The World's Best Technical Indicator: The Ichimoku Cloud By Andrew Keene

Table of Contents

- 1) Introduction
- 2) One Small Favor...
- 3) What is the Ichimoku Cloud?
- 4) What are the 6 Components of the Cloud?
- 5) Why should you use the Ichimoku Cloud?
- 6) How do you use the cloud for trading options?
- 7) How do you use the cloud to trade stock?
- 8) What is the BEST way to use the Cloud?
- 9) Cloud Tips
- 10) Advanced Applications of the Cloud
- 11) Recap
- 12) How Can KOTM Help You With Options?
- 13) Top 10 Mistakes Most Traders Make
- 14) Resources

Introduction

Modern retail traders have access to more technical studies and indicators than they ever have before. Retail trading platforms now come loaded with all of the latest technical indicators and many even allow traders to write their own studies and indicators. With so many tools and resources available to traders it can be difficult to know which indicators will work the best for your trading plan. The majority of technical indicators have very specific applications, and usually don't work the same for every trading style. Another problem with most technical indicators is that they are not forward looking. Most indicators have some kind of lag built in and often have traders entering and exiting trades either too early or too late. One little known indicator called Ichimoku Kinko Hyo, also known as the Ichimoku Cloud, solves these problems.

The Ichimoku cloud is our favorite technical indicator. The cloud is one of the only indicators that is both forward and backward looking. The cloud produces better levels of support and resistance and is a breakout trader's best friend. The cloud is also one of the easiest indicators to use. Any trader, regardless of skill level or expertise, can use the cloud to quickly and efficiently analyze any product on any time frame. The cloud shines in the fact that it can be universally applied to any trading plan by any trader. In this eBook we will discuss why we like the cloud so much and how we use it in our proprietary trading strategies.

I was first introduced to the cloud when traveling through Asia. There I met other traders who used the cloud as their main source of technical analysis. Since then, I have spent time studying the cloud and learning all of the best applications for the indicator. Although I rarely ever looked at charts when on the trading floor at the CBOE, the cloud has become an integral part of my trading strategy that I could not do without. My goal for this text is illustrate the importance of the cloud and how it has changed the way I trade. So if you're interested in learning about the best technical indicator around, please read on.

Andrew Keene Acronym 'AXK' January 1, 2014

One Small Favor...

For those who are reading this, I appreciate your time. I believe the following text be worthwhile, and think this will show in your trading. I feel if it saves you from one losing trade, or if it makes you think twice before taking a trade with a poor risk-reward setup, I have done my job.

If you feel this to be the case, I ask you to please take 5 minutes in order write a brief review on Amazon.com.

What is the Ichimoku Cloud?

The Ichimoku Cloud is a technical indicator I first encountered while traveling through Asia in 2006. Talking shop with other traders I had met I quickly realized that this 'cloud' they kept referring to was different from any other indicator I had ever used. I was also surprised at how simple and intuitive the cloud was to use. While it may look confusing at first the Ichimoku Cloud is actually one of the simplest indicators to use. Before we can approach the actual applications of the cloud, let's discuss what the cloud actually is.

The Ichimoku Cloud is a technical analysis method that uses sets of moving averages to produce key levels in the past, present, and future. The cloud helps traders identify at a single glance if a security or other financial product is trading in bullish or bearish territory. Ichimoku Kinko Hyo literally translates to 'One Glance Equilibrium Chart' because it can be used for analysis using only a glance. For this reason, the cloud is one of the most efficient technical indicators available.

The cloud is made up of 6 key components, each of which we will examine individually later on. When these 6 components are combined they form the Ichimoku Cloud. Below is an image of the SPDR S&P 500 ETF Trust (SPY) on a daily chart with the cloud overlaid. We can use the cloud to identify key levels of support and resistance, determine trend, and determine the strength of the trend.

As can be seen in the image below the cloud is actually a forward-looking indicator. The cloud is projected 26 periods forward so the levels under the current price were formed 26 days ago. The cloud is unique in this fact that is uses both past data and forward-looking levels. Since the levels are forward looking they tend to be more reliable than simple moving averages. The lagging indicator component also provides confirmation of breakouts by looking 26 periods back to determine if a stock is likely to break through levels. It is this concept of looking at the past, present and future that makes the cloud so valuable. In the next chapter we will look at the individual components of the cloud and how they are calculated



What are the 6 Components of the Cloud?

The Ichimoku Cloud is made up of 6 individual components. Each is calculated and plotted differently and each one tells us something different. Here we will discuss how each component is calculated and what it is used for.

The 6 components:

- 1. The Tenken-Sen Line
- 2. The Kinjun-Sen Line
- 3. Senkou Span A
- 4. Senkou Span B
- 5. Kumo
- 6. Chinkou Span Line

Once calculated, these pieces form the indicator set known as the Ichimoku Cloud. In the image of the AAPL daily chart shown below, you can see the components clearly labeled.



Source: TradingView.com

Calculating the Individual Components:

The Tenken-Sen Line: Short term trend line similar to a 10 period moving average. It is known as the turning line and is a signal of a region of minor support or resistance. This component is calculated by taking midpoint between the highest high and the lowest low over the past 9 periods.

The Kinjun-Sen Line: Known as the confirmation line. This component also serves as a signal for support and resistance levels. Many traders use this line as a level for a trailing stop. It also serves as an indicator of trend. If price is above the Kinjun-Sen Line then the stock is in bullish territory, likewise if it is below the line it is in bearish territory. This line is calculated by taking the midpoint between the highest high and the lowest low over the past 26 periods.

Senkou Span A: This line forms one of the boundaries of the 'cloud.' If the stock is trading above the line then the line will serve as a major support level. If price is below this line it will serve as a level of major resistance. This component is calculated by taking the average of the Tenkan-Sen and Kinjun-Sen lines. This line is unique in that the results of this calculation are plotted 26 periods ahead. This means that today's Senkou Span A line was actually plotted 26 days ago.

Senkou Span B: This line forms the other boundary of the 'cloud.' This line serves as a second level of support or resistance and is calculated by taking the midpoint between the highest high and the lowest low over the past 52 periods. Like the Senkou Span A line, this is also plotted 26 periods ahead. This line is similar to a 50% Fibonacci retracement.

Kumo: This is the shaded area, located between the Senkou Span A and Senkou Span B lines, that is used to form 'the cloud' itself.

Chinkou Span Line: This line is also known as the lagging indicator. This line is the current bar's closing price plotted 26 periods back. The lagging indicator is often used as confirmation of signals and can also serve as a support and resistance level. The lagging indicator can also assist a trader in confirming the direction and strength of trends.

Now that we know how each individual component works, we can discuss how they are used together in a trading plan, and how it is you will want to incorporate the Ichimoku Cloud

Why Should You Use the Ichimoku Cloud?

With so many indicators included in charting packages why should a trader focus on only one like the Ichimoku Cloud? In reality, the answer to that question is rather simple. I believe the Cloud is the best indicator in the whole world and is more effective than any other signal. The cloud is unique in the fact that it has current, past and future components that can be used as key levels or to project potential future price action. Although this is the main reason I love the cloud so much, there are other important reasons as well.

One of the best things about the cloud is that not very many people know how to use it. Everyone uses Bollinger bands and moving averages but the cloud is used far less in practice. Why is this a good thing you might ask? In the age of algorithmic trading, many high-frequency trading firms will try and run the stops of weaker traders. They target levels based on where they believe people will have stops in place. Since people tend to put stops in at levels derived from other, more common studies, it is easier for the high-frequency trader to take them out. If a trader uses the cloud to set stops and targets it is not likely there are a lot of other traders at those same levels. This means that my stops won't be targeted as much as they would if I used more popular studies.

The cloud is also one of the only indicators I know of that is forward looking. This fact that the cloud is projected 26 periods into the future means that it will signal earlier than any indicator that is not forward looking. The slope and thickness of the future cloud also tells me how strong the trend is and can also provide an early warning when a trend is about to reverse. We can use the forward projections of the cloud to time entries and exits as well.

I also like the cloud because it takes into account much more data than simple or exponential moving averages do. This means that the cloud produces much clearer levels of support and resistance. Again, this is a good thing when I am using the cloud to set profit targets or stops.

The flexibility of the Ichimoku Cloud is also one of its greatest qualities. The cloud is applicable to any product on any time frame. This means that any trader can use the cloud effectively. The cloud can be used for trading stock, options, futures, and currencies. All of the products will have a time frame that they work best on, but the cloud can be used to trade any of them. Later on we will discuss what time frames work best for what asset classes.

These are all great reasons to use the cloud, but the by far best reason by is that the cloud is very effective. I wouldn't use it if it didn't work and after years of trading with the cloud, I am still profitable. This is hands down the number one reason I use the cloud and you should too, to make money.

How Do I Use the Cloud to Trade Options?

I have been trading equity options for the past 12 years. While I often trade stock and other products like currencies and futures, I still consider equity options to be my bread and butter. When on the trading floor I didn't use charts. I would focus all of my attention on order flow and implied volatility. After I left the floor and moved upstairs I realized that my trading plan would benefit from an addition of technical analysis. The Ichimoku Cloud has proven itself to be the most effective technical indicator I can use as an options trader. Here we will discuss how I apply the cloud to my proprietary trading plans and why it works so well.

As an options trader I base the vast majority of my trades on what I call 'unusual option activity.' Unusual option activity is a large block trade that takes place at a multiple above the average daily option volume in a specific stock. These unusually large trades are placed by large institutional market participants and can represent the flow of the 'smart' money in the options market. Simply put if I see big institutional players betting heavily on upside or downside in a specific stock I try and follow that trade. The key to trading unusual option activity is being able to infer what, if anything, the institutional trader's underlying stock position might be. Remember that the majority of options market participants are hedgers. This means that orders cannot always be taken at face value. If I see a large put buyer it's possible they are hedging a large long stock position rather than trying to get short. Likewise, when I see calls being bought it is possible the trader is hedging a short stock position rather than trying to get long. Determining if a bet is speculative or a hedge is my number one goal when trading unusual option activity, and the Ichimoku Cloud helps me do this.

The cloud is an excellent indicator of trend and the strength of the trend, so when I am trying to determine the motives behind a large block trade I see the cloud as being extremely helpful. If the cloud is indicating a strong bullish trend in a stock that I see puts being bought in, it is much more likely the institutional trader is hedging a long stock position. When I trying to determine if a trade is speculation or a hedge I need to perform my analysis very quickly, in a matter of seconds. The cloud helps with this as well. Thousands of trades hit the tape in any given day so I am constantly looking at charts of stocks I am seeing action in. Being able to determine if a stock is in bullish or bearish territory at a single glance is essential to being able to analyze stocks very quickly. So my use of the cloud for trading unusual options activity really boils down to a single concept: if institutional traders are buying puts in a stock above the cloud, I do not want to get short. Alternatively, if they are buying calls in a stock below the cloud, I do not want to get long.

Using the cloud to weed out all of the false signals and traps has greatly increased the profitability of my trading plan. The cloud helps guide me into the best possible set ups. While I've given only a handful of examples of how I apply the cloud to my trading plan, I truly believe the cloud is versatile enough to work for anyone.

Next we will talk about how I use the cloud to trade stock and what the best setups are and how you can identify them.

How Do You Use the Cloud to Trade Stock?

When using the Ichimoku Cloud to trade stock one of the most important considerations I must make is deciding what time frame I must use. Generally, I believe stock trades best with the cloud on the daily chart. This is not to say intraday equity traders cannot still use the Cloud successfully. However, it will produce more traps when used on tighter time frames

The cloud for the day trader: Using the cloud on an intraday basis can show a trader where intraday levels of support and resistance are. A day trader can also use the cloud to find the highest probability setups.

The cloud for the swing trader: Using the cloud can help the swing trader avoid trading against trends and can help steer them away from stocks that are in neutral territory. Using the cloud can also point them to stocks that are near breakout points.

The cloud for the long-term trader: Using cloud pullbacks can point out opportunities to enter or add to positions. The long-term trader can use the cloud to determine when it is time to exit a position. Since the cloud is forward looking, the cloud can also give a heads up before trend might turn the other way.

No matter which of the above categories you might fall into, you will be able to benefit from using the cloud. As a trader I mostly fall mostly into the first to categories. Most of my stock trades are either day trades or swing trades. Using a shorter time frame may change the way I use the cloud but the basic concepts stay the same. I use the support and resistance levels the cloud provides as levels for stops or profit targets. The cloud also tells me when I should enter or exit a trade. Look at the image below and take note how the cloud provides me with my entry and a level to place a trailing stop.



These same levels can be used on any time frame. The chart above is showing AAPL stock on a daily chart, but I would be looking for the same things on a 15, 5, or even 1-minute chart. The time frame I'm using can also depend on the product I am trading. Some securities trade much faster than others and require a shorter time period chart. Likewise, some securities are slower and produce too many traps on a lower time frame chart. In the next section we will discuss how to determine the best ways to use the cloud no matter what product you are trading.

What Is The BEST Way To Use The Cloud?

As we have explained previously, the cloud is one of the most versatile technical indicators available. Its applications are wide and as long as a trader realizes what the best uses are for the cloud they can easily apply it to their trading plan. Even though the cloud can be used for trading any security it is not a 'one size fits all,' indicator. If used on a less than optimal time frame for a specific product, the cloud can produce many traps. A trader must always consider what they are trading and how fast that security tends to trade. Below we will explain the use of the cloud in several of the more popular products traders trade.

Stocks- The best signals come from the daily chart. Using the daily chart will provide the best setups for swing traders and longer-term players. Stocks can still be day traded using the cloud, but on an intraday time frame using anything faster than a 15-minute chart will produce many traps.

Currencies and Currency Futures- Trade best on a 4-hour bar. Currencies trade very well on the cloud but as with equities, the cloud produces the best signals on a longer time frame. The cloud can be used for intraday trading of currencies but using anything faster than a 15-minute chart will have the potential to produce many traps.

Crude Oil Futures- Trade very fast. When trading crude oil futures or any other fast moving product we can still use the cloud on shorter time frames. A trader can use a chart as fast as the 5-minute bar and still be effective with the cloud.

Treasury Futures- Treasury Futures often trend well intraday. A trader can use the cloud very well when trading these. Time frame depends on the specific product being traded. In general products that tend to trend rather than sit in a range are the best products to trade on the cloud.

As can be seen above there are several considerations a trader must make when using the cloud. The cloud can be used on any product, but in general we want to focus on trending products. Keep in mind that one security might trade differently on a different time frame, and we must always consider this when using the cloud.

In the image below we can see how, on the daily chart, the cloud provided multiple opportunities to short GLD.

A short of any test of the kinjun-sen or tenkan-sen line with stop above the cloud would keep a trader in the trade until this point



Recap

We always say that there are no shortcuts in this game. There is no such thing as a sure thing. All we hope for is a way to increase our chances of success. After more than a decade of trading experience I have learned exactly what tools I am able to make the most of and which strategies and resources don't work for me. When I say the Ichimoku Cloud is my hands-down, most favorite technical indicator I am not joking. I've been using it for years and regret having not discovered it earlier in my career. It is one of the most versatile tools a trader can have access to and its ease of use and overall accessibility make it a great resource for traders of all skill levels.

How Can KOTM Help Me?

Since founding KeeneOnTheMarket.com in February 2012, I've been overwhelmed by the positive feedback and response I've received since. Business is booming, which is great, because I love helping traders improve their P&L through setting up better risk versus reward trades. Everyday in the office, the other traders and I discuss strategies, options set-ups, and reasons why we did or didn't take certain trades. KOTM began as a blog, but I realized I wasn't just content with sharing my market commentary. After all the monetary success options brought me, I wanted to help others *stop losing money* at the very least. One statistics says the average lifespan of a day trader is 18 months (meaning afterwards they blow out their account). Another states that '90 percent of traders lose money.' Both are very troubling to me, but how can the latter be true if every option has a buyer and a seller, and it is a zero sum game? One reason is common mistakes made by many traders, which I have outlined in the next session.

Live Trading Room

Open daily from 8AM- 3:30 PM daily, but never closed. We have audio and visual with market commentary and live trading for all experience levels for 6+ hours. We have traders who trade equities, options, ETFs, futures, and forex. Imagine being able to ask Tiger Woods which club he would use for your next shot or what he thinks of the wind direction. I'm available all day to answer questions in the public member chat forum, or via private message. I'm here to share expertise and offer my take on anything from charting to risk-reward setups, or even implied volatility.

Trade Alerts

Our most popular product. I love twitter and love to tweet, some days I tweet as many as 200 times. Every day I watch 2,000 options trades as they hit all the exchanges, and analyze them to see if I believe the institution behind the trade has an 'edge,' or access to information I do not know about. I tweet out all my trades, the best bullish and bearish setups each day, as well as the most unusual options activity. Basically, I break these 2,000 trades down into the best possible 20 trades, while taking 2-8 trades daily based on the best set-ups I see.

Courses & Workshops

We are currently finalizing the most comprehensive equity option curriculum available anywhere. This includes my three proprietary trading plans, over 500 PowerPoint slides, and over 25 hours of video.

Mentoring & Coaching

We currently offer both 1 on 1 Mentoring and Coaching via Skype and have a Chicago Boot Camp, which includes tours of the CBOE and Board of Trade trading floors, along with a night out with Team KOTM.

Please contact me at <u>Andrew@KeeneOnTheMarket.com</u> anytime for assistance with your individual trading plan. Also, be sure to check our blog at <u>www.keeneonthemarket.com</u> for daily updates on each day's biggest unusual options activity and my daily market recap videos. Thanks again for taking the time to read this, and look forward to hearing from you soon.

Ichimoku Cloud Training Resources

KeeneOntheMarket.com Six Setups Using The Ichimoku Cloud Workshop

This is a live course that is taught by our head trader Andrew Keene. Over 2hrs long this course is taught live via the web and lets members see first-hand how Andrew uses the cloud in a successful trading plan. All of the best set ups and most common pitfalls to trading with the cloud will be explained in detail and real life examples are used. This is easily the best way for a trader to get a solid understanding of the Ichimoku Cloud and its most practical uses.

You Can Click Here To Register

What Are The Top 10 Easily Avoidable Mistakes Most Traders Consistently Make?

1. Not Dollar Weighting Their Portfolio

-Realizing that being long 100 Shares of AAPL at \$450 is different than being long 100 shares of FB at \$29. Dollar weighted would show that 100 Shares of AAPL is 1500 Shares of FB

2. Adding to Losing Positions

-Adding to losing positions unless at a predetermined level is a big mistake, and usually doesn't work out.

3. Moving a Stop Loss Point

-As the expression goes, 'your first instinct is your best instinct.' This can also be read, 'never move a stop,' and following this practice will help you avoid losses from building.

4. Buying too much premium before Earnings

- So many traders are long too much premium going into earnings, and lose money even if they are correct on direction because of the 'vol crush.'

5. Not Managing Trades at Expiration

- Everyone's goal should be to not own stock or be assigned at expiration. Remember, \$0.02 can make the difference between a long or short stock position at expiration.

6. Pin Risk

- By buying cheap options close to where stock settles, you can avoid having to worry about another trader exercising an option on you.

7. Always define risk vs. reward

- Everyone should know the risk-reward setup of every trade they are putting on. If you're not sure of this for a trade, then you shouldn't be making it.

8. Connie Contra trend

- It is very hard to trade against the trend. If a trader is trading against the trend, they must be sure to have a HUGE reward vs. risk set-up.

9. Waiting too long to close Positions

- If I sell a \$2.50 Call Spread for \$1.50 and it moves to \$0.10, my risk vs. reward has now changed as well. Now, I am risking \$2.40 to make \$.10, so closing position like this makes sense.

10. Selling Cheap Call Spreads or Put Spreads

-Selling a \$2.50 Call Spread for \$0.20 might have a small delta, but if you win on 9 and lose on the 10th, your P&L will all be wiped away. I try to get at least a third of the Spreads Price

Other Resources

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ThinkOrSwim

<u>ThinkOrSwim (TOS)</u> is by far the best trading platform for a retail trader of any skill level. The amount of information and analysis available on the platform is staggering. The ability to trade equities, equity options, currencies, futures and options on futures is seamlessly integrated into the platform. Built to be intuitive, the platform is accessible to traders of any skill level and offers professional level charting options. Any retail trader not using the TOS platform is giving up an edge that is extremely valuable to any trader.

You can open an account by clicking here

CBOE Options Hub

CBOE Options Hub is the Chicago Board Options Exchange's for investors and traders to review options trading information. Go to <u>www.cboeoptionshub.com</u> to find information about new products, corporate announcements, blog posts, tweets, investor relations, The Options Institute and much more.

FinancialJuice

<u>FinancialJuice</u> is a real-time news and social network focused on the trading/investing news space. Based in London, UK, their team works in conjunction with partners to provide an unparalleled level of real-time content for traders to make informed and fast strategic investment and trading decisions. It is essentially the Bloomberg Terminal meets Twitter/Facebook.

Options Playbook

<u>Options Playbook</u> provides the novice trader with all of the information they need to begin trading advanced order strategies. The Options Playbook does an excellent job of explaining how to set up different options spreads and how to calculate your risk, reward, and breakeven. Understanding these concepts is extremely important to any options trader. The Options Playbook will be a valuable resource to the novice trader.