TRADING MARKETS.COM Trading Strategies

How To Use S&P 500 Futures To Get A Heads Up On Stock Price Action

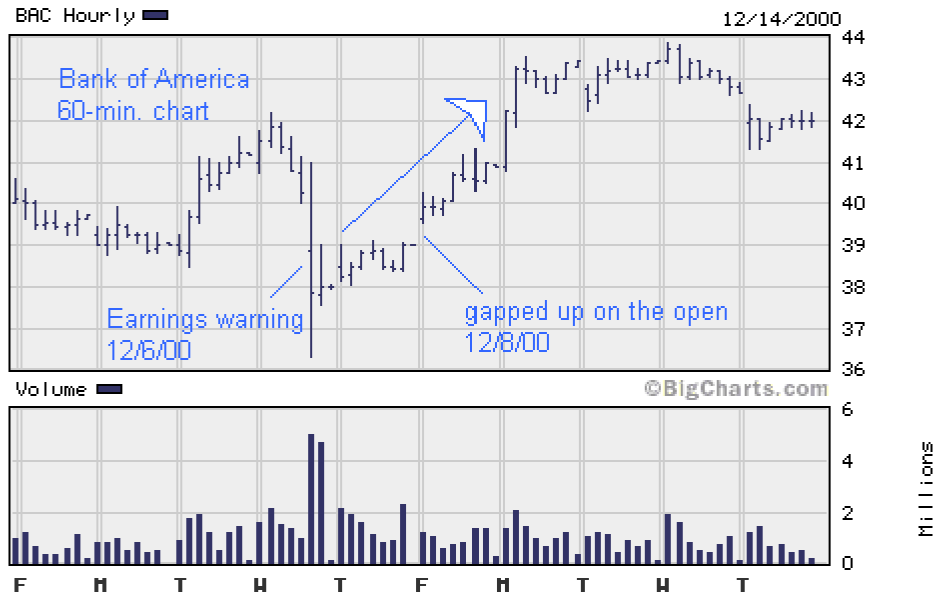
By Tsutae Kamada

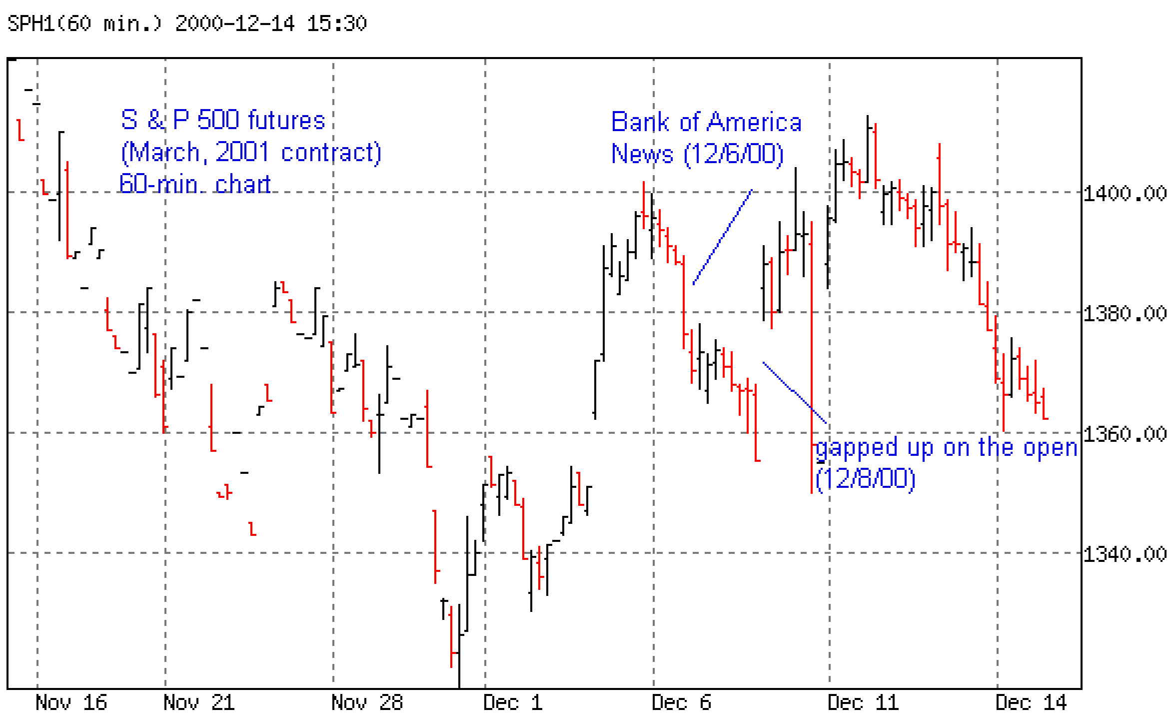
As we know, to be successful traders, we should not fight the overall trend of the stock market. If we are experiencing a weak market, we should sell our stocks or look for short selling-opportunities. On the other hand, in a strong uptrending market, we will be aggressively looking for buying opportunities.

In addition to the overall trend of the stock market, we should not forget to monitor the S&P 500 futures index. This index consists of 500 leading companies from various industries, and its underlying index is S&P 500 cash index. In general, if the S&P futures is uptrending, this is a bullish sign for stocks. But if the S & P futures dives, it will cause a sell off in the stock market.

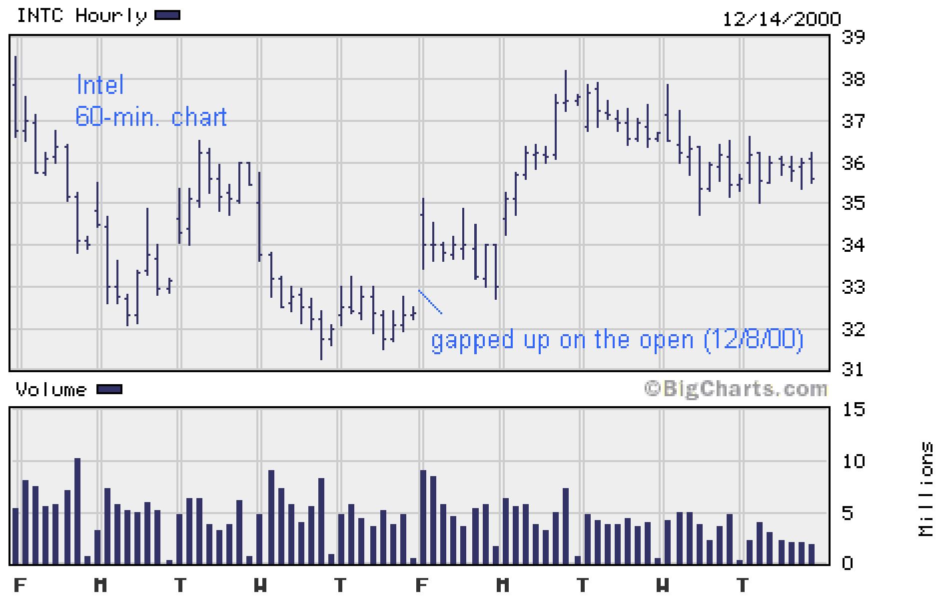
A successful trader shared an interesting story with me recently. On December 6, Bank of America, one of the S&P components, announced its fourth quarter earnings would be less than the consensus estimate. This warning came during the afternoon trading session and hit the bank stock hard. Sell off was sharp and quick. The S&P 500 futures was also touched by this news and sold off.

Two trading days later, on December 8 at the market open, we observed fascinating price movements in both the S&P 500 futures and Bank of America stock. As you can see on the charts below, both of them gapped up. Remember, investors abandoned Bank of America because of its earnings shortfall, but the stock gapped up on the open as well. You might say the stock was way oversold. It had to rebound sooner or later. But the point I am making here is "timing." Why did Bank of America have to gap up at the same time the S&P gapped up? In addition to the gap-up opening, both the stock and the S&P futures pretty much traded in similar patterns the rest of the day. Was this just a coincidence? I don't think so. It is impossible for Bank of America to improve its fundamental conditions convincingly in two days, so all traders would decide to buy in the same morning. I have to say that Bank of America received a big push from the S&P futures in the morning of December 8.





There is one more example from the successful trader I would like to share. Do you remember Intel, one of the S&P 500 companies, warned of an earnings shortfall after the final bell on December 7? As we saw on the chart above, the S&P 500 futures made a gap-up open on December 8. In spite of a negative earnings news from the previous day, Intel also gapped up. (Please see the chart below.) Was it another coincidence? I heard investors say bad news was already discounted into Intel's price. That could be the case, but I have to question the "timing" of the gap-up. Again, I have to say that Intel received a big boost from the S&P futures. In other words, Intel followed them.



As I mentioned above, companies like Intel and Bank of America, which belong to the S&P 500 futures index, would be hit first when the index jumps. In other words, leaders from each industrial sector will be affected first when the futures moves. Pay attention to those leaders such as Yahoo! from the internet, Lucent from the networking, IBM from the computer makers, and Intel from the chip makers. They will quickly react when the S&P moves. Unfortunately, if you could not catch those sector leaders, try to catch second leaders in each sector. For example, if you failed to ride on Intel, try Advanced Micro Devices. If Yahoo! ran away from you, see what Amazon is doing. In general, those second leaders in each sector will follow sector leaders.

Daytraders may want to note the following points mentioned by Mr. *Jea Yu* in his book **TheUndergroundtrader.com Guide To Electronic Trading**:

> "We like to put the S&P 500 futures on three-minute stochastics charts. The three-minute stochastics gives us a smooth and very real visual on the trend of the futures. When the two oscillator lines (%d, %d slow) fall under the 20 band, the futures are in oversold territory and one anticipates a reversal up. When the two oscillator lines run above the 80 band, the futures are in overbought territory and one anticipates a reversal down."

We are stock traders, not futures traders. We realize futures influences the stock market, but we cannot afford to stare at the S&P 500 all day long. How can we monitor the futures effectively? If a stock jumps above its resistance level, that is a breakout. When we see a stock fall below its support line, we call it a breakdown. Often those breakouts and breakdowns create wild price swings. What I am suggesting is you should program support and resistance levels of the S&P into your computer, so you will be alarmed properly when those levels are hit. Please check our website every night. We report Futures Pivots, Support and resistance.

Some of you might say that you don't think your stocks would be affected by the S&P futures price fluctuations because you do not own any stocks represented by the index. You may be right, but let me ask you questions. Do you own bank stocks or brokerage stocks? Do you have any oil stocks or airline stocks? If you answered yes to any of the questions, you need to pay attention to the futures markets.

Bank and brokerage stocks are interest rate sensitive. In general, they prosper under low interest rates environments. The chart below is the Bank Index. It has been rallying since late November, and the index recently broke out above its 50-day moving average.

Now let's see the 10-year US Treasury Note (March 2001 contract) from the interest rate futures. As you can see clearly, the 10-year note has been surging since early November. This rally had started almost two weeks before the bank index began its upward movement. Although the 10-year T-Note did not signal to us the exact moment to get in bank stocks, it certainly warned us of a potential trend change in the bank sector.

TYH1(Daily) 2000-12-11

Airline industries would be negatively affected by rising fuel cost. The two charts below illustrate how rising crude oil future prices hammered down the airline index.

CLF1(Daily) 2000-12-11

Sometimes we experience sudden sharp ups and downs of the market caused by program trading. This is also related to the futures index. Many of you probably heard "fair value." I would like to recommend you not spend too much time trying to figure out when program trading would occur. Let me explain why.

There are three numbers of program trading: fair value, buy premium, and sell premium. The premium is the difference in value between the S&P futures index and the S&P cash index. If this premium equals fair value, we would not see program trading. When the premium widens to the buy premium, the buy program would hit the market. If the premium narrows to the sell premium, we would see the sell program. The buy program means buying the cash (stocks) and selling the futures. The sell program is selling the cash (stocks) and buying the futures. The problem is each brokerage house has its own methods to calculate program trading numbers. The only thing one can do is to estimate what those numbers might be, so don't spend too much time on this subject.

Finally, in addition to the S&P futures, I would like to suggest one non-futures indicator. Make a habit of following the advance-decline line. If we are consistently seeing more stocks are down than up, we should hesitate aggressive buying because it is almost impossible for the market to sustain a healthy rally under negative advance-decline line. Let me state again. We all want to be successful traders. We have to know the overall trend of the stock market. We should buy stocks from strongly uptrending sectors. Although it is tough to pinpoint when we will get a boost from the futures, we should not forget to monitor the direction of the S&P 500 and other futures indices. Good luck and happy trading.