Intermediate Concepts In Index Trading

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Table of Content

Welcome to the intermediate eBook for Index Trading. This eBook will help you to learn more about Index Trading and how trading is conducted, as it introduces Factors affecting Index trading, and trading strategies.

1. INTRODUCTION

Index is defined as a portfolio of stocks that represents a particular market or market sector. Most major economies as well as developing economies have at least one financial index.

For instance, the Dow Jones Industrial Average (DJIA), one of the most frequently used indices worldwide – is comprised of stocks from 30 of the largest companies in the US, representing approximately 25% of the US market. Meanwhile, the S&P 500 index is comprised of 500 of the most widely traded companies in the US. As the S&P 500 is more diverse than the DJIA, it can give a better representation of the condition of US stock market as a whole.

INDEX (also known as Indices) is a sampling or collection of stocks that gives an overview of how a specific part of the stock market is performing. For example, a technology stock index will contain several or all technology stocks. The index then moves with the overall performance of the stocks that it holds within it.

Indexes are popular because they provide information for a basket of stocks, and not just one.

The changing value of an index from one day to the next reflects the fluctuating values of the individual stocks that it is made up of, and is why an index can be a good representation of the state of a country's economy or of a specific industry.

<u>Some widely traded indices include:</u>

Dow Jones (New York City)	**S&P 500 (New York City)**	**Nasdaq (New York City)**	**DAX 30 (Frankfurt)**
Hang Seng (Hong Kong)	**Nikkei 225 (Tokyo)**	**Shanghai Composite (china)**	**FTSE 100 (London)**
CAC 40 (France)	**EUROSTOXX50 (Eurozone)**	**S&P ASX200 (Australia)**	

2. INDEX TRADING

Index trading enables traders to speculate on whether an index will rise or fall, without actually buying shares in the underlying assets. In this sense, one can trade an index just as one would trade a stock, currency or commodity.

Index trading is trading a basket of stocks which make up the index, through one instrument. The index tracks a basket of stocks that are used as indicators of a general representation of the whole stock market (S&P500) or are a specialized segment of a stock exchange such as technology, such as the NASDAQ.

Index trading is normally more rewarding to an investor or a trader because in general indices have a higher return than the stock market they represent partially or wholly.

Market	**Value of one contract**	**Country**
FTSE 100 **(24 hours)**	£10	London
EU Stocks 50 **(24 hours)**	€10	Eurozone
Germany DAX 30 **(24 hours)**	€25	Germany
S&P %00 **(24 hours)**	$250	U.S.
Dow Jones 30 **(24 hours)**	$10	U.S.
Nasdaq 100 **(24 hours)**	$100	U.S.
Hang Seng **(24 hours)**	$ 50	Hong Kong
Nikkei **(24 hours)**	¥ 1000	Japan
Shanghai Composite **(24 hours)**	CNY 300	China

Index trading cannot be done directly and they are available for information only. Market data is available for the index trading, and they can be charted, but there is no way to make either a long or short trade on the actual stock indices. They are actually long or short on a futures or options market.

Futures and options are known as derivatives markets, because they are derived from the underlying stock index. There are futures and options markets available for all of the popular stock indexes.

3. BASIC TERMS USED IN INDEX TRADING

Beta: A measurement of the relationship between the price of a stock and the movement of the whole market. If stock XYZ has a beta of 1.5, that means that for every 1 point move in the market, stock XYZ moves 1.5 points and vice versa.

Volatility: This refers to the price movements of a stock or the stock market as a whole. Highly volatile stocks are ones with extreme daily up and down movements and wide intraday trading ranges. This is often common with stocks that are thinly traded, or have low trading volumes. This is also common with the stocks that Tim trades.

Volume: The number of shares of stock traded during a particular time period, normally measured in average daily trading volume.

4. HOW IS INDEX TRADING CONDUCTED?

In index trading each share in an index contributes towards the calculation of its overall value, with the index rising or falling in value depending on the performance of its collective stocks. So if the FTSE 100 index is 'up', more investors are buying than selling, and share prices have increased. However, if more shares are being sold than bought, the index will instead decline.

If a trader believes the market will increase in value, they may decide to **"Buy"** for £10 per point at 7031. Subsequently, for each point the FTSE 100 rises, the trader will earn £10.

However, since the **"Sell"** level is 7029, the trader initiates the trade £20 down (£10 x 2 points), because if they were to close the trade immediately, this is the loss that would be incurred. If the FTSE rises to 7041 by the day's close, and the trader decides to close the position, the profit will be £100 (7041-7031 = 10 point increase, and 10 x £10 = £100).

5. FACTORS AFFECTING INDEX TRADING

Earnings reports: Stock valuations are driven by earnings expectations and the relation between consensus forecasts and actual figures, forward guidance and leading economic performance data. A positive or negative earnings surprise can have a dramatic effect on the price of a stock, and therefore the performance of an index. Recall that major stocks are assigned large weightings on indices like the FTSE 100. Individual stocks like HSBC, Royal Dutch Shell and GlaxoSmithKline have the capacity to drag the index lower or higher.

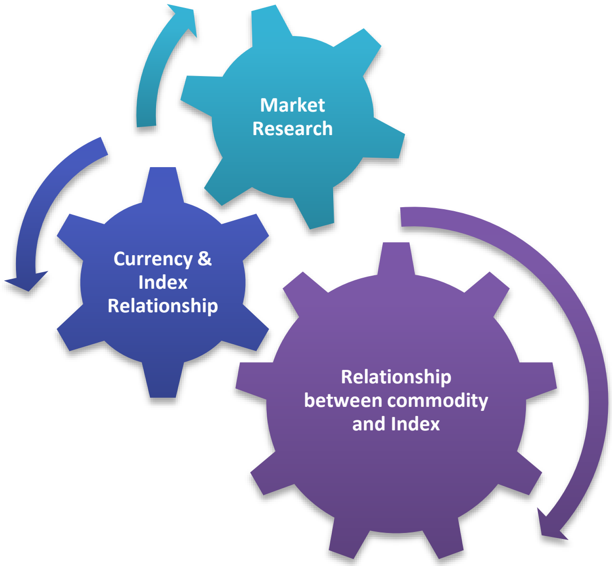
Interest rates: An inverse relationship exists between interest rates and investment levels in equities. When interest rates rise, the level of investment in index component shares declines because higher rates result in decreased corporate profitability owing to higher interest repayments. Higher interest rates result in increased debt and decreased profits, and are therefore associated with decreased investment in stock markets.

Industry performance: When bearish signals pervade the economy in specific industry sectors, they drag the index lower, and vice versa. For instance, the recent oil price woes had a deflationary effect on the UK economy, and oil-related sectors (e.g. mining, construction, oil producers) were dragged lower. Now that oil prices are trading in the $45–$50 per barrel range, oil-related stocks have been able to appreciate.

Inflation report: The inflation report has far-reaching implications for the index trading, as it indicates the current policy on interest rates. If inflation targets are being met, it is more likely that an interest rate hike will come to pass. If not, there is less justification for a rise.
For example if the Bank of England has a pre-stated 2% inflation target for 2018 and, with oil prices rising, it will be easier to achieve this target and justify a rate hike. As mentioned above, a rate hike would be expected to impact on the FTSE 100 in a negative way, at least in the short term.

Changes in economic policy: If a new government comes into power, it may decide to make new policies. Sometimes these changes can be seen as good for business, and sometimes not. They may lead to changes in inflation and interest rates, which in turn may affect index prices.

6. INDEX TRADING STRATIGIES



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Market Research: Before trading an index, examine that index's component parts; is the index composed of shares from a range of industries, or do many of its shares belong to a particular market sector. It is important to understand of the ways in which the value of an index may be influenced.

Relationship between Currency and Index: It is important to have an understanding of an index's sensitivity to currency rates, as there is typically a correlation between the relative strength of a country's currency and the value of its domestic indices.

For example, the value of American indices generally increases with the demand for US Dollars. This may be partly due to foreign investment – as a growing number of traders invest in US stocks, they must first purchase USDs to buy American stocks, in turn causing US indices to increase in value.

Relationship between commodity and index: The relative value of certain currencies can be susceptible to change as commodity prices increase or decrease. An example if oil prices decrease, say, because of weaker global demand, then Canada, an exporter of oil, would be at an economic disadvantage, whilst Japan, a major oil importer – would generally benefit.

For this reason, it is advisable to study the movements of commodities that may affect the value of the index you are trading. Although correlations may fluctuate from day-to-day, over the long term, strong trends tend to occur, and searching and analysing these patterns could aid you in making better trading decisions.