Deciphering Decisions

Behavioral Finance

Technical Analysis - Session 2

Technical analysts use support and resistance levels to identify price points on a chart where the probabilities favor a pause, or reversal, of a prevailing trend. Support occurs where a downtrend is expected to pause, due to a concentration of demand. Resistance occurs where an uptrend is expected to pause temporarily, due to a concentration of supply.

These levels, while they may appear arbitrary at first sight, are based on market sentiment and anchoring. Here, we examine how support and resistance zones are largely shaped by human emotion and psychology.

Before we move on let me underline that support and resistance levels are not set in stone. Once the price goes through these levels, these levels change their roles, that is support becomes resistance and vice versa.

At any point of time there are 3 types of traders in the market - those who have gone long, those who have gone short and those who are yet to enter a trade. Each of these either looks to increase their profits or cut their losses when price reaches a support or resistance. This leads to buying pressure at support and selling pressure at resistance.

Fear and greed, for example, are seen in the market participants' behavior outlined above. As price falls back to a support level, the traders who are already long will add to positions to make more money. Meanwhile, the traders who are short will buy to cover, because they are afraid of losing money.

This behavior is also a classic example of anchoring- what we discussed last time.

Once it so happens that price bounces back from a specific level, traders associate special importance to this level without any definitive logic and thus if a resistance or support level has been established in the past, it can create a shared anchor where those same levels will be met with resistance or support in the future.

Other support and resistance levels that are influenced by human emotion include round numbers (since they are easy to remember), 52 week highs and lows, and historic events such as new market highs.

One reason for this is that these prices have been significant in the past and traders know they are likely to be again. Market participants often gauge future expectations based on what has happened in the past; if a support level worked in the past, the trader may assume that it will provide solid support again.

Volatility and Associated Strategies

Volatility can be historical or implied, expressed on an annualized basis in percentage terms. Historical volatility (HV) is the actual volatility demonstrated by the underlying asset over some time, such as the past month or year. Implied Volatility (IV) is the level of volatility of the underlying implied by the current option price.

VIX - The Fear Index

VIX measures the fear in the market. How does it do that? It measures fear by calculating the implied volatility in the near-term expiration of the S&P 500 options contracts. Thus, the implied calculation is a forecast of the market's aggregate expectations of the volatility in the coming few weeks. The more fearful investors and traders are, the more they are willing to pay for the cost of insurance (options). This is why it's called the fear index. Uncertainty is the enemy for most investors and traders, both in the market and in everyday life, and this is why we are willing to pay for reducing uncertainty.

Vega- an option greek which is the rate of change of option premium with respect to its volatility.

- The VIX, also known as the fear index, is a tool that measures how much investors and traders expect the S&P 500 (and the stock market in general) to fluctuate in the upcoming 30 days.

- When the VIX number is low, the market is expected to have low volatility in the coming days. And when the VIX is high, the market is expected to have high volatility in the coming days.

The logic is very simple – when the VIX is low, then the market is in risk-on mode, meaning stock markets are rising, and the economy is usually booming. On the other hand, when the VIX is rising, stock indices are falling, and investors may consider a risk-off mode.

A high VIX figure indicates that the S&P 500 and the general U.S. stock market will likely become more volatile within a month. It also indicates that the markets are likely to drop since investors' fear is rising. A low VIX figure signals a potential low volatility in the S&P 500 within the next 30 days. Generally, it is said that the market is at increasing risk when the VIX rises above 30. On the other hand, when VIX is trading below 20, investors interpret it as a low-risk market condition.

But, like many other indicators, it can be prone to many false signals.

So, to find the most accurate trading combination, you must try other moving average periods, other indicators, or other trading strategies altogether.

Several indicators can be used to get a view on future trends of VIX and strategies can be developed accordingly.