



3 ways to trade stocks in a volatile market

Commentary: All hands on deck when QE2 makes port

By Michael Sincere

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MIAMI, Fla. (MarketWatch) — Trading in advance of the end of QE2 is like playing poker with Ben Bernanke. At the moment, at least, the Fed isn't revealing its hand. Accordingly, traders should brace for more volatility as June 30 approaches, given the state of confusion many market participants are in.

As a trader, you should always look for profitable opportunities based on probabilities and your own judgment. Here are three strategies to consider using whenever a market-changing event is looming:

1. Stay on the sidelines

If you're new to the stock market, you may want to stay safely on the sidelines when QE2 ends.

After repeatedly entering the market too soon and getting burned, legendary trader Jesse Livermore gave this advice: "After spending many years in Wall Street and after making and losing millions of dollars, I want to tell you this: It never was my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight!"

This could be one of those times to sit tight, at least until the market's direction is clearer.

2. Fade the gap

Erik Swarts, an independent trader and creator of the research site Market Anthropology, has been actively shorting the market, "and it's been exceptional," he said.

Specifically, he has been "trading the gap," or shorting the market after it gaps up in the first few minutes following the open. "Although I'm skeptical of the market, I'm reluctant to get dogmatic on the bear side," Swarts noted.

Yet this strategy is not for beginners. “If I was inexperienced with this kind of market, I’d probably stay away and paper trade it,” Swarts said. “There are too many cross-currents to navigate for the novice trader.”

3. Use the options market

Buy puts: You can turn to the options market for protection or profit. For protection, buy protective puts on stocks you already own. If you want to speculate, buy puts on individual stocks or indexes. Although buying puts is less risky than shorting, it’s still possible to lose your entire investment if you get the timing and direction wrong.

Another option is to initiate what’s known as a “straddle” — though unlike protective puts a straddle is not typically a trade for rookies. Still, it’s good to understand this options strategy, which many experienced traders use.

Straddles come into play if you expect the market to move aggressively in one direction or another, as has been the case over a couple of trading days this week.

“If you buy a straddle,” said Joe Harwood, manager of Investor Services at the Options Industry Council (OIC), you pay two premiums, one for a call and one for a put.”

Be aware that if the underlying stock doesn’t move far enough in either direction, you may not realize a profit. “What can happen is sometimes referred to as a volatility collapse,” Harwood said, which occurs when pumped up implied volatility falls back to normal levels.

Consult your broker before initiating any options strategy. You can also learn more about options at the OIC web site: www.optioneducation.org.

Trading post-QE2

What should investors do now? If you are long-term oriented, you may want to listen to **Bernard Baumohl**, chief global economist of The Economic Outlook Group and author of *The Secrets of Economic Indicators* (Pearson Prentice Hall, 2007). He’s had an excellent market forecasting track record.

The stock market’s situation now, he said, “reminds me of someone trying to swim in peanut butter. You get the feeling there is an inflection point coming, but you aren’t sure how much weaker the economy will be. But you get the feeling that something is in the midst of changing.”

Once QE2 ends, “don’t panic,” **Baumohl** said. “But after June, you must watch the FOMC (Federal Open Market Committee) statements very carefully for a hint of what the Fed might do next.”

Even with the market’s current weakness fueling pessimism, **Baumohl** said he believes the major U.S. stock indices will be higher at year-end.

“Based on our economic outlook and geopolitical assessment,” he said, “we still expect the Dow (DJI:DJIA) to be up around 10%, the S&P (SNC:SPX) to gain 12%, the Nasdaq (NASDAQ:COMP) 6%, and the Russell 2000 (RSU:RUT) up 8%.”

All bets are off if upheaval in the Middle East spirals out of control, **Baumohl** said. “The probability this will occur before the end of the year is still a high 40% to 45%, so it can’t be dismissed altogether.”

(To read my entire interview with **Bernard Baumohl**, including his market forecasts and where you should invest now, click on this link: <http://bit.ly/jjyKJU>)

The lesson for traders — rookies and veterans alike — is always be prepared. QE2 is going to create a big wake once it docks. If you use any of the above trading strategies, cut back on share size. Given the likelihood that the market becomes even more volatile this summer, this is not the time to take unnecessary risks.

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