

WEALTH DAILY

Predicting the VIX Moves

Special Report

"Buy when there's blood in the streets, even if the blood is your own," once said Baron Rothschild.

He should know. He made quite a fortune in the panic that followed the Battle of Waterloo.

Rothschild cast aside the negativity in times of extreme pessimism — just as we have a chance to do today for the long term.

As doom and gloom run amok, scared investors are sending volatility through the roof.

Volatility can certainly defy gravity for awhile longer, but chances are good it'll top out and reverse to the mean very soon.

You can't be afraid to short it long-term — even if the herd suggests the opposite.

In the days following the "downgrade heard 'round the world," VIX ran to a high of 48. That's overdoing it. There's only been a handful of other times it managed a read above 45.

The VIX ran to a high of 89.5 during the 2008 financial crisis in October of the same year.

But typically — even in some of the worst of times — it's peaked right around 50:

- The VIX ran to 49.53 in October 1998 on the Long Term Capital Management Crisis.
- It ran to 49.35 after the 9/11 World Trade Center attacks.
- It ran to 48.64 in October 1997 on the Asian financial crisis.
- It ran to 48.46 in July 2002 on the tech crash.
- It ran to 48.20 in May 2010 on the European debt crisis.
- And it ran as high as 48 during the current U.S. debt rating downgrade/credit crisis.

In the wake of many of those, you could have cashed in quite nicely as volatility dropped and the markets surged:



Look at What the R-4 Trigger Found

I'm sure you remember the [R-4 Trigger](#). The same principles apply in this situation.

Every single time the VIX traded above the upper Bollinger Band, it pulled back hard. The same is likely to happen with the VIX nowadays.

Plus, every time the Williams % Range agreed with the MACD and DMI reads, the VIX dropped.

While MACD and DMI don't agree these days, a move above the upper Bollinger Band and an overbought read on W%R sent the VIX from a high of 48 to less than 35. Check out the chart:



Make Better Trades Using the Fear Gauge

The VIX is one of the so-called contrarian indicators. That is, it tells you whether or not the markets have reached an extreme position one way or the other. If so, that tends to be a sure sign that the markets are about to stage reversal.

The idea here is that if the wide majority believes that one bet is such a sure thing, they pile on. But by the time that happens, the market is usually ready to turn the other way.

Of course, as usual "the crowd" hardly ever gets it right. (So much for the rational market theory).

So the smart money simply uses the VIX indicator as a sign to bet against them all.

If "the crowd" is feeling very bullish, in other words, it is definitely time to think about getting bearish.

It's counter-intuitive for sure, but it works nearly all of the time-especially in volatile markets. And that's why the VIX indicator is a trader's best friend these days.

After all, if there is one way to describe today's markets it would have to be volatile.

So What Is the VIX Indicator?

Developed by the Chicago Board Options Exchange in 1993, the CBOE Volatility Index (Chicago Options: ^VIX) is one of the Street's most widely accepted methods to gauge stock market volatility.

Using short-term near-the-money call and put options, the index measures the implied volatility of S&P 500 index options over the next 30 day period.

But because it is basically a derivative of a derivative, it acts more like a market thermometer more than anything else.

And like a thermometer, there are specific numbers that tell the market's story.

A level below 20 is generally considered to be bearish, indicating that investors have become overly complacent. Meanwhile, with a reading of greater than 30, a high level of investor fear is implied, which is bullish from a contrarian point of view.

The smart thing to do then is to wait for peaks in the VIX above 30 and let the VIX start to decline, before placing your buy. As the volatility declines, stocks in general will rise and you can make big profits. You see it time and time again.

In fact, the old saying with the VIX is, "When the VIX is high, it's time to buy. That's because when volatility is high and rising, that means the crowd is scared. And when the crowd is scared, they sell, and stock prices fall dramatically, leaving bargains for money making traders.

The Best Way to Trade

Hedge by playing the iPath S&P 500 VIX Short-Term Futures ETN (VXX) underlying with a hedged short.

If you want to make some serious money, buy the iPath S&P 500 VIX Short-Term Futures ETN (VXX) December 2011 32 put (VXX111217P00032000), while straddling (or hedging) with the December 2011 32 call (VXX111217C00032000).

Say volatility spiked again this week, which it could...

We'd walk with 15% for every \$1 the underlying VXX moved up. And we'd walk with ~15% to ~20% for every dollar the underlying moved down.

If you did that with a short, you'd walk with maybe 9% if VXX fell to \$30.

You're just playing both sides by buying a call option and a put option on the underlying stock. That means you're covered if the stock falls or rises.

Follow the VIX trades in [Options Trading Pit](#) and [Options Trading Coach](#)...

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