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AIQ Systems
David Vomund, Chief Analyst
P.O. Box 7530
Incline Village, Nevada 89452

UNDERSTANDING FUTURES - PART 1

FUTURES MARKET OFFERS ACTION, LEVERAGE, LOW COST OF EXECUTION

By Edward "Bobby" Florez

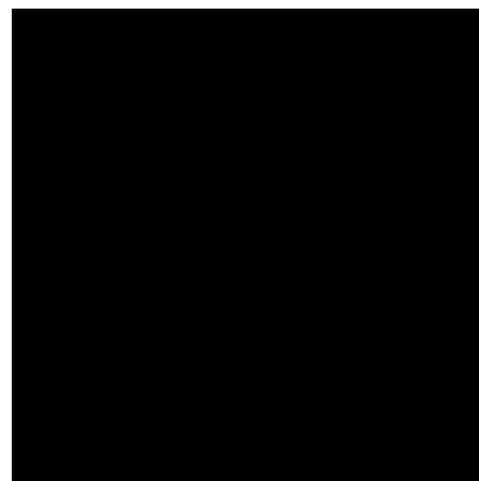
Editor: Trading commodity futures is a subject that we have never covered in the Opening Bell. Yet, AIQ's TradingExpert can be used to analyze futures as well as stocks.

To help us understand futures and how they work, we turned to Edward Robert "Bobby" Florez. Mr. Florez has been a professional trader, analyst, broker, and author for almost three decades. He retired from the Chicago Board of Trade in 1996 and now devotes his time to helping others learn how to trade. He was featured in the March 2000 issue of Technical Analysis of Stocks & Commodities.

In this series of articles, Mr. Florez will review the basics of futures and, once we understand how futures work, he will explain how to pick entry and exit points.

The Futures Market

Commodity futures are *legal contracts* that are traded on all of the commodity futures exchanges. All commodity contracts identify and specify a number of specific charac-



Edward "Bobby" Florez

teristics such as quantity, expiration of the contract, pricing increments, and delivery specifications.

The only thing that is really not specified in the contract is its price. The price is determined by the activity of the traders themselves in the market.

All commodity trades are guaranteed by the commodity exchange where the trade occurs. That is, the exchange is the final buyer to each seller, and the final seller to each buyer. So the trader, as long as he

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FUTURES *continued* . . .

follows the proper protocol for order placement, needn't worry about whom he buys from or sells to.

Most people think of pork bellies or wheat when we discuss commodity futures but stock index futures, interest rate futures, and US dollar futures all fall under the "commodity futures" umbrella as well. *Opening Bell* readers are more interested in stock index futures than they are in grains or livestock so that is where we'll keep our concentration.

Stock index futures represent the actual stock index as a tradable financial product. It is a futures contract for a basket of stocks as represented by a stock index and its price represents some multiple of the stock index's actual value.

There are several securities that one can purchase which track a market index but the ones that offer *the biggest bang-for-the-buck* are stock index futures. Nothing in the equities market compares to the action, leverage, and low transaction cost offered by the futures market.

Traders often prefer the futures market because of the

leverage, quick settlement, and low cost of execution. If traders reverse their stock index positions the same day there is, in effect, no margin requirements. That is, *if they day-trade then they have no margin requirements at all in the commodity markets.*

And commodity trades clear overnight. So, if traders want today's trading profits, they can have them tomorrow.

Contrast this with the stock market. In the equities market, the margin requirements apply from one session to the next until the trade clears, which usually takes three days. This is true even if a

index futures. They could likely get away with this in the commodities market, whereas if they were to take a corresponding position in the shares of the hypothetical merger they could end up in jail.

Another big difference between futures and equities is you can't keep a futures contract in a permanent portfolio. For example, if a trader decided to buy 100 shares of Intel Corporation for a day trade but then chose not to sell, he could then decide to keep the shares in a permanent portfolio. The trader cannot do this in the stock index futures market — even if the trader held the contract through its last trading day. At the end of the last trading day of the contract, he would have to settle up what he owed or else take what was owed him at the settlement price at the end of that day.

If the trader had originally purchased at a price lower than this settlement price, then he would have a profit. Had he purchased at a higher price, then a loss would be *debited* from his trading account.

A final difference between equities and futures is that there is no uptick rule for stock index futures contracts.

An example of stock index futures is found in **Figure 1**, a chart of the S&P 500 Futures. Trendlines and chart patterns can be analyzed just as they can on the index itself.

In order to trade a stock index futures product, a trader must first establish a commodity futures trading account with a brokerage firm. After making a deposit, all you have to do to trade in the commodities markets is to call your broker. You can trade with a market order, trade at a certain

"Most people think of pork bellies or wheat when we discuss commodity futures but stock index futures, interest rate futures, and US dollar futures all fall under the 'commodity futures' umbrella as well."

trader reverses his trades during the day.

Again, you can see why a trader gets a much greater bang-for-the buck in the commodity futures market. Margin requirements are usually 2% to 5% of the contract's value and, for all practical purposes, there aren't any day-trade margin requirements.

There are other outstanding differences between commodity futures and equities trading. An important one, and one that creates an uneven playing field, is that *inside information is not illegal* in the commodities market.

It isn't illegal for those on the inside of a market moving announcement (like a colossal merger, for instance) to take an appropriate position in the stock

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G.R. Barbor, Editor
P.O. Box 7530
Incline Village, NV 89452

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FUTURES *continued* . . .

price, or use a stop order. If you have an online trading account, then you would input this information yourself into your PC. This process is similar to what you do with equity accounts.

When a trader buys or sells a stock index futures contract, he generally considers five different ones: the S&P (Standard & Poor's 500 Index), the E-mini S&P, the Dow Jones Industrial Average Index, the Nasdaq 100, and the E-mini Nasdaq 100. All of these stock index futures contracts are traded in Chicago.

The E-mini S&P 500 and the E-mini Nasdaq 100 are traded exclusively on the computer and represent a true trader-to-trader market, one that is very fast and efficient. There is no floor broker. Even in chaotic markets, you receive instant notification on an executed trade.

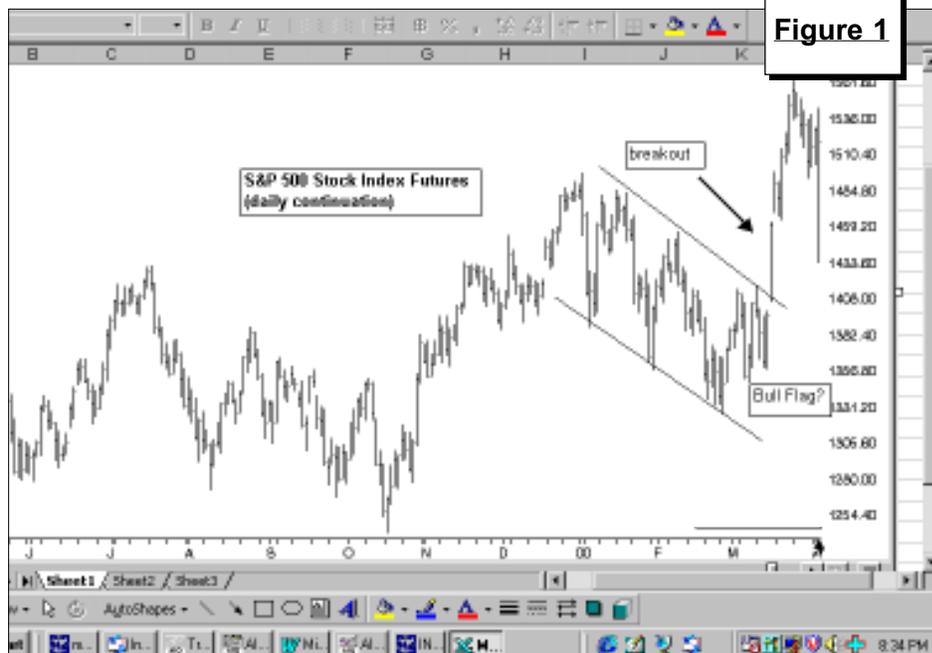
Following is a breakdown of some of the stock index futures products.

The S&P 500

The S&P 500 Index represents about 70% of total domestic U.S. equity market capitalization. Every stock in the index is weighted according to its individual capitalization. Thus, its value is influenced more by the stocks with the greatest capitalization.

Currently, the largest-cap stocks in the S&P 500 index are General Electric, Coca Cola, Exxon, Microsoft, Merck & Co, Royal Dutch Petroleum, Intel, Phillip Morris, Proctor & Gamble, and IBM.

Average daily volume for the S&P 500 futures contract is usually well in excess of 50,000 contracts, and regularly exceeds 100,000 contracts. On chaotic days, over



200,000 contracts can trade.

A total daily volume of 50,000 contracts may not sound like a lot of volume when compared to the hundreds of millions of shares that are regularly traded on the New York Stock Exchange or on the Nasdaq. But one must stop and figure what is being compared

legal terms of the contract. For the S&P, each contract is \$250 times the future's price. In order to figure exactly how many dollars it is worth just multiply the contract's price times the multiple of \$250. So at the end of the quarter we take the September 2000 contract price times 250.

$$1468 \times \$250 = \$367,000$$

Now, that's a lot of money for one single contract. Compare that to the usual minimum position in the stock market, a 100 lot of some common stock. An equivalent would be a stock whose per share value equals

\$3,670.

$$\begin{aligned} &\$367,000 \div 100 \text{ shares} \\ &= \$3,670 \text{ per share} \end{aligned}$$

And in the stock market, at 50% margin, a trader must have \$183,500 in his margin account to stay out of margin violation if he were to trade no more than 100 shares of this hypothetical stock. Few traders, very few, keep that

Futures continued on page 4

“There are several securities that one can purchase which track a market index but the ones that offer the biggest bang-for-the-buck are stock index futures .”

because the value of each S&P contract is enormous.

For instance, on the last trading session of the second quarter of this year the September 2000 contract closed at 1468. At that closing price just one contract was worth \$367,000.

How is this calculated? Every stock index futures contract trades at a multiple as stipulated by the

FUTURES *continued* . . .

kind of money temptingly free in their margin accounts. Yet the overnight margin for the S&P is about \$23,000, and the "suggested" day-trade minimum is only about \$8,000.

The S&P contract trades once for every ten points. For instance, at 1468, the next up tick will be 1468.10. This minimum one tick difference represents \$25 in value.

$$1468.10 \times \$250 = \$367,025$$

and

$$\$367,025 - \$367,000 = \$25$$

Alternately, the next down tick from 1468 would be 1467.90, and this would be equivalent to \$25 as well. Thus, if the market should rally to 1469, or 100 ticks higher, this would amount to \$250. Were it to decline to 1467, this would again be worth \$250.

The S&P is an extremely volatile market and it moves in 100 point increments within minutes all day long.

E-mini S&P 500

The E-mini S&P, a derivative of the S&P contract described above, is *the most active of all of the stock index futures contracts*. The E-mini's daily volume regularly exceeds 70,000, considerably greater than the volume of the full valued S&P.

The E-mini S&P is a very popular market for professional as well as novice traders. Its contract size is *one-fifth* that of the full valued S&P. Therefore the E-mini S&P contracts are valued by multiplying the future's price by \$50.

Each tick is worth \$12.50, and there are only four ticks per 100 points in the E-mini S&P (i.e. one tick every 25 points). Therefore, a 100-point swing in the E-mini S&P is worth \$50 whereas a 100-point



Figure 2

swing in the full sized one is worth \$250.

$$\text{\$12.50 per-tick} \times 4 \text{ ticks (per 100 points)} = \text{\$50 per 100 points}$$

The minimal price increment is 25 points. Thus, if the last price of an E-mini S&P 500 is 1468, its next up-tick will be 1468.25. Conversely, its next down-tick from 1468 would be 1467.75.

E-mini Nasdaq 100

The E-mini Nasdaq 100 is the second most popularly traded stock index futures contract. The daily volume is regularly above 40,000 contracts and is greatly in excess of the original contract that it was derived from, the Nasdaq 100.

One of the key variables of its popularity is the volatility of the index itself. It is not unusual for the Nasdaq 100 to swing over 100 points during the day. This would be equivalent to \$2,000 per contract.

The E-mini Nasdaq contracts are valued by multiplying the futures price by \$20. For example, if the contract is trading at 4020.00,

the value of the contract is \$80,400 (\$20 x 4020.00).

The minimum price movement of the futures, or tick, is 0.50 index points or \$10 per contract. If the futures contract moves one tick, from 4020.00 to 4020.50, a long (buying) position would be credited \$10, and a short (selling) position would be debited \$10.

The Nasdaq 100 index is based on the 100 largest non-financial stocks listed on the Nasdaq Stock Market with each stock having individual weighting within the index as a result of its capitalization. Currently, the top 10 stocks in the index are Microsoft, Intel, Cisco Systems, MCI Worldcom, Dell, Sun Micro Systems, Amazon.com, Amgen, Level 3 Communications, and Yahoo.

Using Futures for a Perspective of Financial Trends

Although it is rarely mentioned, one of the great benefits of commodity futures analysis is that traders can get a precise, daily thumbnail sketch of national and

FUTURES *continued* . . .

worldwide financial trends and conditions. All they have to do is follow certain essential commodity futures contracts on their computer; specifically, the US Dollar, Interest Rates, and Inflationary Indicators.

The US Dollar (Figures 2 & 3)

First and foremost, a trader wants to keep an eye on the trend of the US Dollar against the currencies of its major international trading partners. The major currencies to bear in mind are the continental European currencies and the Japanese Yen.

A majority of the continental European currencies are represented by a commodities market called the "Eurocurrency". It is traded along with many other international currencies at the IMM (International Monetary Market), a division of the Chicago Mercantile Exchange.

The Japanese Yen, also traded at the IMM, is another important currency to watch. Canadian Dollars and the Mexican Pesos are traded at the IMM as well.

Traders can follow all of these currencies or they can get a general overview of the US Dollar's trend by watching only this one currency market. This is a thinly traded market at the New York Cotton Exchange called the US Dollar Index (end-of-day ticker symbol is UD1600).

Even though the US Dollar Index is quite inactive compared to the much more liquid currency futures contracts traded at the IMM, it does give clear indications of the dollar's long and short-term trends. The dollar's value is the lynch-pin that eventually determines the value of everything in the U.S. It is the worldwide

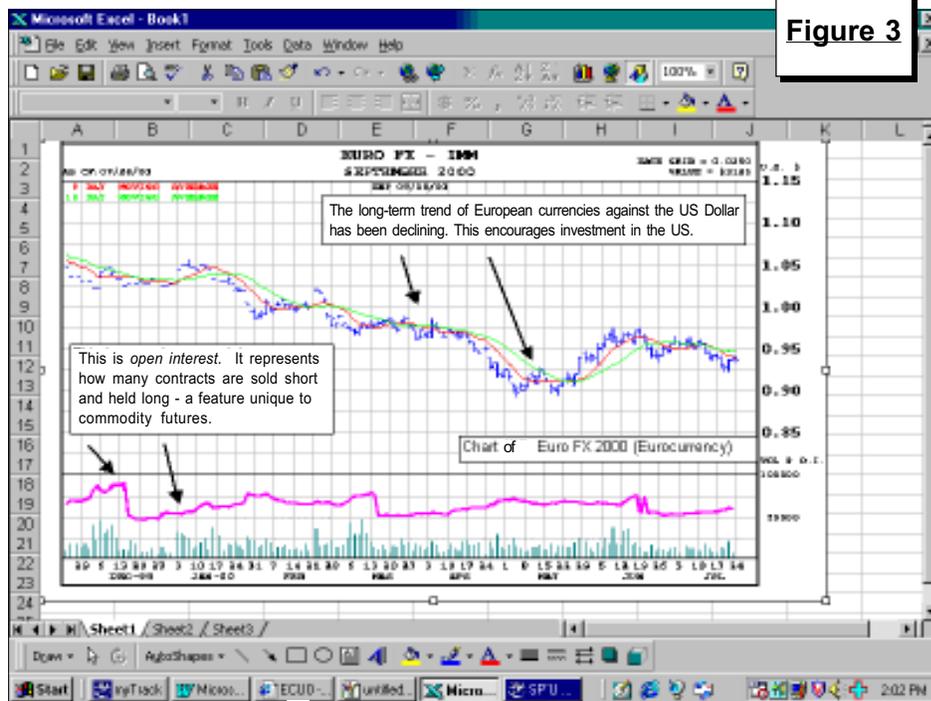


Figure 3

standard of exchange. If it is in a strong position, then generally the U.S. stock market is strong as well.

The fundamental story behind this phenomenon is that foreign

investing in our stock market as long as its up-trend is maintained, or until the value of the dollar begins to decline against their own currency. Should this occur, then they would likely divest their US equities and convert the dollars they receive into their own currency.

To remain invested in the U.S. while the dollar is declining diminishes their total return, even if their investments in the U.S. stock market are profitable. That is why it is important to watch the trend of the US dollar. All major U.S. stock market sell-offs since the 1970's were the result of a declining and overvalued dollar. ■

Next month: A look at interest rates and inflationary indicators, plus a summary of federal and private reports that give a fundamental perspective.

Mr. Florez offers free training online at www.synchronomics.com.

"One of the great benefits of commodity futures analysis is that traders can get a daily thumbnail sketch of national and worldwide financial trends and conditions."

investors holding long US dollars are looking for a place to safely invest them. They are seeking the highest yield for them as well.

For almost two decades the most fruitful investment for dollars held offshore has been the U.S. stock market. This is in deference to the more traditional investments they would have made such as US Treasury securities or the CD's of a money center bank.

Foreigners should continue

IDENTIFY SIGNIFICANT SIGNALS WITH POINT AND FIGURE CHART PATTERNS

By David Vomund

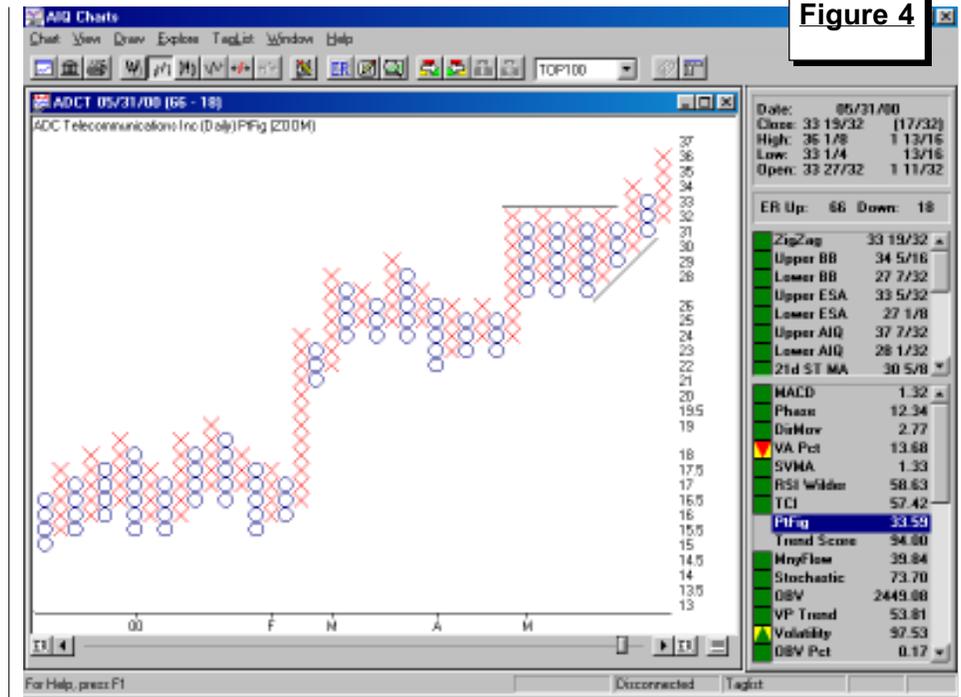
DAVID VOMUND

This is the second of two articles on the interpretation of Point and Figure charting. Last month, we began to identify buy and sell signals and explored the Symmetrical Triangle and Triple Top patterns.

A buy signal is registered on a Point and Figure chart when one column of X's moves higher than the previous column of X's. The theory behind a buy signal is that the stock is able to rise above an important resistance level. A buy signal is never registered when a stock is at or near its lows. Instead, the buy signal comes when a stock "breaks out" above resistance. The stock then remains on a buy signal until a column of O's falls below a previous column of O's.

After a break above resistance, a stock often retests its breakout before heading higher. Because of this, many traders wait for the retest before they buy. Look for a Bullish Catapult formation to buy after a successful retest. For this pattern, the stock must first give a Triple Top buy signal, but after that signal sellers temporarily emerge. Sometime before hitting the lows of the previous column of O's, the stock rallies and the buy signal is registered when the final column of X's moves above the previous column of X's.

An example of this Bullish Catapult pattern can be seen in **Figure 4**, a chart of ADC Telecom-



munications (ADCT). In May, ADCT reached \$32 on four occasions but sellers emerged each time. On its fifth attempt ADCT moved above that level, registering a Triple Top buy signal. The stock only rose to \$34 and sellers promptly emerged. Selling was

"By using Point and Figure chart patterns you won't buy at the lows because it always takes upward price movement before a buy signal is registered."

short-lived and ADCT rose again. The Bullish Catapult buy signal came at \$35 when the last column of X's rose above the previous column of X's.

Editor's Note: TradingExpert does not have the capability to draw

trendlines on a Point and Figure chart. Trendlines were inserted on the charts in this article to help highlight the chart patterns.

A variation of the Triple Top is the Spread Triple Top pattern.

This is a very broad formation and forms during consolidation periods. The buy signal on this pattern is generated when the stock penetrates three tops. The tops need not be in succession, however. There are intervening moves between the price tops. An example of a Spread Triple Top pattern is found in **Figure 5**.

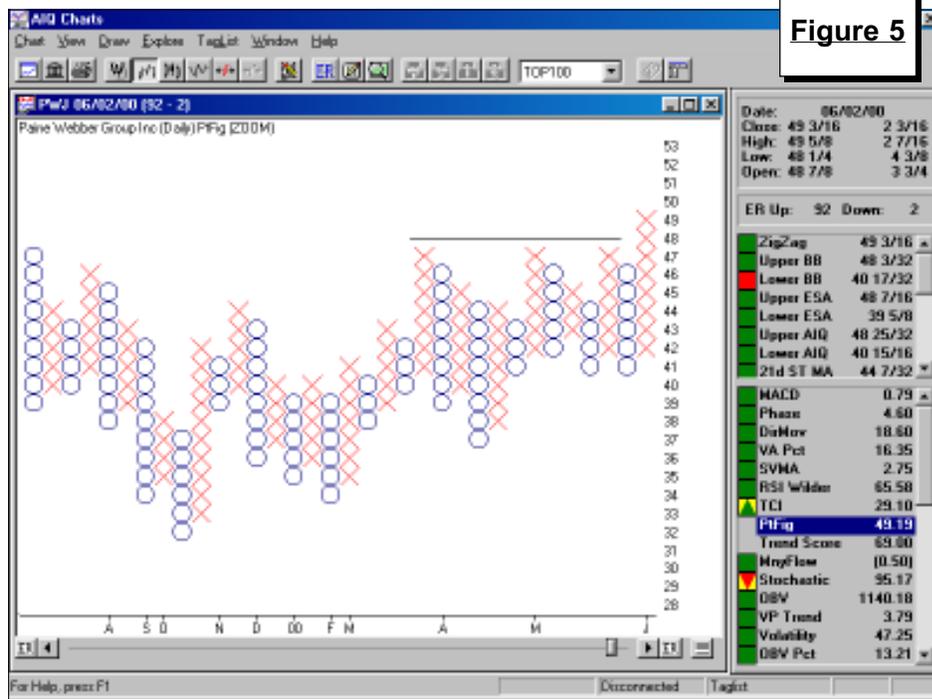
Paine Webber (PWJ) reached \$47 on three different occasions but sellers emerged each time. It wasn't until the last column of X's that PWJ was able to rise above the \$47 resistance level, giving a Spread Triple Top buy signal.

POINT AND FIGURE CHARTING *continued* . . .

By using Point and Figure chart patterns you won't buy at the lows because it always takes upward price movement before a buy signal is registered. One pattern that would qualify as a bottom-fishing pattern because it requires significant weakness is the Bullish Signal Reversal. Under this pattern, you must have at least five columns of lower highs and lower lows. As the stock moves lower the Point and Figure chart is obviously bearish. The buy signal is registered when a column of X's finally moves higher than the previous column of X's. This pattern requires at least seven columns in its formation.

Figure 6 shows a Bullish Signal Reversal. Reebok Int'l (RBK) was one of the worst performing stocks in the second half of 1999 and it formed a pattern of lower highs and lower lows. It wasn't until March 2000 that RBK rallied enough to have a column of X's move higher than its previous column of X's. The downtrend had ended.

The best way to learn Point



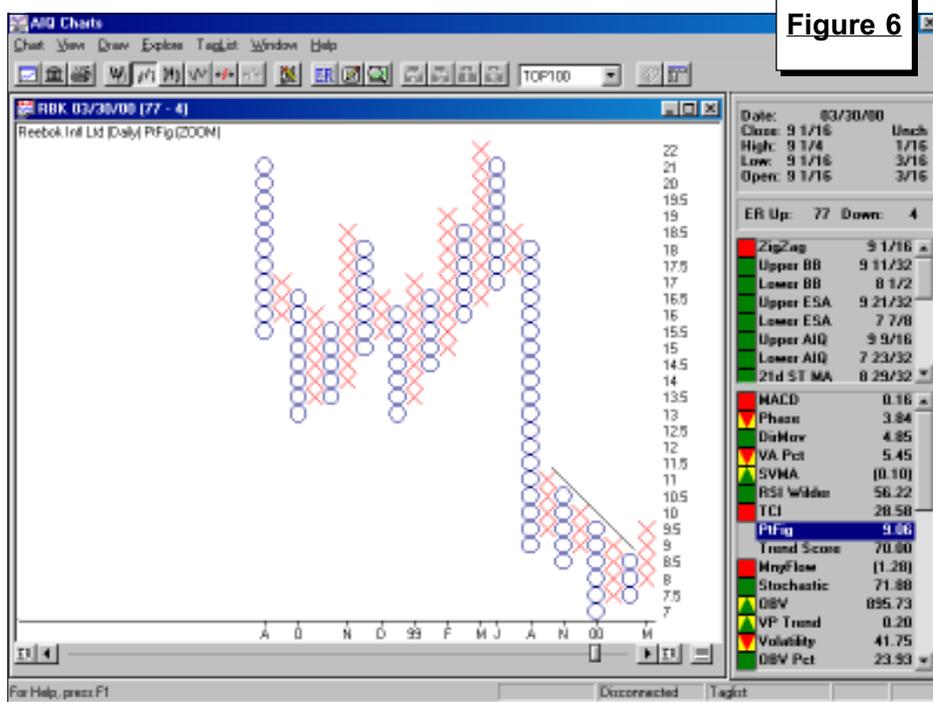
and Figure techniques is to scroll through a list of stocks, identifying the patterns that we have discussed. Nearly every stock will show one or more of these patterns. For example, look at Figure 5. Can you identify a slight variation of the Bullish Signal Reversal early in 2000 as well as the Triple

Top buy signal that occurred before the Bullish Catapult pattern that we discussed? If you can identify the patterns in the past, it will help you to identify patterns as they develop.

The Point and Figure charting technique was not designed to eliminate traditional bar charting. Each charting method has its advantages. With the Point and Figure charting technique, one can more easily identify important chart patterns as well as support and resistance levels as they develop. Yet, Point and Figure charts are based on price only so I like to combine Point and Figure analysis with technical indicators, such as Money Flow or On Balance Volume, that incorporate volume in their calculations.

For additional reading: *All New Guide to Three-Point Reversal of Point & Figure Construction*, by Michael Burke. ■

David Vomund publishes *VIS Alert*, a weekly investment newsletter. For a sample copy, call (775) 831-1544 or go to www.visalert.com.



MARKET REVIEW

September is historically the worst performing month for the market. This September was no exception. The market lost in September what it gained in August. In September, the S&P 500 lost 5.35% and the Nasdaq Composite fell 12.7%.

The AIQ timing model has remained on a buy signal since August 1. After much of the September selloff, the timing model registered several additional buy signals. A buy signal was registered on September 22, a 98 buy signal was registered on September 27, and a 98 buy was registered on September 28. In addition, a high percentage of stocks were giving buy signals near the end of the month. On

September 29, about 80% of the stocks with confirmed signals were on the buy side. ■

David Vomund's
Market Commentary

For those interested in hearing a weekly market commentary from AIQ's David Vomund, visit www.biznews1.com.

Vomund is available every Monday at 9:10 a.m. (PST) for a three minute interview. To see a listing of other guests, click *About Us*, then *Welcome*, and then *Regularly Scheduled Phone Guests*. Other guests include John Murphy, Gerald Appel, and Don Wolanchuk.

S&P 500 Changes

The following are changes to the S&P 500 Index and Industry Groups:

Avaya Inc. (AV) replaces Owens-Corning (OWC). AV is added to the Computers-Networking (COMPUTEN) group.

Dynegy (DYN) replaces Best Foods (BFO). DYN is added to the Natural Gas (NATURALG) group.

King Pharmaceuticals (KG) replaces Young & Rubicam (YNR). KG is added to the Health Care-Drugs Generic & Other (HEALTHDU) group.

STOCK DATA MAINTENANCE

The following table shows past and future stock splits and large dividends:

Stock	Ticker	Split/Div.	Approx. Date	Stock	Ticker	Split/Div.	Approx. Date
Cousins Properties	CUZ	3:2	10/03/00	Greater Bay Bancorp	GBBK	2:1	10/19/00
Corning Inc.	GLW	3:1	10/04/00	Petroleum & Res.	PEO	3:2	10/20/00
UTI Energy	UTI	2:1	10/04/00	Adams Express Co.	ADX	3:2	10/20/00
Human Genome Sci.	HGSI	2:1	10/06/00	Exar Corp.	EXAR	2:1	10/20/00
Audio Codes Ltd.	AUDC	2:1	10/09/00	Lehman Bros	LEH	2:1	10/23/00
Lattice Semiconductor	LSCC	2:1	10/12/00	Nu Horizons	NUHC	3:2	10/24/00
Oracle Corp.	ORCL	2:1	10/13/00	Adobe Systems	ADBE	2:1	10/25/00
Flextronics Int'l	FLEX	2:1	10/17/00	Hewlett Packard	HWP	2:1	10/30/00
Adminstaff Inc.	ASF	2:1	10/17/00	Tektronix Inc.	TEK	2:1	11/01/00
Madarex Inc.	HAR	2:1	10/19/00				

Trading Suspended:

AMFM Inc. (AFM), Castle & Cooke Inc. (CCS), ChemFab Corp. (CFA), CMP Group (CMP), Consolidated Papers (CDP), Geon Co. (GON), Harmon Industries (HRMN), Mark IV Industries (IV), Primak Corp. (PMK), Saatchi & Saatchi (SSA), Summit Technology (BEAM), Vastar Resources (VRI), Verio Inc. (VRIO)

Name/Ticker Changes:

4 Kids Ent. (KIDE) to 4 Kids Ent. (KDE)
 Applied Power Inc. (APW) to Actuant Corp (ATU)
 Healthon/WebMD (HLTH) to WebMD Corp. (HLTH)
 Inso Corp. (INSO) to eBI Int'l (EBTI)
 Media Metrix (MMXI) to Juniper Media Metrix (JMXI)
 Minnesota Power (MPL) to Allete (ALE)
 Morrison Knudsen Corp (MK) to Washington Group Int'l (WMG)
 VISX Inc. (VISX) to VISX Inc. (EYE)