands of books and websites dedicated to the study of Technical Analysis. The author has found the following materials to be particularly helpful in specific topics of Technical Analysis:

*Trading for a Living* - Alexander Elder. Dr. Elder is one of the leading figures in combining Technical Analysis with the mindset of trading.

*Chart Your Way to Profits* - Tim Knight. Tim is a master at developing trade ideas from price action only, which is what every technician should aspire to be. You can also find him on his blog at [http://www.slopeofhope.com](http://www.slopeofhope.com)

*New Concepts in Technical Trading Systems* - J. Welles Wilder Jr. This gentleman wrote the ADX indicator, and shows how he uses it in this fascinating old-school book.

Elliott Wave International - [http://www.elliottwave.com](http://www.elliottwave.com) - The masters of teaching about Elliott Wave theory, this website has some great free primers on EW.

Trading Markets - [http://www.tradingmarkets.com](http://www.tradingmarkets.com) - the authors of the R2 strategy.