

>: Check Out What VIX Option Traders Are Telling You...

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There are a few important topics that I discussed already with members of *The Trend Rider* that I absolutely must bring to your attention. Today's article might be wordy, so if you prefer a quick and easy read over a clearer understanding of today's market then skip this one and start reading The Tycoon Report again tomorrow...

In past articles, I have written about the VIX (CBOE Volatility index, *aka* the "fear gauge".) When the VIX is high, fear in the market is high. When it's low, the opposite is true.

You may have noticed that the VIX hit yet another 13-year low (9.39 last Friday - keep in mind that VIX was created 13 years ago - right after the Dow hit another all time high at about 11:00 a.m.) as the Labor Department report showed little inflation in the U.S. economy. (That story even changed Tuesday when the PPI and CPI numbers came out.)

In 1993, the VIX was as low as 9.31, so we're very close to breaking the lowest level that the VIX has seen since the index was created. This shows that we are seeing the highest levels of complacency in over a decade which, as we've discussed already, is very dangerous.

But what I found most interesting about that is that *although the VIX moved lower, many of the VIX calls moved higher*. So why did the VIX call options move higher when the index moved lower? Because VIX option traders expect the VIX to pop higher due to a market correction!

As you may or may not know, there are several factors that affect the price of an option contract. If you didn't know, I won't give a big lesson on options here, but read on anyway, and you'll get it.

The "*implied volatility*"

factor in the price of the call options increased, and it increased big-time. The implied volatility factor, in a nutshell, is a factor affecting the price of an option and is based on how bullish traders are on a particular option due to the expected future volatility of the underlying stock.

For example:

If XYZ stock is at \$10.00/share, and people don't think that XYZ stock will have much volatility in the near future, any given (hypothetical) XYZ *option* may be trading at \$2.00.

But, if everything else were exactly the same (same time left before expiration, same strike price, XYZ stock still being at \$10.00) except that there were a big story surrounding XYZ stock(such as waiting for an FDA approval on a major drug which could send the stock flying,) the same exact option may be trading at \$4.10 (instead of \$2.00), because people are WAY more interested in playing the options to take a bet on XYZ's direction.

Back to what I was saying about VIX calls...

When VIX moved lower, the call options moved higher. This is a major divergence.

I mean, I saw a particular call option that was trading at \$3.10 a month ago (when VIX was just *over*10.00) trading at \$4.00 just a few days ago, even though VIX was *below*10.00!

Think about that. A month has passed in the meantime, and time passing causes options to *LOSE* value. But after a month passing, and with a slight *decline* in the index, the call option traded *higher*!

The fact that the VIX is so low seems to be leading the VIX *option traders* to believe that the market is likely to be in for a taste of fear soon which would cause the VIX to pop higher.

Funny how that works. The S&P 500 options show a historically low level of fear (which is reflected in the historically cheap S&P 500 (SPX) option contracts,) but the VIX options traders aren't buying it (or selling it.) The VIX options traders are now charging MORE. How come?

Remember: VIX option traders probably know as well as anyone that VIX should be used to call market bottoms, and NOT market tops. VIX is highly accurate when it comes to calling the bottom of a market correction. But the truth is that with the VIX at these historically low levels combined with the fact that we are seeing such an increase in implied volatility in the options on the VIX, I'm starting to think that I attribute more weight than usual to the idea that the VIX can, in fact, be used as an indicator to call tops. I just think that the VIX is *not as precise* when looking for the top, but if you study the history you see that when the VIX is this low, it USUALLY is followed by a steep correction.

for the market.

The market has gained more than 16.1% for the year. But while it is *overbought*, it isn't necessarily *overvalued*. The difference is that "overbought" is a technical term. When the market deviates too far from the mean, it is "overbought." We use several short-term market indicators to understand that the market is overbought. When these indicators tell us what they are telling us, an overwhelmingly large percentage of the time, the market pulls back.

But the term "overvalued" is a fundamental term. The PE ratio for companies in the S&P 500 is about 15 times expected earnings in 2007, which is in line with the long-term average.

Analysts expect the S&P 500 profits to grow 9.4% for 2007 which is above the long-term average of 7.5%. The Dow's 12-month forward P/E ratio is 15.8, which is in line with expectations for the S&P 500 (according to Birinyi Associates.)

So it isn't like we are incredibly over-valued here. But where does that leave us?

It's impossible to have a perfect understanding of the current environment because to do that, we would have to understand the psychology of millions of investors. But it's important to try to have as sharp an understanding of the market as we possibly can. So the way that I see it, since we are not overvalued, but we are overbought, I would think that if the bear argument surfaces, it will come down to the old "the bigger they are, the harder they fall" ideology.

When the bear market volume is finally turned up, it could be devastating for many. Getting back to break-even on the new positions could be very hard to do. This is one of the reasons that trading options is a great idea in this market. You can limit your losses to the amount that you put into the idea, while realizing nearly as much of the upside. (This is true so long as you don't invest all of your trading capital into options. Instead, you should use part of the capital for options, and keep a large amount in cash or treasuries.)

At the same time, we are blessed with a large percentage of options having relatively low extrinsic value, meaning that many options are cheap, and if the market tanks, the implied volatility factor affecting the value of options is likely to increase (on both puts and calls.) This helps with both bullish and bearish positions, as both calls and puts would become expensive, relative to recent measures.

A clearer understanding of this market:

The bear can come in many forms, whether it be mid-east violence, high energy prices, credit bubble (ARM loans,) anything causing a recession, or what have you.

But the current bull can last a while, too, as long as we get some healthy corrections along the way. Why are we riding a run-away bull these days? One of the main reasons is not so much a fundamental one, but a technical one: Seasonality.

Last week, the S&P 500 was up 1.2% hitting a six-year high. This is normal, since its average gain since 1986 for December is 2%.

The NASDAQ was up 0.8% last week, or 11.4% for the year. We should watch the Russell 2000 as right now is when small-caps typically out-perform the large caps.

But what exactly happens here (technically) to cause the markets to move higher?

"Window dressing," which is when funds try to make themselves look smart by buying stocks in December that have already posted large gains for the year (and have been talked about by the media,) typically pushes the averages higher in December.

Why is it the idea of a continuation with no pull-back is so conceivable to some traders?

Just as December is typically the largest gainer for the year, January is also traditionally one of the largest gainers. The S&P 500 gained, on average 1.7% since 1986 according to Thomson research.

Why does this happen? Because retirement funds inject large amounts of cash into the market, and so do the Wall Street pros. Just Google keywords like "2006 wall street bonuses," and you'll see that 2006 is a record-breaking year for cash bonuses for the pros. That may be a contributor to an extra January push for this market.

So, the takeaway from this is just that the market still has reason to move higher, but the higher it moves without healthy corrections, the more dangerous the potential corrections become.

Tops are harder to call than bottoms, and you don't want to miss those huge gains, but the more tempting the market looks, the more cautious you should be.

The indicators to keep an eye on are the contrary indicators. Market bottoms are found when there is excessive bearishness. When the whole world thinks the "sky is falling." You usually see climactic selling pressure with super high volume, and you see the VIX at relatively high levels. When

there is overwhelming negativity, you usually are near the bottom. That's what I mean by "contrary indicators."

Again, tops are much harder to call, but you should still keep an eye out for contrary indicators. For instance, I read in the Wall Street Journal that last week, "one of Wall Street's most outspoken bears raised eyebrows by issuing more upbeat advice to clients for 2007. Merrill Lynch strategist Richard Bernstein raised his firm's forecast for the S&P 500 to a 12% rise in 2007, up from an 8% gain."

This could be one of the contrary indicators that marked the approaching end of the bull rally (at least in the short-term.) The best way to play this type of market is with options. The worst way to play it is to abandon a cautious outlook and join the crowd. That's the classic trap that most traders fall into.

Happy Holidays!

?Profit from the Trend?



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