

THE MARKETPLACE FOR ACTIVE TRADERS

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THE MARKETPLACE FOR ACTIVE TRADERS

In the beginning were the grains, but since then the Chicago Board of Trade (CBOT®) has evolved into an amazingly diversified, nearly 24-hour financial marketplace. Here, on one state of the art electronic trading platform, you can trade the popular CBOT mini-sized DowSM futures contracts, gold and silver in contract sizes to suit your trading budget or style, interest rate futures with maturities all along the U.S. Treasury yield curve, and, of course, the original agricultural futures. In addition, you can trade options on all of these futures to further diversify your trading approaches.

But veteran traders find more to value at the CBOT than just the diversity of the contract offerings. This diversity is important, to be sure. But as Dan Gramza, a trader and world-renowned teacher of market analysis and trading technique, puts it: “The CBOT is a solid exchange that has a broad range of products. Its electronic trading platform is very robust and stable. The CBOT markets are easy to access and liquid with tight bid-ask spreads. These CBOT advantages are recognized by institutional and private traders around the world. They are aware of the CBOT markets, and they actively trade them.”

As an individual trader, you may wonder why traders like Gramza mention institutional traders. After all, these people may have distinctly different interests in the market from yours. The reason to care is simple: Institutions trade in large size, and they are always in the market. Their trading contributes greatly to the depth and liquidity of the CBOT markets. This, in turn, is what allows the tight bid-ask spreads Gramza mentions.

Mark Melin is another trader who especially values the size and diverse participation in the CBOT Treasury futures and options markets. Melin is a CTA (commodity trading advisor) who has devised a trading strategy that combines Treasury options and futures and who says he does 95 percent of his trading at the CBOT.

Melin particularly appreciates the almost round-the-clock market access the CBOT electronic platform makes available to traders. He says, “In many respects I trade like an options market maker, constantly adjusting the delta, vega and gamma of the portfolio, so the ability to cost effectively hedge my options is critically important. This is where the CBOT comes into play. Many times I trade late night Chicago time, due in part to some statistical tendencies that the Asian traders exhibit during their trading hours, yet even then the bid-ask spread in the Treasury options complex is outstanding. It is tight 23 hours a day.”

Another benefit Melin mentions comes directly from the presence of the large institutions in the CBOT markets. Melin says, “I routinely go into the CBOT option market at 11:00 p.m. (Chicago time) and take out a few hundred options contracts in a one tick wide market without any impact on market pricing. This is true depth and liquidity. What more can a trader ask for in a market? Plus, there is a degree of anonymity. When I take an opinion on the curvature of the market, I don't like everyone on the street knowing my position.”

A Variety of Contracts for a Variety of Trading Styles

It isn't just the diversity of contracts and participants and the robust and stable electronic trading platform that make the CBOT markets attractive to individual traders. These features are important, but as Jack Broz, trader and principal of *The Marlin Letter*, says, “All of these contracts also trade very well technically.”

Importantly, these markets lend themselves to a considerable range of technical approaches. This booklet will illustrate the various ways eight veteran traders analyze and trade the CBOT markets.

John Carter, president of TradeTheMarkets, finds opportunity in periods others write off as dead times. He finds that a combination of Bollinger Bands, Keltner Channels, and a momentum index oscillator can help him trade gold futures effectively on an intraday basis.

John Person, president of National Futures and a futures and options trader for over 26 years, uses a combination of candlestick charting and pivot point analysis to trade CBOT mini-sized Dow futures—again, on an intraday basis.

Hubert Senters, a vice president at TradeTheMarkets, uses a combination of candlestick charting and Fibonacci Retracements to locate intraday opportunities in CBOT mini-sized Dow futures that give rise to what he calls “pullback and ambush trades.” The gain here is in the way Senters’ analytical approach allows you to distinguish between a temporary pullback and a longer-term direction change.

Jack Broz and Saul Shaoul are active CBOT traders and partners in *The Marlin Letter*. Concentrating on Treasury and CBOT mini-sized Dow futures, these traders essentially look for scalp trades that have the potential to become slightly longer-term. To locate these opportunities, they analyze charts covering time frames ranging out to a year in search of key price levels, repeating prices, and 50 percent retracements within the various ranges.

Mark Melin, CTA and principal of Delta Numeric, has developed an interesting approach based essentially on the use of options on CBOT Treasury futures. He trades all along the yield curve in an attempt to benefit from temporary misalignments. The result of his analysis of these markets and method of structuring trades is a relatively low risk approach that generates consistent returns.

Dan Gramza, who has been called “King of Candlesticks,” uses candlestick charting to develop a sense of order flow. For the purposes of this booklet, he applies this to the grain markets and uses a weekly CBOT wheat futures chart to show how this kind of analysis can apply to longer-term trading. Further, he shows how this analytical approach can help you discover fruitful trading opportunities in a contract you may have overlooked, such as CBOT rough rice futures.

Jim Wyckoff, a long-time trader and principal of the newsletter, *Jim Wyckoff on the Markets*, also focuses on grains for this booklet. His approach combines technical and fundamental analyses as he discusses how you might trade weather markets. These also tend to be longer-term trades.

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SOLID ANALYSIS LOCATES SOLID TRADING OPPORTUNITY

Illuminating the Agricultural Futures Markets with Candlestick Analysis

Candlestick charting can operate like good theory in science. A good theory, scientists tell us, not only brings order to what might otherwise seem chaotic data, but it also takes you places you didn't know you could go.

In the hands of a careful observer and thinker, a technical device such as candlestick analysis becomes more than just an alternative charting method. It becomes a window to market opportunities you may have overlooked.

Take the way Dan Gramza uses candlestick analysis to find trading opportunities in the CBOT® agricultural futures contracts.

Candlesticks, in Gramza's hands, become an alternative or an extension of Market Profile® analysis, at least in part. The advantage of Market Profile analysis, Gramza says, is that it creates a visual image of the collective behavior of market participants. By arraying futures prices on the vertical axis of a chart and noting when prices trade in terms of letters representing 30-minute segments of the trading day, the image ultimately develops. Often, it takes on the aspect of a vertical bell-shaped curve. A bulge in the profile indicates market acceptance of the price levels within the bulge. A thin area indicates market rejection of that range of prices.

In fact, Gramza was in Tokyo, Japan, teaching bank traders how to use Market Profile when he saw a candlestick chart for the first time. He immediately saw a relationship between the information conveyed by the two charting methods. The candle formations tell Gramza about order flow which, in turn, carries clues about what “the market”—the collective intelligence of all the traders involved—wants to do at a given moment. Consider the weekly CBOT July wheat chart of Exhibit 1.

Exhibit 1: CBOT July Wheat



The Basic Message of the Candles

The red candles represent weeks when the market closed lower than it opened. The green candles represent weeks when the market closed higher than it opened. The wick-like extensions above or below the colored areas of the candles, the bodies, are called shadows. Basically, the colored area of a candle represents market acceptance of this range of prices while the shadows represent market rejection of the prices covered by the shadow. You can see the resemblance to a Market Profile graphic.

To show how attention to these chart formations can show you what is happening in the market, Gramza points to the green candle sitting on the 360 line and right on the line separating April and May. The green color indicates a higher close symptomatic of buyer domination, but the topside shadow suggests this market hit resistance above 375. This week was followed by three more weeks when the buyers were more aggressive than the sellers.

“The size of the body,” Gramza says, “indicates the degree of buying.” Clearly, the long body with little or no bottom shadow and only a relatively modest shadow on top suggests a week where the buyers dominated.

Then, Gramza continues, “as the bodies get smaller and the shadows grow longer, this indicates a loss of momentum.” The fourth green candle in this series has almost no body and a very long shadow at the top. “A shadow like this,” Gramza says, tells us the market is rejecting prices above 415. This shadow formation tells us sellers are becoming more active.” And the sellers dominate July wheat for the next three weeks, as the three red candles show.

“Notice the equal drama to the downside,” Gramza urges. “The first red candle shows strong selling, but notice how closely the second red candle matches the second green candle. By the third week, the sellers still have the upper hand, but they are losing momentum. And the buyers came back in at 360.”

The last green candle in the uptrend, with its almost nonexistent body and long upside shadow suggests that it might be time to go short this market.

Similarly, during the first three weeks in April, you can see a series of such candles—very short bodies and relatively long shadows on at least one end. This suggests a market with no idea where it wants to go. This seems a useful signal to at least be ready to act once the market decides on a direction.

Shedding Light on Trading Opportunities

“Most people think of the big contracts—CBOT corn or soybeans—when you mention agricultural futures,” Gramza says. “They tend to overlook a more lightly traded market like CBOT rough rice, yet you can find some interesting opportunities in rice.”

To illustrate, consider Exhibit 2, a daily candlestick chart of July rough rice futures.

Exhibit 2: C BOT July Rough Rice



From April 24 to May 8, Gramza notes, “this market traded lower but with no gusto.” You can see that most of the

candlesticks during this period have relatively short bodies and are about evenly divided as to color. This was a market with no sense of direction.

“If you’ve sold a market and it begins to behave like this, you want to be cautious,” Gramza says. “Along about May 9, you might have thought about buying.”

Indeed, after May 8, the rice market moved up strongly with the body of each green candle completely above the body of its predecessor. Gramza calls special attention to the large green candle that formed on May 15.

“This is a benchmark candle,” Gramza says. “It shows how dominant the buy-side is at this point and tells of an upside bias in this market.”

Reading this signpost, you might feel justified in holding onto a long position despite the few days when the rice market seemed to be on hold and the sellers seemed to win a few rounds. The May 22 and 23 markets would have amply rewarded your tenacity.

Suppose, having bought this market at \$8.45 per hundredweight on May 9, you had waited until May 24 to sell. The red candle shows the sellers to have dominated the market on that day, and suppose you had managed a sale price of \$9.20. Based on these conservative assumptions, this rough rice trade would have earned \$0.75 per hundredweight or \$1,500 per contract.

Solid analysis can uncover solid opportunity in a market you may have been overlooking. Indeed, candles can be more illuminating than you might think.

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OPTIONS ON CBOT® TREASURY NOTE FUTURES

A Strategy for All Seasons

For traders concerned with generating consistent returns while keeping risk exposure within manageable bounds, options on futures make possible a variety of trading strategies that meet these criteria, and Mark Melin can show you how.

Melin, the trading principal of Delta Numeric Trading, a Chicago-area CTA, has developed an approach that combines multiple options positions (typically short positions), and occasional futures positions, into trading strategies that benefit from pricing inefficiencies among the sectors of the U.S. Treasury yield curve.

Almost every introduction to trading options includes the warning that, while the maximum risk of loss for option buyers is the cost of the option, option sellers face virtually unlimited risk of loss. Therefore, most traders new to these markets often conclude that selling options can be extremely dangerous. However, Melin has found a way to make a trading strategy based primarily on selling options about as low risk as a trading strategy can be.

Melin uses options on Treasury futures to create spread trades across the U.S. Treasury yield curve. “Essentially, I identify what I consider pricing inefficiencies among 2-year, 5-year, and 10-year T-notes, establish an option spread trade across the entire yield curve, and wait for these three yield curve sectors to move back into line with one another,” Melin says.

Riding the Yield Curve

By way of yield curve background, when the yield curve is normally sloped, the 5-year yield is greater than the 2-year yield, and the 10-year yield is greater than the 5-year yield. If the yield of the 2-year Treasury note is 5.35 percent, you might expect to see the 5-year T-note yielding 5.45 percent and the 10-year T-note yielding 5.50 percent. But what if you see a yield curve configuration such as the one depicted in Exhibit 1. If the 2-year and 10-year yields are 5.35 and 5.50 percent, respectively, the 5-year yield in this

graphic might be closer to 5.30 percent. This is the kind of abnormal yield curve situation Melin looks for.

In this case, the reasonable expectation is that these yields will move back into a more normal alignment. This can happen in a variety of ways. One scenario may have the 2-year and 10-year yields stay the same while the 5-year yield rises. Other scenarios might have the 2-year and 10-year yields rise slightly while the 5-year yield rises relatively more, or, the 2-year and 10-year yields might fall slightly while the 5-year yield rises slightly. The underlying futures prices will move opposite to these yield moves, of course.

A Robust Trade Structure

To trade in this situation, Melin uses a strategy that more or less resembles an option butterfly. The typical option butterfly spread involves buying and selling calls or puts at three evenly spaced strike prices. For example, to trade a 10-year T-note put butterfly with 10-year T-note futures trading at 105-18, traders pick three evenly spaced option strike prices—e.g., the 105, 104, and 103 puts—and buy one each of the 105 and 103 puts and sell two of the 104 puts. (Of course, you can trade butterflies in much larger size—e.g., buy 100 of the 105 and 103 puts and sell 200 of the 104 puts. The ratio stays the same, whatever the size.) The one-lot long put positions are the wings of the butterfly, and the two-lot short put position is the body.

Melin, rather than trading various strike price levels at one point on the yield curve, trades all three points. He says he places “a butterfly spread across the curve with the 5-year as the body and the 2-year and 10-year as the wings. It can get a little complicated with the ratios, particularly as the market moves. This isn't a common strategy. Essentially I have taken two or three different spread trades and combined them into one. It takes some work to execute and manage, but it works very well for me.”

If Melin assumes the 5-year yield will rise to a more normal level, he will sell 5-year calls. At the same time he will sell 2-year and 10-year puts. To illustrate, suppose in the yield curve example illustrated in Exhibit 1 Melin assumes that the 2-year and 10-year yields will stay basically the same or fall slightly while the 5-year yield will rise enough to reestablish a normal yield curve. This means the prices of the 2-year and 10-year T-note futures will stay the same or rise slightly, and the puts on those futures will lose value—because of time decay or time decay plus the slight price increase. In contrast, the price of the 5-year T-note futures will fall a great deal, so the value of the calls on those futures will fall to nothing, or almost nothing, because of the combined effects of this price action and time decay. As a result of all this, Melin will keep all or most of the option premium he collected at the outset of the trade.

You might wonder about the potential downside of such a trade. If the prices of 2-year and 10-year T-note futures fall, the puts on those futures will gain value. If, at the same time, the price of the 5-year T-note futures rises, the 5-year calls will gain value. This could get ugly because it is entirely possible for the ending price of all the options to be greater than the initial price, in which case this trade could be a big loser.

However, by using futures to manage the directionality of the trade, Melin essentially creates a hedge against this risk. And, of course, carefully monitoring of such a trade will also minimize the risk of adverse futures price change. Further, time decay will still be at work, so it will take rather large adverse price movements to cause large losses. In short, this kind of trade contains risk, but it is as low-risk a trade as Melin can make it.

A Final Word

Melin frequently gives presentations on futures and options trading, and in one of his presentations, he ticked off a series of points that summarize the chief advantages of using options on Treasury futures in just this way. He reminds traders that, “Options are a depreciating asset.” This is because of time decay, which benefits options sellers like Melin. He goes on to say that “with options you can profit when the underlying futures price (1) moves in your direction, (2) essentially stays the same, or (3) moves slightly against your position.” Melin emphasizes that with this approach, a trader is “trying to hit singles”—to generate a steady stream of modest returns.

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PREPARATION PAYS

Locating Market Levels in Advance Means a Level Head Later

Careful preparation is crucial to successful trading, according to Jack Broz, because it frees traders to concentrate on order flow during the trading day.

Broz and Saul Shaoul, partners in The Marlin Letter, are both long-time CBOT® members who have moved from the trading floor to screen trading. However, Broz also operates an online chat room from the CBOT floor so he can sense the mood of the market as only people on the floor can do.

The primary goal of these two very active traders, Broz says, “is to find scalp trades in the market that have a high probability of ‘running’ into more sizeable winners.” He adds that in placing these trades, they “like to keep our stops very tight, and we trade off levels and order flow.” The levels Broz refers to are predetermined prices expected to offer support or resistance, or that serve as targets for the traders.

“This approach makes trading CBOT 30-year Treasury bonds, 10-year Treasury notes, and mini-sized DowSM futures a perfect fit primarily because they are all deep, liquid markets,” Broz says. “All of these contracts also trade very well technically, and with the CBOT electronic platform being ‘first in, first filled,’ our strategy of using levels lets us get in the queue early and results in a higher percentage of fills.”

Finding Key Levels

In preparing to trade Treasury futures, Broz and Shaoul use a combination of technical analysis and indicators. Broz emphasizes that “We do our analysis prior to the start of the trading session. We rarely, if ever, look at charts or indicators while we are trading.” Having done their analysis before the trading session begins, Broz adds, “We know what prices will be important. This lets us concentrate on the order flow to determine how best to execute our trades.”

The first preparatory step is to accumulate market highs and lows from charts covering various time frames: life of the contract, year, quarter, month, and week. They also locate any 50 percent retracements of these ranges and look for any prices that repeat. “For example,” Broz says, “if the low of the week is also the midpoint of the month, that price becomes a level.”

The next step is to look at the charts for any trend lines, double tops or bottoms, triangles, head and shoulder patterns, or gaps. This search will uncover more levels. A double top pattern could become a target price, or a head and shoulders pattern might indicate a good level for a stop-loss order.

“But perhaps more importantly,” Broz says, “this part of our analysis provides us with the ‘big picture’ of the market. This big picture view will help to keep us on the right side of the market with our scalp trades.” Suppose, for example, the week’s trade has been edging lower, but when Broz or Shaoul look at the yearly chart, they notice a recently-triggered double bottom pattern. Broz points out, “This tells us that the big picture is bullish, and we’ll need to be careful scalping from the short-side in the market.”

Having gathered all this information, the next step for Broz and Shaoul is to consider where the market has been since they last traded. Since Broz and Shaoul trade during the CBOT’s open auction hours (7:20 a.m. to 2:00 p.m. Chicago time) they look at 5-minute charts of the trade from 2:00 p.m. to 4:00 p.m., and from 6:00 p.m. to 7:15 a.m. (all Chicago times) to locate the highs and lows that will become more levels.

Once the Market Opens

With 12 to 15 price levels firmly in mind, and before the open auction market opens, Broz and Shaoul go into the order book and place a buy, sell, or stop at each of these levels.

Broz cites a typical example: “Suppose the T-bond market is going to open at 107-16, and we have defined 107-22 as a resistance level. We will place sell orders in the queue at 107-22 in order to establish a short position. Further, if our technical work reveals that the bond market should break hard if it breaches 107-08, we will place sell stops to enter a short position at 107-07.”

After placing these orders in the queue, Broz and Shaoul turn their full attention to watching the order flow. This should help them locate more trading opportunities. “We look to see who is more aggressive, the buyers or the sellers,” Broz says. “If each trade at the market open takes the offer and immediately bids for more, causing the prints (i.e., Time and Sales) to show a sequence of the form 107-16, 107-17, 107-18, 107-19, we might decide to get long at 107-20 and use the 23s we parked (that is, the original preopen sell order that is resting in the queue) to take profits.”

While Broz and Shaoul use an array of technical tools in preparing for a trading session, Broz believes it is a mistake for traders to overlook the fundamental economic reports. Such data as that contained in the reports of the U.S. gross domestic product, the consumer price index, and the producer price index (to name but three) attract extraordinary attention. Because new Fed Chairman Ben Bernanke has said future Fed policy will be responsive to these reports, Broz says, “It would be a missed opportunity to not trade the Treasury futures.”

When these and other economic reports are due, attention to the order flow they trigger can lead to rich trading opportunities. “At The Marlin Letter, we advocate going into these reports flat,” Broz says. “Our strategy is to let the news come out and let the market tell us where it wants to go. With our pre-determined levels firmly in mind, we enter the market a few minutes after the initial reaction to the report.”

Even these brief examples serve to show the importance of careful preparation. These trades are in no way accidental or lucky. Rather, they result from the careful work Broz and Shaoul do before the trading session which both tells them what signals to look for and allows them to concentrate on the developing order flow.

Each Market Has its Quirks

In addition to careful preparation and close attention to order flow, Broz stresses the importance of knowing the unique aspects of each market. Broz claims, “The T-bond market is arguably the best trading market of all.” Introduced almost 30 years ago, the T-bond market rapidly matured into a very liquid market that has attracted a wide variety

of large institutional investors—including traders from the world’s central banks, the biggest pension funds, insurance companies, and mortgage companies.

“While this keeps the trade very ‘true,’” Broz says, “it also tends to make the market move slowly. Many traders often miss the trading gem that bonds are because they misread its grinding nature as not moving.” Broz says traders must be patient when trading the bonds and other Treasury futures: “Identify your entry point and upon getting filled, place a stop 3 to 5 ticks away. Then stay patient—very patient.” This patience will pay off, Broz says: “While a 3 to 4 tick winner is a very good bond trade, sometimes you can ride the bonds for several more ticks.”

In contrast, according to Broz, the CBOT mini-sized Dow market usually moves very quickly, which makes this market the ideal trading venue for certain traders. He says, “A trader who likes to know right away if he is right or wrong will find the mini-sized Dow the market to trade. A trader who likes to stay active in the market should look at the mini-sized Dow. A trader who has other commitments, and can only devote a few hours a day to trading, should trade the mini-sized Dow. The mini-sized Dow moves, and in the course of several minutes a trader can make several trades.

“When trading the mini-sized Dow, we like to enter trades looking for at least 8-10 ticks and risking an 8 to 10 tick stop,” Broz says. “To risk more in the mini-sized Dow is too aggressive. To attempt to trade with a tighter stop is too conservative.”

Riding the Ebb and Flow of the Dow

Although the CBOT mini-sized Dow market is in some ways a different market from the Treasury futures markets, the preparation for trading this market is largely the same. In preparing to trade the mini-sized Dow, Broz says, “We use a bit more Fibonacci Retracement analysis and trend lines as we prepare for the trading session, but the core of the preparatory analysis is the same: looking at charts with different time frames to identify prices that keep repeating. Those prices have been where the action is, where the volume has traded, so we want to focus on those prices.”

The mini-sized Dow is a great scalping market, according to Broz. Because of this, he and Shaoul can identify trading opportunities, in addition to their “parked” orders, as they watch the order book. “We focus on the upticks and downticks,” Broz says. “If the market is chopping up and down 3 or 4 ticks, we will place sell orders 4 and 5 ticks above the market, and buy orders 4 and 5 ticks below the market. For example, if 11,130 is trading, we’ll place a sell

up at 11,135 and a buy down at 11,125. We are, in effect trying to get ‘picked off,’ and if the market flows up to 11,135 and fills us, we might just pick up 5 ticks as it ebbs back down to 11,130.”

Keeping Trading Expectations Realistic

Another important part of preparing to trade the mini-sized Dow is to identify what the realistic profit potential is in the current market. Broz says, “We’ll look at the number of ticks that comprise the average bar on a 5-minute bar chart. If the average 5-minute bar is 7 ticks, we know it will be very risky attempting to take 10 ticks out of our scalps.”

Broz says traders should apply this same principle to stop-loss placement, saying that “if the market is very volatile, with an average 5-minute bar covering 20 ticks, placing a stop at anything less than 20 ticks would be too conservative.”

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TAKING ADVANTAGE OF QUIET TO BUY AND SELL GOLD FUTURES

Think You're Looking at a Dead Market? Look Again.

How often have you heard other traders complain about a quiet market? “This market is dead,” they’ll say, “can’t make money in this market.”

John Carter doesn’t say this. Rather, he looks for these quiet moments. Carter, president of TradeTheMarkets and author of *Mastering the Trade*, offers interesting insights into these periods and backs his market sense with sound analytics which even traders new to the futures markets should be able to make use of.

Looking at the CBOT® gold futures market, Carter says, “The [volatility] squeeze takes advantage of quiet periods in the gold market when the volatility has decreased significantly, and the market is building up energy for its next major move higher or lower.”

A Set of Analytical Tools

To identify quiet periods and determine a trading strategy, Carter uses a combination of Bollinger Bands, Keltner Channels, and a momentum index oscillator. For traders unfamiliar with these technical tools, not to worry—Carter is a masterful teacher.

“Bollinger Bands,” Carter says, “are a type of envelope plotted at standard deviation levels above and below a moving average. The calculations cause the bands to widen during periods of higher volatility and to contract during less volatile periods. During periods of lower volatility, such as in sideways moving markets, the bands contract toward the moving average.

“Keltner Channels are based on a standard moving average. The actual band lines are offset by a positive and negative standard deviation value from the central moving average value to provide upper and lower bands. But, while Bollinger Bands expand and contract as the markets shift from periods of high and low volatility, the Keltner Channels maintain a more steady range.”

Carter says he uses the momentum index oscillator to

estimate the direction, velocity, and turning points of market movements.

Carter has words of comfort for anyone who worries about understanding the workings of these analytical tools: “Make sense? If not, that’s fine. I don’t understand how electricity works, but I know when I plug my computer into an electric outlet, it will turn on.” He also points out that these are all canned studies that come with most charting packages. To prove you can simply plug them in and go to work, he notes that “for the parameters, I just use the default settings on TradeStation®. These readings are 20 and 1.5 for the Keltner Channels and 20 and 2 for the Bollinger Bands. These settings can also be turned into an easy to use indicator.”

The Analytical Background

In describing how he uses all this for a trade setup, Carter says: “The quiet periods I’m looking for occur when the Bollinger Bands narrow in width to the point that they are actually trading inside of the Keltner Channels. This marks a period of reduced volatility and signals that the market is taking a significant breather while it builds up steam for its next move. The trade signal occurs when the Bollinger Bands then move back outside the Keltner Channels. I use a 12-period momentum index oscillator to determine whether to go long or short. If the oscillator is above zero when this happens, I go long. If it is below zero, I go short.”

Carter points out that this squeeze signal works across a range of time frames and is effective both for day trading and swing trading purposes. As a matter of course, different time frames offer different trade potential. He says, “For the gold markets, a squeeze on a fifteen minute chart is usually good for 1-2 points, on a sixty-minute chart 2-4 points, and on a daily chart, 10-15 points or more.”

Traders shouldn’t worry about the small results the shorter time frames generate. Carter’s perspective: “The kicker, of

course, is that the smaller the time frame, the more frequent the signals. A two-minute chart may fire off three to five signals in a day, while the daily chart will fire off six to seven signals over the course of an entire year.” Carter says his favorite trade setups in gold occur on 240 minute charts.

Trading Rules for Buys (Sells are Reversed)

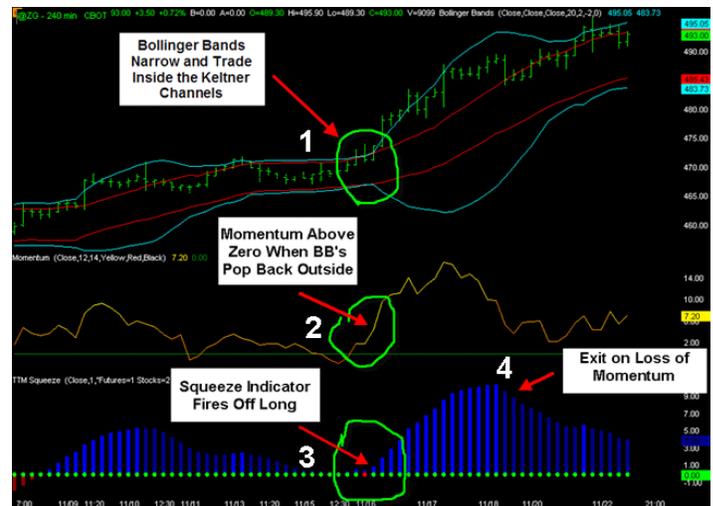
Set up a 24-hour chart so the overnight activity can be accounted for in this indicator setup.

1. The “heads up” on this indicator is the first red dot. This is not a trade signal but a heads up that a trade signal is setting up. This indicates when the Bollinger Bands are trading inside the Keltner Channels.
2. The signal on the indicator is the first green dot after a series of one or more red dots. This indicates that the Bollinger Bands have come back outside of the Keltner Channels. This is shown in detail in the charts that follow.
3. Once the first green dot appears after a series of one or more red dots, Carter goes long if the histogram is above zero (blue). Once the signal fires, he just places a market order. He says, “this is a momentum play, and I don’t want to be messing around with limit orders that may not get filled.”
4. For the various time frames, he used the following initial stops: 240-minute charts, \$8.00; 60-minute charts, \$5.00; 15-minute charts, \$2.50.
5. His target is based purely on the momentum of the trade. Once the momentum index signal starts to weaken, he gets out of the trade at the market.
6. He doesn’t trail stops.

Getting the Heads Up for a Potentially Larger Move in Gold before it Occurs

In John Carter’s expert hands, the analytical parts mesh nicely into an easy-to-use indicator that shows you the right moment to make a trade and, just as importantly, the right moment to exit. Consider Carter’s talk-through of Exhibit 1.

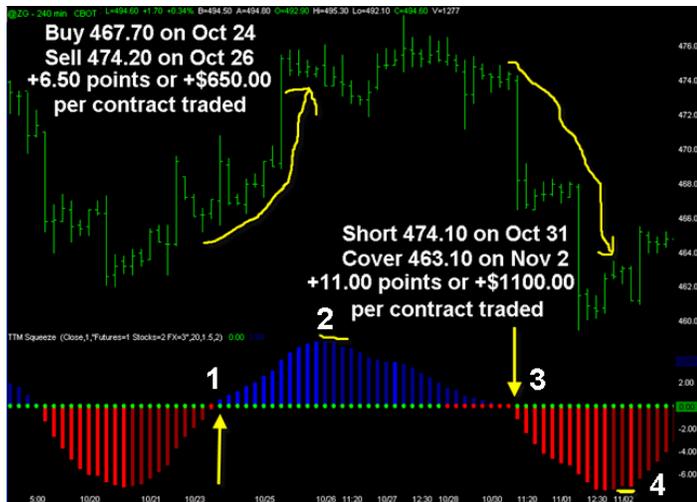
Exhibit 1



1. “At point 1, the Bollinger Bands go inside the Keltner Channels, and spend an hour or so in this formation. This is a heads-up that the gold market has entered a quiet period.”
2. “Once the Bollinger Bands pop back outside the Keltner Channels, it’s time to make a trade. Since the momentum oscillator is above zero, it’s a long trade, a buy. In this case, we enter at the market with a fill at 473.70. Since this is a 240-minute chart, we are using an 8-point stop at 465.70.”
3. “On the indicator, the red dot appears when the Bollinger Bands go inside the Keltner Channels. Once the Bollinger Bands pop back out, the green dots reappear. This shift back to green dots is the trade signal, and since the histogram is blue, it’s a long trade. We’re buying [October] gold.”
4. “We stay in the trade until we have a confirmed loss of momentum. This is indicated by two darker blue bars in a row, seen here at point 4. At this point we exit the trade at 486.00 for a gain of +12.30 or \$1,230.00 per contract.”

At times, a 240-minute time frame will contain opportunity for two trades. Consider Carter’s analysis of Exhibit 2.

Exhibit 2



1. “At point 1, we have a green dot after a red dot which is a trade signal. Since the histogram is blue, it’s a long. We get in at 467.70 with an 8-point stop at 459.70.”
2. “We stay in the trade until the momentum runs out, which takes place at point 2. We exit at 474.20 for a gain of +6.50, or \$650.00 per contract.”
3. “At point 3 a short signal fires off. Once the first green dot appears after the series of red dots, we have a trade signal. This time, the histogram is red, indicating that this is a short trade. We are filled at 474.10 and use an 8 point stop at 482.10.”
4. “We stay in the trade until we have a confirmed loss of momentum. This is indicated by two darker red bars in a row, seen at point 4. We exit the trade at 463.10 for a gain of +11.00 points or \$1,100.00 per contract.”

One reassuring note, Carter points out, is that these kinds of trades do not need to be managed intraday. He adds: “Even though I watch the markets full time, I do not watch my swing trades tick by tick. There is no point. My parameters are in place, and the only thing I’m going to do by watching my position is try to outsmart it, which never works in the long run.”

Carter concludes his discussion by saying, “The squeeze on a 240-minute chart is one of the best ways I know to trade gold, and it can be done on a part-time basis.”

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COMBINING TECHNIQUES TO GAIN A TRADING EDGE

Applying Candlestick Charting and Pivot Point Analysis to the Trading of CBOT mini-sized Dow Futures

Veteran traders often remark that no one analytical technique provides all the trading answers. It would seem, then, that one of the keys to successful trading is to know how to combine technical tools to best effect.

John Person, president of NationalFutures.com and a 26-year veteran of the futures and options markets as trader, teacher, author, and commentator, finds pivot point analysis and candlestick charting to be one such powerful combination. Person says that using these two tools to study futures price action “can truly give traders an edge in the markets.”

Person likens this combination of trading tools to epoxy glue which requires two compounds, neither of which will bond separately but which create incredibly strong bonds in combination. He says, “Combining candlestick charting with pivot point analysis can give you a similarly strong result if, as always, you apply proper risk management in your trading strategies.”

The Tools

For Person, one value of candlestick charting, which he calls a “basic building block method,” is that it reveals the connection among the four most important aspects of price analysis—the open, high, low, and close of a given session—in a clear, visual way.

He says, “A candlestick chart illustrates and helps identify the current market environment, especially by creating a graphic representation of the acceptance or resistance of specific support or resistance levels in a particular time period.”

The shapes of the candles make the message instantly obvious and easy to decode. (The sidebar, Candlestick Rudiments, provides definitions of key formations.)

To illustrate, Person uses two examples: “If prices move higher from the opening price of a session and close near the highs, this shows strong buying interest. However, if after the open the market trades up, establishes the high,

and then falls, the distance formed from those points of interest, called ‘the shadow,’ shows rejection of that price level.”

Of special interest to Person is a candlestick shape called a Doji. In this formation, Person says, “There is no real body because the market closes at nearly the same level as the open. This kind of candlestick identifies ‘swing points,’ or ‘pivot points,’ which are points where momentum changes direction.”

Person emphasizes that these moments should not be confused with pivot point analysis which can be used to predict support and resistance levels. Rather, this use of the terms “swing point” or “pivot point” refers to moments in the progress of a market when momentum wanes and the market is likely to change direction.

However, pivot point analysis is the second tool in the mix. Person likes this tool because it gives traders an easy way to predict where a market will find support or resistance. Calculating the pivot point (P) and the first and second levels of support and resistance are simple. Assume the CBOT® mini-sized DowSM high (H) on a given day was 11,310, the low (L) was 11,233, and the close (C) was 11,248. Given these data, P is 11,264, which is the sum of H, L, and C divided by three. The resistance and support levels follow from this initial calculation given a set of simple formulas:

Pivot (P)	= (H + L + C)/3
11,264	= (11,310 + 11,233 + 11,248)/3
Resistance 2 (R2)	= P + H - L
11,341	= 11,264 + 11,310 - 11,233
Resistance 1 (R1)	= (P x 2) - L
11,295	= (11,264 x 2) - 11,233
Support 1 (S1)	= (P x 2) - H
11,218	= (11,264 x 2) - 11,310
Support 2 (S2)	= P - H + L
11,187	= 11,264 - 11,310 + 11,233

According to Person, the main goal of pivot point analysis is to pinpoint price targets in a specific time period.

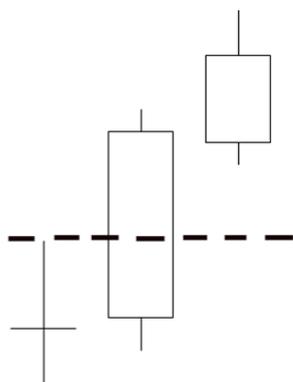
Combining the Tools

Per Person’s methodology, the real trading payoff comes when traders combine pivot point calculations with the visual aid of certain candle patterns. By doing this, they can find superior guidance concerning when and where to enter and exit positions.

During his many years of trading, Person has found that “more often than not, Doji candlesticks form at these pre-defined support or resistance levels.” It follows that in planning their trades, Person says, “traders should concentrate on market behavior at support and resistance levels, especially when Dojis appear at those levels. The key is to watch for confirmation of a transition and to act on momentum shifts.”

A typical candlestick development for which to be alert in the search for a change in market behavior, Person says, is for the market to close higher than a Doji high at or near a pivot point support level. Person calls this a High Close Doji, or HCD, pattern. Exhibit 1 provides a close-up of such a situation. Person says to “notice that once the market closes above the Doji high, there is an immediate reaction in which momentum becomes positive and there is a continuation of higher prices.”

Exhibit 1: A Typical High Close Doji Pattern



Person calls this a “high probability intraday trading pattern.”

Putting the Tools to Work

In Exhibit 2, each candlestick represents a 15-minute segment of trading in the December 05 CBOT mini-sized Dow futures contract. The day shown is September 28, 2005.

Exhibit 2:



Based on the high, low, and close shown on the exhibit, you can calculate the relevant support and resistance levels. The three blue horizontal lines show support 1, resistance 1, and resistance 2. These levels indicate places where you may see momentum changes. You won’t necessarily see them, but these are price levels you should be alert to.

“Notice,” Person says, “how the Doji forms right on the pivot point support Line [ed: which occurs at 11:20]. Here the candle right after the Doji [ed: note the green arrow and the label “High Close Doji Trigger”] not only closes above the Doji high, but see how it entirely engulfs the real bodies of the two candles prior to the Doji as well. The extent of this candle helps signal the power behind the reversal.”

A further signal of this power and that the reversal is taking hold, Person says, is the development of additional green candles. A green candle, remember, indicates a period in which the close is higher than the open and is a sign that buyers are dominating the market.

Following the sequence of candles on the chart, you can see that the Dow maintained this upward momentum all the way from the 10,459 first support line to the 10,592 second resistance line, where it lost momentum and tailed off to end the day at 10,577. The presence of three red candles along the way might be moments to exercise caution. But the emergence of a Doji and a Hammer (see the sidebar for definitions of a Doji and a Hammer) at the 12:35 and 12:50 periods suggest this to have been a pause and not a reversal.

Seeing this, you may well have decided to stay the course. In any case, if you had bought futures upon seeing the Doji at 10,459 or shortly thereafter and held fast until the first resistance level or slightly beyond, this trade could have earned you 100 points, give or take a little depending on exactly where you exited the position.

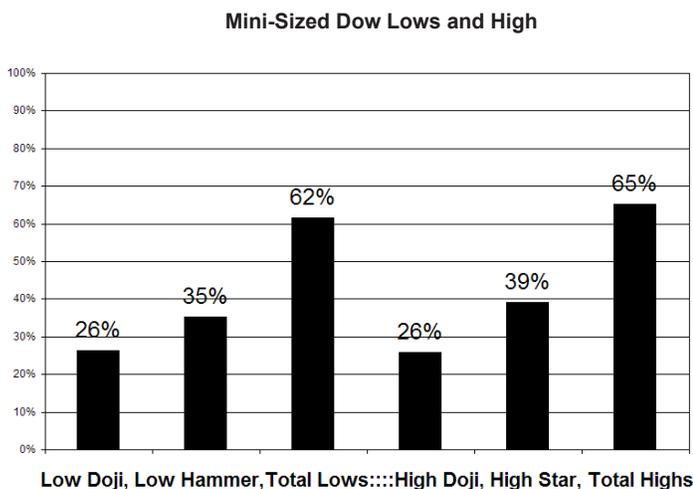
Statistics Support the Generalization

While the evidence of Exhibit 2 seems to bear out Person’s claims about the meaning of the Doji candles and the usefulness of using support and resistance levels as clues about when to look for Doji formations, he created a backtest that gives his observations further substance.

In this study, Person looked at three candle formations as they emerged on 15-minute charts of daily CBOT mini-sized Dow trading: Dojis, Hammers, and Shooting Stars.

Exhibit 3 shows that 26 percent of the lows were established by Dojis while 35 percent of the lows were established by Hammer formations. Combined, that accounts for a 62 percent chance that lows will be established by a Doji or Hammer—based on these 15 minute time intervals. Conversely, 26 percent of the tops were established by Dojis while 39 percent were established by Shooting Stars. So Dojis and Shooting Stars combined to account for 65 percent of the tops covered in this study.

Exhibit 3: Mini-Sized Dow Lows and Highs



This strong statistical foundation suggests that the methods Person introduces can indeed help traders watch and study current price action or, as Person says, “Focus on the now.” The candle patterns provide visual confirmation of price momentum, and pivot point analysis can show you where to look for potential turning points. Clearly, a combination of these two methods can help you develop a solid trading program.

KEY TERMINOLOGY IN CANDLESTICK CHARTING

Person provides helpful definitions and illustrations for those not familiar with candlestick terminology.

Most of the candles on the chart of Exhibit 2 have a thicker colored section with thin lines extending above or below it. The large, colored part of most candles, the real body, shows the relationship between the open and close of a trading period. The lines extending above or below the real body, called “shadows,” indicate market rejection of the price levels covered.

In John Person’s analysis of the CBOT mini-sized Dow futures market, he calls attention to three key candle formations: the Doji, the Hammer, and the Shooting Star.

The Doji



A Doji formation has no real body, or only a very small one, because the market closes at nearly the same level as the open. This kind of candle identifies a loss of momentum and typically signals a price level where momentum changes direction.

Exhibit 4: The Doji

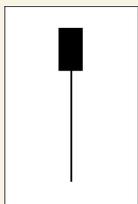
Exhibit 4 contains several Doji formations. The key Doji occurs at the 11:20 mark on the chart, but you can find several others. Another important one, which has literally no real body is the one at 15:20 whose upper shadow touches the 10,592 second resistance line.

The Hammer

The Hammer formation indicates that a reversal or a bottom is near in a downtrend. When this formation appears at the top of an uptrend, it is called a “Hanging Man” and indicates that a top is near. Three main characteristics must be present for a candle to qualify as either a Hammer or a Hanging Man:

- The real body is at the upper end of the trading range, and the color (red or green on Exhibit 2, but in other formats the colors may be black or white) is not important.
- The lower part, or shadow, should be at least twice the length of the real body.
- Hammer or Hanging Man candles should have little or no upper shadow.

Exhibit 5: The Hammer

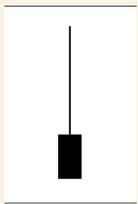


In Exhibit 5, a classic Hammer occurs at 11:05 (right before the Doji at 11:20). Note that, as the second bullet point specifies, the shadow of this candle is twice the length of the real body.

The Shooting Star

As you can see in Exhibit 6, the Shooting Star formation has the opposite construction of a Hammer and has very strong bearish implications. Accordingly, this kind of candle generally forms at the top of an uptrend and signals a major reversal. Here again, color does not matter, but the body should be at the lower end of the trading range and there should be a long shadow. The significance of this candle formation is that it shows the market to have opened near the low of the day, then had an explosive rally that failed, and finally closed back near the low of the day. Usually there is little or no lower shadow.

Exhibit 6: The Shooting Star



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LYING IN AMBUSH TO CATCH THE NEXT MARKET MOVE

A Plan for Identifying and Trading Pullbacks

One of the trickiest judgment calls traders face comes when a market retreats from a strong run. The challenge is figuring out whether the market is just in pullback mode or rolling over.

According to Hubert Senters, Vice President of TradeTheMarkets and a savvy trader of CBOT® mini-sized DowSM futures, Fibonacci retracements can help traders decide which mode the market is entering. Having identified a pullback, Senters says what he calls the “Pullback and Ambush” trade is a good way to capitalize on this market situation.

For those unfamiliar with Fibonacci retracement ratios, Senters offers a succinct explanation: these ratios refer to certain pullbacks or retracements the market is likely to experience before it continues in its original direction after making a run, whether up or down. The most common ratios are 23.6, 38.2, 50, 61.8, and 100 percent. To identify a given ratio—e.g., 61.8 percent—traders can locate the difference between the low and high of a move. The relevant Fibonacci level will then be the high minus 61.8 percent of that difference. Most technical analysis packages will plot these levels as horizontal lines on the price chart.

When setting up a mini-sized Dow pullback and /or ambush buy trade, Senters prefers to use a two-minute chart, and he follows a few simple rules:

- Set up the two-minute chart so you can see the open gap in the morning. Senter prefers to use a 9:30 a.m. open and a 4:15 p.m. close (both Eastern time), but a session chart will also work.
- Look for an up move to top out. This provides the basis for drawing the Fibonacci lines.
- Draw the Fibonacci starting point at the low of the move and end it at the high of this move.
- Look for the market to come back to the 50 percent retracement level and to trade below this level, but

not to close below the 61.8 percent level. This area between the 50 and 61.8 percent lines is the ambush zone (it is labeled on Exhibit 1 [Senter’s Figure 1.1]).

- Set a 10 to 15 point stop for this two-minute pullback and/or ambush trade, and scale out at the target levels.

Senters says, “My target is based purely on the price action of the trade. Once the price enters the ambush zone, I look for signs that it is going to stop, reverse, and continue its up move. Specifically, I’m looking for the low bar in the zone to be overtaken by price action.”

Exhibit 1: Locating the Ambush Zone on a Two Minute Chart



Exhibit 1 shows how Senters uses Fibonacci levels to define an ambush zone. Point 1 marks the low point of the move and the point where you start your Fibonacci trendline tool. Point 2 shows the top of this move and the point at which you end your Fibonacci trendline tool.

Point 3 shows the key point where the market trades below the 50 percent line but does not close below the 61.8 percent line. This is the ambush zone. Incidentally, Senters

says, “If the market closes a time segment below the 61.8 percent line, the trade is off. Just leave it alone.”

Having identified the ambush zone, Senters next decides on an entry point, a stop, and a target price. Exhibit 2 [Senter’s Figure 1.2] locates these trade details on the price chart.

Exhibit 2: Finishing the Pullback Ambush Trade Setup



Senters says, “The entry point for this trade occurs when the low bar is overtaken by the price action of the next bar.” Notice a series of three descending red bars roughly above the 10:40 mark on the chart. The green bar that follows them marks the low point of the pullback. The next green bar, above point 2, closes higher; this makes this 11,104 price the entry level for the trade. This is where you buy futures.

For this trade, Senters places the stop 15 points below the entry level (11,089). The first target price will be the 76.4 percent Fibonacci level, which is a price of 11,129 and is labeled Target 1 in Exhibit 2. The second target will be the 100 percent level (11,139) and is labeled Target 2.

Deriving the targets is straightforward, according to Senters. Using the pullback move from point 1 to point 2 on the chart for a Fibonacci range, target 1 (11,129) is 76.40 percent of that, and 11,139 is 100 percent of it. “All you are doing is reversing the Fibonacci levels after you are in the trade,” Senters says.

Suppose you initially bought two CBOT mini-sized Dow contracts. The plan is to scale out of this trade by selling back one contract when the futures price reaches Target 1 and the other when the price reaches Target 2. At Target 1, a price of 11,129, the trade will have gained 25 index points, or \$125 (25 index points x \$5 contract multiplier). At the Target 2 price of 11,139, the second half of the trade will have gained

35 index points, or \$175 (35 x \$5). The total for the two parts of this trade comes to \$300, a gratifying result considering the short-term nature of this trade.

Of course, you can just as easily construct sell trades using this method. As Senters points out, all you have to do is reverse the process, and you’re in business.

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FEAR, GREED, AND TRADING THE WEATHER

The Grain Producer's Bain, the Trader's Joy

“Trading a full-blown weather market in the grains—and surviving to trade again another day—is a great experience for all traders,” says Jim Wyckoff, who operates an analytical, educational, and trading service called Jim Wyckoff on the Markets. The grain and oilseed markets are always weather markets to some degree, but the situation for which he reserves the term “full-blown” occurs when severely dry weather conditions, and even drought, plague the U.S. Corn Belt. According to Wyckoff, these come around only once every several years.

Adverse weather conditions can affect planting, but traders pay even closer attention to weather conditions during certain crucial crop development stages. Wyckoff says, “The mid to late July period in the U.S. Corn Belt is the timeframe when summertime temperatures are usually the highest. Corn plants are also in their critical ‘pollination’ stage of development during that time, so a few days of hot, dry, and windy weather can sap yield potential in a hurry.”

Just such a situation developed during the last half of June and early July 2006. Around the beginning of July, Wyckoff notes, “Weather forecasters were mentioning a high-pressure ridge forming over the western Corn Belt in the coming days, which had the potential to produce a ‘heat dome’ that blocks out moisture and locks in heat for the Corn Belt.”

This is prime time for traders in the grains, and Wyckoff’s background helps him provide the market counsel to see them through. Based in Cedar Falls, Iowa, Wyckoff has been involved in the futures markets for over 20 years as a market analyst, technical trader, educator, and journalist.

Monitor your Emotions

Traders should approach these weather markets carefully and with self-awareness. Wyckoff says: “There is nothing like a rip-roaring ‘weather market’ in the grain futures to seriously challenge the two most important emotions

a trader can experience: fear and greed. In the heat of a weather scare in grains, prices become extremely volatile and trader emotions run very high, as the latest weather forecasts can and do turn markets ‘on a dime.’”

Although some traders might be tired of hearing these terms and think “fear” and “greed” overused in market discussions, Wyckoff differs. At worst, fear can keep a trader from entering a trade. Almost as bad, fear can prompt traders to set stops too tightly or to exit trades too soon.

Greed, on the other hand, can cause traders to stay with a trade too long. These traders, in Wyckoff’s words, “become intoxicated with thoughts of hitting the ‘grand slam’ of trading, instead of being content with a base hit or even a double. Home runs and grand slams occur only rarely in trading futures. Just as in baseball, futures traders who ‘swing for the fences’ are much more prone to ‘strike out.’ Weather markets do allow for numerous base hits and a few doubles—and even a triple here and there.” In markets that often turn on a dime, an infatuation with the idea of a home run trade can lead to painful results.

Trading Rules for Weather Markets

Wyckoff has formulated some rules from his many years of observing market behavior and trading, that should help you approach a weather market with confidence.

- **Doing some contrary thinking and trading can pay dividends in weather markets.** Wyckoff says: “In weather markets, there is tremendous pressure on all traders to ‘follow the herd.’ Deviating from the consensus market opinion is not easy. However, it’s the traders that can step up and sell into rallies or buy into dips that seem to have more success in trading weather markets in grains.
- **Recognizing the clues that suggest a top is in place in the grains is especially difficult during a weather market, because technical indicators can become less reliable.** For bulls, it’s important

to remember that markets are the most bullish at the very top—it's downhill for prices from there. Thus, being content to catch a bigger part of a price trend should be the goal of the trader. Don't be disappointed if you did not capture all of a price move in a weather market. Becoming greedy and trying to do that will usually get traders into serious trouble.

- **Be on the lookout for a weather market in grains to “factor in” fundamental events well before they actually occur.** August is the most important growing month for soybeans and sure enough, in the big drought of 1988, the soybean crop was most damaged during the months of July and August. Yet, futures prices that year topped out the third week in June.
- **Pyramiding winning trades or “averaging down” losing trades is a no-no.** (Unless adding futures positions was in your initial trading plan of action.) Adding to winning positions when a profitable trade is occurring in a weather market in grains is extremely tempting. Being long CBOT soybeans and hearing a bullish weather forecast heading into the weekend certainly invites adding a couple more long contracts on Friday, but that is pure greed kicking in. Again, greed in trading often leads to grief.

A Look at the Weather Market of 2006

As the early summer 2006 weather market in the grains took shape, Wyckoff used longer-term technical corn, soybean, and wheat charts to suggest what traders should be looking for in this kind of market situation.

While a weather market had developed in corn, you will notice on the weekly continuation chart for nearby corn futures that prices were trapped in a trading range, with nearby prices most recently in the upper portion of this range.



“The direction in which nearby corn futures prices break out of this trading range on the weekly chart is very likely to be the direction of the next longer-term price trend in the market,” Wyckoff says. “Indeed, neither bulls nor bears should get too excited about any bigger price trend getting kicked off until prices move out of this trading range.”

The weekly continuation chart for nearby soybean futures also shows prices to have been trapped in a trading range. The difference here is that the range was narrowing, and a wedge pattern was developing.



As with corn, Wyckoff points out, the direction in which nearby soybean futures break out of the trading range on the weekly chart is likely to be the direction of the next significant longer-term trend in prices.

In his commentary on the wheat market, which was based on the weekly wheat chart, Wyckoff said, “Despite a recent strong downside price correction, the bull market in Chicago soft red winter wheat futures remained alive.” Notice that the weekly chart shows prices to have backed well off the May high, but trend-line support held fast and prices were again working higher.



Curiously, Wyckoff considers the wheat market to be linked to corn and soybeans. He says, “Seeing Chicago wheat challenge the May high of \$4.33 in the coming weeks would not have been surprising. However, my bias is that the corn and soybean futures markets will also have to move higher to support a continued uptrend in the wheat market.”

Special Equipment not Required

“Finally, trading the grains in a weather market can be just plain fun,” Wyckoff says. Best of all, you don’t have to be a full-time trader with lots of fancy equipment to join in the fun of trading these markets. As Wyckoff says, “Traders who don’t have expensive real-time newswire feeds or other connections right to the trading floor can still listen to the Midwest weather forecasts on radio or cable TV—or look at weather maps on the weather websites on the Internet.” This information should be enough to help you form an opinion about the corn, soybean, or wheat market and put on a trade.

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OPTIONS FOR FINDING THE GOLD IN FED MOVES

A good way to express a market opinion on such inflation-related events as the outcome of a Federal Reserve meeting is to use options on CBOT® 100 ounce Gold futures. Here's why.

From earliest times, gold has served as an inflation hedge. Even a hint of an inflation buildup may cause investors to abandon stocks and bonds, whose value suffers from inflation, and turn to gold, triggering a rally in gold futures prices. The opposite is also true. When inflation fears wane, investors leave gold and return to the stock and bond markets, often giving gold futures a bearish turn.

Investors seem especially sensitive to Fed action in making these asset allocation shifts. The Fed shifts its monetary policy according to whether it sees higher inflation or slowing economic growth as the greater threat to economic health. When inflation threatens, the Fed frequently boosts the target fed funds rate. When a slowing economy tips the balance, the Fed will typically lower the target rate. Investors tend to see these Fed actions as signals to take protective measures in the form of a turn to gold or to return to paper assets.

A simple gold options strategy can prove a good way to benefit from these shifts in market sentiment with regard to gold.

An Earlier Reaction

Consider how the gold and stock markets reacted to the June 29, 2006, Fed meeting. The Fed raised the target rate from 5.00 to 5.25 percent on that day. The part of the accompanying statement that seemed to capture the eye of market participants was this: “[H]igh levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. ... [T]he Committee judges that some inflation risks remain.”

Exhibit 1 focuses on nearby CBOT® 100 ounce Gold futures and CBOT mini-sized DowSM futures prices on the meeting day, the following day, and two days during the next two weeks.

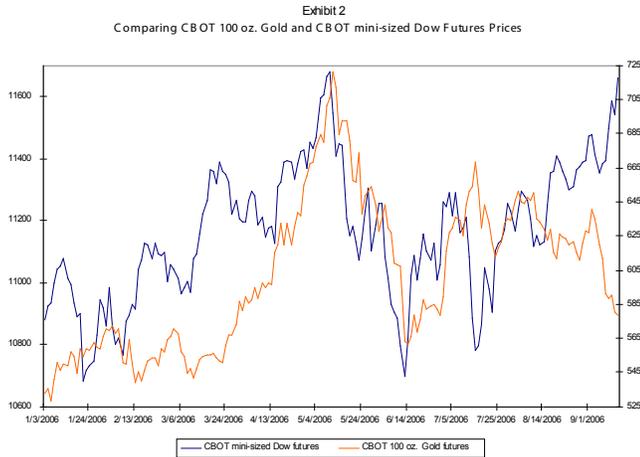
Exhibit 1: How CBOT 100 oz Gold and mini-sized Dow Futures Responded to the June 29, 2006 Fed Meeting

	CBOT Gold Futures (\$/troy oz.)	Change	CBOT mini sized Dow (index points)	Change
6/29/06	589.2		11,260	
6/30/06	616.1	+26.9	11,247	-13
7/6/06	636.2	+20.1	11,289	+42
7/14/06	668.1	+31.9	10,783	-506
Total change (6/29 to 7/14)		+78.9		-477

Neither price series describes a straight line, if you fill in the prices for the intervening days. Bottom line, though, the Fed's inflation warning set off a strong negative reaction in the stock index price and a stronger positive reaction in gold prices.

After July 14, however, fuel prices began to ease lower, and several other inflationary factors began to seem less threatening. Exhibit 2 (which tracks both nearby CBOT mini-sized Dow and CBOT 100 ounce Gold futures prices from January 3 to September 15, 2006) shows the Dow trending higher and gold trending lower. By the August 8 Fed meeting, this state of affairs resulted in a Fed pause and a claim that inflation pressures, while still apparent, were not the concern they had been.

Exhibit 2:



Looking Ahead

After that August 8 meeting and going forward, most Fed watchers seemed to expect no further Fed action during the rest of 2006, but at least a few economists claimed the Fed might feel the need to lower the target rate as early as the December 12, 2006, meeting.

It is possible to imagine two gold market reactions to a Fed ease. First, if enough gold market participants believe such an action means inflation is even less of a concern, they may abandon gold in force, which will probably precipitate a sharp downturn in the price of gold. Second, if enough gold market participants believe this Fed easing move opens the door to an upsurge in inflation pressures that may be fermenting just under the economic surface, they may buy Gold futures in size, which is likely to precipitate a rally in gold.

This two-sided outlook may seem an ideal situation for trading a Gold option straddle or strangle. However, simple is often better, and you may prefer to buy a far out-of-the-money put or call: you would buy a put if you favor the first outlook, or a call if you favor the contrarian second outlook.

Choosing the Right Option

These “event” trades probably do best when you use very short-dated options with far out-of-the-money strike prices. A good rule of thumb is to choose options with 30 days or less to option expiration and with deltas in the 0.18 to 0.30 range.

Based on these rules of thumb, on December 7, five days before the December Fed meeting, you might have chosen the January serial option on CBOT 100 oz. Gold futures. These would expire on December 26 and would have had 19 days to expiration as of December 7. Assuming a \$570.00 per troy ounce futures price, 23 percent implied volatility, and a 5.20 percent interest rate, you could expect to see an array of option prices and deltas such as the one shown in Exhibit 3.

Exhibit 3: An Array of CBOT Gold Option Prices and Deltas

Put strike Prices	Price (\$/oz.)	Delta	Call strike prices	Price (\$/oz.)	Delta
570	11.90	-0.490	570	11.90	0.510
565	9.50	-0.424	575	9.60	0.444
560	7.50	-0.359	580	7.70	0.380
555	5.70	-0.297	585	6.00	0.319
550	4.30	-0.240	590	4.70	0.263
545	3.20	-0.190	595	3.50	0.214

If you are convinced the first outlook is the right one, you will want to trade the put side of the market. You still face the decision of which strike price to choose. Suppose the futures price on Dec 13 drops to \$544 per troy ounce, the implied volatility rises to 25 percent, and the interest rate remains at 5.20 percent. This futures move and implied volatility shift will push the price of the January 570 gold put to \$28.10 per troy ounce and the price of the January 545 gold put to \$10.60 per troy ounce. Exhibit 4 summarizes the two trades.

In raw dollar terms, the 570 put seems to do better. It earned a net of \$16.20 per troy ounce whereas the 545 put earned \$7.40. You can divide these net results by the initial option cost to see that the return on investment (ROI) for the 570 put is 136.13 percent. This is a solid result, but the 231.25 percent ROI of the 545 put is noticeably better. Another way to look at the trade-off between more raw dollars and a better ROI is to ask whether you prefer to risk \$1,190 for the chance to earn \$1,620, or to risk \$320 for the chance to earn \$740. If you buy the 570 put, you risk almost four times as much for the chance to earn slightly more than twice as much. This is a choice every trader faces, and you can find reasons to go either way, though most professional option traders choose the far out-of-the-money options in cases such as this.

By way of contrast, consider how a January 570 straddle (long a 570 put and a 570 call) or a January 545-595 strangle (long a 545 put and a 595 call) might have performed given the futures prices and implied volatilities of Exhibit 4.

Exhibit 4: Example of How At-the-Money and Out-of-the-Money CBOT Gold Options Might Perform

	12/7/06		12/13/06		
Futures price	570		544		
Days to option expiration	19		13		
Implied volatility	23%		25%		
Interest rate	5.20%		5.20%		
Strike price	price	delta	price	result	ROI
Buy 1 Jan 570 gold put	11.90	-0.490	28.10	16.20	136.13%
Buy 1 Jan 545 gold put	3.30	-0.190	10.60	7.40	231.25%

In the case of the straddle, both options would cost \$11.90 per troy ounce, so the straddle cost would be \$23.80 per ounce or \$2,380 for a one-lot straddle. Given the ending futures price of Exhibit 4, the 570 put price would be \$28.10, but the 570 call price would be \$2.20. Thus the put would earn the same \$16.20 as in Exhibit 4, but the call would lose \$9.70, making the straddle net only \$6.50 per troy ounce.

In the case of the strangle, the January 545 put would still cost \$3.30 and the 595 call would cost \$3.50, making the initial strangle cost \$6.80 per ounce, or \$680 for a one-lot strangle. Again, the ending put price would be \$10.60, but the call price would be only \$0.30 per troy ounce. Thus the put would earn \$7.30, the call would lose \$3.20, and the strangle would net \$4.10.

Of course, the straddle and strangle would have the same result if the futures price rose by the same amount that it fell in this example. Still, if you are reasonably confident about your outlook, the simple put or call can do significantly more for you.

A Strategic Extension

You could make this trade and unwind it the day after the Fed meeting, as summarized in Exhibit 4. This would be a good result. But recall the

sequence of events following the June 29 Fed move: the CBOT Gold futures price shot up immediately, then it rose considerably higher over the next two weeks.

Based on this, you might expect a similar sequence following a Fed ease. If this is your expectation, you might think about unwinding this kind of trade in steps. Assume you bought 10 of these January 545 gold puts on December 7 (or any multiple of two). If the CBOT Gold futures price drops to 544, as in Exhibit 4, you could unwind half your position. These five puts would bring you \$5,300. Subtracting the initial \$3,300 premium you paid for 10 of these puts, would give you a net gain of \$2,000. Further, you would still have five puts working for you, but you would have no capital at risk, because the first five you sold back to the market would have paid the whole tab for the 10 puts.

Perhaps the best way to handle these last five puts is either to set a price target or to wait for option expiration. Assume you have set a futures price target of \$525 per troy ounce. If the price falls to this level or lower, the plan calls for unwinding the five puts at this point. Otherwise, you'll wait for option expiration.

Now suppose the gold futures price reaches \$515.70 per troy ounce on December 19. This is well below the 525 target, so you will do well to sell these last five puts. Given the \$515.70 futures price, 25 percent implied volatility, 7 days to option expiration, and a 4.95 percent interest rate, the January 545 put would price at \$29.50 per troy ounce. At this price, the five puts would be worth \$14,750 (29.5 x 100 x 5). Because you covered the initial cost when you sold the first five puts, this price is the net gain on the remaining five puts. The total gain for the 10 puts, given these assumptions, will be \$16,750 (the initial \$2,000 net gain plus this \$14,750). Exhibit 5 summarizes this trading sequence.

Exhibit 5: A Possible Sequence of CBOT Gold Put Trades

	12/7/06		12/13/06		12/19/06	
Futures price	570		544		515.70	
Days to option expiration	19		13		7	
Implied volatility	23%		25%		25%	
Interest rate	5.20%		5.20%		4.95%	
Strike price	price	delta	price	result	price	result
Jan 545 gold puts	\$3.30	-0.190	\$10.60	\$7.40		
Buy 10 Jan 545 gold puts	\$3,300					
Sell 5 Jan 545 gold puts			\$5,300	\$2,000		
Sell 5 Jan 545 gold puts					\$14,750	\$14,750
Total result						\$16,750

A Cautionary Note

Consider briefly what could go wrong with this kind of trade. The worst case would be for the Fed to raise its target rate rather than drop it. Equally bad would be for the Fed to ease, but for the market to foresee a considerable inflation threat. In either of these cases, the price of gold might rise rather than fall, and these puts would suffer a loss. However, the initial \$3,300 paid for the 10 puts defines the maximum possible loss.

Another possibility would be for the market to react initially to the Fed ease as described in Exhibits 4 or 5, but to subsequently be less certain that the inflation threat had evaporated. In this case, the gold price might remain somewhere close to 544 or even rally to some extent. Suppose, the futures price had risen to \$561.50 per troy ounce by December 19. At this futures price (and with 7 days to option expiration, 23 percent implied volatility, and a 4.95 percent interest rate), the sale of the January 545 put would bring in \$1.60 per troy ounce, so the five remaining puts would generate an \$800 gain ($1.60 \times 100 \times 5$). But this is pure gain: the initial cost was taken care of by the sale of the first five puts. The total gain in this case will be \$2,800 (the initial \$2,000 plus this \$800)—not great, but far better than a loss.

All things considered, this simple long put strategy can be an effective way to trade your opinions about events such as the effect of a Fed move on the price of gold. Granted, any trade involves some risk. However, because these options have little time value and are far out of the money, they cost little and so put little trading capital at risk. On the plus side, when events turn out in accord with your predictions, these out-of-the-money options can generate exciting returns, and give you huge bang for your trading dollar.

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		63	12632
		74	12633
		4	12634
		0	12635

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