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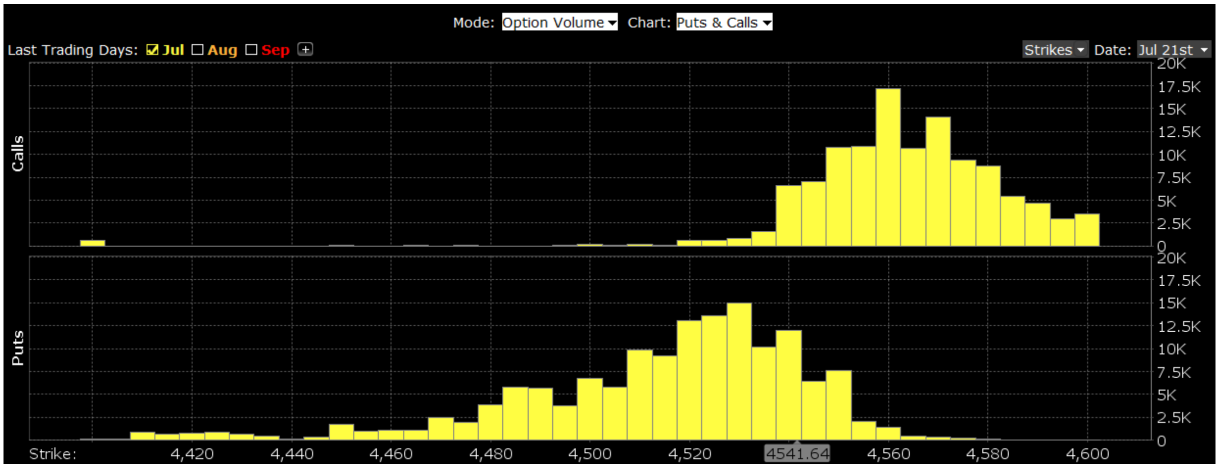
Options Volume

What Conclusions Can We Draw from Options Volume Data?

SPX daily options volume is a valuable tool that can provide insights and aid in the decision-making process. In this lesson, we will explore how to use daily options volume to gain insight into the expected trading range for the day, establish profit targets, pivot points, market sentiment and confirm a trade thesis.

Options volume refers to the total number of options contracts traded during a specific period.



Determining the Expected Trading Range for the Day

By analyzing options volume at different strike prices, traders can gain insight into the potential trading range for the day. Higher volumes indicate increased market interest. When high call volume is concentrated at a specific strike or area, it may act as an upper bound, while high put volume could be seen as the lower bound.

Establishing Profit Targets and Potential Pivot Points

Once you have determined the expected trading range, you can use this information to establish profit targets and entry points for your trades.

It's important to first understand how markets move. Markets naturally seek liquidity, causing prices to gravitate towards areas of high activity, which often act as significant support or resistance. Conversely, low volume areas should be considered low liquidity zones, where price movements can be more rapid, making them generally less ideal entry points for trades.

For example, if participants are positioned with the expectation that price will be contained to 4530 and 4560 for the day, you may look at these strikes as profit targets particularly if they align with our quoted gamma levels for the day (which they often do).

Additionally, high volume strike may be used as a pivot point, particularly if the market is in a positive gamma. This works because traders often monetize or adjust their positions when it goes ITM, this combined with the support of dealers flows from a positive gamma market, buy weakness, sell strength, increases the likelihood of these levels acting as a target and pivot. In addition, if the market exceeds the high volume strike it may be more prone to reversal, in the context of a positive gamma market, unless options volume is consistently building in that direction.

Determining Market Sentiment

The distribution of put and call options volume at various strike prices can also reveal trader sentiment. A higher number of total puts relative to calls may suggest a bearish sentiment, indicating expectations of a decline in the market. Conversely, a larger number of calls relative to puts may indicate a bullish sentiment, suggesting traders anticipate higher market prices. When calls and puts are relatively equal, it suggests that the market may be more prone to consolidation-type action.

This is commonly referred to as the put/call ratio, which can be analyzed from either an Option Interest or Volume perspective. While it is often used as a contrarian indicator in general, for short-term intraday trading, we do not consider it as such.

If you have a bullish bias, observing call volume building further out-of-the-money (OTM) can confirm your bullish view. Conversely, if you hold a bearish thesis, you would look for an increase in put volume. However, if you hold a more market-neutral perspective, a balanced volume profile could offer confirmation.

Pinning & Trade Confirmation

The pinning effect is driven by dealers (market makers) who aim to maximize their profits by having most options expire out-of-the-money, causing the market price to gravitate towards specific strikes. This effect is commonly observed during Monthly OPEX, where the market tends to close near our Absolute Gamma Strike (ABS), resulting in many options expiring worthless and causing a point of maximum pain for participants as a whole.

Although this effect might not hold true for SPXW expirations, it can still provide an indication of where the market might close. For instance, if there is a notable concentration of call volume at 4570 it could result in the market closing just below this level, causing those calls to expire worthless.

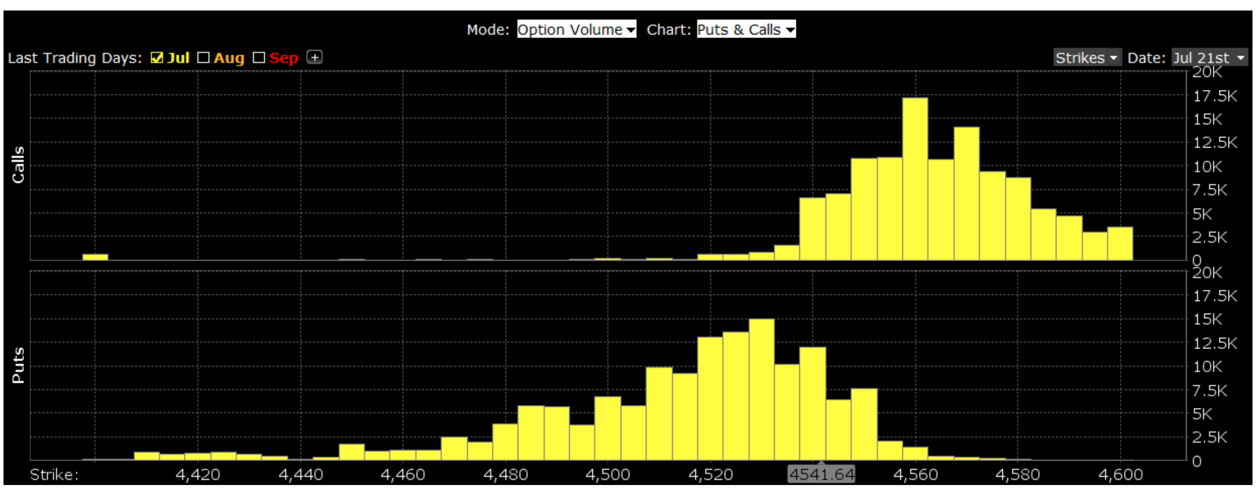
It's important to note, options volume, like any analysis or data, is not static and may not be effective all the time. It can also be disconnected from the underlying price action. Options volume should not be solely relied upon for decision-making; instead, traders should combine this information with other technical and fundamental analysis.

Case Study: SPX Volume Analysis for July 21, 2023

Let's examine a real-life example from July 21, 2023. At the end of this lesson, you will find a price action chart for reference.

At 9:30 AM we observed a concentration of put activity at the strike price of 4530, indicating a significant number of traders expecting the market to decline and close below that level. Additionally, there were a notable number of calls at 4560, suggesting traders positioning themselves with the expectation of limited upside from the opening price of 4550. Oftentimes these high volume strikes act as the upper bound and lower bound of the daily trading range.

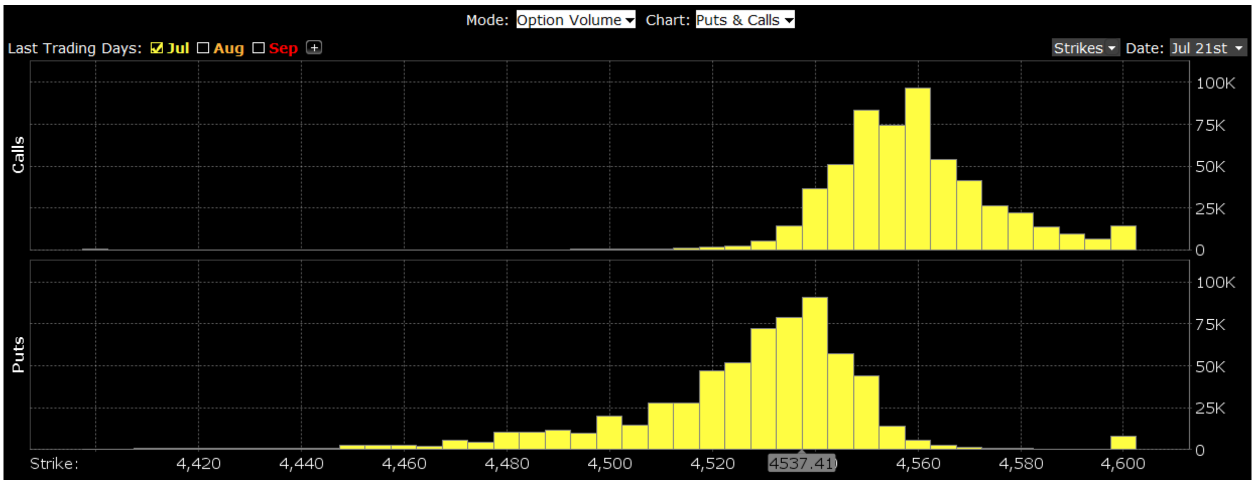
SPX Options Volume as of 9:30 AM



On this particular day, the market opened with a gap up but faced selling pressure at the open, causing the SPX to decline to 4535, just shy of the dominant put volume strike of 4530. The market found support at 4535 and rebounded, reaching a high of 4555 but falling short of the 4560 dominant call volume strike.

During the rebound, put volume started to increase, filling in above 4530, particularly at 4440. Meanwhile, the dominant call strike remained at 4560, while call volume started to pick up at lower strikes, specifically at 4555 and 4550.

SPX Options Volume as of 4:00 PM



Throughout the day, options volume maintained a relatively neutral tone, gradually building within a tighter range, focused around our key Absolute Gamma Strike (ABS) of 4550.

This indicates a potential low volatility and range-bound environment, which materialized as the SPX closed up just +0.03% within a 0.40% trading range, falling short of the 0.60% implied volatility on the day.

SPX July 21, 2023