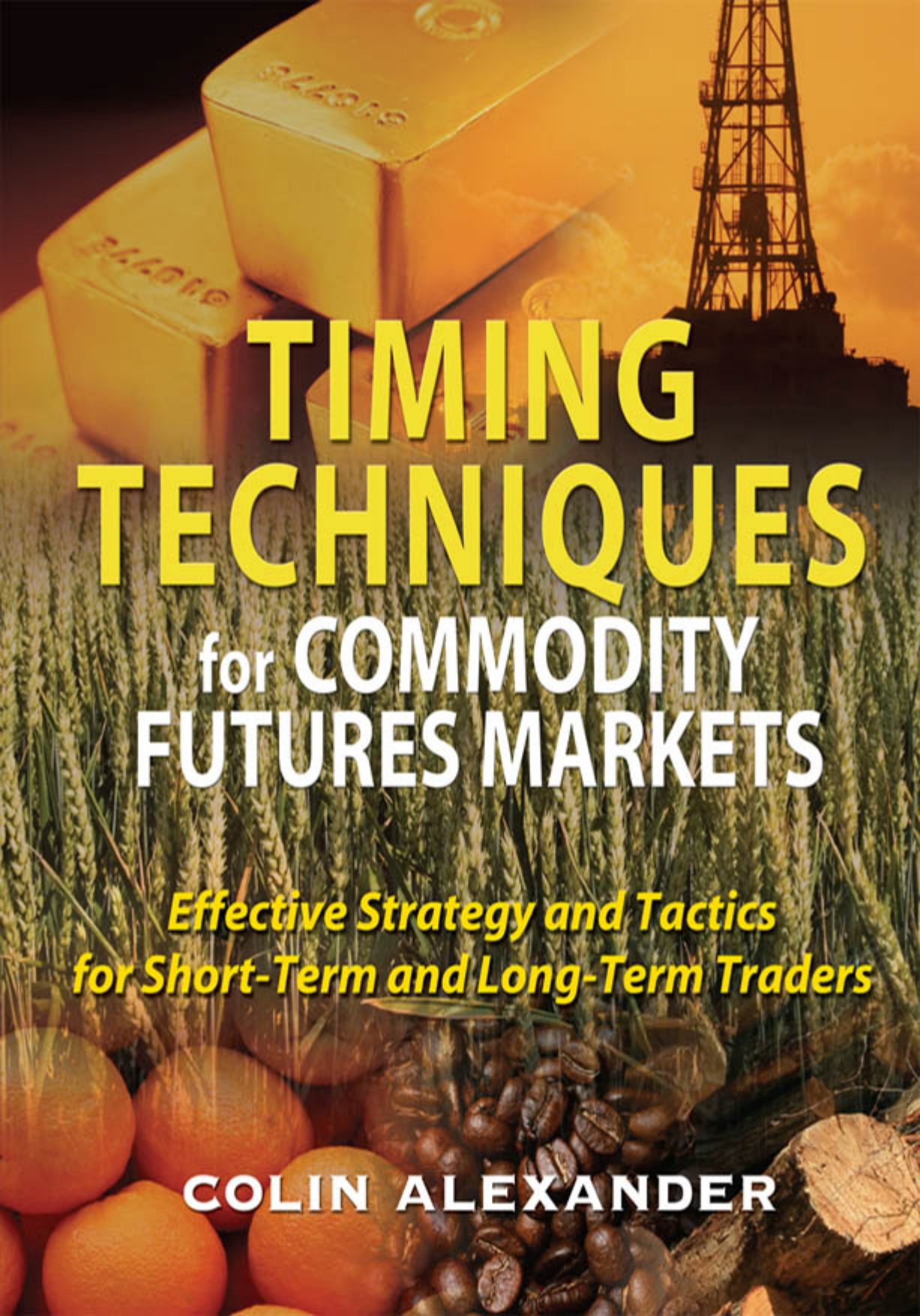
TIMING
TECHNIQUES
for COMMODITY
FUTURES MARKETS
Effective Strategy and Tactics
for Short-Term and Long-Term Traders
COLIN ALEXANDER

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Effective Strategy and Tactics for Short-Term and Long-Term Traders

COLIN ALEXANDER

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Contents

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Similarly, Peter Worden and the people at Worden Brothers, Inc. provide me with a stock charting service which makes things possible today which I could only have dreamed about a few decades ago. Their daily commentary provides nuggets of useful information, insights, and ongoing education which I cannot now envision forgoing under any circumstances.

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Introduction

This book is designed for professionals, as well as for those who are new to commodities and futures markets. It assumes basic knowledge and does not replicate the excellent fact-based textbooks that already exist. Most standard textbooks describe a wide range of indicators and theory, as well as what they do individually. The thrust of this book is different. It focuses intensively on indicators that really work, and—this is the essential point—it shows how to use them together with each other.

For experienced traders, there is certain to be much that restates well-known concepts. Nevertheless, one thing remains constant for every trader, however seasoned: Change is constant, and a new point of view may provide the insight for one or more of those great trades that make futures trading spectacularly worthwhile.

The opportunities for success in futures market, which are indeed unlimited, feature in the forefront of industry promotion and the marketing of books and software. However, one important feature of this book that is new and necessary, as well as insufficiently available elsewhere, is how to avoid many higher-risk and marginal trades without forgoing the majority of high-potential ones.

Changing Market Conditions

In recent times, futures trading has developed to an extent that would have been hard to imagine just a few years ago, with institutions such as pension funds, hedge funds,

and other capital pools now involved in what was once a specialized area. Typical of the many and huge new participants is the Ontario Teachers' Pension Fund. The 2 percent of the fund that this pension fund invests in this sector may not seem like much as a percentage, except that it is $2 billion. On the basis of open interest in July 2007, this single account is big enough to take one side or the other of every corn contract on the Chicago Board of Trade, and corn is the world's biggest agricultural market. In addition, there have been big changes in technology, trading equipment, globalization, and around-the-clock electronic trading. As with many technology-oriented operations, volume has expanded exponentially, and the cost of doing business has fallen sharply.

Despite these innovations, it is remarkable how changing market conditions have altered the dynamics of futures markets relatively little except for those who trade for the very short term. You might expect markets to be more volatile. Looking back, however, it is clear that markets have always had periods of extreme volatility, as well as periods of comparative dormancy. Within a few decades, for example, the price of silver started at around $1, it rose almost to $50, and it then collapsed to trade for 10 years at $1 or so on either side of $5 before taking off, in early 2004, to $15.

In recent years, there has been a substantial and broadly based commodity bull market, and it has attracted almost as much attention as high-tech stocks did during the 1990s. Much of the focus has been on petroleum, foreign currencies, and metals, the counterpart of which has been weakness in the U.S. dollar. But it is not a one-way street; it never was and never will be. For all the challenges, the United States still has more economic freedom and generates more innovation than most of the rest of the world put together. Therefore, it by no means necessarily follows that it will always be profitable to sell short the United States and to buy anything but the U.S. dollar. It never pays to forget what the great stock market guru Joe Granville used to say: "If it's obvious, it's obviously wrong!"

The Structure of This Book

The purpose of this book is to show how to use some of the best trading tools in conjunction with each other. Chapter 2 addresses the essential question of how to define a trend. Chapters 3 to 5 consist of the building blocks for charts, price rules showing when specific price action delivers a signal to pull the trigger on a trade, and how to look at candlestick charts.

Chapters 6 to 12 discuss intensively the specific application and new uses for the most useful indicators, moving-average convergence/divergence (MACD), moving averages, stochastics, and Bollinger bands, and they show how these forces

interact with gaps and the theory of support and resistance. Chapter 13 focuses on the best chart patterns that work in all time frames. Chapter 14 covers cycle theory, including time-based, cyclical, and seasonal forces.

Chapter 15 shows how to interpret the Commitments of Traders data—who trades what and how much and how money makes markets move—until it has become too much, up or down, for its own good. Chapter 16 addresses the cyclical and special influences affecting the stock market and trading stock index futures. Chapter 17 brings everything together with an entry checklist: how to evaluate a market in the context of bringing the most effective indicators all together in conjunction with each other.

Chapters 18 and 19 show how to set stops and how to get out of a trade that may have run its course or that may no longer justify retention. Chapters 20 and 21 provide a case study based on a prospective long position in blendstock gasoline and one based on a short position in copper. Chapters 22 and 23 are a culmination of all that has gone before so as to show how to fine-tune short-term trading, whether for the day trader or for the longer-term trader looking to achieve an optimal entry and an optimal exit. Chapter 24 consists of final comments on aspects of futures trading that extend beyond the immediate techniques of technical analysis.

The Tools You Need

This book is based on data delivered by eSignal over the Internet and processed with Ensign software. There are several sources of data and many more charting programs, but it is hard to envision how to improve on this combination of quality, service, and price. Apart from reliable data feed, there is nothing more important than having a charting program that is robust, reliable, and, above all, easy to find your way around. Some programs include such an array of tools and options as to comprise the proverbial exercise in making simple things complicated. You can pay much more money to get almost infinite sophistication, but that will not make you a better trader, and it may make you a worse one.

In addition to futures data feed and a trusted charting program, there is an invaluable stock market service that you can hardly do without if you want to trade stock indexes or invest in stocks. That is the Worden Brothers Telechart program (available at http://www.worden.com/). This service costs just a dollar or two per day. In addition to providing a comprehensive end-of-day stock charting service, it provides educational insights valuable to anyone, and it is an idea factory in its own right.

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TIMING TECHNIQUES for COMMODITY FUTURES MARKETS

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CHAPTER
1

Industry Background

What the Futures Markets Do

The concept of futures markets is relatively straightforward but it is surprising how few people, even those in the industry, understand it well enough to explain it efficiently. Commodity futures markets, as we now know them, have come a long way since they were first formally established in Chicago in 1848. Then, at last, farmers could offset their risk and establish in advance how much they could sell their hay for compared with what it would cost to buy the timothy seed to grow it. Correspondingly, Wells Fargo could establish how much it was going to cost to feed the horses. Millers could lock in their future cost of wheat by buying forward contracts, or futures, and they could also lock in their selling price for flour by selling a corresponding number of forward contracts, or futures, for delivery many months ahead. The difference between the two prices locked in their margin whatever happened to the price of wheat and flour in the meantime. With standardized specifications and firm delivery dates, futures contracts could be traded much as you might, theoretically anyway, want to sell a contract to buy a house that you decide after all you no longer want to buy.

Fast forward to the modern age, and we have copper mining companies selling futures contracts in order to guarantee the eventual selling price for metal yet to be produced, in case the price goes lower. If the price goes up, they sell the metal from the mine, *the actuals*, at a higher price than expected but must take an equal and opposite loss on the futures contract sold at the price contracted in the

futures market. Opposite the mining companies, copper fabricators take the long side of the market as protection against the price rising. In recent years, markets have developed not just for physical commodities such as copper and cattle, but for currencies, interest rates, and even the weather. Speculative capital has the practical effect of providing the liquidity that makes the market function. Some of that money goes on the buy side and some on the sell side. Speculative traders assume the risks that producers and users offset and do so in the hope of making money. The idea behind futures markets is the same as the way insurance began, and it is still the way that Lloyd's of London operates. Individual and corporate capital aims to make a profit by assuming the risk that John Doe's house won't burn down or that some Hollywood film star won't break a leg.

The challenge, of course, is to make money and, specifically for the commercial account, to try to avoid losing money on hedging operations. One way to express the challenge is that it is the discipline that aims to differentiate between a move in price that is likely to continue, and one that is likely to stop and reverse. On a personal basis, the challenge is to evaluate when to do what you think you want to do and when to do the opposite. You can never lose sight of the fact that someone else takes the other side of every trade, and they may be right. Therefore, you need to evaluate the case for doing the opposite of every trade you consider. A story, which may be apocryphal, illustrates the point. A partner in the London branch of Rothschild's was recommending the purchase of French bonds. "But they're rioting in Paris, and there's blood on the streets!" protested his friend. "That," was the response, "is why it's time to buy French bonds!"

The U.S. Dollar and Commodity Prices

One aspect of futures markets, which traders may overlook, is that every long position on a U.S. exchange represents a short position in the U.S. dollar, and every short position represents a long position in the currency. Markets are interrelated to the extent that a lower U.S. dollar versus the euro, for example, makes gold cheaper for Europeans. Some pricing is more domestically driven but, all things being equal, the price of oil or gold, for example, should go higher in U.S. futures markets when the U.S. dollar goes down. Some people have an aversion to selling short, but every transaction is an exercise in buying one thing and selling an equal and opposite amount of something else. The quick way to see which way the wind is blowing for the U.S. dollar is to look at the U.S. Dollar Index, a basket of major currencies including the British pound, Canadian dollar, and Japanese yen. As with all indexes, the components may, of course, go in opposite directions, but it gives you the general idea. Similarly, the RJ/CRB and the Goldman Sachs commodity

indexes provide an overview of the general trend in commodity prices as denominated in the U.S. dollar.

Looking Back to the Pioneers

Until about 1950, most managers in the investment industry regarded technical analysis with disdain verging on active and sometimes vicious disparagement. No one could pinpoint market tops and bottoms, they said, and anyone who claimed to be able to do so was a charlatan. Actually, you can sometimes pinpoint market tops and bottoms with remarkable precision and for a simple reason that is one of the building blocks of market timing. Market tops and bottoms, as well as intermediate turning points, occur repeatedly at or near the same price levels. Market action remains subject to the fact that human behavior tends to be habitual, with the words *behavior* and *habitual* having the same origins. Traders are human, and perhaps paradoxically, even more predictable now are the behavior patterns of black-box computerized trading programs. They keep on responding, habitually, to the same originating human inputs. Therefore, if enough people get the same idea, expectations of what a market may do can be self-fulfilling, and a significant move, once under way, can feed on itself—until the eventual capitulation, which can be dramatic. Then the predictable unraveling also feeds on itself.

About 50 years ago a surge began in the development of price forecasting tools. Technical analysts today owe a debt beyond measure to those who came before us, those who have done the heavy lifting in the development of technical indicators, including Welles Wilder, George Lane, Joe Granville, and Don Worden, to name just a handful of pioneers. We also have to be grateful to those redoubtable authors who have brought together and published the wisdom of technical analysis including, again, Welles Wilder and, in addition, authors such as William F. Eng, Perry J. Kaufman, John Murphy, and the coauthors Robert D. Edwards and John Magee, and Charles LeBeau and David W. Lucas.

Curiously, however, there exists relatively little that shows how to use the tools of technical analysis in conjunction with each other, and very little important new work has appeared in recent years. As an example of the challenge, one textbook defines an outside bar with an outside close (described in Chapter 3) and suggests that this, of itself, is an example of a pattern which may be profitable if identified properly and traded consistently. It is correct to say that this is a useful indication of a market's potential to follow through in the direction of the strong close. On its own, however, this information is almost useless for a trader to put into practice. But what if you correlate its use with other indicators? What if you narrow its use to buy when an outside up bar occurs during the course of a strong bull market?

Instead of having the narrow use for a trade expected, at best, to last just a couple days, you may be able to do much better, as well as with an acceptable probability of success. In fact, a strong outside up bar in a rapidly moving bull market may provide one of the few ways to get into a trade with a manageable and identifiable risk.

Psychology Makes the Technicals

It may seem obvious, but you need to know the underlying rationale for futures markets in order to understand the nuances of technical analysis. You need to have some appreciation of who may be doing what, how much, and why. People make markets and drive prices up or down, and market action derives from the psychology of traders—their hopes, their fears, their greed, and all the other emotions that make them buy or sell. By extension, you can expect people to do more or less the same things in the future as they have done in the past, but seldom exactly the same. As in the saying attributed to Mark Twain, "History does not repeat itself, but it rhymes."

People often speak of a market rising or falling because there are more buyers or sellers. In fact, the numbers on each side of the market must always be identical because every purchase requires a corresponding sale, and vice versa. It is the relative aggressiveness of buyers or sellers that moves the price. A market needs constant pressure on one side of the market or the other for a trend to be sustainable, but you can have too much of a good thing, whether in the short or the long term. When a market becomes extended and emotions rule, the likelihood increases that firepower may become exhausted at any time, and the risk of a retracement increases exponentially. It is worth remembering that floor traders and professionals take the opposite side of surges in price. When the price settles back, they take their profit, which comes out of someone else's account.

Technical Analysis That Works

Technical analysis is, therefore, an exercise in applied psychology, and the challenge is to determine when the time may be right to go with the flow and when the time may be right to do the opposite. It is counterproductive to try to focus on everything that works in futures markets because the number of approaches that work some of the time is infinite. It is enough to focus on what is manageable to use and those indicators, proven by the test of time, that really work. It is a fundamental principle of effective decisions that good analysis requires several tests, in accordance with the Copernican principle that system decisions trump

part decisions. It is the collectivity that is the essence of success. Reduced to its simplest terms, it is this. Take two entirely independent indicators, each of which has a probability of being right 55 percent of the time. The probability of success increases exponentially when these two entirely different indicators come together simultaneously. Then you need to look for the negating indicators that might undermine an apparently convincing case for a trade. Finally, the case for a trade should rest on a significant net majority of favorable indicators over negating ones.

An additional fundamental principle for success is the need to look at the big picture on longer-term charts, the monthlies and the weeklies, in order to see whether a market may be worth trading and where the major targets and barriers are. Then look at the daily and the intraday charts for specific entries. Like the action of the sea, market action consists of waves within waves. As when looking at the way the tide is running, make a correct interpretation of the major trend or of a trend reversal as it is developing, and the probabilities favor successful trading. Not only that, but if you get the major direction right, there may be significant latitude for a poor entry price. The seemingly obvious but essential counterpart is to see when a trend is not a trend and when a market is merely wandering sideways. This point is essential so as to avoid substandard, higher-risk trades and to know what is involved when attempting a contratrend trade. Contrary to what you might think, there is generally a higher risk of loss in a mediocre trade—often one taken in a market having lower volatility—and it ties up both financial resources and emotional energy. Also, it may mean that you have to forgo a really good new signal providing the entry to a powerful move.

A general rule of trading any markets successfully is that a simple trading system is likely to outperform a complex one. There is truth in this, but only up to a point. Simple may just be simplistic, but complexity can make the entire business so frustratingly difficult that process overwhelms practice. In any case, many technical studies complement or duplicate one another, and beyond a certain point, a multiplicity of similar indicators does not enhance the probability of success.

Fundamentals Also Matter

Fundamentals, the underlying forces of supply and demand, also matter, very much. Reliance exclusively on technical indicators is insufficient, and it is essential to undertake an assessment, however imperfect it must always be, of the prospects for production and consumption. For the pure technician, charts tell the entire story of what has happened, what is now happening and what may, as a result, happen in the future. However, with some traders buying a market for no better reason than because it is going up, or selling because it is going down, it is

useful to know how sound the fundamental factors may be for the way the market is going. Although it is true that market action is often the precursor of as-yet-unknown or under-appreciated fundamentals, market moves often occur without fundamental justification, and are short-lived. It often happens, too, that the reaction from a stretched price level is sudden and violent, with a large loss for traders on the wrong side of the market, and a bountiful profit for those on the right side.

Another important and related factor is that there are major differences between markets. Production and consumption cycles for different products and services vary considerably in duration and amplitude and so, therefore, do price trends. Market action in wheat, for example, responds to forces substantially different from those for stock indexes. Monthly continuation charts provide the first place to look to see those differences. Often monthly charts for wheat may do little more than suggest major targets and potential turning points. They show that the price seldom stays very high for more than a year or so, and then there is a reversion to a lower level. Currencies, on the other hand, can sustain a trend for several years and a newly achieved level becomes self-justifying. These differences do not negate the principles of technical analysis. Most of the time, however, and except for suggesting targets and potential turning points, markets having shorter cycles require use of the weekly chart, and sometimes the daily chart, rather than the monthly chart to identify a tradable trend.

Typical of the grain markets was the way the bull market in corn collapsed violently in June 2007, with the price dropping a dollar, or almost 25 percent, in a few days. Near the top there was an unmistakable signal to close out of a long position at a reasonable price, although the case for a new short position was more debatable. Growing conditions turned for the better and the market had insufficiently factored in the fact that a price above $4 for December 2007 corn led to increased planting far beyond what most people thought possible.

Although apparent fundamentals are important, therefore, they can be deceptive, and it is all too easy to be lured into a market driven by false assumptions. Market action in corn in June 2007 was by no means exceptional and it illustrates the need for constant vigilance. Unexpected developments frequently come seemingly out of nowhere, although at least the potential for a significant reversal is almost always evident when stochastics are at an extended level, as discussed in Chapter 8. Both the fundamentals and the technicals for corn seemed to be supporting the case for the bull market to continue. Then strong technical signs of potential trouble emerged very rapidly but well ahead of the debacle, when the assumptions about the fundamentals turned out to be wrong.

In sum, fundamentals are just one among a range of indicators, but an extremely important one. Therefore, you always have to question what could be wrong about the assumptions, and what could change. You may be right in your

assessment of the fundamentals but the market may take time to set up for the move that you foresee, if it ever does. When the technicals and the fundamentals converge, however, there may be an opportunity for a substantial trade of the kind that makes futures trading gratifying.

The Fundamentals of the Oil Market

Take oil, for example. For a long time there was a sustainable uptrend based on real supply and demand fundamentals. Eventually, the price got ahead of itself. It was widely said in the summer of 2006 that an oil price pressing against $80 for West Texas Intermediate had a premium of perhaps $15 built into it as a result of speculative rather than genuinely demand-based justification. Speculative capital wanted to own oil and to be long futures in case of a disruption in supply. Some well-financed speculative capital was said to own oil outright in reservoirs underground in the Netherlands, thereby impinging on supply that would have been available otherwise. As happens quite often in a major bull market, this one had been feeding on itself as a reflection of hoarding, which, in turn, derives from the expectation of still higher prices and makes them happen. Then it turned out that storage capacity for oil and petroleum products was bursting at the seams, and the northern hemisphere was having a mild winter. Tankers were stranded in Singapore harbor, unable to unload because there was nowhere to put it, and incurring heavy demurrage charges.

The market was slow to awaken to those fundamentals so as to bring the price back toward $50, and it took time for the technical patterns to fall into place to signal a good short sale. With apparently ample stocks on hand, refiners could now make long-delayed shutdowns for maintenance, and storage was no longer full to capacity. The supply tightened again, and there was a new opportunity on the long side of the market, particularly the long side of gasoline. There were good technical signals to get out of the short sale near the bottom. However, the optimal place to go long was after the market showed that it had turned. (This point is demonstrated in the case study in Chapter 20.)

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CHAPTER 2

Defining Direction: An Established Trend Keeps Going

What Is a Trend?

There is an annoyingly simplistic but essentially correct saying: "The trend is your friend." This saying immediately requires clarification on two points. The first is to define a trend. The second is to understand that there are trends within trends. There are intraday trends, daily trends, weekly trends, and monthly trends.

The theoretical definition of a trend is quite straightforward. In a rising trend, or a bull market, price is moving from the bottom left-hand corner of the chart toward the top right-hand corner. In a declining trend, or a bear market, the price is moving from the top left-hand corner of the chart to the bottom right-hand corner. However, because of trends within trends, you need to need to know what duration of chart you are looking at. The monthly chart sometimes, and for some markets, may define a supertrend, and it does so mostly for stock indexes, financial instruments such as currencies and interest rates, and metals and petroleum. These markets can establish a trend lasting for several years. Generally, the weekly chart is more useful to futures traders for defining the major trend and, therefore, for finding markets to trade or avoid.

For the successful futures trader, following a trend means buying a market that shows, by going up, that it can go higher and by selling a market that shows, by going down, that it can go lower. In practice, the search for bigger and longer-lasting trades requires as much agreement as possible between short- and long-term trends. However, shorter-term trends should not have extended so far that the

market may be ready for a setback and possibly a sharp one. Within any major trend, there can be, of course, severe retracements that do not violate the major direction of the market. When there is a short-term downtrend within a long-term uptrend, in all likelihood you should be buying, not selling, but only when the short-term downtrend shows that it may be coming to an end, and the action of price and the technical indicators is showing that the market can start to move up again.

Upward and Downward Zigzags

An uptrend, or a bull market, has price making successively higher highs and higher lows on the chart, on balance, and ideally doing so with reasonable regularity, in the form of an upward zigzag (Figure 2-1).The more tenacious and regular the zigzag, in either direction, the more likely the trend is to continue, and accordingly, the more confidence you can have in trading. This assumption is the counterpart of the engineer's principle that a trend in force is likely to remain in force.

The chart for a declining market shows, on balance, a pattern of successively lower highs and lower lows (Figure 2-2).

When there is a pattern of erratic highs and lows, and particularly when they occur between an identifiable ceiling and a corresponding floor, you have a sideways or trading-range market—one with limited prospects for a worthwhile trade until the price establishes an orderly zigzag up or down.

The way to see zigzags clearly is to use a line chart, one that joins the closing price for each period to the next one instead of having vertical bars covering the range for each period. Apart from showing the underlying and uncluttered direction of the market, there is an additional reason for using a line chart as a tool for designating a market's direction. As with price-rule theory, discussed in Chapter 4, the closing price is important. Many traders, and particularly floor traders, close out some or all of their positions at the end of the day, week, or month, and some will initiate new positions then, but only when conditions appear to be particularly favorable. They shed the weak ones and may initiate or add to ones going in the direction suggested by momentum. The closing price, whether at the end of a

Figure 2-1 Bull market zigzag

Figure 2-2 Bear market zigzag

day, a week, or a month, suggests, therefore, how much these traders, generally representing money that is both substantial and smart, want to take their positions home in the expectation that the price will continue going their way when the market reopens. Accordingly, the significance of the closing price increases exponentially from the daily close through the weekly close to the monthly close.

W Formations: The Start of an Uptrend

Everyone loves to buy at the lowest possible price and sell as high as possible. The reward is often greater and the risk is usually lower, however, when you buy into an established and strong bull market. Nevertheless, trying to get in on the ground floor of a possibly emerging bull market can be exciting when you get it right, so it is worth knowing what to look for.

An uptrend, or a bull market, starts with a zigzag in the form of a W chart (Figure 2-3).

Of course, there are many more W's than there are valid new bull markets, and you have to consider these formations in conjunction with other technical indicators described in later chapters. Also, the reliability of an emerging uptrend is often proportional to the length of time it takes to develop. The longer the setup for an upward move, the greater is the probability of a valid W formation, and the farther the market is likely to go in due course.

The W formation that starts a trustworthy uptrend has an initial higher low that holds above the previous low. Although it may be psychologically more difficult to buy, a W formation is more bullish when the second low is significantly higher than the first one. When a market has been going down for some time, it may require several tests of the low to establish a springboard for higher prices. A successful

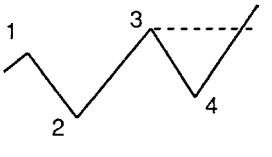

Figure 2-3 W formation

third test down that holds above both the first and the second lows provides additional confirmation that the price may have stopped going down and, in addition, that the line of least resistance now may be up.

To identify a W formation on the line chart:

1. Look for a low at 4 on the chart that is no lower than 2, and ideally is enough above 2 so that there is no doubt that this new low really is higher.
2. A close above the close at 3 confirms the W. Once price has broken above 3 in the W formation, a retracement at least to the breakout level is so standard that you should not be concerned. This is normal price action. Some technicians suggest buying only on this expected retracement. However, the strongest markets never retrace, and you can never tell in advance which these will be. The new upward zigzag remains in force as long as there is no new closing below the previous zigzag low. A third test down, or more, that holds above previous lows strengthens the interpretation that the market has completed its business of going down and is set to go higher.

As with the principle of trends within trends, it often happens that there are small W's within bigger ones. There is also a general and reliable principle that the longer a low holds, the more likely it is to provide durable support if it is tested subsequently.

M Formations: The Start of a Downtrend

Many traders, particularly those with less experience, find it hard to believe in the sustainability of a bull market, and this leads them to succumb to the siren call of trying to sell prematurely, whether to close out long positions or to enter new short positions. The risk of attempting to sell short into a market top is very high until there are convincing indications of topping action. Foremost among these indications, and for all practical purposes a prerequisite, is the M formation (Figure 2-4).

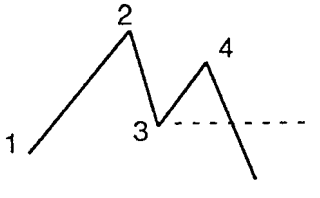

Figure 2-4 M formation

Depending on the length of normal cycles in specific markets, an M formation is exponentially more convincing on the monthly chart than on the weekly, which, in turn, is more convincing than the daily, let alone an intraday chart.

To identify an M on the line chart:

1. Look for a downturn at the high at 4 on the chart that is below the one at 2.
2. A close below the one at 3 completes an M formation.

Reversing the pattern of an emerging bull market, there may be an upward retracement back at least to the breakdown level before a more sustained decline gets under way. Until there is a new bull market designation, don't be fooled into thinking that a retracement means that the market is now going higher after all. There may be a retracement all the way back to the right-hand high of the M without violating its validity. In a confirmed bear market, the price stops at that level, and in a very weak market, it stops much below that level.

The Coiling Zigzag

Proceeding from the principle of upward and downward zigzags, it is additionally useful to consider how they occur in two somewhat different but related varieties, one for the coiling action within a consolidation, which also may be an intermediate cyclical top or bottom formation, and one for a market in motion.

At significant market lows, zigzags sometimes develop with a double or triple W, much like a coiling spring, prior to the actual breakout, and the concept is similar to the rule 5, the Lindahl price rule (see Chapter 4). The range from top to bottom tends to be relatively small, and it is tempting to think that nothing significant is happening. However, the market shows its hand remarkably often when there is a pattern of higher highs and higher lows within a small range. The more developed the pattern is prior to the breakout, with more than just a couple of tops and bottoms, the more likely it is that price will follow through when the breakout occurs.

Equally important is that the line chart can suggest which way price is likely to move out of a consolidation within an apparent longer-term move. Some technicians hold that the probabilities are more favorable for a successful trade if you wait for the breakout from a range before entering a new position. Certainly this is true when the price fluctuations within a consolidation are erratic, because then the breakout may be in either direction. However, orderly coiling on the line chart is a reliable predictive indicator, when it happens, and there can be a surging breakout like the action when you release a spring that has been compressed.

Often, therefore, the best way to trade coiling action within a consolidation may be to enter an initial trade—say, half your normal commitment—as favorable coiling is developing and then to add to the position when the breakout occurs.

The Breakout Zigzag

Once a breakout occurs, and a significant move in price is apparently under way, the thrust of each leg in the direction of the trend should be substantial, and the retracement should be small and short-lived. When you are considering a trade in a strongly moving market, it may seem like tempting fate with the saying, "What goes up must come down." In fact, however, what goes up most powerfully is likely to keep on going and to make only the smallest and briefest retracements. Similarly, a market collapsing from a historically high price, and especially when coming out of an extended consolidation, may have a long way to go when the supports, and corresponding buying power, are pulled away. It is the market that dithers that is most vulnerable to abortive, money-losing spurts when you try to ride them. It may seem at the time that the risk of loss is difficult to handle when you consider entering a powerfully moving market that has left its beginnings far behind. The key to using zigzag theory successfully, and with manageable risk, is not to pass the strong signal but to act on it as soon as it happens. It is also to know that although some apparently strong moves abort, those that follow through should go a very long way, and profits on the successful trades should far exceed losses on the ones that fail. If you want to limit your risk, then place the stop just beyond the turn used to enter the position. It may be some distance from your entry if the turn has come fast, but the risk of loss actually lessens in proportion to the power of the turn.

As with all good indicators, major market moves can occur without the development of a clear zigzag pattern on the line charts for various time periods, and sometimes a zigzag develops too late to justify risking a trade. However, the principle is valid that the probabilities in favor of a successful trade are best when there is good zigzag development. They are considerably less so without one. Subject to reservations about a short-term oversold daily or intraday chart when the major trend is up, and vice versa for a declining market, an *adverse* zigzag pattern is a strongly negating indicator.

M's, W's, and Zigzags on the Cattle Chart

The daily line chart for June 2007 Live Cattle illustrates the concept of M's, W's, and zigzags occurring as bigger waves and smaller waves (Figure 2-5).

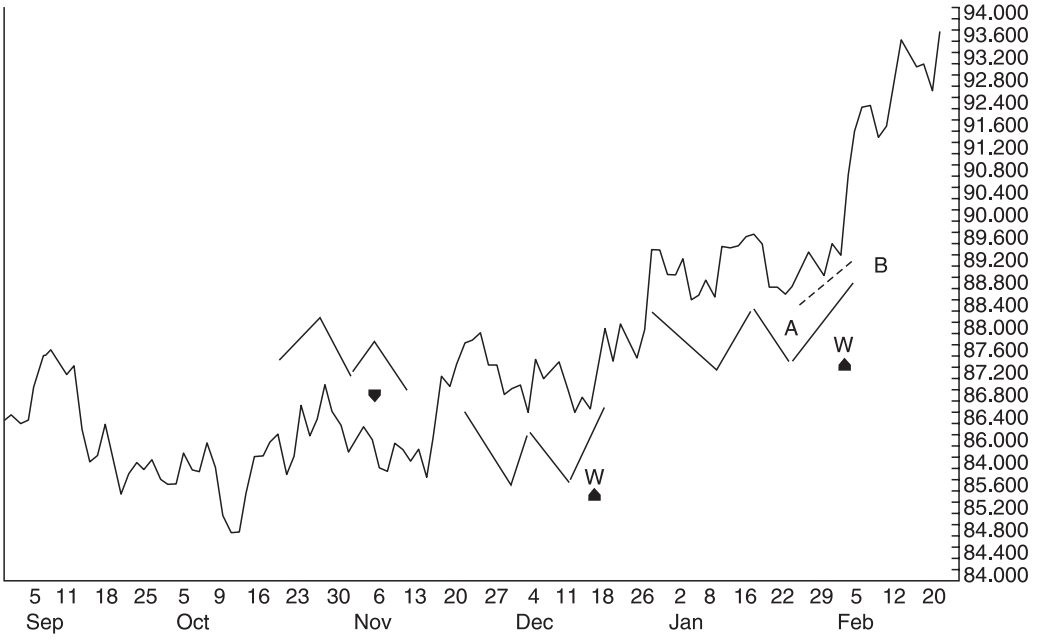

Figure 2-5 M's, W's, and zigzags on the daily line chart for June 2007 live cattle

In November, there was a straightforward M on completion of the lower high. In the event, this market was not to develop any downside momentum, but this does not negate the principle that this was a valid formation.

In December, a big W wave formed, with the right-hand bottom itself making a textbook small W, above the arrow, from which, then, there was to be a worthwhile upward thrust. Then a large W formed, culminating in a W that then made a third higher low, confirming the zigzag, marked with the line *AB*, with the last upturn above the second arrow on the chart. In the event, this coiling was markedly bullish, with each of the second and third lows significantly higher than the one before. Here is an example of how steeper M's and W's may suggest more risk, but in fact, the opposite is almost invariably the case.

How to Use Zigzags

1. To define a trend on a chart of any duration, you need at least an initial M or W and, ideally, an established and regular zigzag.

2. For trading decisions, the weekly chart normally defines the major trend, although the daily chart alone may sometimes justify taking a trade.

   For those markets having very long-term trends, look at the monthly chart for additional confirmation, but don't be deterred from trading if the monthly chart has not yet fallen into line. Monthly charts are most useful for markets that have long-lasting moves, such as the financials, metals, and stock indexes. Agricultural markets tend to have shorter cycles, with trends determined by the prospects from one harvest to the next or by stock breeding cycles.
3. Occasionally, such as when a market has reached a clear and substantial barrier or when there is an island top or bottom, you might want to use an intraday chart, such as the 60-minute or the 120-minute, to use zigzags to make a preemptive assumption of a trend reversal. This application is most valuable for those using day-trading techniques for potentially optimal new entries or to ride a rebound from an obvious excess, as discussed in Chapters 22 and 23.
4. The signal for action occurs on completion of the time period generating a turn.

   A conflicting M or W or an established zigzag on the line chart—one in the opposite direction to the way you want to trade—is a strong negative indicator when it is clear and completed, but it does not constitute an outright embargo.

   Normality is for there to be wobbles and conflicts. You might, for example, consider a trade when there is a good zigzag on the weekly chart and on the 60-minute chart but not on the daily chart.
5. Market action negates a zigzag *in a bull market* with a closing price below the previous *low* on the line chart or *in a bear market* with a closing above a previous *high*. When this happens, there is a strong exit signal from this indicator, but not necessarily a compulsory one, on the duration of the chart on which it occurs. An adverse close is exponentially more important on the daily chart than it is on the 60-minute chart and more so again on the weekly chart than on the daily chart.
6. A negated trend on the line chart does not connote a signal to trade in the opposite direction. That requires completion of an equal and opposite M or W.
7. Look for coiling action within consolidations—particularly when a market is overbought—to sell or—oversold—to buy. A tight range in price does not mean that there is limited potential as and when the price breaks out of the range—on the contrary! Well-defined coiling action often permits a timely entry at an excellent price relative to the risk.

8. In a strongly moving market, thrusts in the direction of the trend should take price a long way, and retracements should give back little in price and last only for a few bars.
9. M's and W's and established zigzags also apply to other indicators such as moving-average convergence/divergence (MACD)and stochastics, as discussed in later chapters.

At the most trustworthy market turns, price and momentum indicators such as stochastics both make simultaneous M's and W's, and then zigzags, in the same direction. When stochastics, a leading indicator, makes a higher second low and a corresponding W, but price makes a lower low, there is so-called negative divergence. Similarly, there is negative divergence when stochastics make a second lower high but price does not. At the very least, negative divergence shows flagging momentum and the potential for price to reverse direction. Action in stochastics is more reliable than price action.

Zigzags in Gold

The monthly chart for gold from 1980 to 2006 shows clearly that there were four extended periods of generally declining prices for gold from 1980 and two periods when the price was rising strongly, with the bull market beginning in 2001 going up dramatically. The regularity of these zigzags, both up and down, is almost uncanny. The only period of real ambiguity during an established trend occurred during the consolidation in the first nine months of 2005 (Figure 2-6).

Notice the three-year sideways market from 1993 to 1996, when the price failed to break higher and instead, after going inconclusively sideways, continued in due course its downward extension. This decline occurred when the stock market generally and high-tech stocks in particular were going to the moon, and there seemed to be no systemic risk and a corresponding need to own gold for insurance. Notice too the two-year period between mid-1999 and mid-2001 when the price seemed to stop going down and in due course began the huge new bull market. In the big picture, there is a lopsided W, with a high made by a very powerful surge that failed to follow through. On the retracement, however, ground was given only grudging until the low made in 1999 was tested and found good.

These periods of sideways market action illustrate the informal law that you expect the price, when it breaks out of the consolidation, to make a substantial move that is somewhat proportional to the length of time that is has been going sideways. There is no way to calibrate this phenomenon mathematically in terms of time and price, but this does nothing to diminish the validity of the principle.

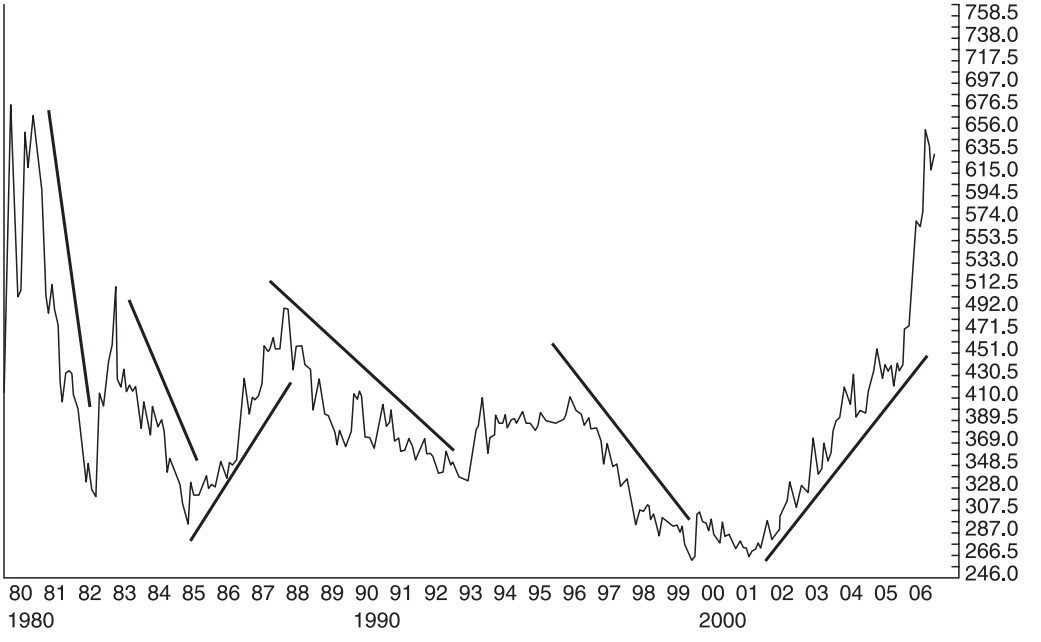

Figure 2-6 Monthly line chart for gold (1980–2006)

While the move out of a long consolidation may be substantial, there is always the challenge that there is no way to avoid getting stuck in some trades in markets going sideways. Therefore, they are to be avoided unless the coiling action within the range becomes unmistakable or until the breakout actually happens.

The weekly line chart for gold between 2004 and 2006 illustrates the point about sideways markets, with their corresponding frustrations and also the potential when the consolidation ends (Figure 2-7).

You see a persistent but much more ragged uptrend than you see on the monthly chart—the weekly chart starts where the monthly chart shows the price coming out of the dip and the apparent break of the zigzag in 2004.

The daily line chart for gold between November 2005 and July 2006 shows zigzag theory working somewhat erratically and reflecting short-term technical damage to the uptrend in February and March 2006, which is also evident on the weekly chart as a distinct wrinkle (Figure 2-8).

Once the price broke higher in April, there was never a single aberration until the eventual top. Once the market topped out and began a downward zigzag, there was never an adverse zigzag until the violent decline ended. At the eventual top of the market, the intraday price exceeded the intraday high at the market top in September 1980 by just $3! The top in 1980 was itself $13 higher, with the M having a gigantic dip in the middle.

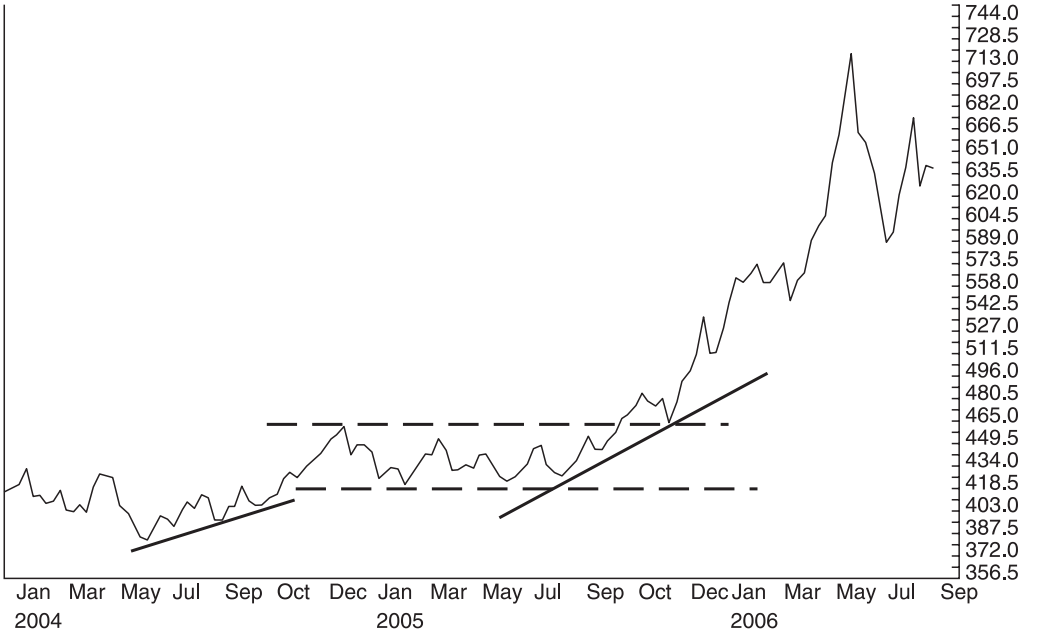

Figure 2-7 Weekly line chart for gold (2004–2006)

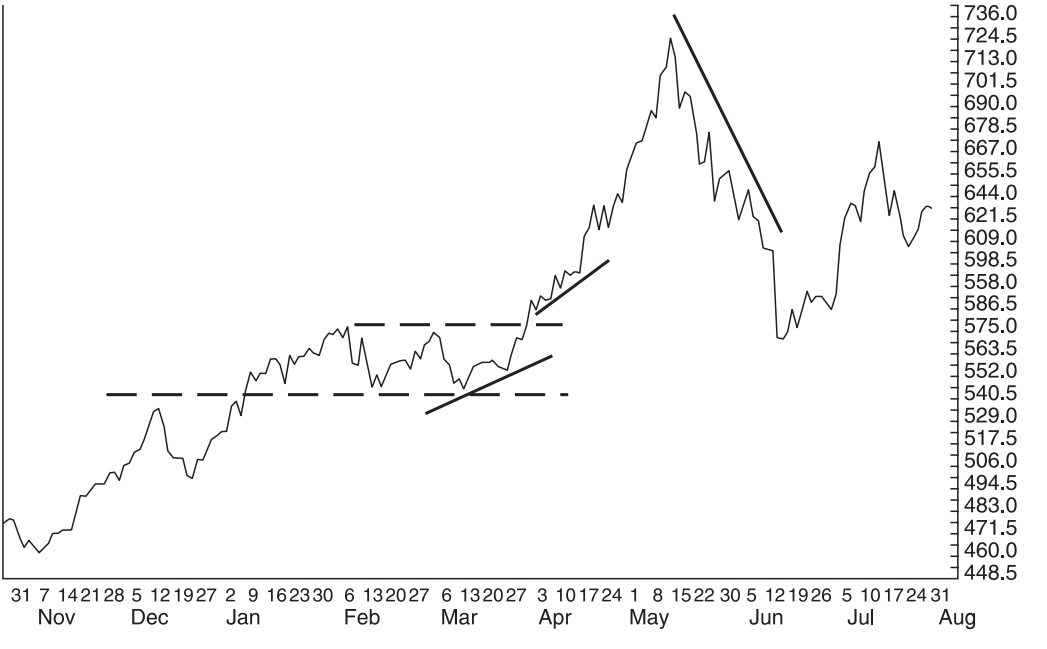

Figure 2-8 Daily line chart for gold (November 2005–July 2006)

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CHAPTER
3

The Building Blocks for Charts

Price Bar Action

Those who are already professional futures traders may just skim this chapter, although some of the nuances nevertheless may serve as a useful refresher. Those who are new to futures trading must become familiar with the building blocks for charts and be able to see at a glance their potential significance for future market action. Even a single bar may show whether there is greater buying or selling pressure for that particular time period. Several bars taken together and put in the context of the larger picture may indicate the kind of momentum that leads to a more significant move in price.

The *basic bar* is the building block for all bar charts. It represents the range of trading for a certain period—a day, a week, or a month—on its respective bar chart (Figure 3-1).

Figure 3-1 The basic bar

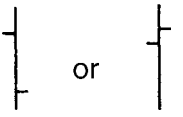

Figure 3-2 The significance of the closing price

The bar is set against a scale for calibration and has a notch on the right-hand side to indicate the *closing price* at the end of the period. A notch on the left-hand side of the bar denotes the *opening price* for the bar.

The *closing price* is particularly significant, depending on whether it occurs at the top, bottom, or middle of the bar (Figure 3-2).

If the close is at the top, it suggests greater buying pressure. If the close is at the bottom, it suggests greater selling pressure. A close in the middle is neutral, but we assume that it has the same message as the previous bar's close.

Smart professional money tends to trade toward the end of any given period, whether a day, a week, or a month, once it can be seen which way the wind is blowing. On the other hand, more speculative money and, obviously, day-trading money trades on or near the open. If, for example, a market opens at or near its high for the day and closes near the low, speculative money is likely to bank the loss while it is small and manageable. Smart money may enter new short positions on the low close. A notably strong or a very weak closing bar on Friday (or the last trading day of the week when there's a holiday) has a high probability of following through in the same direction after the weekend. Therefore, it often pays well to enter a strongly signaled trade on the Friday close and to get out of marginal trades before the weekend.

An *inside bar* is one where trading is confined within the high and low prices of the previous bar (Figure 3-3).

If traders cannot push out either the high or the low of the previous bar, assume that the heavy money is taking a rest. It may signal the start of a change in sentiment when a market has gone a long way.

An *upside closing-price reversal* occurs when price exceeds the previous bar's high and closes above the close of the previous bar (Figure 3-4).

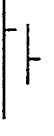

Figure 3-3 An inside bar

Figure 3-4 An upside and downside closing price reversal

It also occurs when price exceeds the low of the previous bar and closes above the close of the previous bar. A *downside closing-price reversal* is the term for this reversal when it moves from a high toward the downside (the new indicated direction).

The closing-price reversal is important. It suggests the possibility that the market may be setting up for a worthwhile move. However, there are many more reversals than important changes in direction, so you must consider one in conjunction with other indicators. It should not be used indiscriminately.

An *outside up bar* occurs when price exceeds both the high and the low of the preceding bar, and it normally closes near the top. (This is the same as what is called an *engulfing bar* on candlesticks charts, discussed in Chapter 5.) An *outside down bar* reverses the sequence, and the close is normally near the low (Figure 3-5).

Depending on other indications, an outside bar may deliver a signal for action, although it can be deceptive because it also occurs quite often as a buying or selling climax.

A *high/low reversal* occurs when price closes at one extremity of the trading range on one bar and at the opposite extremity on the next bar (Figure 3-6).

Although sometimes omitted from textbooks, the high/low reversal is particularly significant when followed by another high/low reversal or when one occurs shortly before or after a closing-price reversal.

If you are using Ensign's charting software, you need to know that its description for this pattern is a *key reversal pair* (athough, as you can see from the next figure, there is an important and better definition of a key reversal). You can program most software to highlight this pattern, with the suggestion that you color-code it green for an upside reversal and red for a downside one. When other indicators are confirming, it is remarkable how often this pattern occurs at the exact moment when it is timely to pull the trigger to enter a new trade or to exit

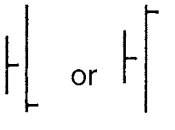

Figure 3-5 An outside up bar and an outside down bar

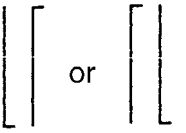

Figure 3-6 High/low reversals

an existing one. A succession of high/low reversals in the same direction increases significantly the probabilities of a further move in the indicated direction.

The Key Reversal

A real *key reversal,* as the term is normally used, is particularly useful to signify the possible completion of a buying or selling climax. An upside key reversal is the same as an ordinary upside closing-price reversal, but it must fulfill the following requirements (described here for a daily bar, although sometimes applicable for bars of longer or shorter duration, such as one for a week or for 60 minutes):

1. The market makes a new intraday low for the downswing in price beyond the pattern of the preceding days.
2. There has been a powerful and generally steep downswing with conspicuous momentum.
3. There has been a vigorous liftoff from the bottom.
4. The bar closes in the upper half of the range and above the previous close.
5. A *key reversal* may be particularly significant when the price has opened at or near the bottom of the range.
6. The *key reversal* occurs on a marked expansion in volume as it is forming—that is, in particular, volume should not be diminishing toward the close.

A *downside key reversal* reverses these requirements. A single key reversal occurring in a strong bull market is far less reliable than one occurring in a declining market, and it often requires a second one in order to complete a buying climax so that the market can then begin to go down.

An *accumulation pattern* consists of a pattern of bars, each having successively higher lows and, ideally, also higher highs (Figure 3-7).

During accumulation, persistent buying pressure finds buyers unable to buy as low as they could before, resulting in successively higher lows. It is likely that price can continue to move higher. An accumulation pattern can be significant

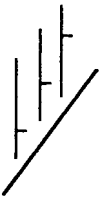

Figure 3-7 An accumulation pattern

regardless of the closing price for the bar. It is valid on all charts but increasingly more so on weekly and monthly charts.

A *distribution pattern* is the reverse of an accumulation pattern (Figure 3-8).

Sellers are able to sell only at successively lower prices as buyers become steadily less aggressive about how much they are prepared to pay or as buying dries up.

A *consolidation* or *congestion area* occurs when price moves sideways. A wider band of equilibrium is often called a *trading range.*

A *gap* often occurs on daily charts. It is a blank space on a chart with no direct connection to the preceding bar or group of bars because no trading has occurred at the intervening prices.

When a market has gapped up from a previous close, the gap is *filled* when there is a close at or below the price from which it gapped. A gap is *tested* when a price returns into the gap and even beyond the close from which the market gapped but does not fill it on a closing basis. The same applies in reverse when there has been a gap down. (See Chapter 9 for detailed information on gapping.)

An *island* consists of one or more days of trading where there is a gap on the chart in both directions. It is often the ultimate manifestation of exhaustion at the end of a major move. It assumes greater significance when it consists of several bars.

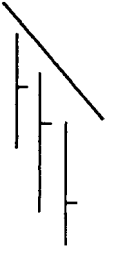

Figure 3-8 A distribution pattern

Then it signifies that the greedy or the desperate have truly finished doing the wrong thing.

Five consecutive closes in the same direction constitute a pattern of unusually persistent buying or selling and suggest that it is likely to continue—unless it is an expression of exhaustion in a conspicuously overbought or oversold market.

Like Eavesdropping

Studying charts has been compared with eavesdropping. The big money moving into a market or out of it cannot help but show what its buying or selling pressure has been doing to affect the way the charts develop. Close inspection of individual bars and groups of bars often gives vital clues that confirm a direction or warn of a possible change in direction.

A strongly rising market tends to have the majority of closes at the upper end of the range. It also tends to have a higher number of closes up than down. When the direction is up, individual advances are usually larger than individual declines.

A rising market that is tiring may show aberrational behavior despite its ability to make gains in closing prices. For example, one downside reversal bar is likely to be a random aberration, especially if it has a small range. Several downside reversals suggest that sellers are asserting themselves. Sellers are consistently knocking down gains early in the period later on. Consequently, there is a high probability of at least a short-term correction, if not necessarily a change in the major trend. This interpretation is reversed when a declining market starts to show signs of buying pressure.

Gaps constitute one of the most obvious indicators of pent-up buying or selling pressure. One small gap within a consolidation area may mean nothing. They occur frequently and are likely to be filled soon—hence their designation as *common gaps*. The incidence of several gaps up indicates the release of pent-up buying power, suggesting a market where you want to hold a long position.

When there are several daily gaps down within a consolidation pattern, the market may soon take a more substantial tumble. Downward gapping that leaves behind an island above the market is highly likely to signify exhaustion of the uptrend, at least for the intermediate term.

CHAPTER
4

Price Rules

When to Pull the Trigger

This chapter describes price patterns, or price rules, that call for action when other indicators confirm a buy or a sell signal. Like catching the optimal moment for a surfer riding the big wave, the idea is that you hope to capture the moment when a surge in price may be starting, when there is enough evidence to know that it can start but not so much that the move may be nearer its end than its beginning.

Ways to Enter a Trade

First, consider the options when considering a trade. Some traders simply know they want to be in a market, for whatever reasons, and just go ahead anyway. For a technician, this approach is inherently undisciplined and unreliable. It may work for those who get the trend right and for those who have a commercial need to buy or sell that is immediate or not unduly price-sensitive.

Other traders set targets to buy low and sell high, usually on the basis of identifiable support and resistance levels. Market makers, commercial accounts, and those wanting to trade very big positions use this approach much of the time. For nonspecialist traders this approach has its place, and it can work well. However, you don't know until after entering the trade whether it will in fact start to perform as expected. Therefore, buying low and selling high at a predetermined level

generally constitutes a better way to get out of an existing position than it is for entering a new one.

The problem with setting target prices for entering new positions is that you really want to see how a market acts when it approaches the target price and what it does when it gets there. If the reach is temporary and the rebound is strong, it suggests that there may be plenty of people with the same idea. Alternatively, you may see a market reach a target and traders' attempts to push the price farther runs out of firepower, and the thrust fails from exhaustion. The point of price-rule theory is that you want to see the responsiveness of traders before arbitrarily assuming that the price will not only stop but also turn and start going in the direction of your trade.

At the other end of the spectrum there are traders who buy high on the basis of price exceeding resistance levels, and in the expectation of the price going higher still. They sell low on the basis of a market falling through an identified support level, expecting the decline to continue. This approach tends to be more successful than trying to buy low and sell high, and it shares with the concept of price rules the idea that you want to get onto a bandwagon when you expect it to keep on moving.

How Price Rules Work

The idea behind price rules is that a market shows, by the pattern development of price bars, that it may be set up, subject to overall chart patterns and other indications, to proceed in the signaled direction and, ideally, right away. Enter any earlier, and the market may never start going in the expected direction. Enter any later, and the market may be getting away on you, and the risk may no longer be manageable. Price rules work for charts of all durations, from intraday to monthly, but their most general application for pulling the trigger on a trade is to use them on a daily or intraday basis. Even if there is unfinished business and price has to return toward the bottom of a buy formation or the top of a sell formation, the process of developing a price rule shows, of itself, which way money has been going and is likely to keep going. Reduced to its simplest terms, a market is likely to continue the next bar in the same direction as a strong close near the top or the bottom of the range. The probabilities increase significantly for price to continue in the indicated direction when a strong close forms part of an apparent behavior pattern rather than being a random occurrence. Price rules are not perfect, and you can enter a trade without a price rule. However, price rules have stood the test of time.

The theory of price rules, when used in conjunction with other indicators, also suggests that market action may be starting a worthwhile move and has not yet

developed so much evidence that the opportunity for making money ends just as you think it is starting. Even if price fails to follow through immediately as expected, you can think of the price rule itself as a miniature trading range within which a retracement is tolerable as long as the price doesn't go against you beyond this range. The price-rule formation generally allows enough room for price to move, within the range generating the signal, without incurring an unacceptable loss if price breaks the wrong way out of the range.

The eight price rules described in this chapter follow the same general principles as the ancient Japanese candlestick price bar patterns, discussed in Chapter 5. If your charting program has the capability to switch between bar charts, line charts, and candlesticks, it is useful to compare them. Neither price rules nor candlesticks are sufficiently reliable for use as stand-alone indicators (although some people try to use candlesticks on their own). Both these approaches help in deciding when to buy or sell, provided they are related to the bigger picture.

It is worthwhile to grasp the underlying principles of the price rules before looking at them in detail. Both buy and sell signals are illustrated because it is just as important to know when to sell or when to sell short as when to buy. The rules themselves are not cast in bronze, and you can stretch them occasionally if other indicators suggest that such a move would be a reasonable course of action. The most important thing is to internalize the concept of bullish, bearish, or neutral bar patterns.

Price Rule Principles

1. When random buying or selling occurs in the ordinary course of business, price charts show random patterns. When there is a persistent weighting of pressure toward either buying or selling, price charts also reflect this fact. One footprint in the sand says nothing. When a pattern of footprints starts to point the way, start looking for evidence that the trail may continue. Put another way, you want to buy strength and sell weakness, but only when the probabilities favor continuation of the pattern.
2. A close at the extremity of a bar's range suggests that the market is likely to continue in the direction of the strong close when bars have completed a coiling pattern or when there have been several consecutive strong closes in the same direction.
3. It is important to act on a price-rule signal as soon as it occurs. The best signals lead to price following through immediately. By waiting for more confirmation, you increase the risk of a retracement as the market moves

away from a price-rule signal. Confirming the balance of evidence can be too much of a good thing once a market starts moving, and the market moves away from a manageable stop-loss point 5. After completion of a signal, there may be a retracement that would permit you to enter a trade at a better price. However, the signals that let you do so are often the ones that fail. The best signals often lead to a profit right away. In the long run, it pays to act as soon as a strong price rule occurs.

4. A price rule occurring on the weekly chart may signify the potential for a major long-term trade, and even more so on the monthly chart for those markets having long cycles. Signals on daily and intraday charts deliver the signal for pulling the trigger for a trade. It sometimes happens that there are signals occurring simultaneously on monthly, weekly, and daily charts. When this happens, there is a very high probability of a worthwhile move starting right away.

Conditions for All Price Rules

1. To complete a price rule, the final bar has to close in the top 25 percent of the bar's range for a buy signal or in the bottom 25 percent for a sell signal.
2. A price rule may take longer to complete than the minimum specified time. Thus it could take four or five bars rather than three to complete a three-bar close rule (rule 1, shown below). Sometimes it can take until the fourth or fifth bar to obtain a close in the top or bottom 25 percent of the bar's range, thereby completing the signal.
3. When price closes in the middle of the range, the result is neutral. Assume the same closing designation as for the previous bar.
4. When an emerging pattern is violated, start counting again at the beginning of the formation with a new bar 1.
5. When a price signal is completed (and other indicators confirm the action), buy or sell right away. If you miss the signal, don't chase the market. Wait for a new signal.
6. The point of price rules is that the market should ideally keep on going right away in the direction of the signal. The probabilities favor this happening, with the close in the respective top or bottom 25 percentile of the range, but you need to look at the intraday chart to see more precisely how the market closes. There may be many zigzags in both directions between the open and the close. If you are buying, for example, the best scenario would be for the market to open on the low and close on the high. You should be wary of going long when the market opened on the high and then fell away and

made a labored rally back toward the initial high without reaching it, let alone surpassing it. It is important to look at intraday chart action as well as the daily bar on the entry day. Similarly, you need to interpret bars on the weekly and monthly charts in the context of how the market has been acting.

Price Rules

1. The Three-Bar Close Rule

A buy signal occurs on completion of three consecutive bars in which price closes in the upper half of the range and the next bar closes in the top 25 percent of its range. A sell signal is the reverse (Figure 4-1).

This rule is reliable when market action occurs in a group with three or more bars more or less side by side, ideally with an upward bias indicated by an accumulation pattern, as discussed in Chapter 3. When it occurs as a result of two strong bars running away from the first one, the risk of a pullback and, therefore, of a less manageable risk may increase.

Figure 4-1 The three-bar close rule

2. The Reversal Rule

Shorten the proving time from three bars to two when either of the two bars is a closing-price reversal, key reversal, or high/low reversal (Figure 4-2).

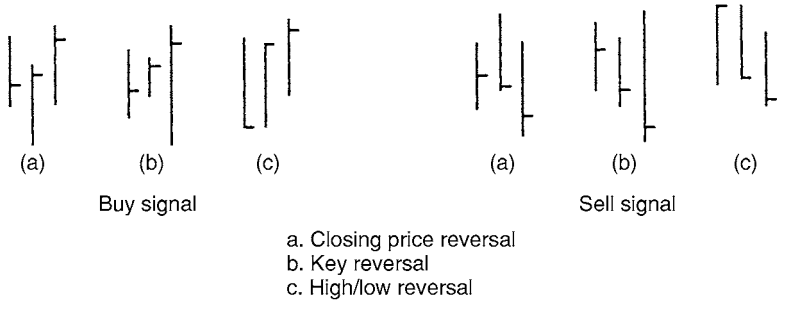

Figure 4-2 The reversal rule

3. The Gap Rule

Shorten the proving time from three bars to two when a gap occurs (Figure 4-3).

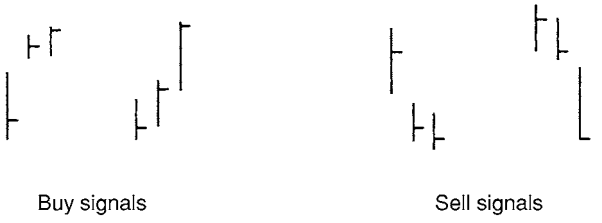

Figure 4-3 The gap rule

4. The Island Rule

Shorten the proving time to one bar when an island occurs. It is not necessary for closing price(s) within an island to be in the top or bottom of the range. An island may consist of one bar or many. However, the more time taken to form an island and the more symmetric the gapping, the more likely it is that price has reached an important turning point and will continue in the direction of the new gapping. Islands often indicate absolute exhaustion of the previous trend (Figure 4-4).

Figure 4-4 The island rule

5a. The Lindahl Buy Rule

The renowned futures trader Walter Bressert popularized this rule (Figure 4-5).

Within nine bars from the bar of the low for the formation:

- Price must exceed the high of the bottom bar for the formation: *b* must take out the high of *a*.

- Price must then take out the low of the preceding bar: *d* must take out the low of *c*.
- To buy, price must take out the high of the preceding bar and close above the preceding bar's close and the current bar's opening price (*e*).

This formation may be completed in as few as three bars or as many as nine depending on the number of intervening bars that do not contribute to development of the formation. Put another way, it is not significant when price exceeds previous highs and lows. There may be several neutral bars in between.

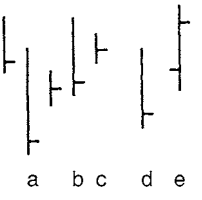

Figure 4-5 The Lindahl buy rule

5b. The Lindahl Sell Rule

Within eight bars from the bar of the high for the formation (Figure 4-6):

- Price must exceed the low of the top bar for the formation: *b* must take out the low of *a*.
- Price must then take out the high of the preceding bar: *d* must take out the high of *c*.

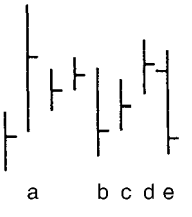

Figure 4-6 The Lindahl sell rule

- To sell, price must take out the low of the preceding bar and close below the preceding bar's close and the current bar's opening price (*e*).

This formation may be completed in as few as three bars or as many as eight depending on the number of intervening bars that do not contribute to development of the formation.

Walter Bressert found that valid buy signals may require one more bar than a sell signal. Some people find it difficult to grasp the detail of Lindahl signals. It may take time, but it is worth the effort. Lindahl signals are very reliable when other indicators indicate a turn in price. They also occur frequently on charts of all durations. If you have difficulty recognizing Lindahl signals, think of them as looking like a miniature M or W formed by just a few bars. A Lindahl signal on a monthly chart tends to be very reliable because it takes so long to form.

6. The Double-Reversal Rule

Trade on completion of a second reversal bar in the same direction within a period of six bars or fewer, whether closing-price reversals, high/low reversals, or a combination. Both reversal bars should close in the top or bottom 25 percent, as appropriate, of the bars' ranges (Figure 4-7).

As suggested by the name *double reversal*, this rule is a double trend continuation (rule 8). Double reversals occur often and are very reliable. They also occur frequently in Lindahl formations (rule 5).

When buying, the signal is much stronger if the second low is higher, and when selling, if the second high is lower unless the second reversal is exceptionally powerful. The same goes for closes. Ideally, the second one should be higher when buying and lower when selling. Occasionally, this rule can be completed in as few as two bars. It is very powerful when the second bar completes a double reversal and is also a key reversal bar.

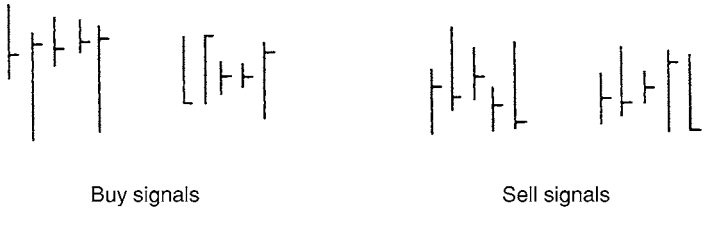

Figure 4-7 The double-reversal rule

7. The Key-Reversal Rule

Trade with the direction of a single, very big reversal bar—even though the trend appears to be in the opposite direction—hence the name *key reversal* (Figure 4-8). Make sure that you are familiar with all the components of a key reversal, as discussed in Chapter 3. This rule is particularly useful for getting out of an existing trade even if you don't want to enter a trade in the apparently new-found direction.

Unless the key reversal is exceptionally powerful, it may be better to wait to see whether the market comes back to test the low when buying or to test the high when selling. Even with a strong key reversal, there is a high probability that the low or the high will at least be tested, if not necessarily exceeded. Then there should be a new M or W on the line chart. V tops and V bottoms on the daily chart comprise considerably less than half of all trend reversals.

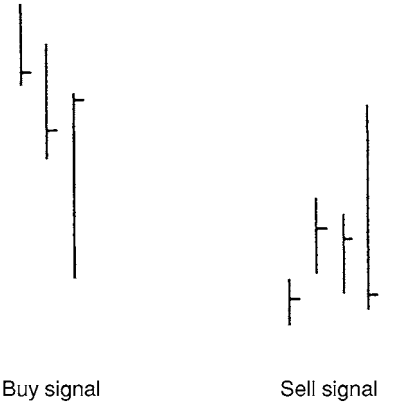

Figure 4-8 The key-reversal rule

8. The Trend-Continuation Rule

This is a catch-all for entering a new trade in a rapidly moving market. The point is that the strength of the trend trumps the need to wait for more confirmation. Therefore, shorten the proving time to one bar when there is a single reversal bar, either a closing-price reversal or a high/low reversal, and ideally an outside reversal

bar in the direction of an established and unmistakable trend. A clear and unmistakable trend normally requires the 25- and 40-bar moving averages to confirm the direction on the monthly, weekly, and daily charts. Most likely, too, the daily bars will be contained within a 10-bar moving average.

It is psychologically difficult to chase a rapidly moving market. This price rule provides the mechanism for buying with both a manageable stop loss and a high probability of making a profit right away.

Illustrating the Price Rules

The day-session-only daily chart for gold between September 2006 and February 2007 illustrates all the price rules, some of them buy signals and some sell signals (Figure 4-9).

It does not, of course, follow that you would necessarily have pulled the trigger on every signal, and there are several occurrences when you would almost certainly not have done so.

You can see that some of the price rules duplicate one another. In fact, the Lindahl buy signal (rule 5a) at the end of September is also a rule 1, a rule 2, and

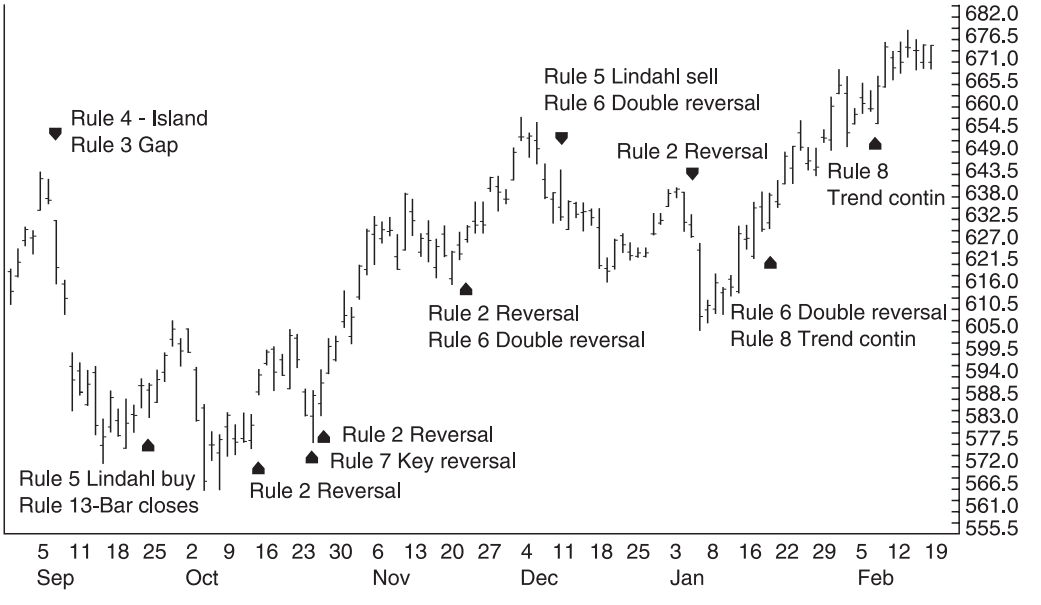

Figure 4-9 Gold continuation daily chart with price rules

a rule 3 signal. It is rare to have such a conjunction of price rules, but that does not, of itself, mean that the signal is exponentially stronger. The power of the signal rests just as much on the conjunction of other and different indicators and notably those showing momentum and the direction of the trend. The island top at the beginning of September set off the strongest immediate move over the entire period of this chart. By contrast, the key-reversal rule (rule 7) toward the end of November is, arguably, a bit dubious in terms of both range and power, although it was reinforced by the fact that it occurred after price successfully rebounded from support in the gap left behind a week earlier.

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CHAPTER
5

Candlesticks: A Useful Tool

Another Way to Look at Charts

Japanese candlestick charts have become so popular in recent years that some people use them exclusively. Following is a brief overview of how to look at candlestick charts, which are a good tool. However, they do not serve as an indicator as such. Their significance is marginal with respect to timing techniques because, on their own, none of the individual candlesticks or multiple-stick patterns provides statistically reliable trading signals. It is enough, of course, that they suggest potential developments and timely entries and exits when other indicators confirm the case for pulling the trigger. As such, they may serve as either a substitute for or a supplement to the price rules described in Chapter 4.

What Candlesticks Do

Candlesticks provide good evidence, by the bar, of buying or selling pressure and, arguably, do so better than regular bar charts. To some extent offsetting the benefit of seeing buying and selling pressure clearly is the complexity and number of candlestick patterns in widespread use, numbering well over a hundred. This compares with the eight price rules described in Chapter 4. It is impossible to develop a trading program based entirely on candlesticks, and even their most ardent devotees say only that they comprise just one tool among many.

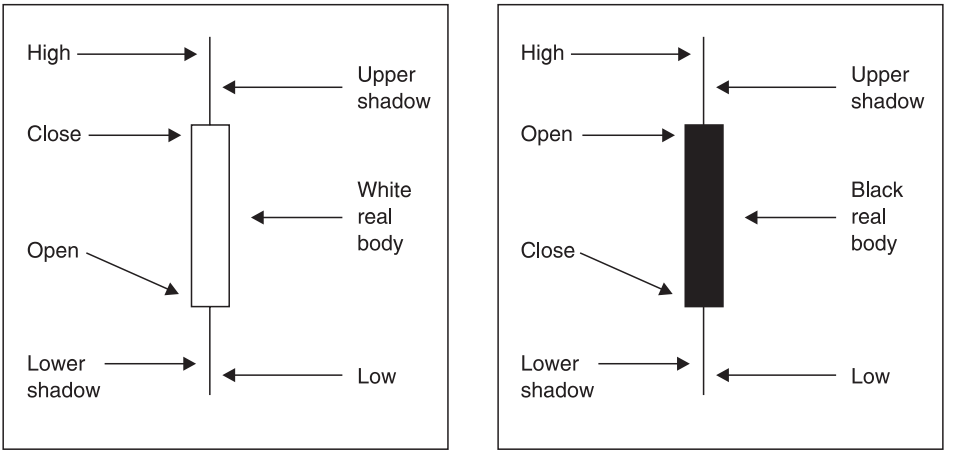

Figure 5-1 Candlestick formation

This reservation does not diminish their usefulness and their well-deserved place in every trader's toolbox. The main thing is to internalize what they represent so that you understand at once the underlying forces generating what you see (Figure 5-1).

A candlestick bar consists of a wide rectangle that is either hollow or filled, called the *real body*, with a thin line normally coming out of the top and the bottom. These lines are known variously as *shadows, tails*, or more to the point given the name for the methodology, *wicks*. The high for the bar is at the top of the upper wick, and the low for the bar is the corresponding bottom of the lower wick. When the closing price is higher than the one for the previous bar, the real body is hollow, and when it is lower, the real body is solid. The range for the real body consists of the range between the opening price and the closing price for the bar. The idea is that it is important where the starting gate was, and it is also important how trading action finishes when all the backing and filling of short-term buying and selling pressure has been exhausted for the period of that bar. When there has been trading beyond the range of the high and the close for the bar, a wick sticks out of the end of the candle, although it happens quite often that there is little or no wick. This simply means that most of the trading occurred within the confines of the respective high or low. Some charting software provides the useful capability of color-coding a higher or a lower close—say, green for higher and red for lower.

Candlesticks Showing Momentum

The longer the real body is, the more aggressive is the buying or selling pressure. On the other hand, short candlesticks indicate little price movement and may represent either consolidation or indecisiveness (Figure 5-2).

The strongest candlesticks are those of the Marubozu brothers, solid for bearish and hollow for bullish. They have no upper or lower shadows, and the high and the low are represented by prices right on the open and the close. Everyone on the right side of the market for that bar is making money, and everyone on the wrong side is losing. Until a move runs out of steam—usually after a succession of very strong bars—both buyers and sellers can expect a continuation of the momentum—those on one side of the market to add to profitable positions and those on the other, to get out of losing trades.

These candlesticks, and similarly strong ones with small wicks, may predict the immediate market action when

1. There are several solid or several hollow ones together in a cluster, suggesting that the market is trying to push out in the direction of the thrust.
2. There is an engulfing candlestick—the equivalent of an outside bar on the bar chart.
3. The thrust of the candlestick follows through from a gap.

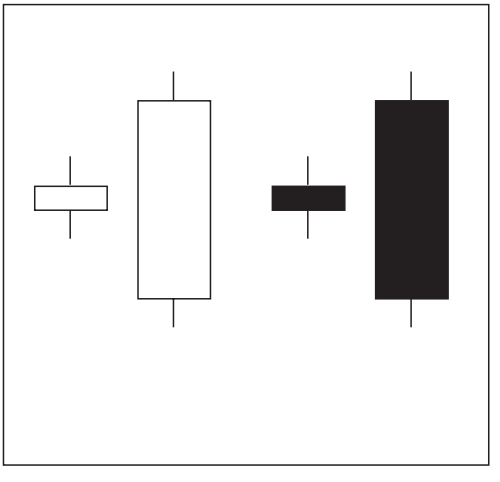

Figure 5-2 Long and short real body

Strong hollow candlesticks are particularly significant when they occur where a market may be rebounding upward from a support level and stochastics show an oversold reading. Correspondingly, strong solid candlesticks may indicate the start of a new downward thrust, in the opposite direction, when price falls away hard after running into resistance and stochastics have been at an overbought level. On the other hand, apparently strong candlesticks also occur frequently right at the end of a move as an expression of the last gasp by traders driven by excessive enthusiasm, and by those unwilling to finance further losses by fighting them. Stochastics provide one of the best antidotes for misinterpreting a thrust that may terminate a move.

Candlesticks Showing Indecision or Exhaustion

A candlestick with a short wick and a short real body signifies that there is no aggressive pressure on either side of the market, and price is marking time. More important are candlesticks with longer wicks, regardless of the length of the real body, and depending on which shadow is longer or whether they are both long. It is also important where the opening and closing prices are in relation to the real body. The general rule is that the longer the wick, the more market action shows that efforts to push the price further in that direction failed and that traders were prepared to push the price back from the extremity of the range.

Following on from this principle, candlesticks are a valuable tool for helping to identify a possible reversals, and the most important one to this end is the *doji*. It occurs when both the opening and closing prices are at or close to the same level, and there is little or no real body. It often shows that a move is running out of firepower, and it is particularly useful on the daily chart. A *doji* may suggest that at least short-term retracement, and maybe more, may be starting now or may start soon. Therefore, it warns of the risk of buying at the top of a move or failing to get out at a good price. Similarly, a *doji* may suggest exhaustion of selling pressure and the potential at least for an upside correction.

The *doji* candlestick, with almost no real body is similar to a group of candlesticks with clear wicks and relatively small ranges, including spinning tops, the hammer, and the hanging man. All these bars manifest a certain indecisiveness in market action, but none of them on their own has any statistical reliability except in relation to other indicators, the trend in force, and what happens with the next one or more bars. As always, gapping, even in relation to the close of the previous bar, and never mind a complete separation, introduces real significance. In particular, there is most significance when price gaps one way and then back the other way.

A *doji* shows that supply and demand are in equilibrium, with a standoff between buyers and sellers. Of itself, a *doji* really does little more than sound a

warning that something more dramatic might happen. A market in equilibrium is inherently unstable, and a sudden and sharp move may seem to come out of the blue, particularly when there are other indications of risk, such as extended stochastics readings.

Good *Dojis* and Bad *Dojis*

Depending on how the shadows form, there are four types of *dojis*—common, long-legged, dragonfly. and gravestone (Figure 5-3).

A *common doji* has a relatively small trading range. It reflects indecision. When there has been an uptrend, buyers have been in control. Now, the outcome is in doubt. In a downtrend, sellers have been dominant. Now, some buying power has emerged, and the tide may be ready to turn.

A *long-legged doji* is far more dramatic. When the market went up sharply, it ran into heavy selling. When it broke hard, it found solid support. There are, however, two things to look for that help to interpret this candlestick. The first is simply to see whether the closing price was above the midpoint of the range, which would be bullish, or below the midpoint, which would be bearish. Even more important than this, however, and depending as always on other indicators, is the additional component factor that interpretation of candlesticks requires. This is to know which way price was traveling as time for building this bar was coming to the end. Then the probabilities are weighted toward continuation of the most recent thrust rather than the one that failed when the bar started (Figure 5-4).

A *gravestone doji* is the most ominous candle of all, resonating for those long the market like the death-watch beetle. It often has the characteristics of a key reversal on a bar chart. Depending on the underlying strength of the trend, one gravestone *doji* may result from profit-taking, and the market may regroup in a day or two to continue higher, although possibly not for long. Of all individual

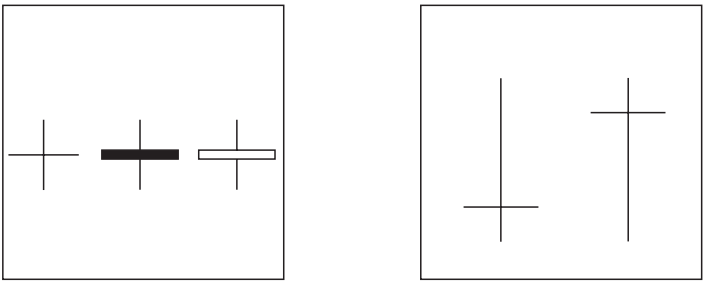

Figure 5-3 *Dojis* with long and short candles

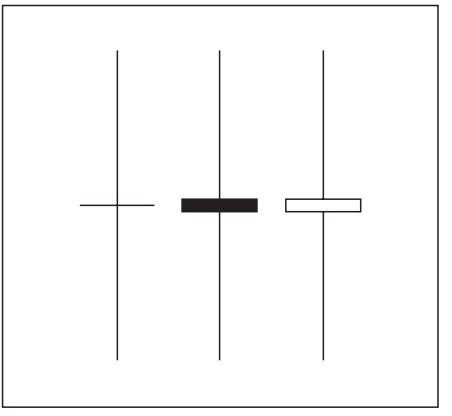

Figure 5-4 Long-legged *doji*

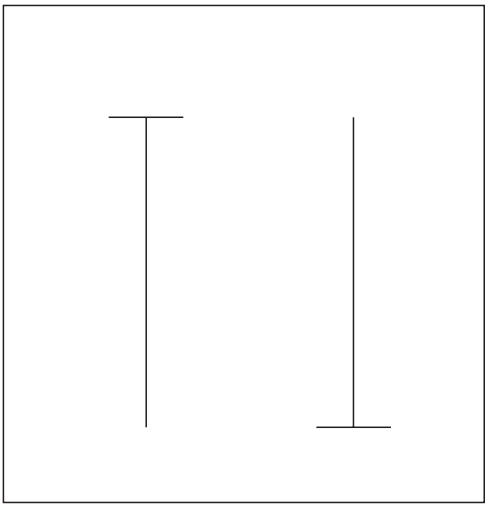

Figure 5-5 Dragonfly *doji* and gravestone *doji*

candlesticks, it stands out for its above-average reliability for warning that the market may have run out of buying power, including the running of stops, and particularly also there may be the death throes of a short squeeze (Figure 5-5).

A *dragonfly doji* is the counterpart of a gravestone *doji*, occurring often at or toward the end of a significant decline, but sometimes as an expression of heavy profit-taking in a powerful bull market. Price rebounds after a hard break and returns to the opening price.

Noteworthy as *dojis* are, you have to interpret them in light of the overall pattern of the market. Having set off an alert, you have to see what happens next and whether the expected follow-through actually develops or not, especially when it develops with a gap in the expected direction. The important thing about any charting methodology, whether line, bar, candlestick, or any of several others, is that such methodologies do not lessen the importance of indicators showing direction, support and resistance, momentum, and overbought/oversold oscillators.

Candlestick Summary

There are six main kinds of candlesticks (Figure 5-6):

1. A long white candlestick shows that buyers were dominating the market.
2. A long black candlestick shows that sellers were dominating the market.
3. A small candlestick with price ending at or near the same place as it started shows that there is equilibrium between buyers and sellers. It may, and only may, show exhaustion at or near the end of a move.
4. A long lower shadow shows that sellers hit the market hard but lost control by the end, and buyers made the price come back impressively.
5. A long upper shadow shows that buyers took charge early but lost control by the end, with sellers—whether profit-takers on longs or new short positions—more aggressive than buyers.
6. A long upper and lower shadow indicates that buyers and sellers both took charge some of the time, but the final outcome was a standoff. This can be a setup for more dramatic action and possibly at least a near-term reversal. Therefore, it is important to find out which way the market was going into the close.

Candlesticks and Price Rules

Many of the patterns built with candlestick bars are similar to what you get with regular bars. One thing that you see better with candlesticks than with a bar chart is the matching low and matching high, where you have a second powerful bar, with price unable to go farther. The implication may be that there is a barrier there that will continue to contain attempts to push through.

The *mat hold pattern* is essentially the same as a Lindahl pattern (rule 5), and it is rated as having a high level of reliability. The buy-side *three white soldiers pattern*

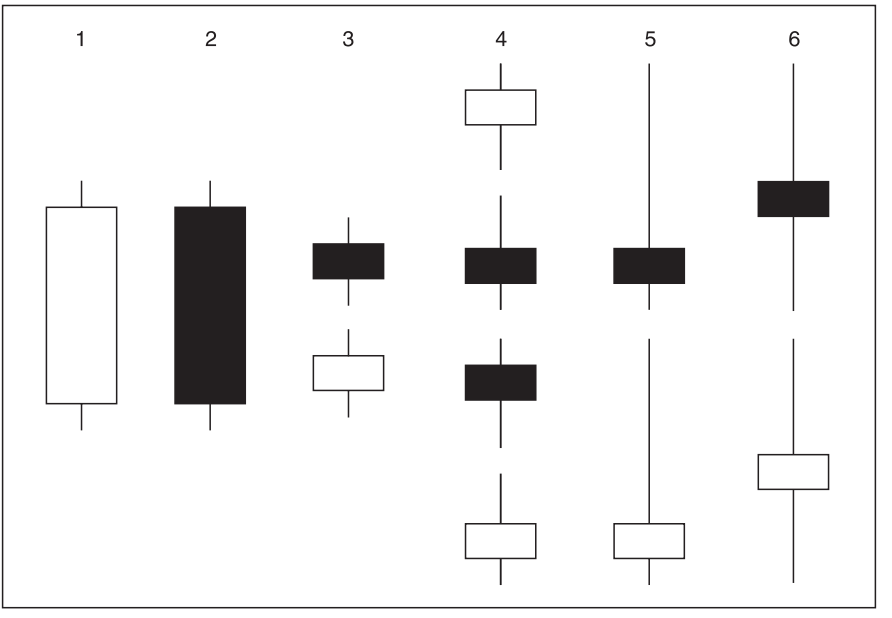

Figure 5-6 Candlestick summary: long and short candlesticks

consists of three consecutive strong bars with closes at the top and is the counterpart of the rule 1 three-bar close pattern. In candlestick charting, an outside bar is said to be engulfing, and on its own it is said only to be moderately reliable, which is clearly correct. Surprisingly, there are many generally accepted patterns rated as having only a moderate to low level of reliability.

An *abandoned baby* is a well-defined island-bottom reversal pattern requiring a *doji* at the bottom, and its reliability is rated high. The reality of trading is, however, that all island reversals are reliable when occurring in conjunction with an overbought or an oversold condition. They can have such variations as to comprise more than one bar at the extremity, and therefore, an excess of precision can be counterproductive if it introduces too much detail or inhibits entering trade. As with price rules and any other methodology, it is often best to approach the use of candlesticks with the attitude that they provide helpful guidance rather than that you have to follow them slavishly.

CHAPTER
6

Moving-Average Convergence/Divergence (MACD)

When Does a Trend Have Staying Power?

Moving-average convergence/divergence (MACD) may be the single most valuable *trend-reliability* indicator. It can confirm both the validity of a trend and the likelihood of its continuing. The invaluable counterpart of this use is to signal extreme caution when MACD conflicts with a trade. There is, of course, the constant challenge of how to reconcile conflicting indications from charts of different duration, but this does not lessen the value of MACD.

The Construction of MACD

Gerald Appel originally developed MACD in 1979 as a stock market timing indicator. It is not necessary to know the equation in order to know how it works, although some traders may want to look under the hood. It consists of three exponentially smoothed moving averages that are expressed as two lines. Using the standard settings, the first line, *slow MACD*, represents the difference between a 12-period exponential moving average and a 26-period exponential moving average. The second line, *fast MACD* or the *signal line* as it is sometimes called, is the approximate exponential equivalent of a 9-period moving average of the first line.

The standard values, recommended both for the buy side and the sell side of futures markets, are 12, 26, 9. For use with stocks for the buy side, Appel preferred to use 8, 17, and 9. This buy-side formula reacts slightly more quickly to changes in market forces, but it is therefore slightly more subject to whipsaws. For all practical purposes, and considering the fact that successful traders are looking for major long-term moves, fine-tuning the settings is unnecessary because incremental gains or losses are insignificant.

You can normally display MACD as a line oscillator, as a histogram, or, as with Ensign software and as used here, as both of them. MACD normally fluctuates between readings of about +5 and –5. However, unlike stochastics, discussed in Chapter 7, high or low readings say little about when a major move might have gone far enough, except to let you see at what levels there have been recent turns. There is no limit to how high or low readings can get when adding numbers day after day or bar by bar. In the huge bull market in copper, MACD at one point in 2006 reached a plus reading over 45 on the weekly chart. Therefore, the attempted use of MACD levels to measure when a market may have done enough is counterproductive during the course of the strongest market moves, which is when you most want to stay in a trade and least want to get out prematurely.

What MACD Shows

MACD's primary function is to indicate momentum, and momentum frequently leads price, sometimes with considerable advance notice. Sustainable moves generally take time to develop and, once under way, tend to last far longer and go much farther than you might expect. A reliable move should ideally continue steadily without disturbing the trending MACD. When MACD starts to falter, it may be delivering advance warning, sometimes long in advance, that it is again leading price and that the market may be heading for a consolidation or a retracement. However, you need to temper this general interpretation of MACD with an awareness that a powerfully moving market may achieve peak momentum long before the end of a move. The rate of change in price just slows down, and even a significant period of consolidation does not necessarily lead to a trend reversal. When, on the other hand, the MACD fast line bulges beyond the slow line, it may mean that there is too much of a good thing, and market action may be heading for a climax and a corresponding reversal.

Much of the time there are conflicts between what is happening on charts of different duration, but this does not negate what MACD shows on the chart you

are looking at. The general rule holds good for MACD, as it does for other indicators, that the weekly chart shows, for trading purposes, the momentum of the major trend, while the daily and intraday charts suggest possible entry and exit points.

Typically, although often erratically in real-time market action, MACD shows the way in five phases.

1. After an extended move, MACD starts rounding out and then begins to trend in the opposite direction. Then it may be much harder work making money by trading in the direction of the previously established price trend, and retracements are more likely to be sudden and sharp. Now the apparent trend may be living on borrowed time prior to a period of going sideways, if not necessarily a trend reversal.
2. MACD is trending quite clearly in the new direction with fast MACD crossed over slow MACD and, ideally for trading purposes, with a series of regular zigzags. Once MACD establishes a clear trend, there is a reasonably good expectation that price will also now trade in the new direction and will maintain the trend.
3. With a clear trend under way in both MACD and price, and particularly in a fast-moving market, MACD should maintain a steady course in the same direction. Depending on which chart you are looking at and the overall agreement between charts of differing duration, price seldom bucks the trend of steadily trending MACD. As long as MACD doesn't seriously falter, market fluctuations are most likely no more than what you should accept as normal market action within the trend. Warning signs are
    a. MACD starts flagging—suggesting that the move in price is running out of momentum, or
    b. MACD bulges—suggesting that the move in price may be heading toward a climax.
4. Momentum eases back eventually, even in the strongest markets, and then MACD may hold steady. In this case, there may be little cause for concern that the trend is ending. Price seldom changes the direction of a major trend until MACD shows that the thrust of momentum has gone out of it conclusively. Therefore, except after a major buying or selling climax, a trend reversal in price is relatively unlikely to occur without MACD leading with its own significant reversal in direction.
5. Finally, MACD starts reversing the process and sets the market up to go in the opposite direction.

The MACD Histogram

The MACD histogram shows another way of looking at the relationship between fast MACD and slow MACD. Much of the time the MACD histogram shows whether underlying momentum is humming along steadily or its action is erratic. Since the most reliable confirmation of a trend occurs when fast MACD maintains a moderate and consistent separation above slow MACD, the histogram should not then extend far beyond the zero baseline. When it does, you may too have much of a good thing, because a perceptible bulge often occurs at the extremity of a move. It may be an expression of peak momentum and, quite likely therefore, an expression of exhaustion of eagerness to press the market in the direction of the trend. To this limited extent MACD may serve as an overbought or oversold indicator regardless of what level it reaches, showing at least temporary buying or selling climaxes.

Following on from the theory of bulges in the histogram, therefore, you may be able to see the potential for a significant and tradable turn in price when a bulge is ending, either an opportunity to exit an existing position or to enter a new one. Put another way, when the histogram has been at a steep discount below its zero baseline and starts making a series of shorter bars, it may well be time to buy or at least cover short positions. When it has been at a high level and starts fading, it may be time to look to sell long positions, if not necessarily to go short.

The MACD Zero Baseline

Although of limited use as a timing indicator, MACD above the baseline confirms a bullish condition, and when below a bearish one, and the corresponding condition serves either as a confirming or a negating indicator for a trade. Nevertheless, when MACD is below the zero baseline, it can still develop a new and apparently conflicting positive indication when it starts to make a clear upward incline after fast MACD crosses slow MACD, particularly one with an upward zigzag from an apparently low level or vice versa from an apparently high level. A zero-baseline crossover as such seldom provides a useful trading signal because it generally occurs too late.

Learn to Believe MACD

Although there may be exceptional circumstances requiring judgment, on balance it pays hand over fist to believe what MACD is indicating rather than to become overly anxious about staying in a profitable trade until there are strong exit signals. The best trades do not abort prematurely. On the contrary, they can go on

and on, far beyond what you might think possible when you enter the initial trade. Subject to all the usual cautions and watching the exit, you want to think in terms of having the capacity both to withstand reasonable adverse fluctuations and also to add to a winning trade rather than cut it off prematurely. Major buying and selling climaxes, and corresponding violent reversals, occur relatively seldom, although you have to be prepared for them. In any case, even when a trend appears to be ending violently, there is usually another run at the top or the bottom before the market reverses and establishes a new trend in the opposite direction.

On the cautionary side, it is remarkable how many dramatic reversals occur against an otherwise seemingly well-signaled trade that has lacked confirming MACD or with MACD coming on side only long after the move in price has gone a fair distance. Therefore, when MACD is trending in the opposite direction to a current or a prospective trade, it delivers a strong warning, although not necessarily a negating indicator so emphatic as to constitute an outright embargo. You need to heed most particularly what MACD is saying on the weekly chart, in accordance with the principle that the weekly chart is the primary determinant for selecting a market to trade. When MACD fails to endorse a trade on most combinations of weekly, daily, and 60-minute charts, it is almost certain that you should be out of that market and, quite possibly, in a trade in the opposite direction.

Summary of Uses for MACD

Consider the case for or against a trade according to the following points:

1. A MACD crossover with a confirmed direction indicates a favorable or unfavorable condition for entering a trade or for staying out of one on the basis of underlying momentum. Under the best of circumstances, MACD simultaneously confirms momentum on weekly, daily, and 60-minute charts.
2. M's and W's in the MACD fast line strongly reinforce the probability of the trend continuing both for the indicator itself and therefore for price.
3. A signal for action occurs on completion of the bar which makes the MACD fast line turn. More important, and not a timing indicator as such, is the condition of having MACD's signaled direction in force.
4. Adversely trending MACD is a strong negating indicator on its particular chart.
5. Conflicting MACD indications on charts of different duration show turbulence, but by no means necessarily headwinds strong enough to embargo a trade. For example, with a confirming condition on the weekly chart but a negating one on the daily, there might be a new entry when MACD turns

favorable on the 60- or 120-minute chart. The timeliness of a good entry price could be lost by waiting for the daily MACD to confirm an entry.

6. For the big picture and for confidence in the major direction of the trend, MACD readings are incrementally more important on the monthly (depending on the market), weekly, daily, and intraday charts—as with waves within waves going backward and forward within the major direction of the tide.
7. MACD precedes price when the momentum of a trend is slowing, and price may be trying to stabilize, if not necessarily preparing to reverse. Apparently slowing momentum often gets going again after taking a rest.
8. MACD confirms a bullish indication when it is above the zero baseline and a bearish one when below it.
9. The MACD histogram serves, although only in rough-and-ready fashion, as a useful overbought/oversold indicator. In a bull market, there may be a favorable time to buy when a downward bulge in the histogram is easing with a series of shorter bars from an extremity and vice versa in a bear market for selling after an upward bulge shows signs of easing back down.
10. The histogram crossing the zero baseline provides another way of showing when the MACD fast line crosses the slow line.

MACD and Gold

The monthly continuation chart for gold shows how MACD can diverge from price long before an established trend finishes, let alone before the trend reversal—showing what technicians call *negative divergence* (Figure 6-1).

During the major bear market beginning in 1996, the steep decline in MACD rounded out in 1998. All that meant, initially, was that the relentless decline led into a period of consolidation lasting 16 months, which concluded with the final drop to the bottom in August 1999. Far from confirming the low, MACD made its low at a far higher level. As we saw when looking at M's and W's in Chapter 2, even that did not mean that a new bull market was about to begin just because the bear market might be ending. After the W formed by MACD with its low in August 1998, this indicator was suggesting that it was an exercise in going against the forces of momentum and money flows to be selling gold short. The moving averages were still confirming the downward direction and were to continue doing so for more than two years. However, MACD was saying that there was no more low-hanging fruit to pick by trading the short side of gold. Indeed, the last $20 or so was hard-won gain, if you managed to capture it, which would have been difficult. Equally difficult to capture was any profit from trading on the long side of gold. It was to

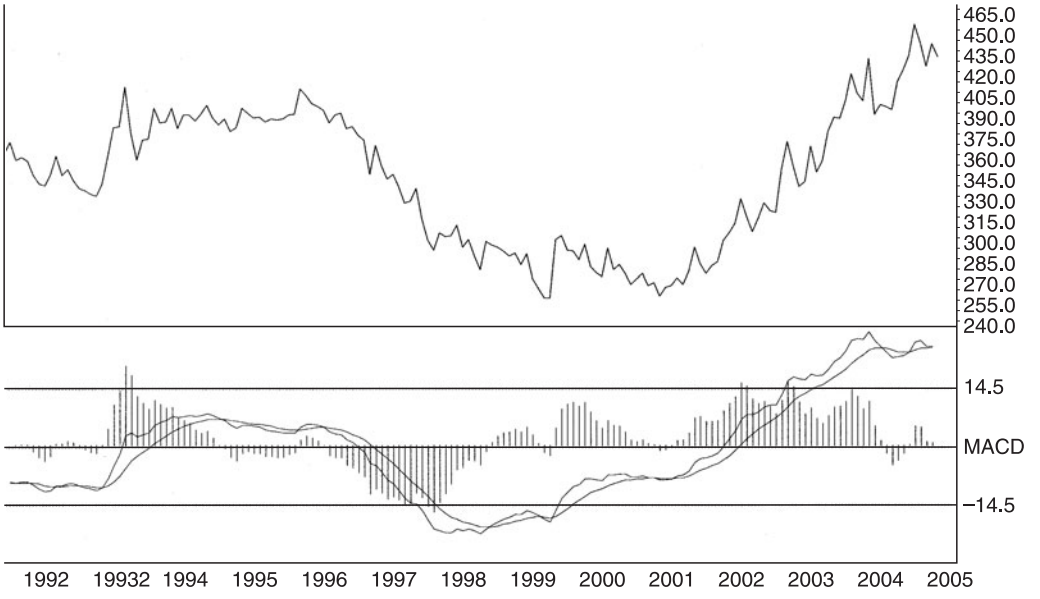

Figure 6-1 Monthly continuation line chart for gold

take a further two years for the pieces to fall into place for the price not only to stop going down but to start going purposefully upward again.

The histogram on the monthly chart illustrates in broad-brush terms how buying and selling pressure reached extremes and temporarily ran out of steam when surges finished running their course. Although only a rough-and-ready indicator, you can see that there was a lower-risk sell in an established bear market when the histogram bars crested at the top of a hill, and a lower-risk buy in a bull market when the bars turned higher after going down into a valley.

The Weekly Chart for Gold

The weekly chart for gold between 2004 and 2006 shows MACD in action (Figure 6-2). The chart went flat as a retracement lost momentum and then began rounding upward during the late summer of 2004 as well as in the second half of 2005. Each time, MACD crossed over and turned up at almost exactly the same time as an upturn occurred on the weekly line chart, which could be considered significant enough to signal a place to buy. Every bit as important as these two buy

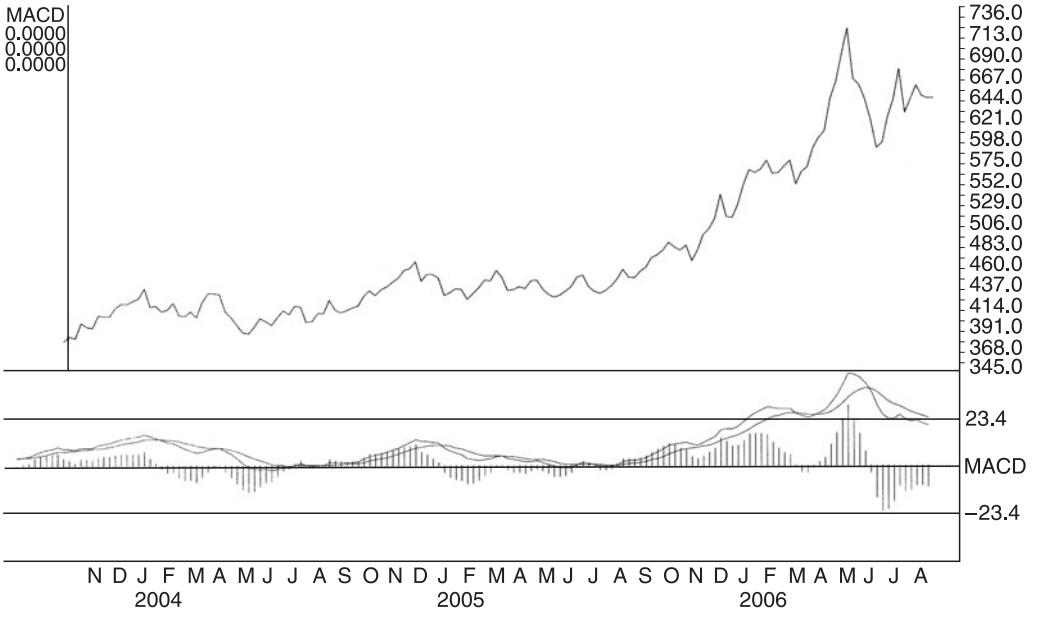

Figure 6-2 Weekly continuation line chart for gold

signals were the indications from MACD that opportunities on the long side were likely to be limited when it was trending down during the first half of 2004 and the first half of 2005.

It is also worth reviewing the apparently aberrational behavior both on the line chart and with MACD during the retracement in the first three months of 2006. On the weekly chart, MACD turned down and made a short-lived downside crossover, and the line chart for price made a clear lower low, even though the previous high had been just a few cents higher at the top than the preceding one.

The Daily Chart for Gold

Now look at the daily line chart for gold at the end of March 2006 (Figure 6-3). Price made a confirming small zigzag as it was setting up to break to a new high, and MACD was clearly charging upward again. Note too that MACD on the daily chart seemed to be heading into new high ground. As such, you might think that it was getting into a territory where MACD as well as price could be vulnerable to a sharp retracement at any time. Appel suggested that you could establish high

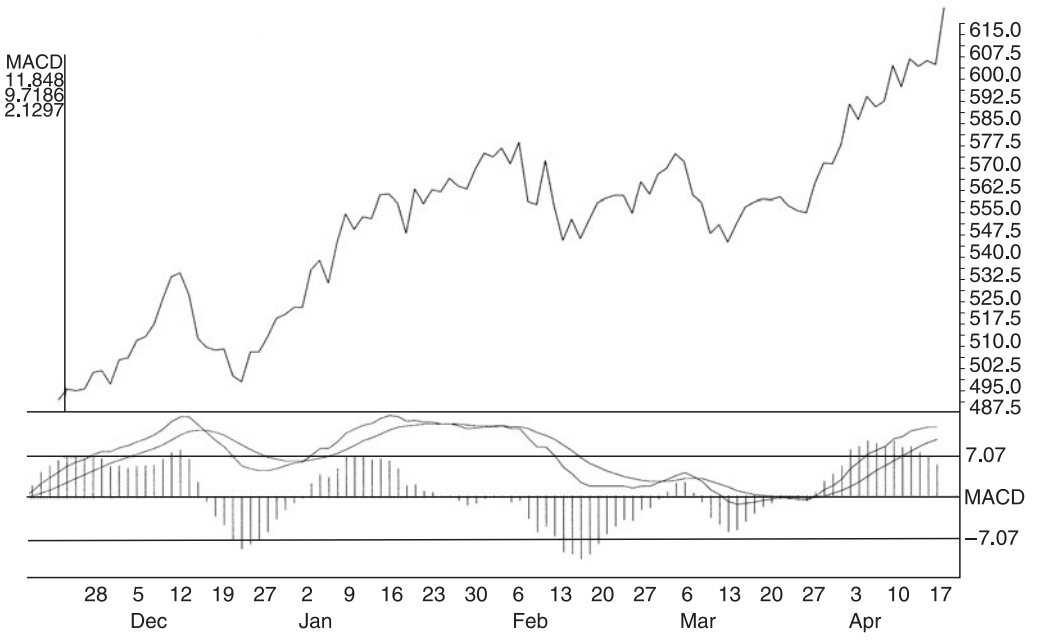

Figure 6-3 Daily continuation line chart for gold

and low levels on MACD for various markets to know when they might be overbought or oversold and therefore vulnerable. However, all markets change over time and an apparently overbought or oversold condition at one time may signify the strength of a very powerful trend at another time.

During January and early February 2006, MACD began to trend slowly downward even as the price of gold was initially working erratically higher. In doing so, it indicated that momentum and buying pressure were abating, at least for now. Then came a simultaneous sharp break in both MACD and price, almost as if MACD were a river heading over a waterfall. After the initial break, the short and sharp rally in price did nothing to lessen the newly established downtrend in MACD, which was to lead the way for price until mid-March. Then MACD began regrouping, and its decisively higher low, making a new W at the end of March, indicated a timely new place to buy for the next strong upward surge.

On the daily line chart for gold, the histogram shows a much higher series of bars below the baseline in March than occurred at the low in February, although the price made a low at approximately the same level. This is a good example of a technical indicator showing bullish divergence.

Trending MACD Connotes Price

You can almost look at the pattern for MACD and ask the question: "If fast MACD represented price, would you want to be in that trade?" An affirmative answer may suggest that you could be looking for an entry if you don't already have a position, and you should not be jostled out of one too fast by fluctuations that may be no more than aberrational. In sum, MACD is the best available indicator of the underlying momentum that makes for great trades and for avoiding superfluous losses. Ideally, both weekly and daily MACDs confirm a trade capable of making an extended move, and a double negative on both these charts almost amounts to a complete embargo. You may miss some superb entries, but the point about successful futures trading is to try to have the maximum probabilities lined up for every trade you take. Overall, the probabilities are overwhelming that what MACD tells you is likely to deliver on what it is forecasting.

There is little point in looking further than MACD for an indicator to do the job of confirming momentum and the potential staying power of a trend, although many traders like the Directional Movement Index (ADX) for this purpose. ADX shows the persistence of a strong trend, and that is worth knowing. However, once a trend becomes established, the curvature and incline for the ADX line, with standard settings, are essentially the same as for MACD. The up-index and down-index lines for ADX do not generate signals with acceptable consistency.

CHAPTER
7

Moving Averages for Direction and Support and Resistance

Three Useful Functions

Moving averages, on their own, comprise one of the most valuable tools of all, and you could build a simple and profitable trading system almost entirely based on them. But you have to know what to do with them.

A moving average consists of the average of the closing prices for the designated number of preceding periods. Using moving averages is therefore like looking in a rear-view mirror. If the land behind you is falling away, you know that you now are going uphill, and if the land behind you is rising, then obviously you must be going downhill. A rear-view mirror does not tell you when the road is approaching a sharp turn or is about to start going up instead of down, or vice versa. Nevertheless, the principle is valid that a trend in force is likely to remain in force until something happens to end it or to reverse it.

There are two things that moving averages do well and one thing less well but well enough to heed nonetheless. The first of the good things is that moving averages indicate the direction of a market, although there is more to know than that. They indicate whether a market is making a potentially sustainable move up or down, as opposed to a sideways pattern, only when there is a clearly established incline. Much of the time they do not indicate a clear direction, and there are many false starts, even when other indicators are supportive.

The second good thing moving averages do well is to perform the same general function as a trendline by providing support or resistance (discussed in

Chapters 10 and 11). Once they establish a clear direction, price should remain above the moving averages in a trustworthy bull market move, or below in a credible bear market move. You then expect price and the moving averages to converge from time to time during the course of an extended move but not, ideally, for price to cross to the other side of the moving averages.

Following on from the principle of convergence, the third thing moving averages do is to suggest when a market may be vulnerable to a retracement. When price has pulled a long way from the moving averages, it follows that the market may be due for a rest or be vulnerable to a setback. The farther price has moved away from the moving averages, the greater is the probability that the convergence will come by way of price retracing rather than by price resting until the moving averages catch up.

Beware of Crossover Theory!

Contrary to popular wisdom, there is one thing that moving averages do not do well, and you have to beware of falling into the trap of thinking that they do. Moving-average crossovers, on their own, don't work. There is no formula for price-crossing moving averages, nor for one moving average crossing another, that works in any market with acceptable consistency.

From time to time, the results of computerized testing have been published that purport to show which duration of moving-average crossovers make the most money in various markets. However, they are based on hindsight, and when they show net profits at all, it is because there are a few huge profits along with a disproportionate number of losses. With most markets moving randomly much of the time, moving-average crossovers also occur randomly, and reversion to the mean—namely, to some moving average—is the norm. The result is that most crossovers fail and reverse direction without an intervening bankable profit. Start or finish trading before or after a big gain or loss, and the net result changes dramatically. The structural defect of any approach based on moving-average crossovers, on its own, is incurable without using other indicators.

Paradoxically, the ineffectiveness of moving-average crossovers is to some extent turned to advantage with Bollinger bands, discussed in Chapter 12. Successful use of Bollinger bands relies, in part, on the expectation that there will not be a sustainable follow-through after price crosses the median moving average, normally a 20-bar average, but instead will stop in the expected range of deviation and then revert to the mean. Depending on the overall situation, therefore, you could be looking to use a moving-average crossover to present an opportunity to buy low or sell high in the expectation of a rebound back to a moving average.

Despite the shortcomings of this misapplication for random crossovers, moving averages are an essential tool when used in conjunction with other indicators.

Settings for Moving Averages

Many traders use a 200-day moving average as the prime determinant of major bull and bear markets. It can show direction and provide pivotal support or resistance for financial markets generally, as well as for markets such as metals and petroleum, which can have very long trends. Trustworthy as this moving average is in general, it has to show an established direction, and in addition, price has to be decisively on one side or the other and must hold there. The 40-week moving average is essentially the same as a 200-day moving average and is correspondingly useful on the weekly chart.

There is hardly a more remarkable example of the effectiveness of the 200-day moving average than what happened when gold and silver crashed in June 2006. The apparent runaway bull market was so far extended that it was the proverbial accident waiting to happen. After collapsing by $185, the price of gold held $2 above its rising 200-day moving average. Silver, the more volatile market, had one close 5 cents below its rising 200-day moving average, by just 6 cents, as it completed its decline of $5.75 (Figure 7-1).

This chart shows no wavering in the direction of the 200-day moving average in June 2006. Potentially more sinister was that the ensuing rally failed far short of the high in May, with price coming all the way back again to the 200-day moving average and silver setting up a decidedly ambiguous chart pattern.

25- and 40-Bar Default Settings

For general use, it is hard to beat simple moving averages with default settings of 25 and 40 bars. In a steadily trending market, and not necessarily a rapidly trending one, it is almost uncanny how price moves away from moving averages with these approximate settings and then comes back again. Then it holds there and goes on again. Given the inherent variability of markets, it is helpful to use both these moving averages side by side. Sometimes one will lead when a trend is starting, sometimes the other, and it doesn't matter which.

The silver chart shows a succession of rebounds after converging toward the 25- and 40-bar moving averages, as well as the one discussed above, from the 200-day, all marked with up arrows. The 25- and 40-bar moving averages even caught silver and held it when it fell like a rock in April. Also note the two instances where price crossed below the 25-bar moving average, stabilized, and then the

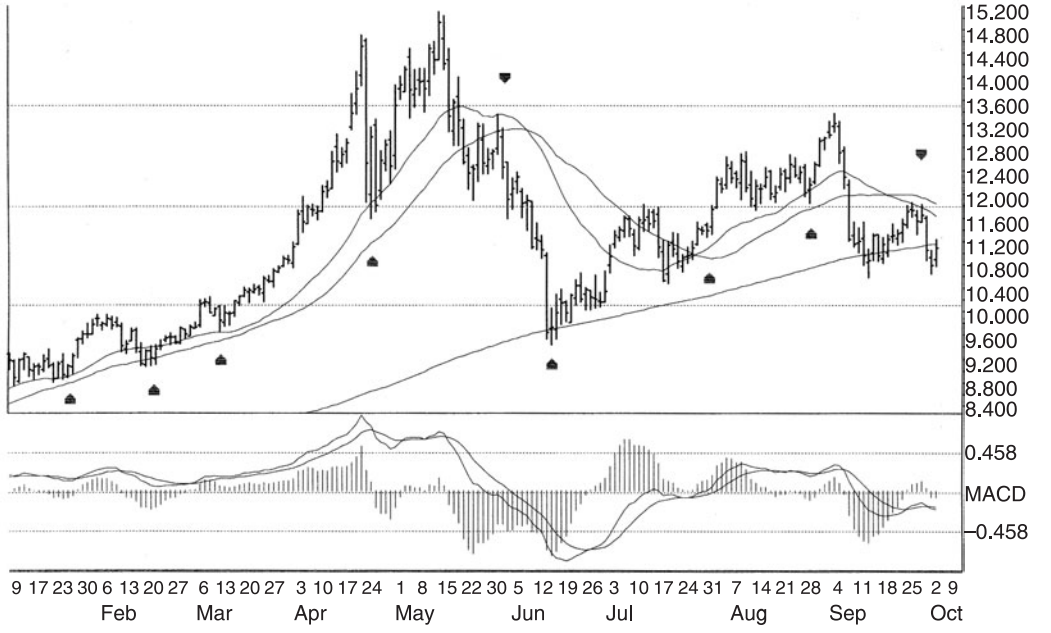

Figure 7-1 Daily continuation chart for silver, with 25- and 40-day moving averages, 200-day moving average, and moving-average convergence/divergence (MACD)

market sold off—in the first of these instances, the 40-bar moving average had not yet rolled over, as sometimes happens. In the event, there was to be almost no follow-through on this second signal, but of course, the decline from the first of them was substantial.

Moving Averages to Fit the Market

There is another way of looking at moving averages that may seem obvious although it receives insufficient attention. A moving average is a form of trendline. The reality of drawing trendlines is that you have to achieve the best available fit with market action on the charts. The more rapidly a market is moving, the steeper the required trendline, or vice versa. Instead, therefore, of relying only on default settings for moving averages, it is often useful to see which one fits best what the market is actually doing. A strongly and regularly trending market has smaller fluctuations and will be contained by a shorter-term moving average compared with a market that has bigger fluctuations and is probably making net gains more slowly.

Although steep trends tend to last only for a relatively short time, some of the best ones can go on for a number of weeks. In the process, they offer the opportunity for huge profits very quickly. They also offer prime opportunities for new entries when the moving average is tested and found to be good.

In a strongly trending market, moving averages with settings of 5, 10, and 20 on the daily chart usually come close to defining the trend. Ideally, the 10-day moving average contains fluctuations when the market is really moving. A setback to the 20-day moving average may just be aberrational. However, it is quite likely that you will not want to stay in a trade to find out whether it is or not once price crosses back over the best-fitting moving average, especially when there are other adverse indications such as gapping. When looking for the best-fit moving averages, you might consider using weighted and exponential moving averages. They are more responsive to recent market action. However, these fine-tuning variations seldom contribute more to what you know already about whether the trend is gaining or losing momentum.

Trends on the 60-Minute Chart

In a strongly trending market, 25- and 40-bar averages often contain price fluctuations on the 60-minute day-session charts and provide support with an almost self-fulfilling effectiveness. During its big bull market, the 40-bar moving average on the 60-minute day-session chart contained fluctuations in the price of crude oil for several months. For markets trading around the clock, it appears, nevertheless, to be better to use the day-session-only chart for this purpose. Despite heavy trading overnight in some 24-hour markets, trading during the U.S. daytime sessions has tended to maintain the underlying direction. With the expansion of 24-hour trading, the 25- and 40-bar moving averages may do much of the same job when applied to the 120-minute chart. That is, keep the moving-average settings, but change the number of units per bar.

You might think that using the 60-minute chart with 25- and 40-bar moving averages would allow for finer tuning so as to capture more profits and fewer losses with smaller retracements. Not so, unfortunately. Even the most strongly trending market, and one contained by moving averages on the 60-minute chart, can fluctuate within the range of a limit move or more, and within the range of the entire original margin, without damaging the major trend. Significant fluctuations within an established trend are an inherent characteristic of all market action, and attempts at more detailed fine-tuning are likely to result in prematurely closing out trades when you should be adding to a position rather than subtracting from one.

Using Moving Averages at the Start of a Trend

It is uncanny how zigzag theory comes into play yet again at the start of a trend. It is easy enough to tell when a trend is established but more difficult to tell when one might be starting, with the market therefore offering a prime entry. The ideal pattern for the start of a new uptrend on any duration of chart is for price to cross above an upward-rounding or a rising moving average and then to consolidate there for a few bars—say, for three or more—to show that it can stay above, as if it were cradled by the moving average. The longer the basing pattern from which the crossover emerges, the more likely the market is to make a sustainable move. You can generally see confirming action in MACD if the apparently developing uptrend is likely to be sustainable.

Best of all is when there is a new consolidating zigzag after the crossover rather than a runaway surge, and there should be a strong conclusion on completion of this zigzag. Continuing with the buy-side example, when there is a sharp upward thrust from below the moving averages, the likelihood of a retracement is very high indeed, and the risk to a new trade is correspondingly high. The risk is much less if you wait to see how the market acts next. A good zigzag completed above the moving averages reinforces the probability that the market has completed any unfinished business by potential sellers, and shows that the thrust was probably more than an exercise in running stops placed by traders who sold short. It serves also to reassure the confidence of buyers already on the long side and encourages more buying. You can see where buyers were prepared to step in to support the market on the last dip, and you can expect them to do so again should the price retrace toward the bottom of the last upturn in the zigzag.

The optimal time to buy after the crossover therefore is on the close of a strong bar completing this zigzag, ideally with a completed price rule. The probabilities suggest that the confirming consolidation has ended and that the price will now follow through immediately. Although some great trades may get away from you by waiting for the confirmation to show that strength is holding, the confirmation is worth waiting for. It reinforces enormously the likelihood that the move will be sustainable, and it usually does happen.

The British Pound Soars

The weekly continuation chart for the British pound shows extended bottoming action for almost a year, with MACD at its lowest level coincident with the first of the prominent lows (Figure 7-2).

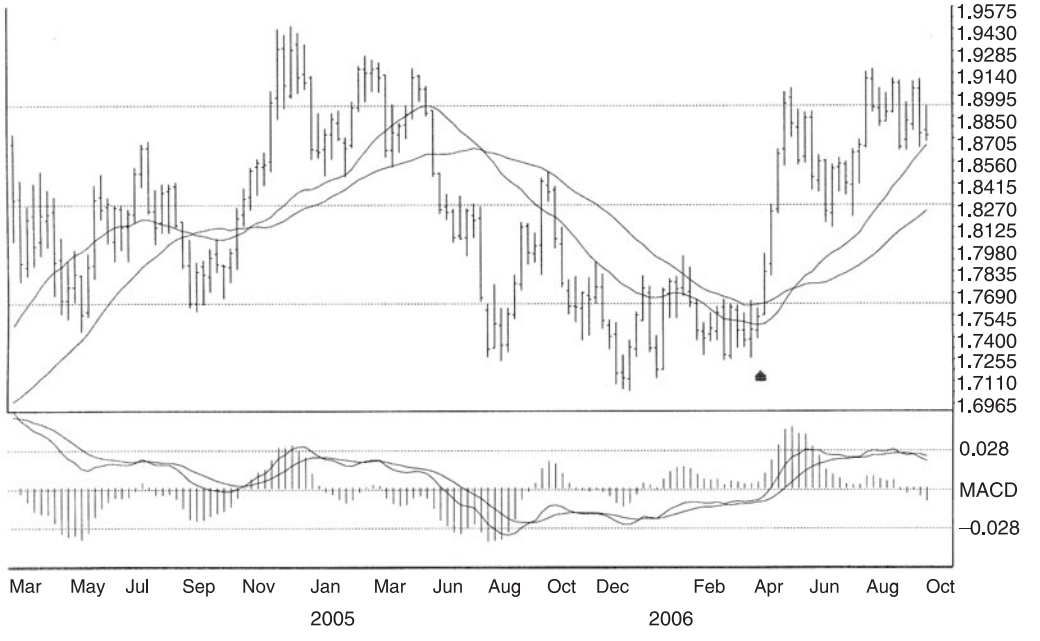

Figure 7-2 Weekly continuation chart for the British pound, with 25- and 40-week moving averages and MACD

However, moving averages were stubbornly bearing down on price until April 2002, when the price crossed after coming out of a tight and prolonged consolidation at the arrow.

The daily chart for the pound shows an apparently successful crossover and the start to a new uptrend, with two possible points to buy, marked with arrows at *A* (Figure 7-3).

However, the weekly chart was still extremely negative. Then the market went sideways in a tight range for the next three months, and then it was time to believe that the market might be ready to go up. Then there were also two possible entries at the start of the trend at *B*, both marked with arrows. This time, both these strong bars signaled possible entries, and the market followed through strongly after each of them. You might have been wary of buying into this market at the second arrow when the market had traveled a fair way. However, this action illustrates the principle that you want to buy a market that shows, by going up, that it can go up. The majority of the move was still to come.

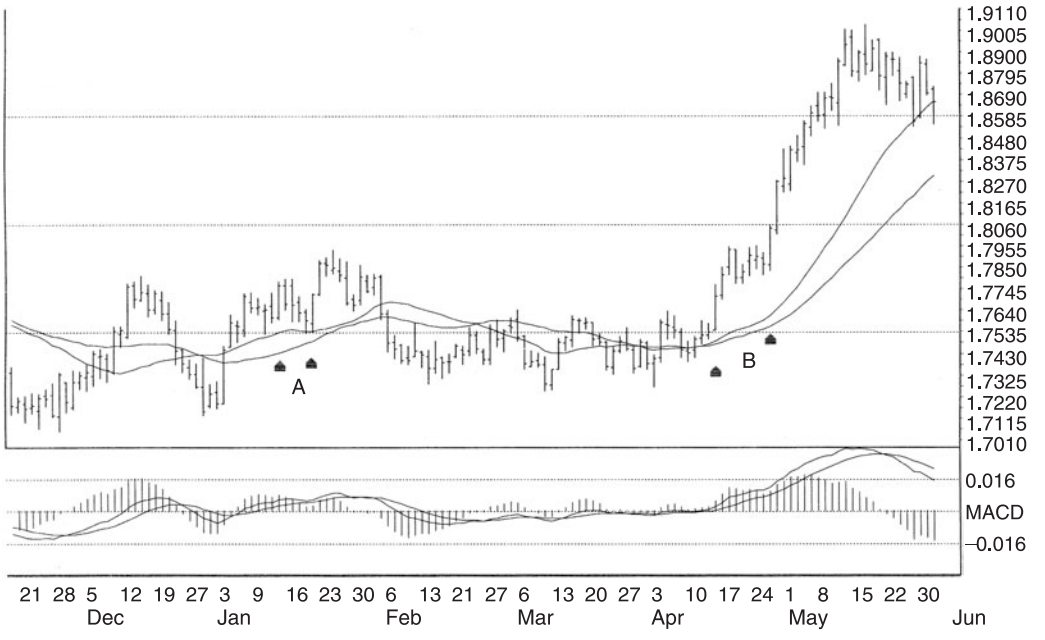

Figure 7-3 Daily continuation chart for the British pound, with 25- and 40-day moving averages and MACD

The Bull Market in Corn

The daily bar chart for March 2007 corn shows a bull move in the autumn of 2006, with price contained by the 10-bar moving average and the 20-bar average showing the major direction (Figure 7-4).

The bull move began with a W in price action during August and September. After the moving-average crossover, there was relatively little of the hesitation to confirm the emerging uptrend, but there was a good high/low upside reversal at *A* (color-coded as a key reversal pair in Ensign software) that set the market on its way. Additional upside reversals occurred at *B* and *C* as the price bounced off the 10-bar moving average.

At *X*, there was an adverse crossover of the 10-bar moving average that occurred in conjunction with a gap. Time to get out! From then on, market action became more volatile and upward progress more labored, although there were to be some reasonable signals. There was a reasonable buy signal at *D*, only to be followed by another essentially mandatory exit at *Y*, to bank a 7 cent loss. It would have taken more judgment and luck rather than a good signal to get into the market for the

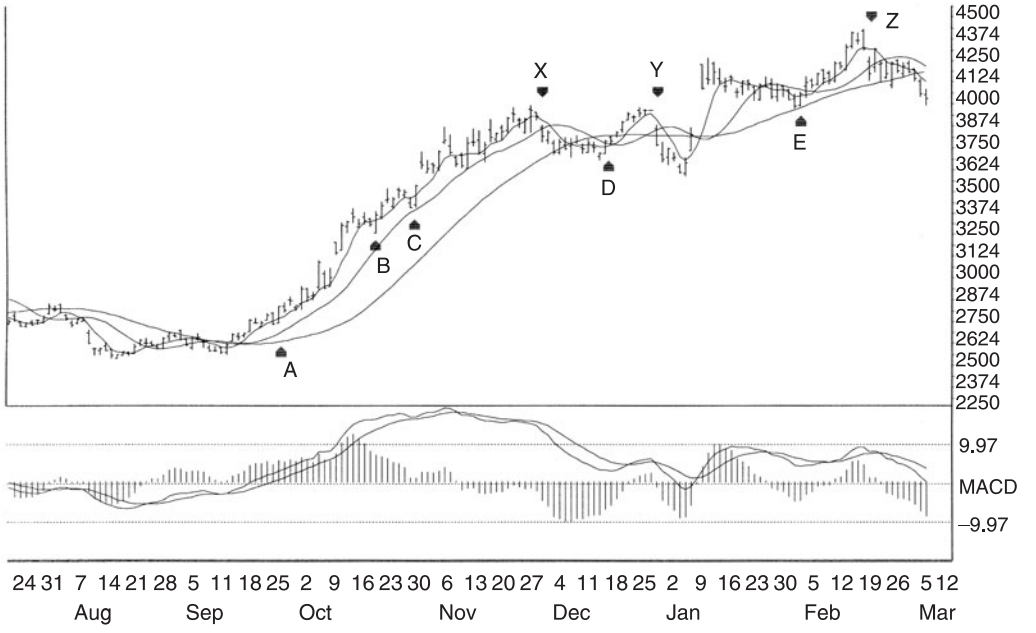

Figure 7-4 Daily chart for March 2007 corn, with 5-, 10-, and 20-day moving averages and MACD

big surge following the production report in January. There was a well-signaled entry to buy at *E*, to be followed a couple of weeks later by a clear eviction notice on the gap down if you had not already acted to get out on the outside down bar that turned out to be signaling the top for the move.

It is interesting to note how MACD started rounding out well before the upturn in price at the end of September. Then it started rolling over well before the initial top at *X* and started trending down. At *E*, MACD suggested that a sustainable new uptrend might now be starting, but it soon rolled over again.

The 60-minute day-session chart for March 2007 corn shows the price contained by the 25- and 40-bar moving averages, as so often occurs during a major market move once it becomes established (Figure 7-5).

Noteworthy is the series of closes just below the 40-bar moving average at *A*. This first adverse close set up the first warning that the move might be flagging. Until then, there was no cause for concern on the basis of this chart. Now you might have started to look for an opportunity to sell into strength in the event of price failing to follow through on a rally. In any event, the fall through the 40-bar moving average at *B* was sufficiently decisive to warrant banking the profit and standing aside.

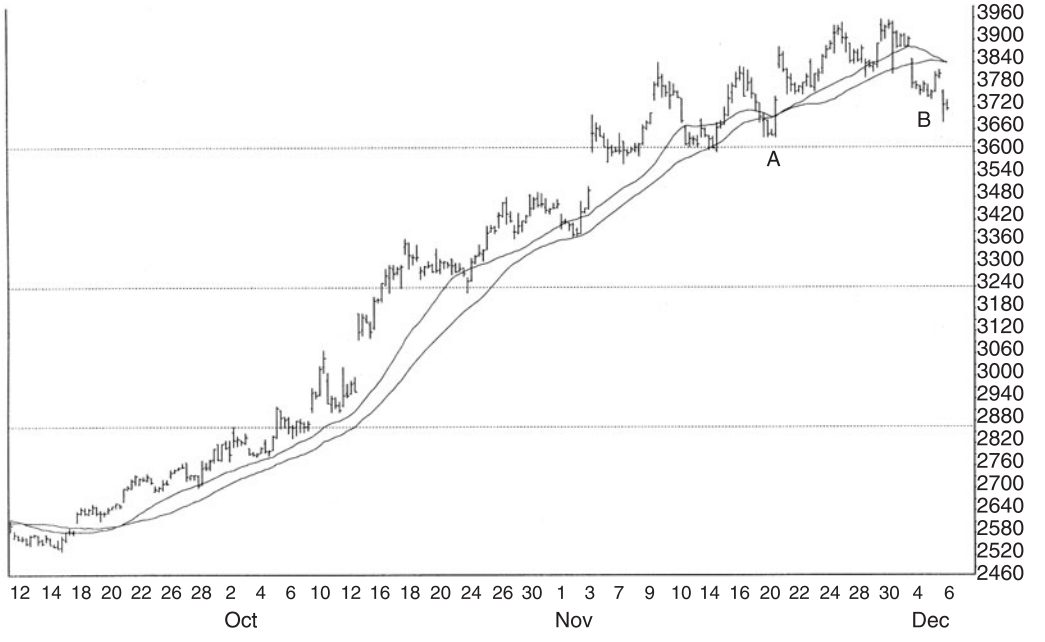

Figure 7-5 Sixty-minute chart for March 2007 corn, with 25- and 40-day moving averages

Sell June 2006 Live Cattle

The daily chart for June 2006 live cattle shows these averages working like a charm with the 5- and 10-bar moving averages, although the 20-bar average turned out in this case to be almost redundant (Figure 7-6).

Here is one of those rare examples where there was to be little of what you normally expect in the way of a rebound and failure in order to establish the validity of the downtrend. The one key failure, occurring late, was the one-day island left behind in February, at the first arrow on the chart. To some extent alleviating questions about the sustainability of the trend was the relentless downtrend established by MACD. There were many reasons to expect a major top in the market, including the extended duration of sideways market action at a historically high price level. Once the slide started, the 5-bar moving average was, in effect, a smoothed surrogate for price, and the 10-bar average contained almost all the move. There was a constant succession of bars inviting new entries all the way down.

Note that this chart shows how the market acted when the move came to its end. Clearly, panic selling extended price farther away from the 10-bar moving

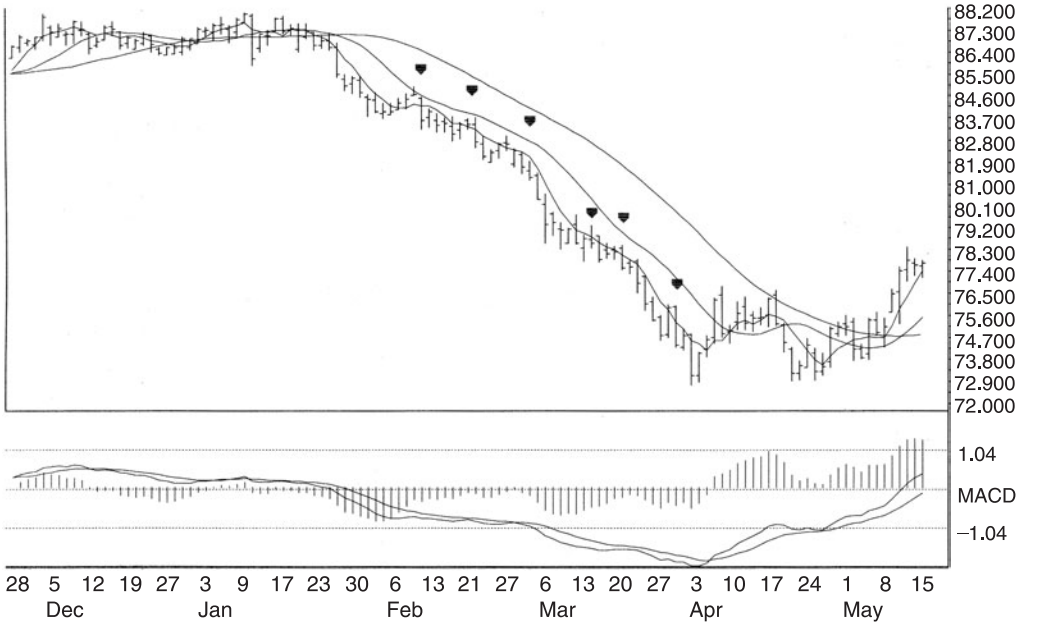

Figure 7-6 Daily chart for June 2006 live cattle, with 5-, 10-, and 20-day moving averages and MACD

average than during the earlier part of the trend, and then the rebound was convulsive. As usual, it was not the first rebound that was to establish the trend reversal, but the second one. One period of adverse crossover, together with a small W on the four-price line, showed that the momentum had gone out of the move. The second crossover signaled conclusively that the trend was reversing, with a big W-shaped double bottom in price and a double bottom within the double bottom on the second of the major lows.

Sell Off the 60-Minute Chart

On the 60-minute chart for June 2007 live cattle, the ever-useful 25- and 40-bar moving averages did almost exactly the same job as the 10-bar average did on the daily chart, that is, until this market started fluctuating violently as the move was coming to an end (Figure 7-7).

The 60-minute chart was to contain the entire move with uncanny consistency, and there was a succession of reasonable entries to sell short all the way down when price was hugging the underside of the moving averages. Equally important

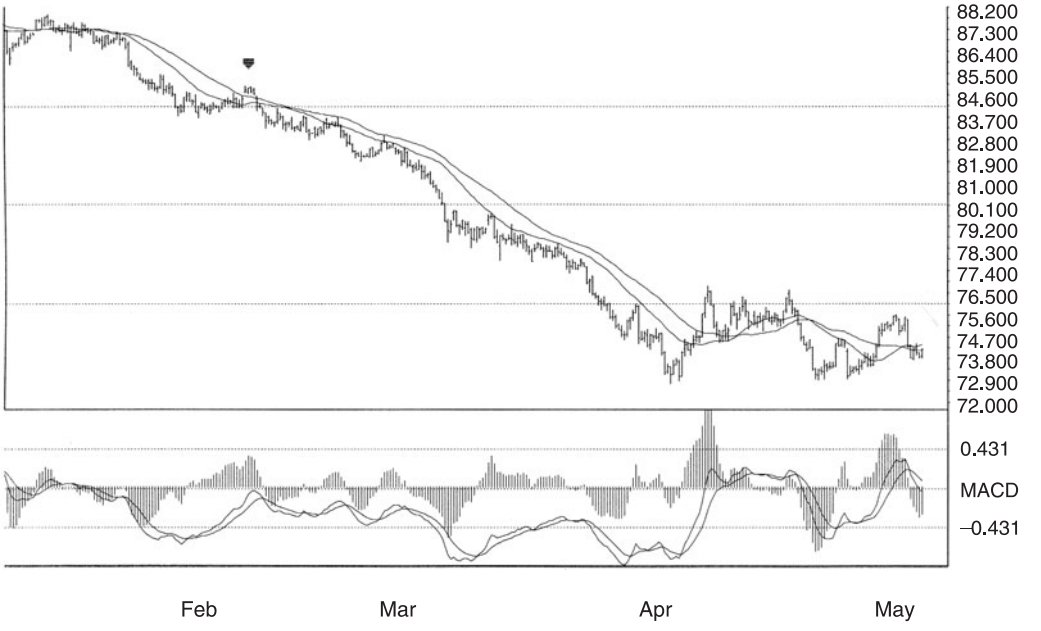

Figure 7-7 60-minute chart for June 2007 live cattle, with 25- and 40-bar moving averages, and MACD

to note is the higher risk when the price pulled away from the averages and the increased likelihood of at least some attempt at consolidation.

Summary for Moving Averages

1. Moving averages indicate the direction, but only when they there is a clear incline established on the applicable chart.
2. The default setting is to use 25- and 40-bar settings, but use best-fit settings of shorter duration in a strongly trending market.
3. Look to buy when there is an established uptrend, and price retraces to the moving averages and shows that it can hold and turn so that the trend resumes. Look to sell when there is an established downtrend, and price shows that it can hold and turn down again.
4. In a powerfully strongly trending market, the only retracements may be to moving averages on the 60-minute chart and none for a long time even to the averages on the daily chart, let alone the weekly chart.

There are almost always consolidations for two or three days from time to time that permit price to converge with the moving averages on the 60-minute chart before going on its way again. It is remarkable how the 60-minute chart, using day-session-only prices, sometimes contains price retracements for a very long time, sometimes for many weeks. For 24-hour markets, use the 120-minute chart.

5. Initial moving-average crossovers are unreliable. Instead, look for a retracement and a successful test back toward the moving averages, and look to see whether they are now confirming direction, in order to establish the potential credibility of a new trend.
6. Beware of entering a new trade when price has pulled a long way from the moving averages.

   The farther price moves away from the moving averages, the more overbought or oversold the market becomes, and the more vulnerable it is to a retracement, possibly a violent one. On its own, distance from the moving averages requires judgment and is not readily amenable to calibration except by application of tighter moving averages. Therefore, look to tighten stops and be prepared to get out if the market starts to falter.
7. One adverse moving-average crossover may be an aberration and no cause for alarm if the market gets going again in the direction of the trend. However, beware of a second adverse moving-average crossover, particularly when it occurs in conjunction with flagging momentum or adverse gapping.

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CHAPTER
8

Stochastics and the Relative Strength Index (RSI): Overbought/Oversold Indicators

When to Buy Low and Sell High

Stochastics constitute the single most valuable indicator, apart from price action, for pulling the trigger to enter or to close out a trade. This indicator actually has four distinct functions, two positive and two negating. First, the more general use of stochastics is to pursue the elusive objective of buying low and selling high and to do so primarily within the confines of the major trend and secondarily at potential major turning points. The second confirming function, which stochastics share with moving-average convergence/divergence (MACD), is to indicate momentum and direction, and some technicians use this indicator primarily for this purpose, particularly on long-term charts.

In addition, stochastics serve two correspondingly vital negative functions, indicating when the probabilities are unfavorable for a trade on the basis of the specific chart you are looking at. The first invaluable negating function is the counterpart of showing when there may be an opportunity to buy low or to sell high. It is to warn against doing the opposite. It is one thing, to take the buy-side example, to buy in the expectation that the price will go higher still. It is quite another to buy when so much firepower has been spent that the line of least resistance may turn out to be down. The second crucial negating function is to warn of adversely trending stochastics that show when momentum is going against the direction of a current or prospective trade.

Settings for Stochastics

The patterns for stochastics and MACD look similar when they are both set up with data of similar duration. However, stochastics are generally used with settings consisting of fewer units of data. Like MACD, stochastics consist of two lines, the fast one, %*K*, and the slow one, %*D*. An important difference is that stochastics oscillate between zero and 100, whereas there are no outer plus-or-minus limits for MACD.

There are three components of the equation for stochastics calculated for standard use. The first is the number of units—as in hours, days, or weeks—from which the ranges are extracted. George Lane, developer of this indicator in the 1950s, recommended using 14 units, but most technicians now prefer to use a setting between 9 and 12 units, and this book works with 9. A setting of 14 provides a better compromise if you use only this indicator. Better still is to use stochastics with the shorter setting in conjunction with the more broad-brush MACD based on more back data.

The value between 0 and 100 represents the relation of the current price to the highest high and lowest low of the last *n* bars—the designated number (using here nine bars). For the basic equation, the current price is compared with the high-low price range of the last nine bars. The value will be 100 if the current price is equal to the highest high of the last nine bars. It will be 0 if the current price is equal to the lowest low of the last nine bars. The value will be 50 if the current price is exactly in the middle of the price range of the last nine bars. From the initial number of periods used comes the first smoothing to produce %*K*, the fast line, by way of its own average, normally of three units. The %*D* slow line comes from a further smoothing, normally also of three units.

As we see from Chapters 4 and 5, the range is very significant as an indicator of potential direction and momentum, particular when the closing price leaves a substantial range behind, as with a key reversal. A significant retracement in price within the range for a single bar can make stochastics change direction. Unlike stochastics, the popular *relative strength index*[1] (RSI), which performs a similar function, is based on the closing price and does not notice that anything remarkable has happened when there has been a wide swing in the range. You need to pay attention when that happens.

[1]The name for this indicator is a misnomer because it is illogical to say that anything is relative to itself. Nevertheless, this is what this indicator is called universally.

Buy Low, Sell High

Stochastics indicate when price may have reached a favorable level to buy low and sell high. Primarily, you buy low on a retracement in a bull market and sell high on a retracement in a bear market. Secondarily and exceptionally, you may look to buy when price has reached an extreme low and shows that it can hold or sell at an extreme high when there are indications that the upward thrust is likely to fail, with price reversing downward. It may be enough to close out a profitable trade when stochastics reach an extended level. However, it pays to wait for evidence that the market can stop and set up to go the other way again before entering a new trade.

The idea is that stochastics show when the market may be at or near an extremity and when the firepower of buying or selling may be at or near exhaustion. Then the impact on price may be like the release of a rubber band that has been stretched and is suddenly released. With many traders using stochastics, as with most standard indicators, awareness of overbought and oversold stochastics levels tends to make their impact on price action self-fulfilling. However, there is a challenge beyond this apparent statement of the obvious. You have to be aware of a psychological component to the challenge of using stochastics to buy low or to sell high. Even under the best of circumstances, it can be difficult to believe what you see at the moment when stochastics make the turn that generates a signal to act. It is all too tempting to wait for further price action to confirm what stochastics have already indicated. By time the expected confirming evidence comes through, the entry to a new trade may be at a much less favorable price, and the stop loss may be expensively distant.

Stochastics at Market Turns

These factors come into play when %*K* turns at the start of a potential new move in price that may be suggested by overall chart patterns and other indicators, but not necessarily all of them at every turn, and not necessarily in this sequence:

1. First turn, ideally from an extended level.
2. M or W ideally with a lower high for a potential top or a higher low for a potential bottom—often the prime moment for a new entry on completion of the bar making the M or W.
3. Zigzag established with a third high or low.
4. Confirming turn in %*D*.

5. %*K* crosses %*D*.
6. %*K* reaches the target and exceeds the oversold level of 20 in a declining market or 80 in a rising market.

A relatively infrequent variation on these steps occurs when %*K* just makes a single turn without making an M or a W and continues until it reaches an extended level. Then it may be far more challenging to get into a trade. Normally, %*K* makes a second higher low or a second lower high in parallel with price doing the same thing. Yet another variation occurs when stochastics lead price, making the pattern called *negative divergence*. There is a new M or W in stochastics but not yet in price. Stochastics, in their function of expressing momentum (discussed next), may be delivering the correct indication of future price action.

Showing Direction and Momentum

It is useful to think of stochastics as a surrogate for price, complete with M's, W's, and zigzags, as well as with this indicator having the capacity to establish its own trend with a corresponding trendline. %*K* crossing %*D* confirms the trend. As with MACD, the principle holds that price is likely to continue moving in the same direction as stochastics once this indicator establishes a trend. Aberrations in price are likely to be no more than noise on the line until stochastics falter.

Contrary to what might seem logical, however, a correction in price and a reversal in stochastics may not lead to price making much of a retracement. The market may just go sideways, as happens when moving averages have to catch up with price instead of price retracing to the moving averages. After an upward move in price, for example, stochastics can go down a long way, even taking %*K* below 20, as a market consolidates its prior gains. Then the next leg up in price may be significant once it starts, and an upturn in %*K* is likely to be a reliable signal to pull the trigger on a new long position.

Stochastics May Indicate Power

Stochastics sometimes exhibit a function that shows powerful momentum and appears to contradict the concept of buying low and selling high. Stochastics reach an extreme level, above 80 or below 20, and more or less jam there when a market is moving relentlessly up or down. For this reason, many technicians underrate the usefulness of stochastics in a trending market. However, it is exceptionally valuable to know that a market is trending strongly, and there is nothing wrong with

the way stochastics perform this function. It is this kind of market condition that leads some traders to buy, successfully, each new high in a soaring market or to sell, successfully, each new low in one that is collapsing. Stochastics may indicate vulnerability, and there are better and less good times to enter new trades in a rapidly moving market. Nevertheless, in this kind of market condition, extended stochastics levels serve as a reminder that there is no price so high that it cannot go much higher. Correspondingly, there is no price so low that it cannot decline much further.

Depending, therefore, on chart patterns and support or resistance levels, there are times when the bromide of stochastics' contrariness, showing an extreme overbought or oversold level, may be unhelpful. It can sap courage just when you need it most to get onto a rocket taking flight or to get onto a falling rock at the moment when the supports are shattering. In the final analysis, there is no substitute for experience and good judgment to assess the balance between risk and reward. However, even when you are wrong to assume the potential for a market to continue to skyrocket or to plunge, there will be no doubt that you will be getting on board what looks at the time like the ultimate in trend-following moves. Some of these supercharged moves fail, of course. However, the ones that succeed should make up for the failures many times over, and it may seem paradoxical that the ones most likely to be successful are the surges that are most powerful. This kind of runaway bull move often occurs in conjunction with readily identifiable fundamental factors such as the hurricane that struck the petroleum market in 2005, or the long-lasting supply crunch in copper that began in 2003. On the other hand, a collapse may occur as the result of a bubble bursting, with the lack of bids creating a vacuum under a market that had gone up with hopelessly insufficient economic justification.

In sum, extended stochastics levels signal the need for caution but by no means an embargo when considering a new trade. The risk—a very real one that stochastics highlight—is that once a correction starts in a runaway market, there may be little guidance available as to how far it might extend.

Then you may face a difficult challenge, both financial and psychological. The remedy for achieving an acceptable balance between the prospect of a huge gain and a correspondingly painful loss is to trade within your emotional and financial capacity, not to pass on trades having parabolic momentum.

Directional Applications for Stochastics

1. Any turn in %*K*, even at a high or low level, constitutes a *potential* signal on completion of the bar which makes %*K* turn.

2. An M or a W in %*K*, or a confirmed zigzag, confirms the validity of a turn, and reinforces the probability that %*K* is showing the way for price.
3. There is a confirming *condition* for a buy when %*K* is trending above %*D*. Also, there is a confirming *condition* to sell when %*K* is trending below %*D*.
4. At the potential start of a move in the new direction, it is useful to draw a trendline when a double top or a double bottom in %*K* occurs.

   A trendline on %*K* indicates the persistence of a trend in both stochastics and price, and a break in the trendline may suggest the end of the current move in price. However, in a powerfully moving market %*K* can lock beyond above 80 or below 20, and then a broken trendline may not be significant.
5. On its own and in a powerfully trending market, an aberration by %*K* from a level above 20 or below 80 may provide the opportunity to enter a trade in the direction of the trend rather than requiring an exit, let alone a trade in the opposite direction.

The Negating Function

The negating function that stochastics performs is quite straightforward and requires less explanation than its confirming functions. As with confirming indications for a trade, stochastics deliver two varieties of negating indications, one for an overbought or oversold condition and the other showing negatively trending momentum. There is an important factor to consider when looking at the negative application of stochastics. The practical effect is to raise doubts about a certain proportion of trades that look good, and you pass on some trades that would have made money. This is not the point. There is hardly a consideration more important than raising the probability of success. Therefore, filtering out potential losers is disproportionately valuable even if it also means filtering out some winners. Having stochastics on your side puts the wind behind you, and there is an element of wind against you when stochastics are emitting negating indications.

Given the emotional component of trading, it is inordinately seductive to buy at or near a significant top or to sell at or near a significant low, which may be when you should do the opposite of what you think you want to do. Of course, you would not be considering a trade if you had the foresight to know that the market was about to start retracing, possibly violently. However, stochastics indicate when the condition for a reversal is in place and when the risk is significantly higher. From the perspective of the buy side, what goes up a long way may, at the very least, need to rest as some traders take profits and others, including producers, enter new short positions. It by no means follows that there will be a major retracement, let alone a collapse just because a market has gone a long way. However, the immediate room for the market to move down may be greater than the immediate room for it to

move up. When, at the extreme, there are no more buyers left at the plate, there can be a vacuum under the market with no supporting bids on the way down. Similarly, even the most precipitous collapse runs out of sellers eventually and is met by profit-takers on short sales and a few nibbles at the long side of the market.

Although momentum, as represented by stochastics, may precede price, most of the time stochastics and price go hand in hand. By extension, %*K* is likely to continue in the same direction until it shows that it may be ready to reverse. On whatever chart you are looking at, the probabilities are, therefore, against price bucking the trend of adversely inclining *%K*. It happens often, of course, that price and stochastics turn at the same time, and that may be the exact moment to enter a new trade or to consider getting out of an existing trade.

The Negating Applications

Thus %*K* counts as a negating indicator:

1. It is an overbought/oversold negating indicator when %*K* is at a level below 20 for a short sale or above 80 for a long trade.
2. It is a doubly negative overbought/oversold indicator when %*K* is below 10 or above 90, and for all practical purposes amounting to an embargo on new entries.
3. It is a negative-trending indicator when pointing in the opposite direction to a trade.
4. It is additionally negating when there is an adverse M or W. An adverse zigzag consisting of a triple adverse top or bottom is almost a mandatory embargo and may well contribute toward a new trade in the opposite direction.
5. It is an additionally negative trending indicator when it is below %*D* for a long position or above %*D* for a short position.

Stochastics on the Weekly Oil Chart

The weekly continuation chart for crude oil shows stochastics working in conjunction with moving averages to indicate when the probabilities were favorable to go long and when they were unfavorable (Figure 8-1).

It was almost always right to be looking for an entry to go long when one of two things happened. First, it was almost always favorable when there was a W or a double bottom in stochastics even, as in September 2004 and in March 2005, when the second low was a long way off the bottom. Stochastics theory holds that the much higher low is a sign of strength, not of vulnerability.

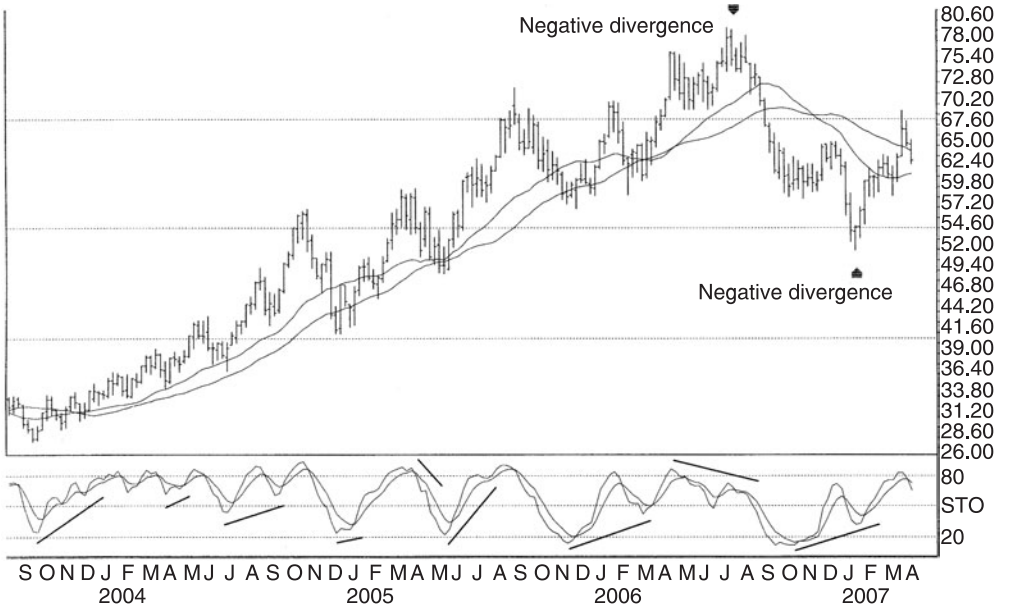

Figure 8-1 Crude oil weekly continuation chart, with stochastics and 25- and 40-week moving averages

Note particularly how stochastics and price both crested at highs in October 2004, April 2005, and September 2005, when price was conspicuously far from the moving averages.

The high in July 2006 fell in place with a pronounced high/low reversal and was confirmed three weeks later on completion of a new closing price reversal and a Lindahl sell signal (rule 5). The tipoff that this could be an important top was the extreme negative divergence in stochastics.

The one really substantial failure for stochastics occurred in the weeks toward the end of 2006. %*K* developed a clear W at 12, well under the oversold level of 20, and then started traveling upward above 20, but without doing much for price. Once this small rally crested, of course, the market was to plummet down to the eventual low, from which it turned up with a perfect example of negative divergence. When you get this kind of divergence, it often pays to think in terms of %*K* as a surrogate for price on the principle that the probabilities favor price developing the momentum that %*K* suggests that it ought to have.

Just as important as all the positive confirming indicators was the way adversely trending %*K* indicated when the upward thrust had gone out of the market. There was seldom much to be gained in trading against the direction of %*K* despite the

fact that oil was in a major bull market. It required much fortitude and unnecessarily deep pockets to finance the drawdown when oil was retracing. Carrying long positions through the many and deep retracements would have made it difficult to justify buying more as those retracements were ending.

Another feature of this chart is the way it shows just how few prime entry points there can be for a really major trade and how it pays to be patient when looking for really strong entry points. In all the three and a half years covered by this chart, there were only a dozen or so prime new entry points on the basis of stochastics, moving averages, and market action on the weekly chart. But what great entries those were! Certainly, there were more entry points on the basis of daily charts but more by way of add-ons than as prime initial trades.

Cattle Show the Way

The daily chart for June 2007 live cattle for the period between September 2006 and January 2007 shows stochastics functioning as you expect, with stochastics in the panel above and MACD below (Figure 8-2).

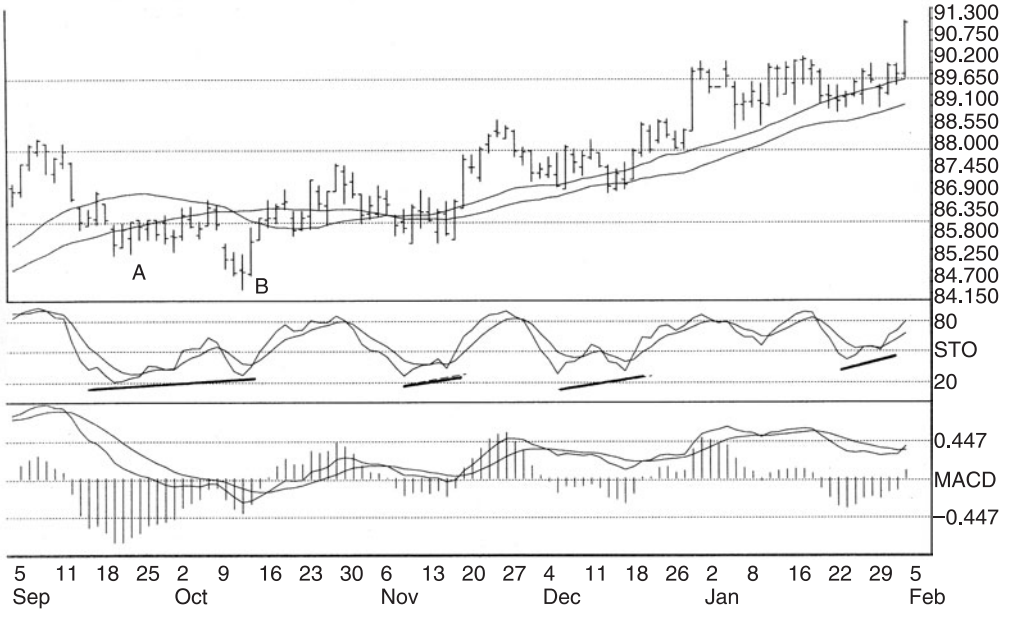

Figure 8-2 June 2007 live cattle daily chart, with stochastics, MACD, and 15- and 40-day moving averages (to February 2007)

Note the low at *A* and the lower one at *B*, occurring in conjunction with a higher second low in stochastics—a textbook example of negative divergence. Subsequently, you can see how this market was moving erratically and rather slowly upward and, after mid-November, above the rising 40-day moving average. It is notable that each single upturn in %*K* had an insignificant impact on price, but the market moved to a new level each time %*K* made a W with a second and higher low. Action in MACD was lackluster, but it is notable how the histogram was coming out of a clear low and turned positive exactly on the final bar of the chart illustrated here, on the breakout.

Now the daily chart for the same contract for the period between November 2006 and March 2007 carries market action forward from the breakout at the beginning of February. %*K* now more or less jammed above 80 for six weeks and two small blips below 80 provided a new opportunity to buy rather than to get out prematurely (Figure 8-3).

Note that peak momentum, as measured by %*K*, occurred at *A*, although the price was to go higher. At the top, there was a conspicuously lower high in %*K*. Not only that, but the price had by now extended so far beyond the moving averages that it should have been straining credulity to believe that this market could continue skyrocketing. Price had indeed broken above the upper channel line, and

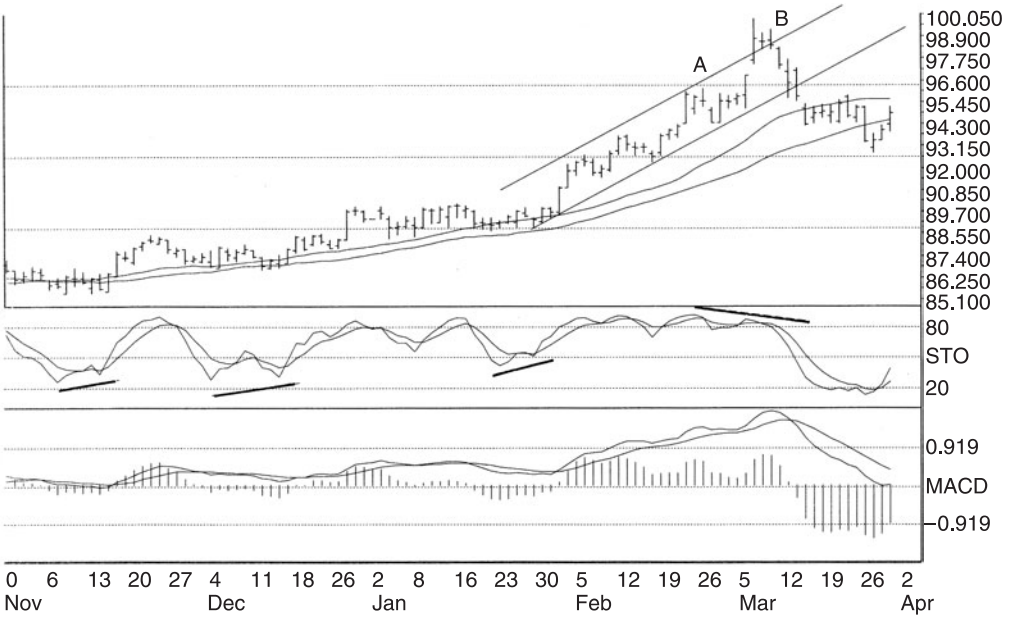

Figure 8-3 June 2007 live cattle daily chart, with stochastics, MACD, and 15- and 40-day moving averages (to April 2007)

according to some textbooks, this suggested that the market might manage to hold above it and continue to accelerate higher. However, the probabilities are not generally favorable for such an extension; on the contrary, you should be looking to take a profit on the least sign of hesitation. Much more usual is the sharp retracement that actually occurred here. There were many and good reasons, and there was plenty of time, too, to get out in the early stages of the retracement, with a series of gaps down and low closes culminating in price breaking the uptrend line that had been in force for six weeks.

Once the price topped out, stochastics kept trending down. Despite upward-inclining moving averages, there was no reason to expect the price to hold and move up again, let alone move up strongly, seeing that %*K* was relentlessly trending downward, as was MACD. This is a good example of how adversely trending %*K* signals caution verging on an outright embargo. In the event, cattle were to make a worthwhile move out of the low once %*K* rounded out with an erratic triple bottom below 20 and then crossed above %*D*. However, market action was extremely erratic, and indicators were suggesting that the prospects were too ambiguous to have much faith in resumption of the uptrend.

The Relative Strength Index (RSI)

The RSI duplicates what stochastics do, and its equation is a variation of the same concept. The RSI is useful as a supplement to stochastics when you want to take another view of underlying forces. It is both a strength and a weakness that is based on closing prices rather than on the range for the bars in question. It is a strength because of the importance of the closing price. It is a weakness when there has been a substantial reversal bar back to the level of the previous closing price. Then stochastics respond with a turn, but RSI takes no notice.

A setting with 9 periods is in common use, and with this setting, RSI provides another useful way of looking at a chart. As with stochastics, there are two functions—direction and the one indicating an overbought or an oversold condition. To confirm the trend, you really need a zigzag and ideally also a crossover of the 10-bar moving average for RSI. There is an overbought condition for this setting at 70 and an oversold condition at 30, although it can go to significantly more extreme levels.

RSI and Lean Hogs

The daily chart for April 2007 lean hogs shows the 9-bar RSI plotted against its 10-bar moving average (Figure 8-4).

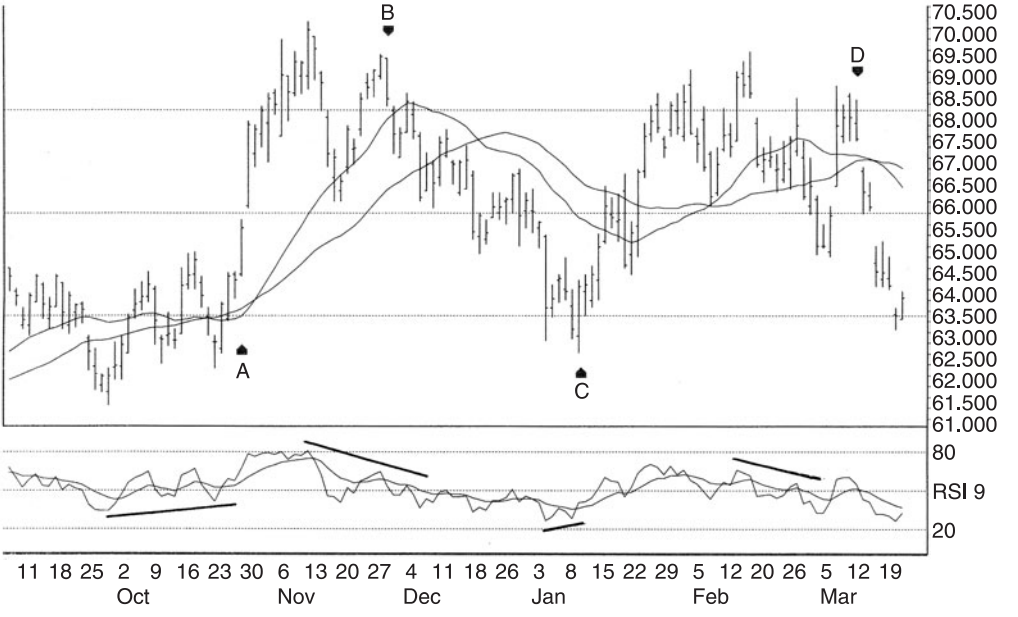

Figure 8-4 April 2007 lean hogs, with RSI

In October 2006, the market was evidently attempting to find a low, with erratic action in both price and RSI. There was a clear conjunction of confirming price action and an unmistakable W in the RSI on the breakout. It would have been hard to enter on the basis of the daily chart when price had traveled 4 cents already, but there was to be a further gain of 5 cents before the move ran out of steam. Here is a good example of how you might use the intraday charts and short-term trading techniques to achieve a much better entry rather than sitting on your hands while the market is running.

When the market turned quite hard down at *B*, you could see, on that first day down, how RSI was showing that peak momentum had already occurred two weeks earlier. From that point, both price and the RSI were to trend erratically lower, with price holding below a clear trend line (not shown).

At *C*, RSI made a small positive divergence, with price making a lower low. Of course, by that time price was all the way back to the support level in the vicinity of the October lows. It was to be a bumpy ride uphill, but market action and action in the RSI were quite decisive at the top at *D*. The market refused to fill the gap at 68.50 on a closing basis, hard as it tried for four days. This was enough to get RSI rolling over, showing that in all likelihood the gap would never be filled on the close and that the line of least resistance was down.

A great challenge altogether for the futures trader is to find markets having significant potential at an early stage of pattern development. Yes, you want to get into a market that shows, by market action, that it can move. However, you need to be wary of getting caught flat-footed when a market is already running, and may stop in its tracks at any moment. Readiness requires being able to foresee what could unfold. There is hardly a better tool than RSI for providing this insight when there is a double and ideally a triple bottom at a low level or a double and ideally a triple top at a high level.

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CHAPTER
9

The Magic of Gaps: Three Bars Open and Go!

Changing Perceptions

There is hardly a more important indicator, both for entries and exits, than gapping. It shows an abrupt change in perceptions and it can be the precursor of a major move. Therefore, you have to be wary of holding any trade on the wrong side of gapping action, and you may well want to be going with the flow of a gap. It is not that every gap necessarily leads to something more. It is that sometimes dramatic market action, or at least a shift in underlying forces, starts with gapping, much as a shift in market dynamics may begin when stochastics have been at an extremity and then turn. Much of the time, but by no means always, you can tell which gaps may be significant, such as when there is the additional confirming action that makes a rule 3 price rule. Even then, of course, you have to look at the price rule in the context of other factors.

All gaps show a surge in buying pressure when the gap is upward or in selling pressure when it is downward. The surge may not last, which is another question, but it still expresses the immediate uncorking of traders' aggressiveness in the market. Many gaps are insignificant, but enough of them occur just at the moment when a sharp move starts that traders must heed them. There could be a snowball effect, with a move in the direction of the gap feeding on itself, and there could at the very least be a reversal of the intermediate trend. Gaps may be particularly significant on the weekly chart when there is a change of perception between the close on Friday and the opening on Monday morning.

Normally, a gap is defined as a blank space on a chart with a bar having no direct connection to the preceding bar or group of bars because no trading has occurred at the intervening prices. As a rule, the bigger the gap, the more significant it is likely to be. Nevertheless, it is also valuable to extend the conventional definition of a gap. Watch for any gap when the opening price gaps away from the previous day's close regardless of whether or not there is a complete separation between the bars. Most important then is whether the current bar closes, in the direction of the gapping, beyond the previous close. A temporary but failed attempt to regain the previous close reinforces the interpretation that the gapping may be the start of something more significant.

Types of Gaps

Although you may not know the significance of a gap until later, it is useful to think of gaps coming in different varieties. Then you can be alert to what may be starting.

The Common Gap

A *common gap* can occur at any time. Often occurring within a congestion area or in an indecisive sideways market, a common gap may be filled within a few days by price moving back to establish a connection with the other bars on the chart. Of course, you never know until after the event whether this will happen or whether you are looking at the start of a breakout to a new price level. The gapping action increases in significance when there is a strong close in the direction of the gap. It is also exponentially significant when there is a succession of gaps in the same direction, even small ones, as occurred before corn took off in September 2006.

When there is an established trend, an open in the opposite direction to the trend may result from routine profit-taking, and there is no significance whatever if price goes back through the unchanged level for the previous bar. It actually strengthens a trend when profit-taking occurs and is absorbed successfully. Ideally, in a strongly trending market this should happen on the daily chart within the first hour of trading.

The Breakaway Gap

A *breakaway gap* occurs when price breaks away from a congestion area and never looks back. It is a reliable indicator of important buying or selling power. It suggests that a major move may be just starting, and you want to get on board. At the very least, you almost certainly want to get out of a trade going against you after

a breakaway gap is confirmed by price following through in the direction of the gap. You may also want to consider a double order to get out of an existing position that is going against you, and to reverse it. (If you are faced with such a decision, however, you have to question how you came to be in that first trade. It is relatively seldom that a breakaway gap comes out of nowhere without first setting up for a move in that direction.)

Although it can be alarming to see how far price has moved on the first day of a breakout, the rule of thumb is that the more powerful the breakout, the farther price is likely to go, and the more reliable the breakout is likely to be. Consequently, there is unlikely to be another chance to trade at a more favorable price and with a more manageable risk than by trading right away.

Overall, the probabilities in favor of a substantial reward generally far outweigh the risk of loss when there is a breakaway after a good preceding setup. Then you need the courage of your convictions to pull the trigger on a strong signal—the ones that have the best ratio of probable reward to risk.

Gaps Based on Overnight Action

A variant on the breakaway gap is the one based on day-session action after an overnight surge. An important feature of this gapping action is the way differences show up on day-session-only charts compared with ones reflecting trading around the clock. Gaps occurring between day sessions reveal significant surges in pressure to buy or sell, whereas there may be no visible breaks on charts for continuous trading. It is remarkable how often it happens that you can make money right away by taking a position on the open of the day session with the expectation that there will be follow-through from strong market action overnight. When there is a break in time, as in grains and soybeans, a conspicuously strong close in either direction right at the end of the overnight session often results in a worthwhile gap beyond that level when the day session opens, and the move goes on from there.

The Runaway Gap

A *runaway gap* occurs in a market that is continuing to tear away in a major run. These gaps occur when a market starts to go straight up or collapses downward. They are sometimes called *midpoint gaps* or *measuring gaps*. The idea is that they tend to show up around the midpoint of an apparently nonstop move. Nevertheless, this is only a rough rule of thumb for estimating how far a runaway move in price might go before it stops for breath.

Quite often you can see a market setting up on the intraday chart for a runaway gap, and there may be an opportunity to anticipate it on the close of the

preceding day. If you miss trading into the close, then there may still be a superb opportunity to get in on a gap open occurring after a day or two of consolidation.

This configuration often offers a very good ratio of reward to risk for a new trade or adding to an existing one. Again, as with breakaway gaps, it is worth emphasizing the point that the strongly trending market is the one most likely to continue. Depending on the chart pattern, there may be marginally less risk in trading in the direction of an upward gap in a bull market than a downward gap in a bear market.

The Exhaustion Gap

An *exhaustion gap* occurs at the end of a move, and you might think of it as a runaway gap that doesn't run. You know only after the event that there has been an exhaustion gap, after price has filled the gap left behind on a closing basis, and particularly when the market has gapped back the other way and left an island behind, discussed next. These gaps often occur as a result of climactic or panic buying or selling. When it is all over, the price can go the other way very fast. The setup for an exhaustion gap generally occurs when stochastics are at a very overbought or oversold level. There may also be other indicators of where price might stop, such as previous levels of major support or resistance (discussed in Chapters 10 and 11).

The potential for an exhaustion gap coming through increases exponentially when price has gapped in the direction of the trend and has reversed to close near the opposite extremity even if the price fails to make it back to the unchanged level. Candlestick charts reveal this potential with a *doji*.

The Island Gap

An *island gap* is the counterpart of the exhaustion gap, proving the exhaustion of the aborted gap in the direction of the trend. It consists of one or more days of trading where there is a gap on the chart in both directions. It is often the ultimate manifestation of exhaustion at the end of a major move and it assumes greater significance when the new gap leaves several bars behind. Then it signifies that those driven by the emotions of greed or desperation—the latter on the wrong side of a squeeze—have truly finished doing the wrong thing.

While island gaps occur relatively seldom, when they do, there may be the end of a major move and a trend reversal. It is often hard to believe that a move ending in exhaustion with an island can go a very long way, partly because there may seem to be a long way from the outer extremity to the current price. Nevertheless, the general rule is that the probability of success is proportional to the power of

the reversal. Therefore, an island may indicate a prime entry to a very good trade on completion of a strong daily close.

Three-Bars-Open Theory

Three-bars-open theory brings together all the wisdom of gapping so as to forecast future market action with almost magical reliability at the start of a potentially big move. Price makes an initial gap on the first day, and the gap remains in good standing for three days or more. This market action shows that the gapping may signify much more than a random aberration. In the ideal circumstances, the price does not take flight immediately but simply consolidates the gain achieved on the first day. Then the resulting consolidation should provide the springboard for the next surge.

The basic rule is to enter a new trade on a strong close of the third day in the direction of the gapping. Depending on overall market condition, you can shorten this to just two days when there is convincing market action and particularly when the intraday chart suggests the possibility of a gap on the open of the next day. If there are more than three days of consolidation before you get the strong close, the probabilities may be just as favorable. Each day that the gap remains unfilled reinforces the probability that the market has taken a step to a new level and lessens the likelihood of its going back where it came from. It happens quite often that a market will gap over the 25- and 40-day moving averages when they are in any case setting up to change direction, and then the price consolidates after the crossover.

When the price keeps on going after gapping and without an intermediate consolidation, it shows that the thrust is strong, and it may signify the start of a runaway market. However, there is also the risk that consolidating market action and a corresponding retracement could occur at any moment, possibly a sharp one. You have to assess the potential reward compared with the risk relative to a reasonable protective stop loss. You really need at least a small notch in the zigzag to show up so as to establish the basis for believing that the move may be sustainable.

Gaps as Support and Resistance

The corollary of gapping that shows a sudden shift in market sentiment is the function of gaps as support and resistance levels, discussed more fully in Chapter 10. A downward gap on the chart shows that there has been an exhaustion of willingness to buy or to hold long positions at the higher level. An upward gap shows

a corresponding exhaustion of willingness to hold short positions or to sell at the low price range left behind. The exhaustion factor may have a long-lasting effect, and its significance grows with time when subsequent chart action shows that the gapping occurred at a prominent high or low.

A curiosity of gapping is the propensity for price to be drawn back toward and even into a gap—*testing the gap*, in the jargon of the business, as opposed to filling it on a closing basis. One explanation is that gapping doesn't only bring out traders wanting to go with the new-found flow. It also brings out profit-takers who have benefited from the gapping. For many traders, a bird in the hand is better than two in flight. Their willingness to take profits may be greatest at or near the extremity of the initial move. Gap theory does not suggest how far the price may come back to the takeoff level but only that you must be prepared to live through this consolidating retracement if it happens. As the price settles back, new and generally smarter traders come in, encouraged by the well-founded expectation that price often draws back toward a gap and in doing so provides the opportunity to get in at a good price. In fact, many traders refrain from doing business until price has drawn well back into a gap. The result is that this expectation, like so many expectations in markets, becomes self-reinforcing.

This idea that a gap may be tested ties in with three-bars-open theory. Depending on the overall chart pattern and other indicators, the probabilities tend to favor a continuation in price after it gaps but those probabilities are not overwhelmingly favorable. You want to see how market action unfolds after the gapping. Testing back and consolidating is an integral part of the process of enhancing the probabilities.

Gaps as a Target

The second main variation of gaps as support and resistance is the way that gaps from previous market action, sometimes from weeks or months before, become targets as well as barriers. There is a saying, "Gaps get filled," which means, in theory anyway, that a market that has gapped away will at some point return to fill the gap left behind, however long it takes to do so. The saying is hopelessly unreliable except for the fact that traders know where gaps have been left behind. That is enough for them to establish a target price, but only is if the market starts striking out again toward it. The soundness of the concept ties in with the idea that people are driven by emotions, and there is an emotional component making people want to do business at the favorable price that they missed last time they had the chance. They wait for price to reach the identified level so that some take their profits there and others enter new positions there in the opposite direction, in the expectation of a reversal.

It is mandatory to draw horizontal lines on a chart where there has been gapping. Otherwise, you may inadvertently attempt to sell right at a support level where the market may be expected to bounce or to buy right at the level where there is a ceiling above the current price. Depending on overall chart patterns and the length of time the barrier of a gap has stood the test of time as support or resistance, the probabilities tend to favor these barriers trumping all but the most powerful momentum. When price reaches into a gap and, in addition, stochastics are at an extended level, it is almost certain that a market will spend time consolidating so as to work off the excess pressure even if there is not going to be a reversal.

Two-Way Gaps

Despite the effectiveness of gaps as support or resistance, there is always a challenge when there has been gapping in both directions, as often occurs with small gaps within a trading range or a consolidation. Sometimes too, there is more than one exhaustion gap as a result of a climactic termination of a correction. There may be nothing wrong with the soundness of the major trend but a market that has become extended may start a snowballing correction that goes farther than many people expect, running stops in the process and, as a result, taking the correction farther still, with gapping on the way.

When, therefore, there has been a series of what looks like runaway gaps, but there also has been an apparently terminal gap the other way, there is a conflict of evidence when you consider trading in the direction of the last gapping. You have no choice but to recognize the adverse gaps as potential barriers that may stop a new trade in its tracks. In the final analysis, however, there is no substitute for evaluating their likely effectiveness as barriers in light of the overall balance of evidence from all the available indicators, particularly including an assessment of the major trend on the basis of the weekly chart.

Gaps and Reversals

The significance of a gap dissipates when it is filled on a closing basis, that is to say a market that gaps up—normally a gap on the daily chart—and then closes below the price from which the gap started. Yes, there has been the buying pressure to cause the gap, but it has been insufficient to sustain the price level. Everyone who bought into the surge is now losing money and is a potential seller. The same applies with a gap down where the market fails to follow through but reverses instead.

In the extreme, there can, for example, be a major gap down and heavy selling, often after the market has already traveled a long way or after a major news announcement, and then the market finds support and comes all the way back to close higher. This climactic market action is what makes a key reversal (described in Chapter 3), and it may signal an opportunity to take a trade in the opposite direction—in the direction of the new upward thrust. The opposite occurs when there has been a buying climax, and a market not only fails to follow through, but the upward thrust also aborts.

Jumping Soybeans

The daily day-session chart for May 2007 soybeans shows most of the examples of how gapping works in practice (Figure 9-1).

There was a series of small exhaustion gaps at the bottom in September, with the market not following through to the downside but not being able to break upward either. Finally, there was something of a triple bottom, with the strongest recent bar moving away with a gap on the open, leaving behind the small gap on the basis of closes from which the dotted line extends at *A*.

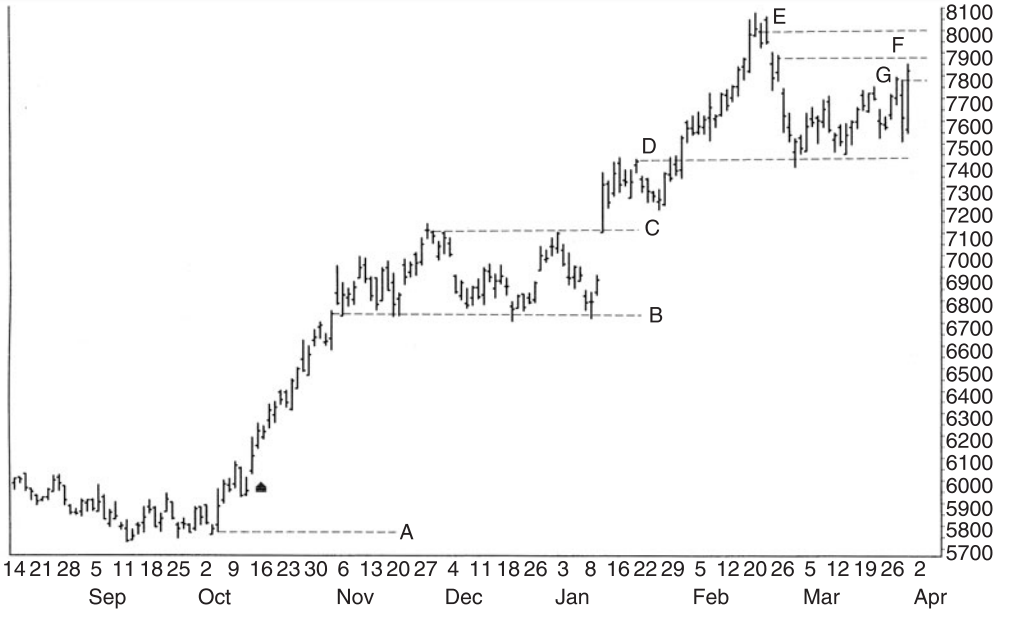

Figure 9-1 May 2007 soybeans

There were several opportunities for an entry on the basis of three bars open, with the unmistakable one delayed until the bar above the arrow. In textbook fashion, the market kept moving higher with a series of runaway gaps and outside up days until the one with the close from which the dotted line extends at *B*. This was to prove a concrete floor for retracements. However, there was to be a similarly strong lid on the market from the gap down on the basis of the closing price from which the dotted line extended to *C*.

Next, the market was to jump over the barrier of that dotted line at *C*, charging upward by almost exactly as much again as the amplitude of the range from *B* to *C*. Then there was to be another gap down, followed by a retracement that held well above the breakout level. By holding well, the market suggested that there might be more power in it than the gapping at *D* initially suggested. The price now sliced through the resistance level, charging all the way to the level of the ultimate buying climax from which the price gapped down, at *E*. Subsequent downward gaps put in place potential new resistance levels at *F* and *G*. Note again, of course, how the previous resistance level at *D* now became the new support level.

This chart illustrates the challenge of interpreting market action when there are gaps above and below the market. This double gapping expresses ambiguity, which is the bane of futures traders. Unless you have a high level of confidence that the adverse gapping may express exhaustion, on the basis of other indicators such as extended stochastics, then it may be better to stand aside.

Watch the First Hour

Depending on other conditions, the probabilities may favor a strong extension of the move when the gapping occurs in the direction of the major trend. A gap open against the direction of the major trend may occur simply as an exercise in profit-taking, although many substantial reversals start with an adverse gap opening, even one that is barely perceptible. Sometimes there is no more than a subtle shift in sentiment that begins to feed on itself. At other times a gap open may occur in the opposite direction to a powerful close in the preceding bar that turns out to have completed a climax of buying or selling—there is always a constituency looking to trade in the opposite direction when there is a perception that the preceding move has gone too far.

Gapping action, on its own, is insufficient to indicate whether you should enter a new trade. However, gapping against an existing trade strongly suggests the need to review the merits of staying with the position. When there is an adverse gap open, the price should snap back quite soon—if it is going to. The same thing goes for market action when the previous close has been very strong and right against

a support or resistance level so that you expect the market to break through and keep on going—except that it doesn't happen, and the market opens with a gap, versus the previous close, in the opposite direction. It may be that the previous day's apparently strong close was an expression of exhaustion, and now traders come back in who think that the move was overdone. When this kind of situation arises, there may not only be a need to get out of an existing trade, but there may be a case, particularly for a day trader, to enter a trade in the opposite direction.

Gaps on news can be particularly challenging. Even when the news is favorable, as expected, there may be no more than a short-lived surge, and then the market settles back on profit-taking. It happens quite often too that news apparently contrary to expectations is taken as such only for a short time on the open. Then the market goes the other way. There is an imperfect remedy for handling all gapping, particularly for gapping on news. This is to see what the market does in the first 40 minutes after the open of the day session. If the gapping is a forerunner of sustainable market action, then the immediate market action should be sustained. When, therefore, there is upward gapping on the open, the market should make a new high after the initial surge and then keep on going, and vice versa after a low open.

An example of nonsustainability occurred in Kansas wheat after the Easter weekend in April 2007, when there had been a freeze over the weekend. The market hit limit up, 30 cents higher, on the open and then closed lower on the day. It was a great day for traders taking the other side of the buy stops!

CHAPTER
10

Support and Resistance: Horizontal Barriers

Support and Resistance Levels Work

Following on from Chapter 9 and the discussion of gaps acting as support and resistance, there are other barriers of prime importance. All support and resistance levels have an almost uncanny ability to set boundaries for price fluctuations even when the supply-and-demand fundamentals suggest that there is only one rational direction for a market. The boundaries may not hold, and certainly may not hold for long, when there is a persistent imbalance in supply and demand. Nevertheless, there is always a constituency wanting to take advantage of a current price in order to take profits or to put on hedges. Therefore, all markets fluctuate to some extent even when the overall trend is very strong.

Identifiable levels of potential support or resistance on the charts suggest price levels where some traders want to do business, and their trading, as with other features of technical analysis, makes the charts self-fulfilling. Then a retracement from support and resistance levels, once started, often takes price farther than might seem remotely reasonable. Sometimes, therefore, the reliability of support and resistance levels may be good enough not only to justify profit-taking but also, on occasion and mostly just for short-term traders, to justify an intentional contratrend trade.

There are two variations of support and resistance theory, both of which are reliable. The first variation, of which gapping is part, discussed in Chapter 9, consists of horizontal or static levels based on what has happened in the past and having

little or no relationship to time. The second (discussed in Chapter 11) consists of diagonal support and resistance levels, which combine both time and price.

It is a part of the stock in trade for the successful futures trader to enter a trade when there is an established trend and, in addition, a market retraces to one of the barriers represented by standard support and resistance levels and shows that it can rebound. By extension, there is an absolute imperative that you cannot trade successfully without locating the boundaries within which a market is likely to fluctuate. Otherwise, many a trade seeming to have unstoppable momentum simply runs into the proverbial brick wall, only to go smartly in the opposite direction. Therefore, there is no substitute for drawing support and resistance levels on your charts. They may not be the ones which hold, but at the very least you must know where they are.

Seemingly contradicting the principle that support and resistance levels work is what happens when they don't hold. Once a market breaks decisively through a barrier, it is likely to extend its thrust beyond the breakout level by a distance in approximate proportion to the range of the preceding consolidation. In recognition of this alternative principle, many traders enter stops beyond identifiable support and resistance levels so as to close out trades based on expectations of the barrier holding. Other traders enter a new position in the direction of the breakout. Other trade use stops to enter a double order to reverse their position—an approach which, in principle but subject to other confirming indications, has much to commend it.

Highs, Lows, and Closes

The most immediate although least reliable horizontal support and resistance levels are the highs, lows, and closes on the bar on whichever chart you are using. These limits are most useful to short-term traders and when looking for the immediacy of an entry or an exit.

The closing price is twice as significant as the high and the low, particularly when at an extremity, because it suggests which way traders are more eager to press the market when the ballots are counted at the end of the period making that bar. It is most significant at the end of a week or a month, when traders have finished squaring their books and are deciding what they want to continue holding into the next week or month. The tendency will be to retain profitable positions and ones expected to become more profitable and to shed losers. When a market has gapped away from any closing price and the gap remains open, that closing price stands as the most useful level from which to draw a new horizontal support or resistance line that is likely to contain future retracements.

Also, the closing price may be significant for the end of a week or a month or even the year.

In a rising market, the majority of bars should have highs exceeding the highs of preceding bars and lows of subsequent bars higher than the lows of the ones before. Therefore, buyers should come in when the market retraces toward the low of the preceding bar, and sellers should come in when the price approaches the high of the preceding bar. However, sellers should not be as aggressive as buyers. In a strongly moving bull market, price may not test anywhere near the low of the previous bar.

Similarly, in a declining market sellers are more aggressive, and the price may not rally close to the previous high but it is likely to exceed the previous low. In an uptrending market, bars tend to develop so that lows form a regular upward incline, identifiable as an accumulation pattern, and vice versa for highs in a declining market, identifiable as a distribution pattern (illustrated in Chapter 3).

As with the principle of price rules and gapping, potentially significant support or resistance develops when there is a gap on the chart and even when there is a gap on the basis of the open versus the previous close without white space between the entire ranges of the two bars. A gap occurring at the beginning of the week is more significant than one occurring during the week, and one occurring on the first day of the month also assumes great significance as a potential departure point for price to go farther and for the market top to hold beyond the level of the previous month's closing price.

The daily bar chart for May 2007 cotton shows a series of downside reversal bars below the horizontal resistance line *AB* (Figure 10-1).

This market action strongly suggested that cotton was unlikely to drive through that level. On the other hand, there was strong support at the approximate level of the line *DE,* where there had been a succession of bars closing at or near the top of the range. The fact that this level also constituted the all-time low level for this contract provided an additional reason supporting the idea that there was a good floor under the market at that level. Given the strength of the rebound from the bottom and the lid on the market at the top, it was questionable what might happen on a test of the minor support line *BC*.

Sometimes you see an apparently strong market that develops a pattern of daily highs all at about the same level. This may mean that there is unlimited supply at or near that level, with knowledgeable traders, often producers putting on hedges, who are prepared to give eager buyers as much as they want. The opposite can happen at lows when, for example, coffee roasters might be happy to buy whatever the speculators want to sell them. The flatter such a pattern of tops or bottoms, the more likely it represents serious money setting up a barrier to any further move in price.

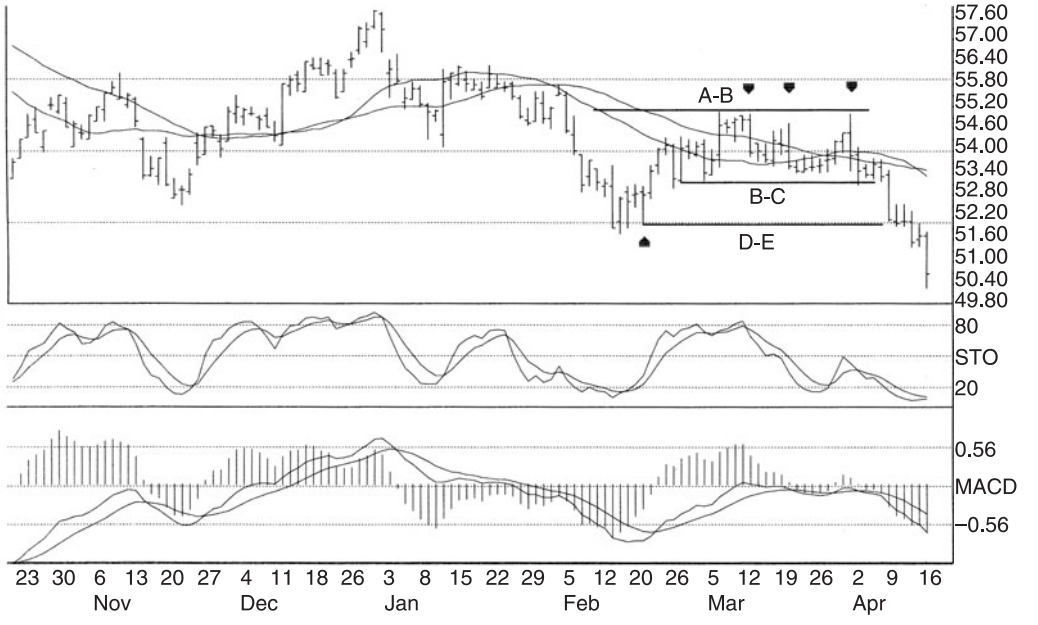

Figure 10-1 Daily chart for May 2007 cotton

Market Action Repeats Itself

In the bigger picture beyond the immediacy of individual bars, the underlying principle of support and resistance, both for the short and the long term, is that a market is likely to do something similar to what it has done before. Traders keep charts, and they can see what price levels were attained previously and therefore what prices are likely to satisfy them in the future. Repeated and conspicuous failure at an identifiable barrier reinforces the likelihood of its holding. As you can see on the daily chart for May 2007 cotton, one test of the upper boundary barrier may mean little, but its significance increases when it has been tested and found impenetrable, with buyers in this case rudely rebuffed (see Figure 10-1). Not only that, but the likelihood of a barrier holding increases in proportion to the length of time that it remains unbroken, whether for days, months, or years.

Sometimes you can tell when traders are making an assault on a level of support or resistance that is likely to succeed in breaking through. Again, the cotton chart shows how this happens. The conspicuous lack of success with the upward thrusts toward the ceiling set the scene for a successful break through the floor. Note the pattern of lower highs and the low close prior to the rapid plunge to the next support level around 51.75.

Longstanding Barriers and Targets

It is not enough to look only at the daily chart. It is essential to look at the big picture for potential barriers on the weekly and monthly charts, as well as immediate potential barriers on the daily chart. The corporate trading memory of markets is elephantine, and it is remarkable how effectively these levels work when identified correctly. There is a counterpart of the momentum player aiming to go with the flow of buying or selling. It is the trader intentionally taking the other side of what may be no more than temporary enthusiasm. It is the trader knowing where a market is likely to run out of steam and reverse, most likely at identifiable target areas to buy or sell. When there is a conflict, support and resistance levels more often than not trump momentum, particularly when a market is already overbought or oversold.

As discussed in Chapter 9 with respect to gaps, it is easy to overlook the principle that support and resistance levels also act as targets and not just as barriers to further progress. Using the buy-side example, it is not just those who want to enter new short positions who have target prices to sell, based on what happened before, but also those who hold long positions and set their objectives for banking profits. Similarly, there is double cohort of traders wanting to buy at a low price level, consisting of those who want to bank profits at their target price on short positions and those who want to establish new long positions.

The corollary of support and resistance levels serving as targets is that you have to beware of a market falling short of a prominent barrier. Generally you can tell from sloppy market action in individual bars if not initially from stochastics that the momentum is going out of a move. Sometimes, however, market action may look strong as it approaches a prominent barrier, and it looks as if the price should charge through. Despite the strong indications, it stops in its tracks and turns sharply the other way. A declining market that falls short of reaching a conspicuous support target is bullish, or at least not bearish, and it may rebound with unexpected vigor. A market falling short of a conspicuous upper target is bearish, and suggests that it may go much lower once it clearly turns down.

The Long-Term Dow Jones

Typical of how support and resistance can operate in the long term is the way the Dow Jones Industrial Average fluctuated between the 500–600 level and 1,000 for 20 years from 1962 to 1982 (Figure 10-2).

From 1959 to 1982, the Dow was essentially to remain confined within a box with a concrete lid almost exactly at the 1,000 level. The floor was less clearly

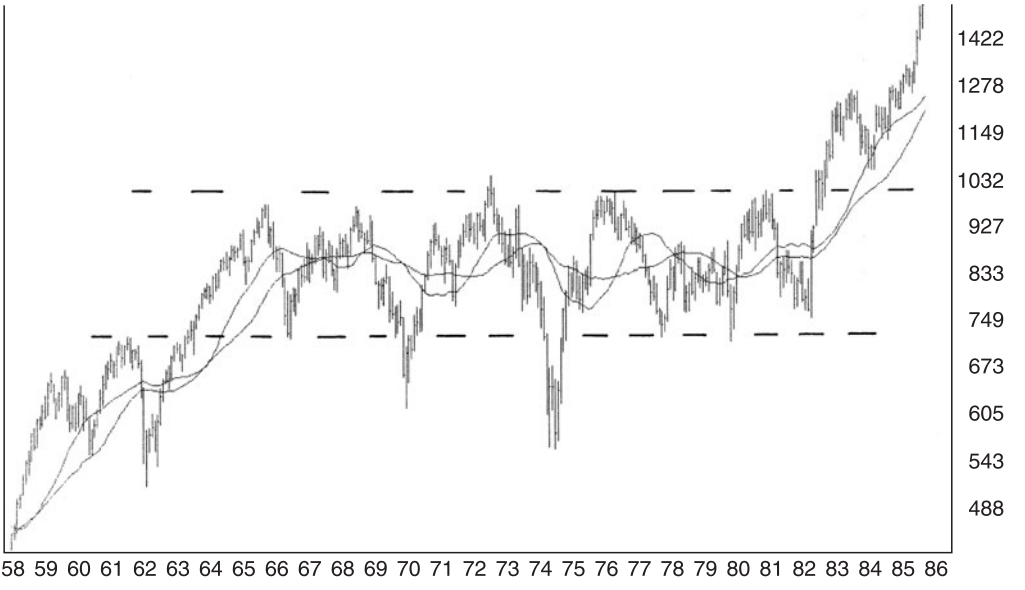

Figure 10-2 Monthly Dow Jones Industrials, 1959–1986

defined, with the exceptional plunge in 1973–1974 occurring in conjunction with the Arab oil embargo, which severely stressed the entire world economy. When, eventually, the Dow broke above 1,000 and showed that it could hold above that level, the entire universe of stock market investment changed. The rest is history except for the fact that this immensely long period of sideways action demonstrates so forcefully two essential concepts of technical analysis. The first is that support and resistance levels work. The second is that the longer they stand the test of time, the more significant is the eventual breakout, when it happens.

The chart for the Dow also illustrates how, in a sideways market, moving averages serve as an approximation for a median line. The 25- and 40-month moving averages overlaid on this chart show price tending to travel an approximately equal distance from one side of the crossover to the other. This chart also shows how in 1984 the Dow was likely to come back to the breakout level after breaking out of the box, just to make sure that the breakout was the real thing. You can have a high level of confidence in the sustainability of the breakout once it has been tested and found good. You can see too how moving averages should contain retracements once they establish a clear trend.

Historic Highs and Lows Hold

The majority of markets develop long-term barriers that correspond to support and resistance. A typical one is corn (Figure 10-3).

You can readily see from the long-term chart that there is a solid floor under the price at around $2 and also that the price has remained only very briefly above $4 since 1974, when it stopped at exactly that level. When the price is around $2, this does not mean that it has to go up much. It has often meant that it might just bounce to half a dollar or so and the settle back again. A price at the bottom of the long-term range merely signifies that there is little prospect of making money on the short side of the market. Similarly, when price is near the top of the range, the prospect of further gains may be limited, and the risk of a decline, that much greater. There may be a trend in force, which ought to continue, but at some price it may have done enough, and the long-term chart suggests where that level might be.

When, therefore, you hold a position in a market approaching or actually reaching a conspicuous target level, there may be a prime opportunity to bank a profit rather than holding on and waiting to see what happens. Depending on the

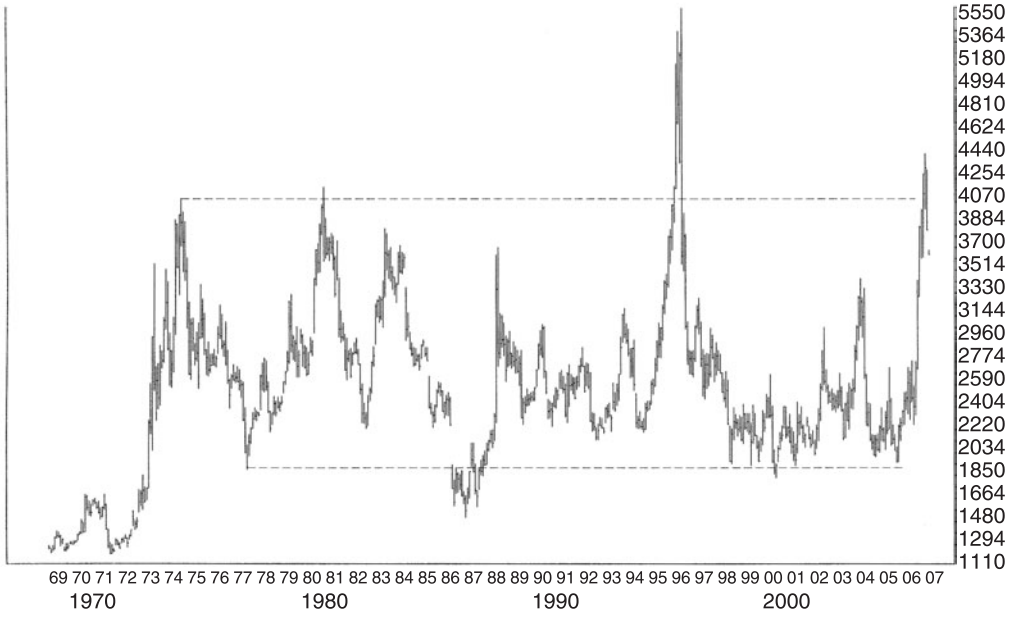

Figure 10-3 Monthly continuation chart for corn

overall trend and other indicators, there may be a prime opportunity to enter a new trade going the other way, on the assumption that the price will in fact stop and turn there. Some of the best opportunities occur when you see a market heading toward a place where it might stop and have the patience to wait for a good entry and the fortitude to take it at a good price.

The long-term monthly charts for the Dow and for corn illustrate the essential principle that you need to know where the important levels of support and resistance are. It is also necessary for the immediacy of real-time futures trading to find and to heed near-term and intermediate levels of significance. Close examination of the monthly Dow chart, in isolation, for the period around 1979–1981 could well have suggested coiling ahead of a successful breakout instead of fatigue and distribution. Not only was the breakout not to happen then, but the market had to retrace almost all the way back to the bottom of the box before launching the ultimately successful assault on the 1,000 level.

The Top of the Gold Market

A prominent example of a historic high holding was at the top of the big run in gold and silver in May 2006. At the preceding major top there was a prominent first high in gold all the way back in February 1980 at $742 and a second one, after a massive selloff of $289, at $729 in August of that year (Figure 10-4).

In May 2006, the price momentarily reached a high at $732. The price was to fall by $183 over the next five weeks to $546. Similarly, in September 1983, there was a prominent high in silver at $15.20. The price stopped at $14.93 in May 2006 and then fell $5.15 to $9.78. There had been support at a steep trend line at $14.00, from which level the market fell by a dollar in a single day once it was violated, making almost no attempt to rally, as gold had done.

The Power of Round Numbers

Round numbers also work to contain highs and lows. There are many obvious round numbers serving as targets or as support and resistance, including that long-standing top in the Dow at 1,000. They include live cattle at $1, soybeans at $10, and copper—most conspicuously—at $4 and likely a ceiling to last for a long time. Copper actually went to a high of $4.16 at a top in September 2006, from which the price fell by 40 percent, with increasing speed, once the decline got under way. Similarly, there has been an identifiable top in corn at around $4 and a low around $2, and there has been the long-standing failure to get soybeans printing a number

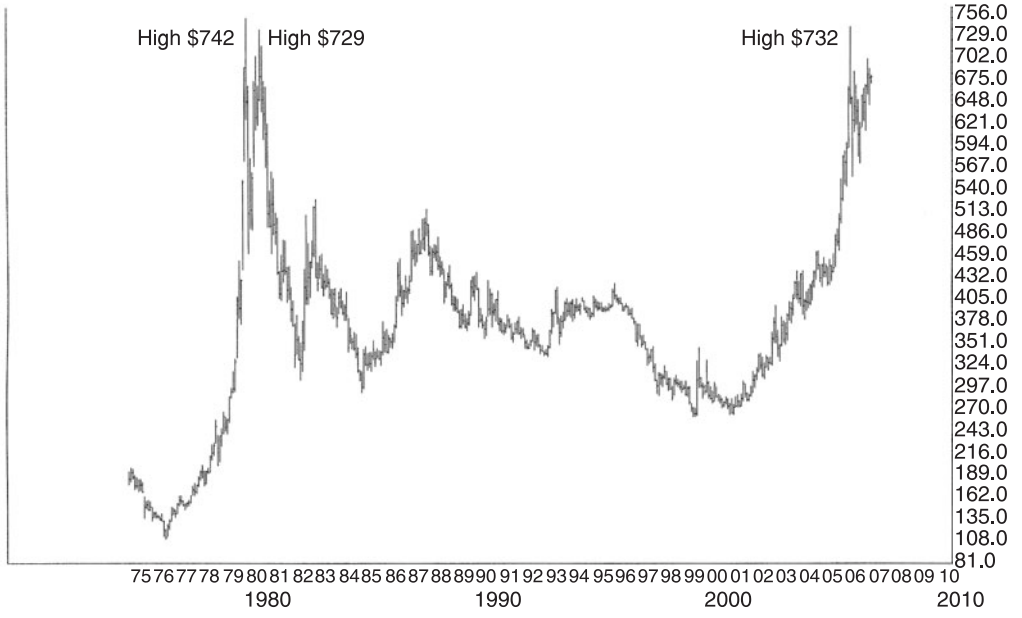

Figure 10-4 Monthly continuation chart for gold

in the teens. The high all the way back in 1973 at $12.90 has never been seriously challenged since then. The $10 level has been the round-number extremity.

When a Market Breaks Out

Looking the other way around at support or resistance, a market that goes blasting through an apparent barrier with little or no hesitation is one that is likely to keep on going. There is no getting around the fact that it is often difficult to tell when this might happen. However, you can sometimes tell that a barrier is likely to give way when the market has launched a fast attack, and there has been no more than a small retracement in time and price before the market takes another run at it. Once a market breaks out and shows that it can stay beyond the identifiable boundary, the probabilities favor its continuation, with the caveat that even so, there are many false breakouts. The probabilities in favor of a successful breakout increase when the breakout is conspicuously powerful, such as when price gaps over the key boundary level.

There is always the challenge of whether to trade immediately on the breakout or wait to see what happens on the retracement, if it comes. On balance, it pays handsomely to enter a partial position right away and normally on the close of the

breakout day, if not during the day. But you need to keep plenty of firepower on hand with which to weather that retracement to the breakout level, if it happens. Depending on how the market then acts, it is time enough to put on the other part of the position when the market shows that it can hold the breakout and starts moving in the expected direction.

There is an important financial element about breakouts that follow through, particularly ones breaking to a new contract high or a new contract low. It is a truism that any move in price in futures markets generates a profit for those on one side of the market and an equal and opposite loss for those on the opposite side. When a market makes, for example, a new contract high, every trader on the long side of the market has a profit with which to pyramid more long positions, and every trader on the short side is under pressure to buy back so as to cover the loss. The result, therefore, is a doubly fueled demand to drive the market higher.

Resistance Becomes Support—Support Becomes Resistance

There is a reliable rule for an uptrend that horizontal resistance levels, once broken, become support on a retracement. Similarly, in a declining market, a support level that has been exceeded becomes the new resistance level on a retracement. This principle works both for near-term breakouts and on long-term charts at levels where you expect substantial and lasting support or resistance. A corollary of this rule is that the effectiveness of a support or resistance level, on the retracement, is likely to increase in proportion to the length of time the market previously backed and filled there before breaking out. It often happens too that there are multiple tops and bottoms at about the same level, in which case these barriers are even more important.

It does not follow that the major trend is negated when price digs deep into support or resistance levels although, ideally, that should not happen in a strongly trending market or one having substantial potential. The final level of support or resistance for the overall wave action of trending markets, normally more applicable to a trading-range market than to one with an established trend, is the previous low for a wave in a bull market, and the previous high for a wave in a bear market.

Barriers in the Corn Market

The daily chart for May 2007 corn illustrates well the principles of horizontal support (Figure 10-5).

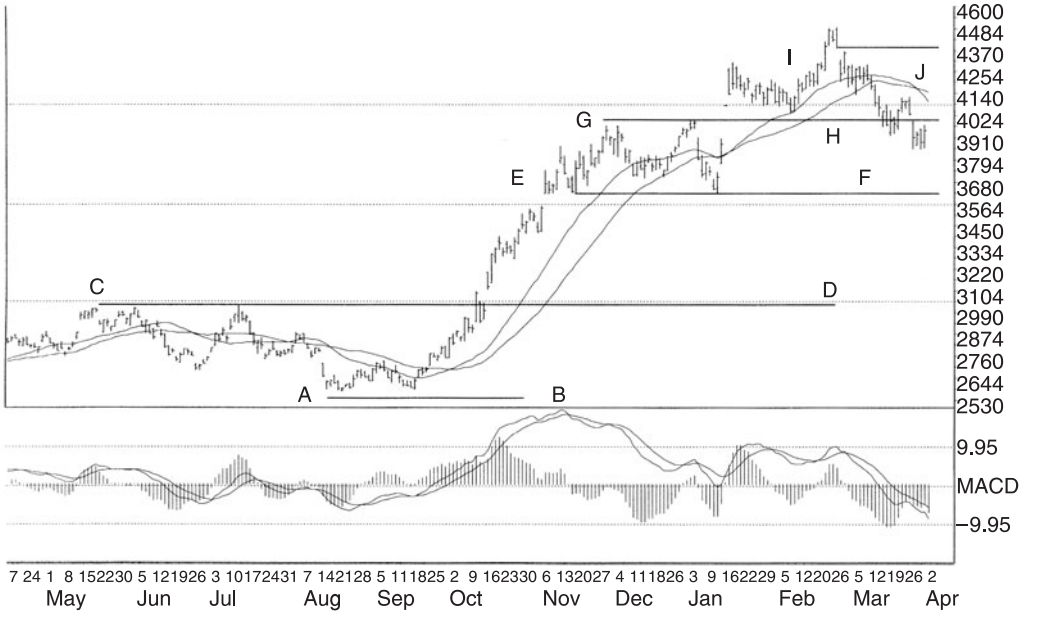

Figure 10-5 Daily chart for May 2007 corn, with MACD

The nearby futures had been as low as $1.86 in December 2005, making a harvest-time low and responding to a record crop. During 2006, it began to dawn on traders that however plentiful the supply from increased planting, industrial demand for making ethanol might be insatiable, leaving livestock producers unable to fill their needs, or at least not at a reasonable price.

Beginning with the double bottom in August and September, above the support line *AB,* the bull market was to begin with a more positive upturn by MACD than the one for price. The second low in price was less than 1 cent higher than the first one, but this constituted a valid double bottom nonetheless.

Once the market started moving, it gathered a significant head of steam, racing right back to the resistance line *CD,* drawn off the highs in May and June. Unusually, the price hesitated no more than a couple of days before charging through that resistance level. In doing so, corn illustrated the rule that a powerful market heeds support and resistance levels only briefly. Of course, you know it only after the event. Nevertheless, the leap over the resistance-level line was no fluke but, on the contrary, an indication of how much more there was to come and how rapidly.

Note the big surge in price and the corresponding gap at *E.* Market action here illustrates the principle that gaps provide, of themselves, support or resistance. Sure enough, a horizontal line drawn from *E* across to *F* was to provide support

seven trading days later. Even more significant was the way that it continued to support price on the retracement a full two months later at exactly the same level.

Continuing on, the top of the surge at *G* warranted yet another horizontal resistance line that was to prove its worth on the second attempt to surpass this level. The first of these two highs was at $3.97, with that price hit once and again three days later. After the retracement, on the second run at that key $4 level, the price managed to hit $3.99½ before settling back to the *EF* support line.

On the announcement of the January crop production report, the market was to gap through that resistance with a limit move. But now it was much heavier going. The market grudgingly set back to the trend line *GH* and into the newfound gap before making its final death-throes lunge to the eventual top. At this point, note the inside down day with a gap, then an outside down day, and then the clear gap down. The new horizontal resistance line *IJ* following the gap down comes off the close from which the market gapped down. As was predictable, there was an attempt to regroup by filling the gap, but it was not to be done, although the price pressed quite near to the new resistance line. From there, corn was to move erratically but significantly down all the way into the March crop production and planting intentions reports. This news culminated in two consecutive daily limit moves down of 20 cents, until the market made a low all the way down to $3.43.

The corn chart illustrates somewhat inconclusively two further general principles. The first is that there is likely to be a relationship between how far a market may project and the length of time it has been preparing to do so. The duration of the sideways action from May to September was to provide a solid technical base for the substantial move that followed. This chart also illustrates the principle that a market often moves by making a chart pattern like a staircase or a series of boxes stacked on top of each other. There is a surge and then a regrouping, which may take the price all the way back to the level where that last surge started. Then it breaks out and makes a new surge roughly equal in the amplitude to the last one.

Summary

It is impossible to overstate the importance of knowing where horizontal support and resistance levels are. You have to look to buy at a support level when the trend is up and to sell at a resistance level when the trend is down. The principle is valid both for entering new positions and for taking profits on trades entered in the expectation that the market will perform as expected. In order to put this into practice, there is no known substitute for diligence in drawing on charts those key levels and for carrying them forward on charts of different

time frames. The reciprocal of enabling profitable opportunities is that of all the reasons for forgone profits and for unnecessary losses, there is hardly a one more significant than failure to appreciate the significance of important technical barriers.

Elliott Wave Theory and Its Applications

There are various theoretical criteria in popular use for projecting how far a market might extend, how far a move might retrace, and what pattern the fluctuations in price might generate in going there and back. These approaches tend to be helpful only with reliance on other supporting methodology, much of which is duplication anyway. More important than theoretical projections based on geometry is the basic but effective principle that a small and short-lived retracement suggests a market capable of projecting farther than one making a more substantial and longer-lasting retracement. More important, too, as with most principles of technical analysis, is the general rule that a market is likely to do something similar to what it has done before.

Many traders use Elliott wave theory,[1] which, in turn, is based on the Fibonacci series, the so-called golden ratio. There is considerable variation in the level of credence given to this methodology, varying from believers of almost irrational religiosity, on the one hand, and those who discount it entirely, on the other, and everyone in between. One thing you can say for certain about Elliott wave theory is that it looks wonderful with 20/20 hindsight. In real time, however, it can be extremely challenging, when trying to project ahead in either time or price, to know the highs or lows from which to start counting. Whatever the merits of the theory, those of its practitioners who establish a credible record almost invariably reach their conclusions using additional indicators such as the ones discussed in detail in this book.

In sum, it as well to bear in mind the contrarian view of all market forecasting when evaluating and applying Elliott wave theory. The contrarian view states that every market will do what it has to do and that it is the job of markets to fool as many people as possible as much of the time as possible.

[1]There is an excellent essay by Chris Stephens on the background of R. N. Elliott and his theory at www.luckymojo.com/fibonaccimkt.html. The best book on Elliott theory and its application in markets is Tony Plummer's *Forecasting Financial Markets* (London: Kogan Page, 1989).

Fibonacci Retracements and Projections

Most common charting programs include Fibonacci retracements, arcs, fans, and time-frame tools. However, if you apply several of these tools to multiple points in multiple time frames, the chart is too cluttered to be useful. Nevertheless, with many traders using Elliott wave theory, it is worth knowing some of the basics of what they are looking at and where they may make things happen. The important thing is to use it as a guide rather than as a crutch to put much weight on. Conclusions based on Elliott can be resoundingly wrong, as demonstrated by the work of some advisory services using it as the primary basis for their work. In sum, Elliott is useful to a certain extent, particularly when it confirms what you think you already know based on more basic expectations derived from support and resistance levels and from other indicators.

The Fibonacci sequence progresses by adding the previous two numbers to get the next one and so on to infinity as follows: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, etc. Reduced to decimals, the higher number is greater than the lower one in the ratio of approximately 1.618, or 1.62 when rounded, and with small variations between each interval. In algebra, it is indicated by the Greek letter phi ($\varphi = 1.618$). The resulting Fibonacci numbers, including the standard ones below 1, are 0, 0.38, 0.50, 0.62, 1.00, 1.38, 1.50, 1.62, and 2.00. Below 1.00, the numbers depend on whether you start from the top or the bottom, but they are equally significant either way. These numbers may be expressed alternatively as percentages.

Regardless of how much you rely on Fibonacci or Elliott, the single most effective number when estimating the potential limit of a retracement is the 50 percent level. Time and again, a market will retrace approximately that far on any chart of any duration regardless of whether there is any other discernible support or resistance there. Many traders target that level both for entries and exits, and therefore, it is another self-fulfilling axiom of technical analysis. The corollary of 50 percent retracements is that you may well want to avoid trading a market that has been retracing much more than 50 percent of prior moves. It is worth repeating that the best markets to trade have small and short-lived retracements.

The corresponding number for projections is 100 percent. It derives from the principle that a market is likely to do as much again as it has in the past. This principle has almost universal application for breakouts and wave fluctuations generally. Put another way, the so-called measured move on a breakout is the same distance you expect a market to project as it has traveled from the outer boundary of the formation from which it is now moving. Seemingly contradicting this principle is the likelihood of the projection going farther when the market is breaking out of a longer-lasting consolidation. You can expect a similar 100 percent projection if, for example, the last move up in soybeans was 20 cents and lasted for

10 market days, and the market then retraced by 10 cents over 5 market days. A rough rule of thumb then calls for the next advance to do the something similar in both time and price. It often happens too in a very strong market, up or down, that there is a pause for consolidation, and this may be the halfway mark for that leg of the move, providing a 50 and 100 percentile move depending on whether you look at it from the midpoint or from the eventual target.

Weekly Silver and Fibonacci

The weekly continuation chart for silver shows a vertical line from the September 2005 low at $6.63 and the high in May 2006 at $15.20 (Figure 10-6).

The sharp selloff in May 2006 looked at the time as if there was no stopping the crash. However, on a closing-price basis, the price held above the 40-week moving average (roughly equivalent to the much-watched 200-day moving average), and it also closed above the last identifiable high at $9.95 from the preceding February at *A*. Whether by coincidence or calculation, silver similarly tested the 62 percent Fibonacci support level after attempting to take a stand for a couple of weeks at

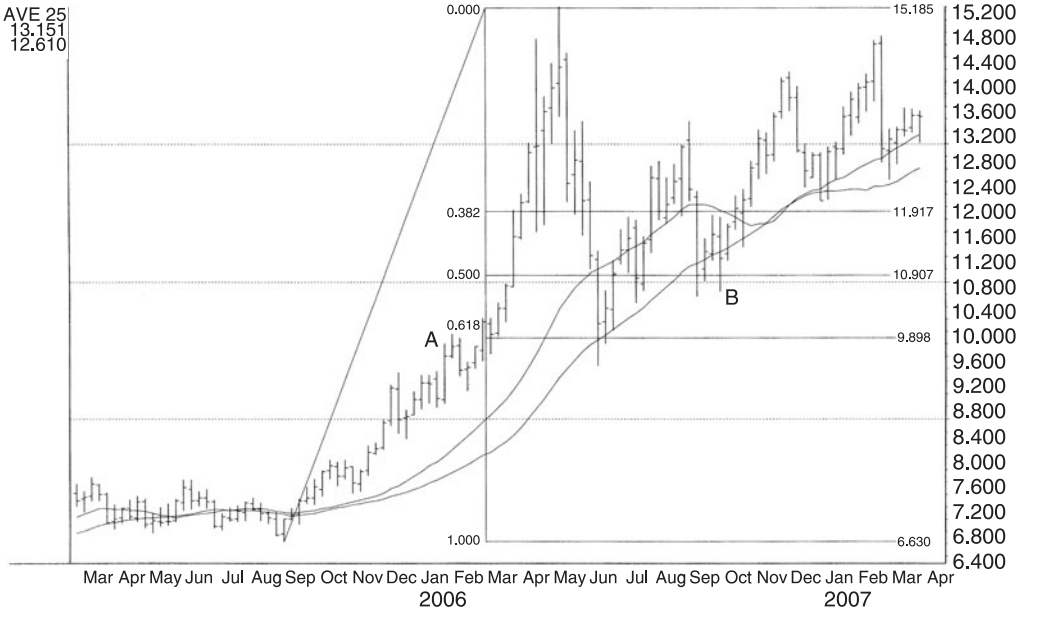

Figure 10-6 Weekly continuation chart for silver with Fibonacci retracements

the 38 percent retracement level. On the rebound, the 50 percent level at *B* was to provide substantial support, twice. Despite the apparent efficacy of these support and resistance levels, silver became challenging to trade once the top was in place.

As with all geometric theories about support and resistance, forecast retracements and projections are always tentative, and some are even more tentative than others. They may be useful for seeing where a market might go, but you have to be extremely flexible and constantly prepared to redraw the map if market action fails to unfold as expected.

Summary of Support and Resistance

Retracements and Projections

1. It is essential to mark up charts with horizontal support and resistance levels and, ideally, to carry them forward onto charts of different duration. (Failure to do so is one of the leading causes of inadequate homework, bad judgment, and losing trades.)
2. Key horizontal levels of support and resistance are
   a. Gaps, both those where there is a clear separation between bars on the chart and where there is a space unfilled between closes on a closing basis.
   b. The high, low and close of previous bars—daily weekly or monthly.
   c. Long-term historic highs and lows.
   d. Round numbers.
   e. Breakout levels—previous support and resistance levels, in role reversal after a breakout.
3. The longer a support or resistance level has stood the test of time, and the more times it has been tested and found good, the more likely it is to go on holding.
4. There is almost certain to be some hesitation when price approaches any previous high or low, but the more decisively a market cuts through a support or resistance level, the more likely it is to keep on going.
5. Failure to reach to a target level at or near a support or resistance target may signify that the market is running out of steam and may be setting up to go the other way.
6. The key retracement level is the 50 percent mark.
7. The measured-move key projection target is 100 percent of the amplitude of the current formation.

CHAPTER
11

Diagonal Support and Resistance

Drawing a Trendline

The second variation of support and resistance theory consists of diagonal or dynamic levels, and they depend on a market's ability to maintain both direction and speed—a trend, in fact.

Following on from the erratic immediacy of zigzags, trendlines provide the most basic tool for seeing a smoothed, underlying direction of a market, whether in the shorter or the longer term. Along with channel lines, which are their counterpart, trendlines stand the test of time. Since many investors use them, their effectiveness becomes self-fulfilling. While the principle of trendlines may seem obvious, particularly in hindsight, the successful futures trader needs to know what to do with them in real time when looking forward. You can be absolutely certain that the professionals and market makers use the same charts and are lying in wait for those not doing their homework.

A trendline connects lows in a rising market and highs in a declining market. You can draw a tentative trendline when you see two prominent highs or lows on the chart. Its validity is confirmed only when price returns to the assumed trendline for a third time or more and again turns there. It is often tempting to assume that a trendline is developing on the appearance of every small blip in price action. There is often no choice but to make this initial assumption, although most good longer-term trendlines take a significant time to develop between the initial points of contact. By extension, the longer a trendline remains in force, the more

validity it has—and the more significant it is when it fails to hold, and the market breaks through. One rough rule of thumb for assuming a trendline on the daily chart is to draw a tentative line from the apparent high or low and then to look for a secondary high or low about four weeks later in accordance with cycle theory, discussed in Chapter 14.

Sometimes it is relatively easy to see where a trendline should go, but by no means always, and it often becomes necessary to revisit assumptions as market action unfolds. It can happen, for example, that there is a prominent but aberrational high bar within a cluster of bars, and the best fit comes not from that high bar but from the high of the first bar within the cluster. The purpose of a trendline for trading is to express both potential support and resistance levels and, most important, the speed of the market.

It happens constantly that there are opportunities to draw steeper trendlines if a price trend gets going. Then the original, shallower one may well represent the major trend of the market, and it may remain valid and provide support or resistance for more significant retracements later on. The best trades accelerate and therefore allow you to draw that steeper trendline. However, the steeper the trendline, the more unstable it may be before price has to retrace. Violation of a steep trendline may afford the opportunity to bank a profit at a good price with a view to getting back into a trade at or near the support or resistance afforded by the major trendline.

The opposite of the opportunity to draw a steeper trend is, of course, the need to draw a shallower one. Here, too, there is often an element of judgment required. You have to allow for the fact that a major long-term trend regularly has major fluctuations within the trend on the weekly and monthly charts. Particularly in markets such as stock indexes or currencies, which often have long trends, there can be enormous fluctuations within that major trend. Subject to this reservation, the general rule is that a market requiring shallower trendlines is one that is losing momentum and it may be in the process of reversing that apparent trend.

For futures traders, there are often conflicts between early and late assumption of a trendline. Given that trends in futures markets are often much shorter than trends in the stock market, particularly in agricultural commodities, it often pays to pull the trigger on a trade when there is no more than a second point of contact, providing—and this is a crucial point—that other indicators support the trade. The potential gain on a trade entered at a good price, and early in a move, may justify a risk that is more apparent than real. By extension, a futures trader may have no choice but to heed the violation of a short-term, steeper trendline within a major trend and to get out of a trade right away in case the retracements starts costing more serious money.

Drawing a Channel Line

After assuming a trendline, find the most distant point from the trendline, or the most prominent—not necessarily the same thing—and ideally the one found between the two lows that mark the contact points for the assumed trendline. Then draw a line parallel to the trendline. There is then an upper and a lower line between which the market has fluctuated in the past and should continue to do so. Here, too, the object of the practice is to find the line that best fits the overall direction and speed of the market when it is making its outbound thrusts away from the trendline. It is remarkable, too, how often a channel line also confirms the best incline for the trendline. If in doubt, remember that the object of the practice with both the trendline and the channel line is to achieve the best-fitting channel that represents both the direction and the speed of the market

An important component of the theory of trendlines and channel lines, as of all support and resistance levels, is that previous support, once exceeded, then becomes resistance, and previous resistance, once exceeded, becomes support. There is a reasonably plausible explanation to the effect that traders on the wrong side of the market look to get out near breakeven when and if they can, so these levels become self-justifying. In any event, it is fundamental to successful futures trading concepts to think in terms of the most reliable market moves being confirmed by price going back to make sure, to kiss good-bye to the homestead now being left behind. This is the same point as zigzag theory and, in fact, of all trends, whether price trends, indicator trends, or trends in supply-and-demand fundamentals.

Enter When the Market Retraces

The idea behind trendlines and channel lines is that price typically zigzags backward and forth between the trendline and the channel line. In a steadily trending market, price moves backward and forward while maintaining a steady overall direction. It is similar to the way a sailing boat tacks backward and forward while maintaining an overall forward direction and hence the term *linear retracement* used by some technicians.

There is likely to be an opportunity to enter a new trade when price comes back to a trendline and shows that it can hold there. Occasionally, you can simply make the assumption that the market will turn as expected, depending on how powerfully the market has retraced. However, it usually pays to wait for confirming action in the form of a new price rule and a turn in the stochastics overbought/oversold indicator. Ideally, you want to see that momentum is actually coming back into

the market in the direction of the major trend in the expectation that the new trade will go to a profit right away. At the very least, you normally want to see the potential for exhaustion of the retracement, and therefore resumption of the major trend, coming through in intraday action such as on the 60-minute chart.

The need to see how market action develops on a retracement to a trendline may seem obvious. However, it is critical what happens when the price is at or near a trendline. The market may turn, or it may not. Or it may mark time for ages while traders make up their minds. Therefore, it generally pays far better in the long run not to jump the gun on a new trade. On the other hand, a decisive trendline crossover may mean that the trend is reversing altogether.

Beware of Channel Lines!

Channel lines serve the immensely important function of suggesting where a retracement may start. If one starts, then it not only may take the market back to the trendline, but it may take it beyond if the trendline fails to contain the retracement. It can be extremely tempting to chase a market that seems to be moving fast without any sign of slowing down, let alone stopping. However, it can be at just such times, when there is maximum enthusiasm, that an uptrend runs out of buyers or a downtrend runs out of sellers. Failing to draw a channel line may therefore be an exercise like driving a car without talking the trouble to see where the stop signs are or at least the yield signs. When price reaches a channel line, therefore, it is likely that you should be looking to bank a profit rather than entering a new trade.

There is a theory that a market is likely to keep going to another level if it breaks decisively above the channel line in a bull market or below it in a bear market. The expectation is that it may go a further distance beyond the channel line as it has traveled already from the trendline. This theory is extremely unreliable. Yes, it works reasonably well to stay in a trade entered at a good price, as long as you keep an eye on the exit. However, the practicality of real-time trading is that you are likely to be carried away at the worst possible moment if you try to chase a runaway market when it breaks beyond a channel line. You may be right, but that's not the point. If you are wrong, the risk of loss may be greater than the potential reward.

In addition to suggesting a target level for banking a profit, there may seem to be an opportunity of entering a contratrend trade at a good price when a market reaches a channel line. However, the risk is seldom manageable relative to the prospect of reward, and for all but the most nimble traders it is almost mandatory to pass on the apparent opportunity. There is, of course, a considerably higher risk

in selling against a channel line when the major trend is up or buying against a channel line when the major trend is down. The major trend is likely to dominate, and surprises are likely to happen in the direction of the major trend, even when a market is already considerably extended. There has to be an extremely good reason to take a contratrend trade. Those reasons can be found—but seldom.

Channel lines perform another important function. With channel lines providing a target, you have to beware of the market that fails to get there. Say, for example, the price runs into heavy going around the halfway level between the trendline and the channel line. It may well be that the validity of the entire move is suspect. If the price starts reversing after failing to reach the channel line, there is considerably greater risk that the trendline may give way.

Exit When a Trendline Breaks

An essential extension of trendline theory is the call for action arising when price breaks through a trendline. Trendlines signify support, and the general rule is that you expect the support to hold: The trend in force is supposed to remain in force. So what do you do when the trendline fails to hold? Logically, as well as practically, the breaking of a trendline means the ending of a trend. Depending on factors such as the steepness of the trend, it may well signal a mandatory exit from a trade with the trend. It may also signal the start of a new trend in the opposite direction and provide justification for a trade in this new direction.

There is often considerable advance notice of a forthcoming trendline break by way of flagging momentum showing up in stochastics and MACD, in price failing to reach to the channel line, and in price bar action generally. When price slices decisively through a clear trendline of longer standing, in all likelihood there will be something between a surge and a stampede as traders seeing the failure hurry to get out of trades in the direction of the previous trend as well as to take a position in the direction of the breakout.

Channels on the Weekly Oil Chart

The weekly continuation chart for crude oil shows remarkably efficiently how trendlines and channel lines can work (Figure 11-1).

Unusually, the continuation daily chart (not shown here) suggested the possibility of a trendline starting from *A* on completion of the low at *B*. For all practical purposes, this uptrend line was to hold for some 15 months, with price constantly coming back to test it, even after significant upward thrusts.

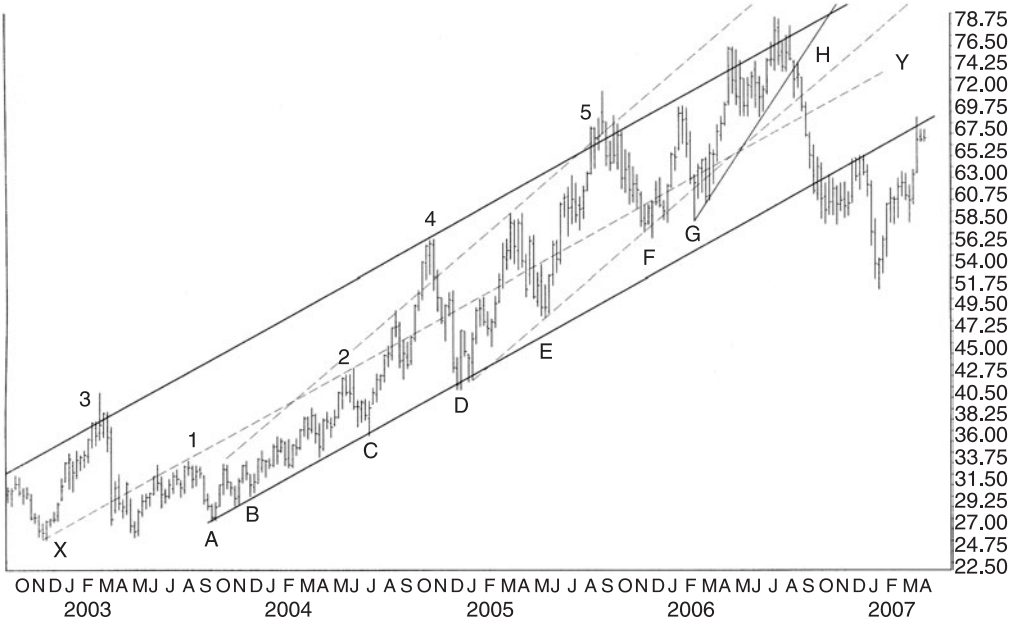

Figure 11-1 Weekly continuation chart for crude oil

After starting the potential trendline *AB*, it was possible to assume the potential for a channel line with its point of contact at 1. This channel line was indeed to pinpoint an identifiable high at 2, but then, on the next thrust, somewhat unusually, the market was to accelerate through it. That this was unusual is supported by the fact that breaks beyond channel lines normally have a low probability of following through and a high probability of failing, making what is known as a *bull trap*. What made this upward extension a better proposition than most was that the market regrouped only a little before making that thrust out to the new high. In doing so, it fulfilled another adage of support and resistance theory—that a powerful market shows little hesitation at those levels before continuing on to the next level. It is the slow-moving market, on the other hand, that is most likely to be turned back. In any case, it was valid to keep in place the line from *X* that was eventually to extend to *Y* as a potential support or resistance line in the future, and in the event, it turned out to be something of a median line during the rest of the major bull market from *X* to *Y*. Already the validity of this line developed some additional significance from the fact that it happened at the low at *X*, and it provided resistance in the weeks prior to the retracement starting at 1.

Once the market broke above the channel line 1–2, you could have been looking for a potential new target. In the event, and by no means surprisingly, it turned

out that a new channel line drawn off the approximate high at 3 was to make contact at 4, and yet again at 5, and right on to the eventual top of the market.

Once the low at *E* held, you could draw a steeper potential trendline, assuming a channel contained by a parallel line drawn off the recent high. This new channel was to prove less effective than you might expect ideally from channel theory, although there was a major conjunction of the two channel lines and price at 5. At *F* and *G*, the price came back through this trendline, notably with a monthly close below it at *G*, although, of course, the prior low held firm.

Crucially, the low at *G* generated the opportunity to draw the new, steeper trendline that was to become the line from *G* to *H*. In textbook fashion, the market was to make a run at the channel line and to retrace for another run—perhaps for the magical $100 level touted by some enthusiasts. Finally, however, there was a last run at the eventual high, achieved with seriously flagging momentum. Once that new steep trendline gave way, it signaled the end of one of the all-time great bull markets. Not only that, but there were now many and strong indications that this really might be the end of the bull market, with a corresponding opportunity for a big trade on the short side of the market.

As a footnote to the history of that bull market, price was to break the long-term up trendline *AE*, then rally back to the resistance level that it represented, and finally fall to the eventual low for the move, a massive $28 from the top.

Channels on the Daily Oil Chart

The daily continuation chart for crude oil during 2006–2007 shows trendlines and channel lines working to perfection (Figure 11-2).

The huge convulsions at the end of 2005 resolved with a firm base forming just under $60 and a pronounced upward zigzag getting under way in March 2006. Almost uncannily, the second low from that bottom, at the arrow, proved valid for a new upward trendline *CD* with a channel line *AB*. It is notable that the market ran out of steam short of the channel line at *B* and then went into choppy sideways action before the final thrust at the top. This time the market made no attempt to shoot anywhere near the channel line. It made a double top at *E* and then fell away to break the long-term trendline decisively.

As happens ideally with every major trend reversal, the market broke the uptrend line and then returned to establish a significantly lower high, thereby enabling the potential new downward trendline *EF* with its tentative channel line *GH*. Then, of course, it was hard down all the way for the best part of $15, with no attempt to rally back to the trendline until the market eventually found support at the channel line.

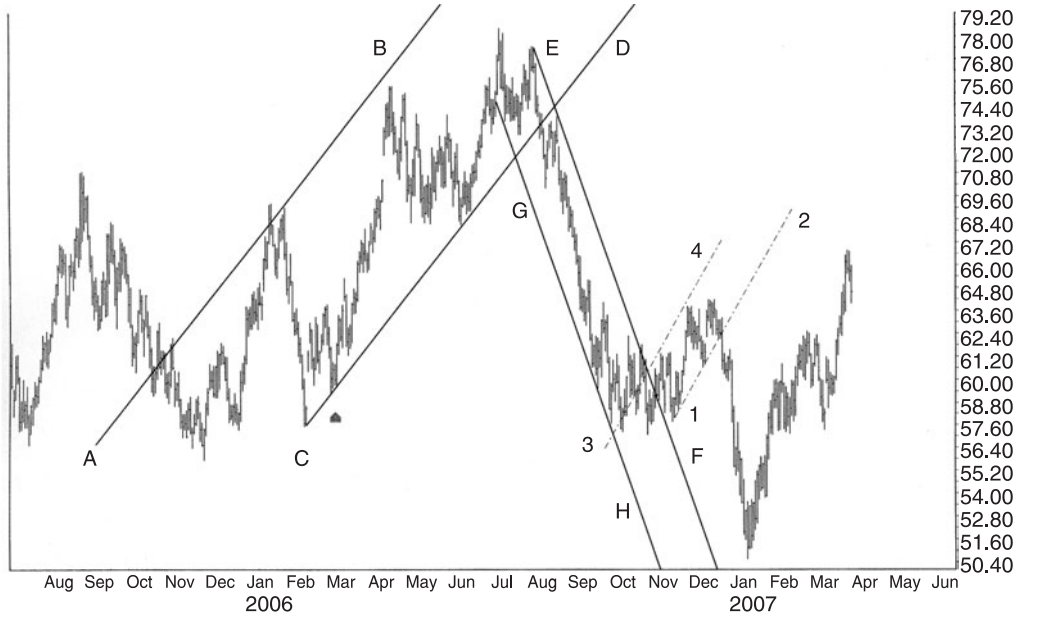

Figure 11-2 Daily continuation chart for crude oil

It turned out that the apparent uptrend established between the trendline 1–2 and the channel line 3–4 was to be no more than a consolidating flag formation on the way down to the $50 level. Once the tentative new trendline 1–2 failed to contain this new trend, there was no more than the most tentative holding pattern until the price fell, like a rock, to the eventual bottom.

CHAPTER
12

Bollinger Bands

The Guide to Wave Action

Bollinger bands provide a further variation on the concept of support and resistance, and they do so by identifying deviation from the immediate trend. You can construct a trading system based on Bollinger bands in conjunction with other indicators such as moving-average convergence/divergence (MACD) and stochastics and tools to identify the major trend. They serve some of the same functions as moving averages, and the median line is a moving average.

The idea is that deviation, by definition, may not last and that price will revert to the mean. Therefore, Bollinger bands help to identify the potential for a market to find support at a low and resistance at a high. Then you may be able to achieve the elusive objective of buying as near to a low as possible and selling as near to a high as possible while doing so with manageable risk and reasonable reliability. Lines based on a standard deviation extend beyond a moving average. The bands vary in distance from the moving average as a function of the market's volatility. A curiosity of this indicator is that volatility causing a bulge in one direction causes a bulge in the opposite direction, taking it far away from price and thereby making the opposite side of the channel seem irrelevant. In practice, this doesn't affect the use of this indicator.

Settings for Bollinger Bands

The development of Bollinger bands is credited to John Bollinger, former market analyst for CNBC/Financial News Network and current president of John Bollinger Capital Management, Inc. For the technically minded, two standard deviations should contain the majority of subsequent market action. The standard deviation involves the squaring of the deviations from the average price, making the calculations responsive to short-term price changes. The bands rapidly expand or contract, therefore, with market volatility. Put another way, they are sensitive to recent market action, and they establish the range for fluctuations in price. The recommended setting is for a simple moving average of 20 units, with 2 for the standard deviation envelope.

There are several different formulas for channel bands containing price fluctuations, and many of them have similar action. Notably, Keltner bands do almost the same job as Bollinger bands. They are useful enough of the time to justify inclusion in the trader's toolbox, although, when a strong move is under way, they serve more as a coincident indicator than as help in predicting when the move might end.

Applications for Bollinger Bands

Bollinger bands are useful on charts of every duration and are used by many day traders, who have to be particularly precise about entry and exit levels. They may suggest where to get into a trade at a better price just as a market is cresting or bottoming rather than waiting for additional confirmation, such as price crossing a moving average or a trendline and showing that it can stay there. The risk may be readily identifiable and quite small, whereas the potential reward may be substantial. The objective for reward could be at least to the opposite outer band, where it now stands, and beyond that if the market does in fact respond as you expect. Then that opposite outer band can expand so as to allow the price to go farther.

Every trading methodology has its wrinkles, and the notable one for Bollinger bands is that it doesn't follow that a market will go up by a worthwhile amount just because it shows that it may have stopped going down—and vice versa if you try to sell into a potential top. If, however, you have identified the direction of the major trend correctly, and it has overall momentum, it is likely that a good move will come through when the market gets going. There is often quite a scramble as a market reverses from an overbought or an oversold condition, and price can move rapidly a long way, with pressure coming from those on the wrong side

of the market and from those aiming to enter new trades at a good price. Therefore, Bollinger bands are also particularly useful for traders taking a longer-term view who want to fine-tune entries at a good price but also want to cut trades short if price action falters.

The Beginning, Middle, and the End of a Trade

Looking at Bollinger bands another way, they help to show when a market move may be successively putting in place its beginning, its middle, and its end and then moving on to the next beginning, all of these ideally within a defined major trend. They suggest a possible entry point when the bands have been going sideways for a time and show that price has held at least once at an outer band and that it is turning again a second time or more depending on the overall strength of the major trend. Fewer bounces off the outer band are fine when the consolidation is likely to be short-lived within a strongly confirmed trend. During this setup, MACD and stochastics should be coming onside to indicate gathering momentum for a sustainable move by price off that outer band, which, itself, may start showing direction.

Assuming that there is a good trend established on the weekly and daily charts, once a trade is on its way, price should at least reach the opposite outer band and, best of all, press right through, taking the outer band along with it. Sharp moves tend to occur after the bands tighten toward the moving-average median line—a process comparable with the coiling of price zigzags within a small range. A move outside a tight range, therefore, calls for a continuation, not a barrier, to further moves in price. Once there has been a strong breakout price and Bollinger bands move together, price may hug or exceed the outer extremity. Then, ideally, the moving-average median line should contain retracements, and a retracement that holds there may provide the opportunity for a new entry.

When a market reaches the targeted outer band—as, for example, the upper band for a long position—it always pays to look out for a possible exit. The standard deviation may have completed its business of forecasting correctly how far the market might go before it has to retrace. In a strongly trending market, the price and the outer Bollinger band should stay close together and maintain the angle of the incline. Once they start to falter, it may be time to get out, particularly for a short-term trader using intraday charts. As with channel lines discussed in Chapter 11, it is the weaker market falling short of the targeted Bollinger band that is most vulnerable to a setback, whereas the strong one is more likely to keep on going.

The Length of Time for a Setup

There is the usual inescapable conflict between a short-lived consolidation or a longer one. A short-lived consolidation occurs in a strongly trending market, the kind in which you most want to trade. However, as with the principle of support and resistance generally, the longer Bollinger bands contain price during a consolidation, the more likely it is that the support or resistance will hold, and the more likely it is that the next thrust will deliver a sustainable and worthwhile move when the breakout comes, which should be in the direction of the major trend. It is remarkable how the probabilities increase exponentially when price tests a relatively flat or flattening Bollinger band two or more times and shows that the apparent boundary may hold and also support a significant and sustainable rebound.

Depending on market action and the performance of other indicators, there may be a prime entry to a new trade at the exact moment when price surges through an outer Bollinger band. When this happens after an extended period of setup, the likelihood of follow-through for a big trade is very good.

Bollinger Bands as a Negating Indicator

It is always useful to run Bollinger bands on weekly, daily and intraday charts so as to see where the market may be in relation to overall chart action. It is a rough and ready indicator but it often provides some overall guidance with respect to the potential reward and risk involved with a new trade.

Bollinger bands' function of containment means that you have to be aware of the risk for a new trade *against* the inside of an outer Bollinger band. As with overbought or oversold stochastics, this condition serves as a warning to evaluate all factors rather than amounting to an embargo. When other factors such as chart action confirm the likelihood of a breakout and follow-through, then these indications may far outweigh this warning.

Cattle and Bollinger Bands

The daily chart for June 2007 live cattle shows this market initially in a slowly and erratically waving uptrend and then gathering speed in January (Figure 12-1).

Almost every time the price went to the lower band and, in addition, there was a W on stochastics, there proved to be an intermediate low as price moved up from the band. The one prominent exception was at the arrow marked *X* in October,

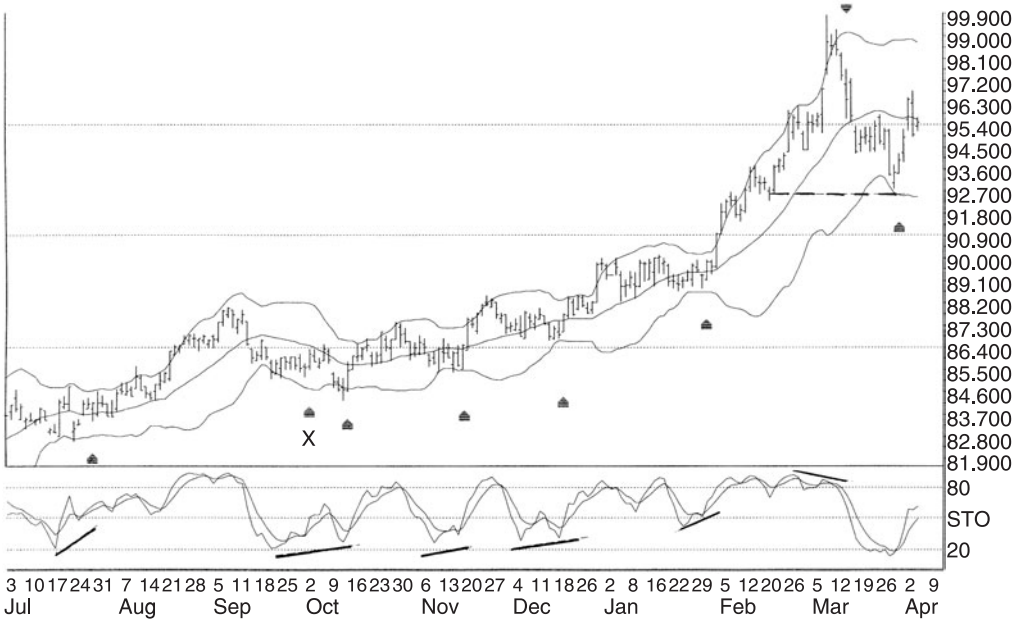

Figure 12-1 Daily chart for June 2007 live cattle, with Bollinger bands and stochastics

but the next one worked for almost 200 points before price arrived at the upper band. The most conspicuous success, of course, was when the price approached the lower band in February and took off like a rocket on completion of the W in %*K*.

Once the market took off, the price stayed between the upper band and the 20-bar moving average. At the eventual top, there was a notable bulge in the upper band and an even bigger bulge in price. It occurred in conjunction, however, with an M in %*K*, which strongly suggested that this market might be making a climactic top.

During the decline, %*K* remained steadfastly below %*D*. %*K* took an initial stand below 20 before making an eventual low at 16. In the event, there was to be no W in %*K* as this market came out of the equal and opposite climactic low, although price was to rebound from the lower Bollinger band and an identifiable horizontal support at the low five weeks earlier.

One of the most important things to note about the cattle chart is that the risk of buying was low when the price was at a level at or near the lower band. Correspondingly, the risk was very much higher in buying when price was at or near the upper band. The one exception to the ratio of reward to risk was in February, when the market had been going sideways for an entire month and then broke above the upper band.

Cattle on the 60-Minute Chart

The 60-minute chart for June 2007 live cattle shows the period when the market was going almost interminable sideways during January (Figure 12-2).

As on the daily chart, you can see that the price tended to hold between the range of the Bollinger bands, apparently unable to break higher or lower. Bollinger bands tended to warn against arbitrarily buying strength or selling weakness.

Things began to change as the month progressed, although you would barely know it either from Bollinger bands or from price. The change was that the momentum was gradually coming into the upside. To know this, you really needed some other indication. It came, as it does so often, from MACD, which began trending upward in midmonth. With strengthening MACD and the notably higher low just before the breakout, the signs were there for a potential upward resolution and possibly a significant one. Note how the lower Bollinger band contained the small retracements on the new upward trajectory.

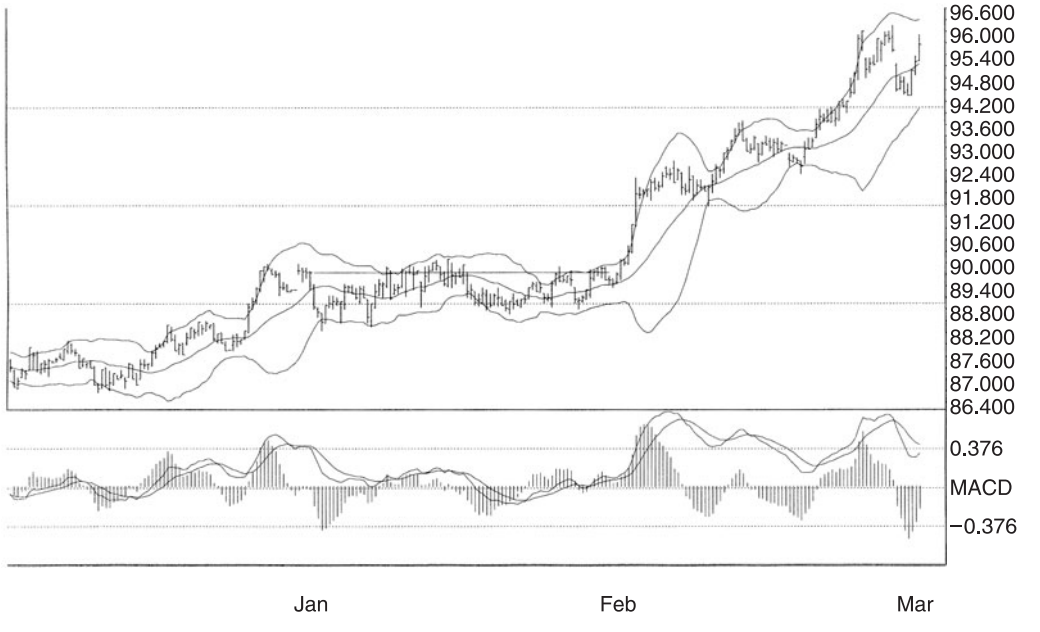

Figure 12-2 Sixty-minute chart for June 2007 live cattle, with Bollinger bands and MACD

CHAPTER
13

Chart Patterns That Work

Review Charts for Maximum Long-Term Potential

Some technicians identify a large number of different chart patterns, but there are just a few that are both readily identifiable and work with reasonable reliability. It gets better, too, when a reliable chart pattern performs as expected on a weekly chart; you can have an elevated level of confidence in staying in the market for the long haul.

Although there is never time for complacency, you can find markets in which it pays not only to tolerate larger swings for existing trades but also to buy into dips in a bull market or to sell into rallies in a bear market. There is just one important qualifier to this generalization. Certain markets have long and reliable trends quite often, and others do not. Count among the markets that often trend well the financials, including stock indexes and currencies. In recent times, the metals have trended well, especially the base metals. Petroleum has trended well to an extent, but some of the swings within major moves have been massive and far too costly for most traders to think of holding positions for the long haul.

The best chart patterns work on charts of all time frames. Within patterns on the weekly or monthly chart, there will be a succession of contratrend moves on the daily and intraday charts. Nevertheless, there may be a prime entry when a pattern falls into line on a shorter-term chart, the daily or an intraday chart, and the big picture is favorable all along. Major moves tend to follow a successful breakout from the pattern that sets it up, and it is a fundamental principle of futures

trading that you want to look for the kinds of major moves that begin with a successful breakout. Therefore, you need to watch for charts developing the kinds of chart patterns from which major moves tend to come. A major component of the challenge, however, is that even at the best of times a market may be overbought already when an upside breakout occurs, or oversold on a downside breakout. Since many breakouts abort and some backfire dramatically, particularly when the setup has lasted only a short time, you need to watch closely how market action unfolds as the breakout is developing. There need to be more confirming indicators than just the break to a new high or low.

Double Tops and Double Bottoms

The most basic and reliable chart pattern is the double top and the double bottom. Reliability increases exponentially when there are triple and multiple tops and bottoms and when the big picture forms a pattern consisting of multiple bars over a longer period. This is the same general principle as the one that forms the basis of zigzag theory and the making of M's and W's by individual bars. It is also the same principle in the microcosm of market action that is manifested by the double reversal and the Lindahl price rules. Reliability also increases in the big picture when a market is at an identifiable long-term low, or support level, for a W and at an identifiable long-term high, or resistance level, for an M.

For all that this pattern is reliable, you have to interpret it in the context of overall chart patterns and other indicators, notably, but by no means exclusively, MACD and stochastics. It is all too easy to assume, before its time, the reversal of a trend with a double top or a double bottom—particularly double tops. Note the adage, "A bull market dies hard!" Also, just because a trend seems to be stopping, it does not necessarily follow that the market will go the other way in the near future, let alone by enough to warrant attempting a trade. In apparent conflict with this caution is the obvious fact that an early entry at a good price leads to a bigger profit and it allows for a more manageable risk—but only when the indicators and also, ideally, the supply-and-demand fundamentals have the potential to line up.

The monthly continuation chart for Kansas wheat shows two separate and clear long-term double bottoms and W's, each formed over a period of several years (Figure 13-1).

The chart also shows a double-double bottom in 2004–2005—that is, with a smaller one within the larger one and with the final low shared by both of them. In the small double bottom there was actually a lower second low than in the first one, by 3.5 cents, which is no more than aberrational.

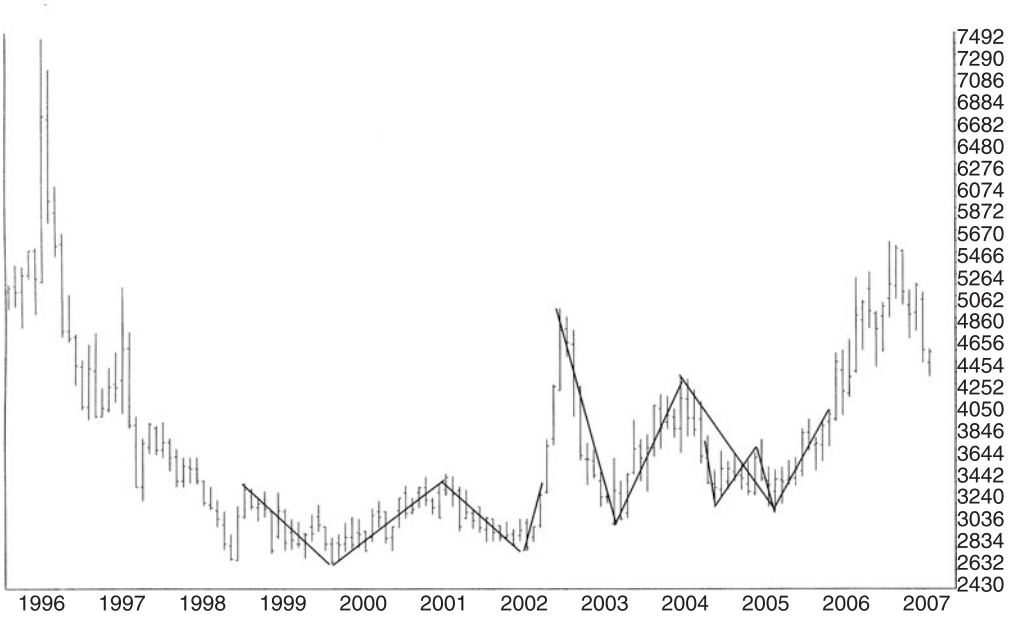

Figure 13-1 Monthly continuation chart for Kansas wheat

In principle, a big new M formed when Kansas wheat crested in 2004, although on the basis of the M alone, it might have been difficult at the time to forecast that this market could decline so far. The lesson there is that more often than not it pays to believe what the charts are indicating: *Believe the technicals!*

The Long-Term Saucer Bottom

The long-term saucer bottom is the ultimate expression of a chart pattern showing the end of a decline turning into an upward incline. It occurs fairly frequently within the universe of thousands of different shares in the stock market but only seldom on long-term charts in futures markets. However, it occurs quite frequently on daily and intraday charts, and it can be the harbinger of a huge move relative to the duration of the chart on which it develops.

When this pattern develops over several years on the monthly chart, and in addition, the price recently has surpassed a long-standing high—say, for a year or more—the likelihood of an upward extension is almost guaranteed. The development of this chart pattern is almost certain to occur with a conjunction of strong price-rule buy signals on the monthly, weekly, and daily charts. The monthly chart

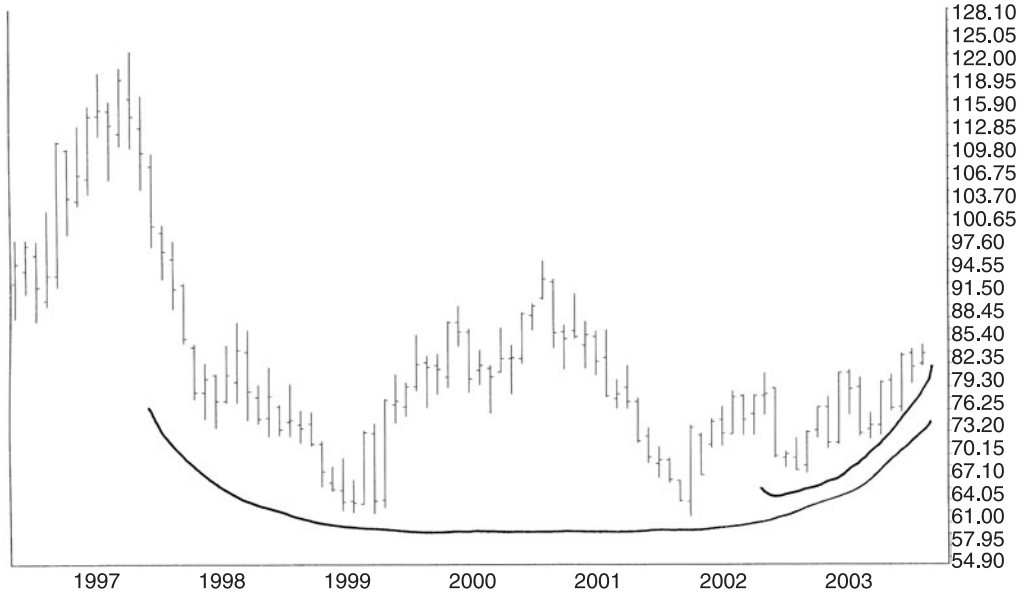

Figure 13-2 Monthly continuation chart for copper, 1997–2003

for copper shows this pattern developing over a period of five years, with additional rounding in 2002–2003 (Figure 13-2).

Sometimes the move on a breakout can be explosive, so you have to know how to look at a chart as it is developing to appreciate the potential for a substantial move. The immediately following monthly bar on the chart (not shown here) went from 82 to 94 cents, gaining in just one month as much as the amplitude of the entire range for the preceding two years!

The weekly chart for copper for part of the same period shows how this market began to gather upward momentum during 2003 (Figure 13-3).

Given the relentless decline ending in November 2001, the pattern on the weekly chart, on its own, would not necessarily have suggested that there was the substantial long-term potential that eventually took the price above $4. However, the monthly chart strongly suggested that much more might follow from a successfully tested double bottom. Note where moving-average convergence/divergence (MACD) began trending strongly upward above the zero baseline when the move got under way in earnest.

There have been similar patterns in wheat, silver, and other commodities in recent years. This chart pattern occurring in the copper market at a relatively low price level in historic terms shows the unwinding of excess supply and the

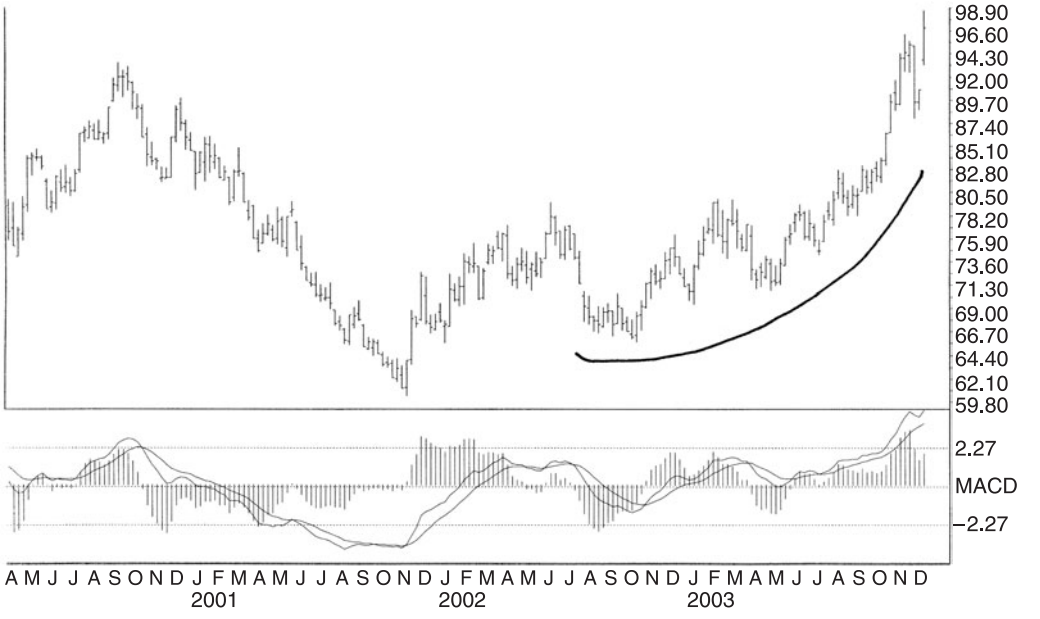

Figure 13-3 Weekly continuation chart for copper, 2001–2003, with MACD

slow-motion shift to shortage. Low prices curtailed production and led to drawdown in stocks, and demand began to exceed supply. Low prices were cured by a prolonged period of low prices, and the ensuring bull market was immense.

The Short-Term Saucer Bottom

Saucer bottoms also work on intraday charts, sometimes spectacularly. The chart for July 2007 soy meal shows price rounding out after a retracement and then heading upward with relentless endurance (Figure 13-4).

There were several places to enter trades as the price was rounding out and then again once it surpassed the light resistance represented by the lines *AB* and *CD*. MACD also began rounding out and then maintained a steady pace until the price began to falter. In a move like this, which is persistent and without significant swings, fast MACD and slow MACD simply cling to one another. It is when there are bulges in MACD that such a move becomes suspect, as indeed it did correctly as this market was making its final, terminal thrust toward the high.

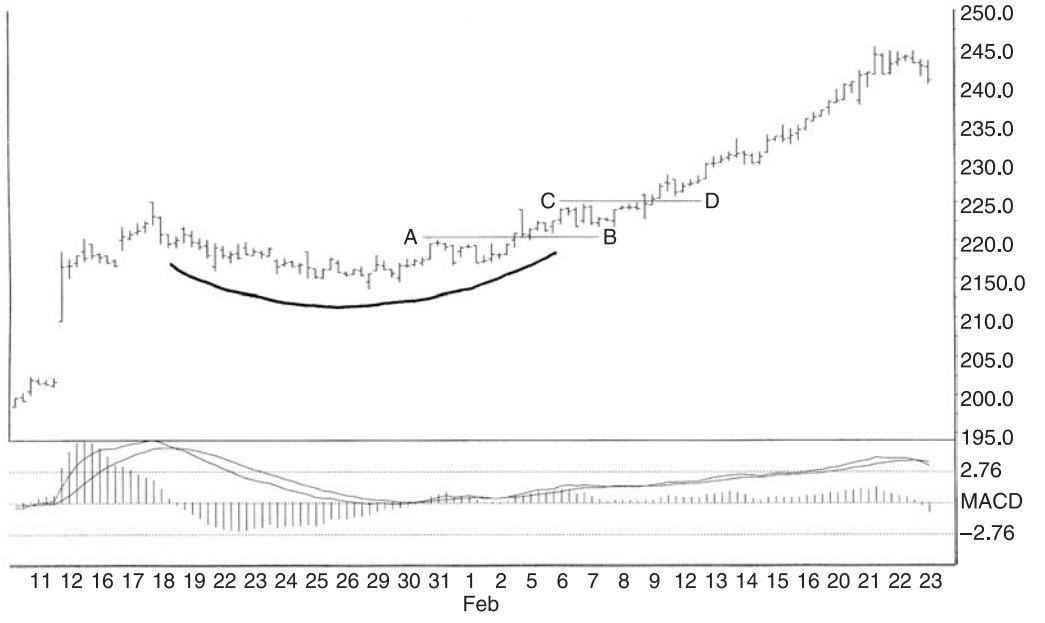

Figure 13-4 Daily chart for July 2007 soy meal, with MACD

The Difference Between Short and Long Term

There is a vital difference between the circumstances for copper and soy meal that is fundamental to the way you can expect even the best chart patterns to work in futures markets. The patterns for the two markets are very similar. However, the rounding bottom in copper was occurring on a monthly chart when the price had been low for a long time. By contrast, soy meal had already had a substantial run, and the prospect of substantial further gains was not well supported by the historical evidence. On the monthly chart for soy meal, there was a previous prominent high at $238. There was a worthwhile move to come, to an intraday high at $245.20. Then the market settled right back below $200. A move of $25 in soy meal is very much worth having, but the market had already come a long way, from the $170 level. Although there is no theoretical limit to how far any market can go, the amplitude in agricultural markets tends to be more constrained than what can happen in other markets.

In sum, when looking and hoping for a major move, you have to look at the weekly and monthly charts and look at the shorter-term chart in the context of that bigger picture.

Figure 13-5 Weekly continuation chart for cocoa, 1997–1998, with MACD

The Saucer Top

The saucer top is the counterpart of the saucer bottom, although it happens far less often. You really need to know that it is happening at a historically high level and that there is a reasonable prospect of the supply-and-demand fundamentals coming back into better balance. Then this pattern is very trustworthy.

The weekly chart for cocoa shows this market attempting to go higher at the 1,700 level for a period of about 18 months, but it was turned back every time (Figure 13-5).

Finally, in November, cocoa succumbed to fatigue, MACD was trending down strongly, and the price broke below the low from January. The long-term distributional top was to indicate correctly the start of a protracted bear market that was to take the price below the 900 level by the following May. After that, cocoa became more volatile until the final low in November 2000 at 680.

The Ascending Triangle

For the buy side, the ascending triangle is a very reliable pattern, and it is particularly powerful when other indicators confirm a trade. The idea is that you see a

succession of higher lows, but there is a flat lid on top of the highs within the formation. This pattern doesn't occur all that frequently, and it is easy to assume one that lacks backing and filling within the triangle.

Ideally, those higher lows should be as regular as possible, showing accumulation when buyers can build a position only by paying increasingly higher prices on downward fluctuations. Ideally, too, there would be a majority of closes in the upper half of the range. The tighter the coiling within the triangle, the greater is the probability that the outcome will be what you expect. An ascending triangle mostly occurs as a consolidation during the course of a major move. It can also occur when a move is just starting and forming the tail end of a sideways consolidation (discussed below). This pattern occurs relatively seldom at the end of a move, which is one reason for its fair reliability. Eventually, price must reach the apex of the triangle if it does not break out beforehand. Since it is evident from the higher lows that sellers have become less aggressive and buyers more aggressive, each time the price tests down, the probabilities favor a further increase in the aggressiveness of buyers once the price breaks out. Then the trade should fly and go to a good profit right away.

Some traders say that this pattern is likely to lead to a greater gain with more reliability when the price breaks out of the triangle some time around its midpoint and a worthwhile distance before it reaches the apex. More important, however, is the bar action and coiling within the triangle before it goes. In theory, it is more conservative to wait until the breakout happens, and then you may have a probability of success approaching 80 percent. Although it is more aggressive to buy before the breakout on the assumption that it will come through, there is, of course, the prospect of a bigger profit if the breakout does in fact happen. Best of all is normally to take an initial position within the triangle, provided that other indicators are positive, and then to add when it goes. When action within the triangle is inconclusive, then indeed it is better to wait for the breakout.

A good thing about triangles is that this formation suggests a price target that is likely to be reached fast. The market should surge up by as much as the distance between the top and the bottom of the vertical line making the base of the triangle. Some traders make the case for simply banking some or all of the profit when that price objective is achieved. On balance, it generally pays to see how the trade develops rather than have a preconceived compulsion to bank the profit just because it is there. Otherwise, the greater risk on a powerful breakout is that you bank a small profit, leaving a much bigger one on the table from a really great trade. If you get out prematurely, there is then the challenge of getting back into the market with a new trade having a manageable risk.

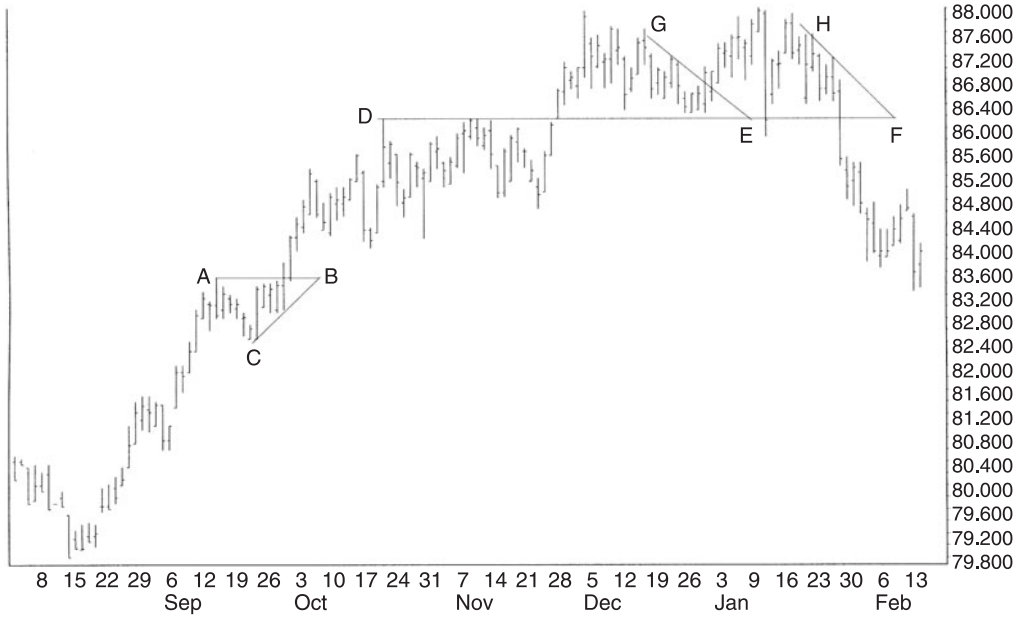

Figure 13-6 Daily chart for June 2006 live cattle

The daily chart for June 2006 live cattle shows a small ascending triangle (points *A, B.* and *C*) in the course of what was unquestionably a strongly trending bull move (Figure 13-6).

The horizontal line is clear enough, but the diagonal line is something of a moving target right to the point where the price broke out. Even more significant, however, is that there were 10 consecutive bars closing in the upper half of the range, mostly near the top, particularly the ones immediately preceding the breakout.

The Descending Triangle

The descending triangle is the counterpart of the ascending triangle, and it too is very reliable. The June 2006 live cattle chart also shows this pattern even more clearly than it shows the ascending triangle. This chart is interesting for the way it shows support holding exactly at the top of the breakout level, marked on the chart by line *DEF.* The underside of the first triangle formed by the diagonal *GE* contained price at this level, and having held support, the market took another run at the top. The next time this market formed a new descending triangle as

a result of line *HF,* the price went into free fall as soon as the base of the triangle was penetrated. After extended topping action, this breakdown was the start of a major decline. You can see that there was an intermediate consolidation for several days at a level well beyond the amplitude of the base of the triangle. The fact that it found so little support and so late was a harbinger of the further substantial decline. When the immediate follow-through is limited, there will, of course, be lower expectations of more to come.

The Long-Term Upward Breakout

Long-term breakouts are the ultimate in demonstrating an important principle for all risk management at all times for all markets. The principle is that the longer a market trades within a consolidation, the more likely the eventual move is to be both significant and also reliable when the market breaks out eventually. Reduced to its simplest terms, this is why one day's market action, unlike a price rule, seldom gives a trustworthy signal, and why reliability requires a confirmed zigzag, not just a single turn on the line chart. You may think that a market going sideways is boring and not warranting attention, but it is remarkable how the apparently sleeping dog can wake up and spring into action. However, it is generally best to wait until the breakout from a long sideways market actually happens.

A long sideways rectangular trading pattern may suggest great upside potential with relatively low downside risk once it goes. This is to say that the gain may be several times the margin money required for the trade. There always will be some risk of loss, but there are two situations that minimize the risk and fortify the probability of gain.

The Nikkei Breaks Out

The weekly continuation chart for the Nikkei Stock Index shows how this market went sideways for almost two years, consolidating a gain after reversing from the multiyear low at 7,650 (Figure 13-7).

The question now was whether this market would continue sideways, break back down, or what. In due course, this market resolved to the upside in August 2005 by breaking above the high in April of the previous year. Since the market essentially went from the bottom of the range to the top with barely a pause on the way, the breakout was suspect despite a huge high/low upside reversal that actually made it happen. The final bar shown on the chart printed here ends at the exact moment when you might have considered a trading decision, with a close

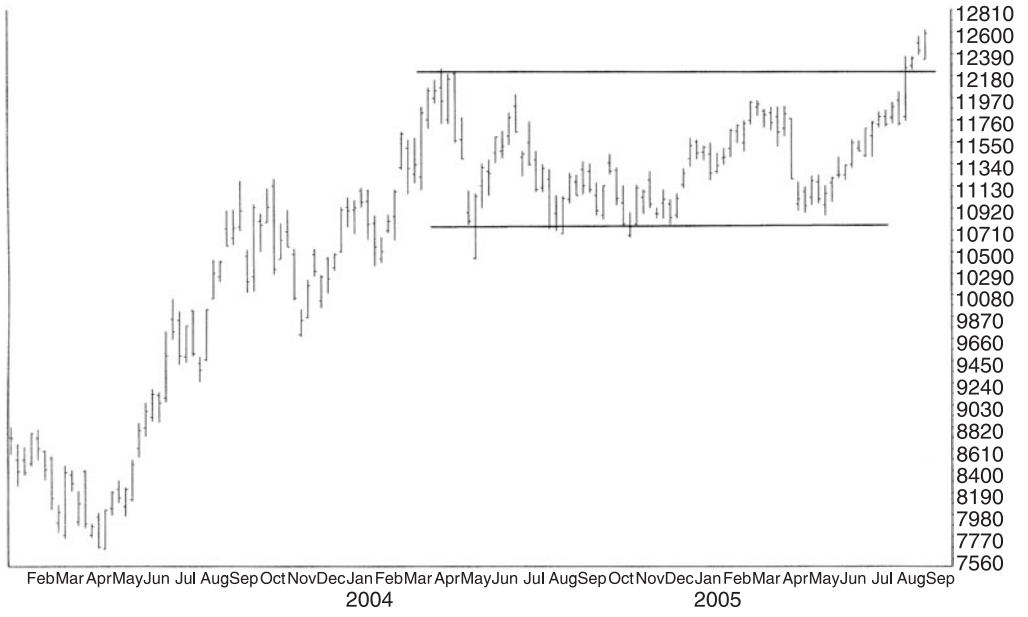

Figure 13-7 Weekly continuation chart for the Nikkei Stock Index

at 12,580. The market had gapped away but closed at the bottom. The last bar shown here is an outside up bar, with three bars open, on the basis of closes, from the actual breakout bar.

The Nikkei was now to move steadily upwards until the following January before any perceptible correction, reaching a high for that upward thrust at 16,520, a level 31 percent above the putative entry-level price. Even more to the point, the gain represented approximately three times the entire amplitude of the sideways market action preceding the breakout.

Sometimes there can be a breakout similar to the one for the Nikkei that occurs as a result of some event of lasting fundamental significance coming out of the blue—something like what a hurricane did to oil and natural gas futures in 2005.

The Long-Term Downward Breakout

The corresponding potential for a long-term trading-range breakout from a rectangular pattern occurs seldom on monthly and weekly charts at a major market top. Tops tend to be of much shorter duration than long-term market bottoms, and they tend to set up differently, and often more violently, prior to the onset of

a major bear market. Despite the shortage of this occurrence on longer-term charts, this pattern shows up more often on daily and intraday charts. Even then, this pattern may be ragged. If it is to be any good in its predicative power, then it may well resolve its ambiguity with a descending triangle.

Gold on the Way Down

The monthly chart for gold shows how the price went sideways in a narrow range for three years, making two unsuccessful attempts to break upward out of the box (Figure 13-8).

After a resounding second failure to follow through in February 1996, at the first arrow, the price simply started sliding, which happened in conjunction with the U.S. dollar soaring. Additional arrows show additional monthly downside reversal bars. You could tell that there was a high probability of a significant breakdown after completion of the monthly outside down bar, at the second arrow, just under the now-declining moving averages—itself a textbook action for a market setting up to go lower. As was predictable, however, there was to be a fearsome upside reversal bar, back to the breakdown level, immediately following the apparently

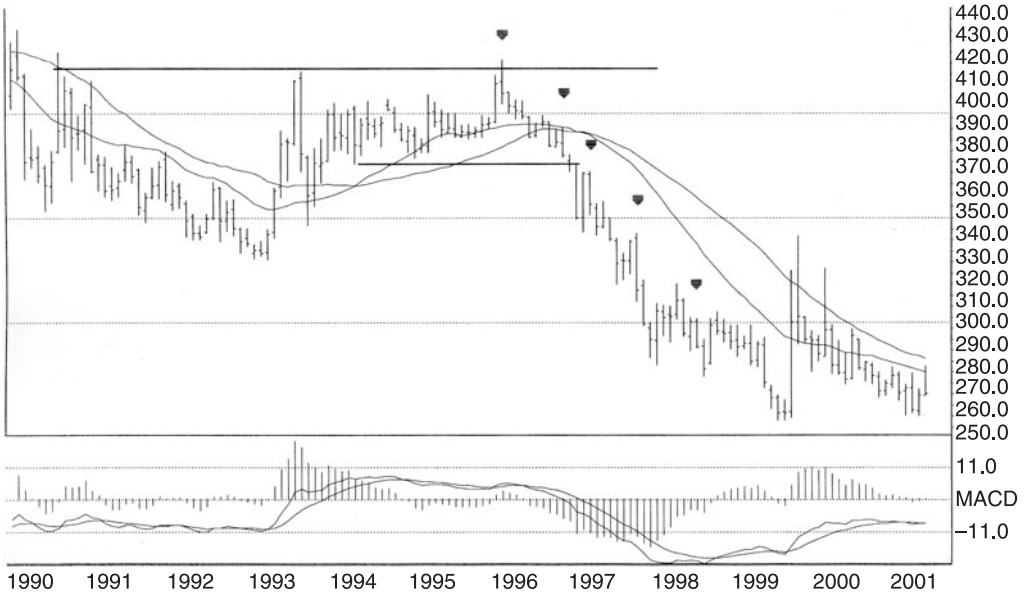

Figure 13-8 Monthly continuation chart for gold, 1990–2001

successful downward thrust. Then that upward bar was itself immediately negated by a powerful new downside reversal bar.

Note how MACD had set up well in advance of the decline. Then note how MACD started flattening well before the eventual bottom, with the final stages of the decline quite volatile, as buyers were now beginning to look for that low to happen.

This chart illustrates another point worth noting about bear markets. You don't want to be greedy about how much to take out of a declining market, and you must be prepared for rebounds. One school of thought says that you should simply take profits one leg at a time when selling short. In one sense, selling short is easier than going long in a market making new highs because you can readily tell where the support levels are and where the market might try to take a stand. In the event, the move from the close of the outside down bar at $373 eventually went to $253 at the bottom. However, the last $80 was a very bumpy ride.

The Head-and-Shoulders Top

There is hardly a more important chart pattern than the head-and-shoulders top. It is not that it always works for short sales or even for exits. However, when it does work, it can be the harbinger of a very substantial move—one that can be lethal for long positions and hugely profitable for shorts. Depending on how it forms and whether the top extends a long way out or the final thrust is shallow, the head-and-shoulders top can resemble an upside-down saucer top. The monthly chart for the Japanese yen is unusual in showing several examples of this pattern, as well as its counterpart, the reverse head-and-shoulders pattern (Figure 13-9).

The idea behind the head-and-shoulders top is that the market makes a new high, usually in a strong bull market, and then retraces normally and consolidates. At this point there is just an ordinary consolidation in an uptrend. Then the market goes to a new high—sometimes with a powerful surge having even at the time the characteristics of a furious and emotionally driven buying climax. This is exactly what happened in the yen in 1995. Sometimes, on the other hand, the market moves more grudgingly higher before succumbing to fatigue, as occurred at the top in 2000. Either way the next high is lower this time, making the right shoulder, ideally at about the same price level as the first high that made the left-hand shoulder. Generally, a lower right-hand shoulder is even more bearish than one just slightly below the central *head*. However, most of the eventual decline from the high in 2000 occurred as a single leg down from the top.

As a head-and-shoulder is approaching completion, it may well seem like a long way from the top to contemplate a new short sale, or a late sale of a long position.

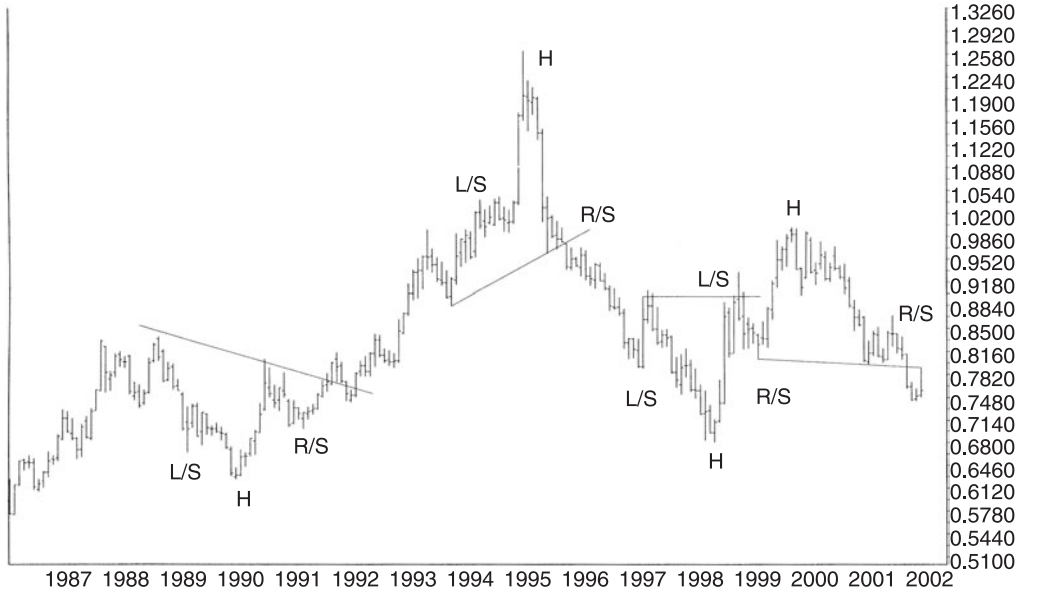

Figure 13-9 Monthly continuation chart for the Japanese yen, 1987–2002

After a long bull market, however, this is what makes for the most reliable trend reversal. A market liable to break hard may have only a short-lived right shoulder, and the consolidation, such as it is, may occur at a level somewhat below the level of the left shoulder. This too was what happened in the yen on the way down from the high in 1995.

Many technicians look for confirmation of a head-and-shoulders formation when the price breaks through a so-called neckline. While it is true that the breaking of any apparent support line may be significant, it is by no means always easy to see where to draw that line. Depending on the action of price bars, you can often assume the emerging formation of a head and shoulders before the next leg down, and once it breaks, you can then add to the position. Normally, you can find a good entry point, and one with a manageable risk, as the potential for a significant downward extension is developing. If you miss a preemptive entry, you can enter a new trade on the break when the market starts falling away.

As with other formations, such as the ascending triangle, a rough rule of thumb is that the market will go down as far as the entire distance between the bottom of the shoulders and the top of the head. Somewhat surprisingly given the immensity of the bull market, this was exactly what happened in the yen, plus some more.

There is a second head-and-shoulders pattern on the Japanese yen chart, with the head in 1999–2000, and the top forming this time more from fatigue than from

an excess of enthusiasm. In doing so, it made an irregular triangle in the process, something between a descending triangle and a symmetric one. Arguably at the time, the advance from the low had ended the bear market, and the big picture was ambiguous. In the event, the price was to hold well above the 1998 low as the yen went into a wide-swinging sideways market.

The Reverse Head and Shoulders

The monthly chart for the Japanese yen also shows two examples of the reverse head-and-shoulders patterns, with the head on the pavement. This tends to be even more reliable than the head-and-shoulders pattern when the low is at a historically low level to start with. The first low, with its head in 1990, was indeed to be the harbinger of the immense gains that the yen made on the way to the eventual top in 1995. Note how the right-hand shoulder was higher than the left-hand one. It may look on this chart as if it took only a short time to form the right-hand shoulder. In fact, its six months of gestation may have seemed like an eternity to a futures trader expecting instant gratification. Unlike this reverse head-and-shoulders formation, the one with its head in 1990 had a labored right-hand shoulder. This grudging market action was to lead to an underperforming extension to the eventual high.

Both the head-and-shoulders pattern and the reverse head-and-shoulders pattern can be extremely useful on shorter-term charts, as illustrated by the chart for February 2007 pork bellies (Figure 13-10).

Note the very powerful outside up bar right at the low. Not shown here is that this reversal occurred as price tested and held above a prominent low on the daily chart from a month earlier. MACD started turning up and trending higher in textbook fashion. An advance of 18 cents was to get under way from that low before this market showed any serious need for a rest.

Ambiguous Chart Patterns

The corollary of chart patterns that are reliable is the list of chart patterns that are ambiguous or untrustworthy. Many analysts present the symmetric triangle or the diamond-shaped pennant and say that you should look to trade in the direction of the breakout. This is all very well up to a point, but you should already have an idea which way the market ought to break out based on other indicators showing direction and momentum. Another problem with symmetric triangles, when you look at them without regard to other indicators, is that they make apparent breakouts too often, only to abort and then go the other way.

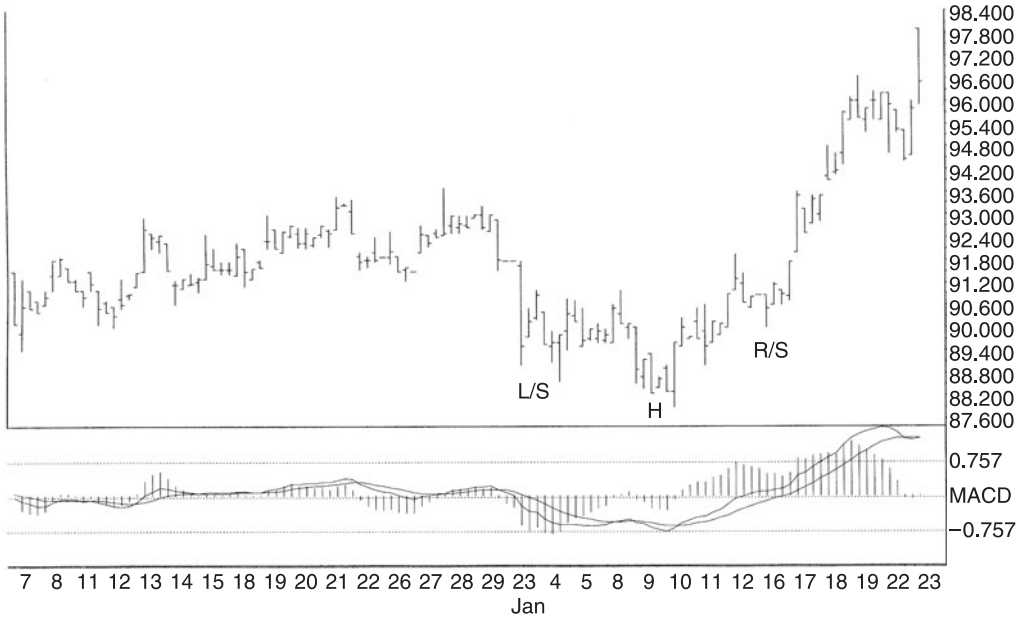

Figure 13-10 Sixty-minute chart for February 2007 pork bellies, with MACD

Somewhat similarly, the retracement flag—a rectangular pattern going against the direction of the trend—tells you little about whether you want to be in a trade, let alone when you want to assume that the retracement has gone far enough. Sometimes you can reasonably assume the end of a retracement when price breaks out of the flag and shows that it is picking up to continue where it left off. However, the retracement flag in itself is not particularly useful or at least not until price reaches a potential turning point, such as a trending moving average or an identifiable support or resistance level.

CHAPTER
14

Cycle Theory: Time-Based, Cyclical, and Seasonal Forces

Technicals Should Fit the Timetable

It is a statement of the obvious that markets fluctuate. Less obvious is the extent to which traders can forecast fluctuations in both time and price and do so with useful consistency. There are some regular behavior patterns and corresponding techniques that are fairly easy to apply. Others are more arcane and less accessible, and in any case, they tend to be less reliable. For traders looking at cyclicality from the perspective of maximizing gains with the most manageable risk, it is enough to concentrate on those aspects of periodicity that have been most consistent in the past and which are likely to continue with above-average reliability.

Operating in conjunction with theories related to time-based market forces is the overriding principle that markets are likely to continue doing in the future what they have done in the past. Market players are human, and human behavioral patterns recur. Some markets almost develop a personality deriving from the people who trade them. Regardless, therefore, of any time-based theory, such factors as support and resistance arising from previous market action are likely to dominate when there appears to be a conflict. If price reaches a major support level before time-based theory suggests the time for an ideal low, the market may just stop at that level and mark time. Many traders are as responsive to high and low prices as any consumer shopping on the basis of the weekly advertisements put out by grocery stores. Knowing what they consider a fair price, they buy or sell accordingly.

The application of all time-based forces is subject to an apparent contradiction. Although market action and cyclical timing may not come together with sufficient reliability to use in isolation, market action responding when the timetable says it could can drive a market a long way. Thus, you may have an idea of when you could be looking for something to happen, as with soybeans (discussed below). Then you want to be looking for technical signals to take a trade or to close one out. In sum, it is remarkable how often really strong signals occur within an expected seasonal or cyclical time frame. However, it seldom pays to take any trade at any time without positive confirming technical action.

Boom and Bust Market Cycles

In the very big picture, there are major business cycles and major price cycles for different commodities. Some commodities have very long cycles, and some, such as most agricultural products, have relatively shorter ones. The underlying force behind specific long-term commodity cycles is profitability for producers. When prices are low and production delivers little or no profit, some producers withdraw from the business, and there is little or no new investment. A classic example is what happened in the mining industry with copper between 1998 and 2003. There was almost no new investment, with above-ground stocks burgeoning and price in the doldrums. In due course, demand, largely from China and India, caught up with supply. Inventories fell close to zero, and the price soared to unbelievable highs between 2001 and 2006, from 62 cents to $4.15 from low to high. The cure for low prices, eventually, was low prices.

It practically never fails to happen that when prices are high and everyone is making money, few can resist the lure of profits to make new investments and to increase production. In due course, high prices and rationed demand induce oversupply, and the price falls until the excess of supply causes losses for everyone. As before, when prices were low, some producers leave the business. Even those able to withstand hard times reduce production, although in some industries the opposite may happen. At least for a short time—sometimes it pays to increase production and to dump product into an unreceptive market as long as price covers marginal costs. Then the stage is set for the next swing of the cycle. This phenomenon affects almost every industry and every commodity some of the time, with even production of such stolid materials as steel, on occasion, hugely profitable.

It used to be that there was hardly an area of the commodity market more susceptible to huge swings in both production and price than meat markets. Like clockwork, the cure for high prices was high prices, and the cure for low prices was

low prices. Recently, there has been some evidence that there may have been a fundamental shift that could prevent the return of bankruptcy-level prices.

Calendar Time Theory

For immediate use to futures traders, there is a tendency for the following times to be significant:

1. *The Friday close*. A closing price at the extremity of the day's range on Friday has an above-average probability of following through on the open on Monday (or Tuesday when there is a long weekend). By extension, gaps on the open at the start of the week tend to have added significance, as well as gaps on the first day of the month. Therefore, the timing is particularly favorable to enter a new trade when there is an entry signal on the Friday close, and there is often a strong case for closing out an underperforming trade.

   An exception in recent times has been the behavior of petroleum markets and, to a lesser extent, the precious metals. With so much political uncertainty, many traders have been unwilling to carry short positions over the weekend. Therefore, regardless of the major or intermediate direction, the market has often gone up on Friday, sometimes notably from about mid-morning or in the last half hour or so. Unless the trend has been strongly bullish, these markets have then weakened early in the week.
2. *Around month-end and the first two or three days of the month*. Here, expect turbulence and sharp market moves, up or down, either continuing a move or ending one. Money managers tend to have new money around the start of the new month. Also, futures traders sometimes make big shifts in commitment to markets around month-end, whether to lock in the profits on which their bonuses depend, to take losses, or to position their trades for the next month's market action. Therefore, a strong monthly close, in whichever direction, may establish the major direction for some time to come.
3. *The week before a national holiday*. There is a strong tendency for the stock market to go up during the week before a national holiday and particularly on the day before the holiday or before a holiday weekend. Then it should follow through on the first day after the holiday. It seems that holidays make people feel good, so they want to buy stocks or, at the very least, cover short positions. If, on the other hand, the market goes down on the day before a holiday, then it is likely to go down when it reopens.

4. *At the new and full moon*. Many years ago, Ian McAvity, publisher of the market letter *Deliberations*, did a major study showing that stocks tend to make at least a temporary top around the full moon and corresponding lows around the new moon. In recent years, this pattern has been less reliable than the study might have led one to expect. Nevertheless, there is some basis for traders in any futures market to be aware of the moon. When a move seems to be starting, in either direction, a day or two either side of the full moon or the new moon, there is a somewhat increased probability of it following through.
5. *At the year's quarter markers, the equinoxes and the solstices, when stock taking historically has occurred, notably in Europe at the equinoxes with agricultural leases*. Of course, the winter solstice occurs very close to the stock taking widely done around New Year's Day.

Cyclical Periodicity Theory

At the best of times, cycle theory for real-time market trading tends to be somewhat tenuous. Nevertheless, there are standard features of cycle theory that stand the test of time and apply to all markets most of the time. Regardless of how much time you spend on cycle theory, it is useful to internalize an understanding of the fact that a market's cyclical fluctuation, once started, may go a fair distance in both time and price before it runs out of steam. By extension, however much credence you give to the expectation of a cyclical crest or valley, you need to wait for confirming action in price and other indicators before entering a trade or closing one out. Other indicators such as stochastics serve to identify, by other means than counting, cyclical action as it is developing, but it is useful to know beforehand, by counting, when to expect a turn. It is remarkable how it can pay to be patient when watching a market that you believe you could want to trade and to wait until the pieces, and the signals, fall into place.

One of the key characteristics of cycle theory is that you expect to see a prominent low in price every so often and not just a ripple. While it is true that many smaller cyclical lows may be imperceptible, normally you can count on a worthwhile decline, if only a temporary one, in every market every so often. In order to make a major cyclical low happen, it is necessary for price to decline fairly substantially from a significant high so that the market does a good job of washing out weak long positions and puts them into stronger hands. When a market has gone up a fair amount, you need to watch for the near certainty that at some point there will be a shakeout. When this happens, it often looks at the bottoms as if the only direction can now be down to still lower price levels. Then it is challenging

to believe that the market can continue higher after all. Reality is that declines do run out of sellers, and then prices do go up. Although various support levels may suggest where the market might stabilize, it seldom pays to attempt to buy at or near the bottom of a potential cyclical low until there is real evidence of stabilization. Evidence comes mostly from such indicators as stochastics and, of course, price action itself.

Regardless of whether markets turn fast or slowly at cyclical lows, the probabilities are outright unfavorable for making money until the technical evidence of a cyclical low really falls into place. The risk when fishing for a cyclical low, before the evidence comes through, is that it may not come until the market has gone a lot farther than you would ever believe possible: Declines feed on themselves as more traders holding long positions despair of the market, making that expected cyclical low. It has to finish washing them out. The probabilities may seem reasonable to buy an initial position preemptively when price reaches a prominent trend line. Even so, there may be another leg down, if only enough to establish negative divergence in stochastics. There is the perpetual challenge that you not only want to see the market stop going down, but you also want to see it setting up to go higher.

Applied Periodicity Theory

Here is a summary of periodicity theory, the idea being that intervals may occur at statistically useful predictability:

1. For an expected cycle, start counting from a previous prominent low, ideally where at least an intermediate trend has reversed.
2. Even the most dedicated cycle devotees frequently run into difficulty deciding which low to begin counting from and may keep changing their minds or allowing for an alternative count. In a powerfully trending market, expected cycle lows can be almost imperceptible or can disappear entirely. Nevertheless, they should reappear more or less on time some time later.
3. Cyclical lows have a fair level of reliability, but cyclical highs are very erratic for almost all markets. Nevertheless, it is useful to count how many days or weeks a market has been going up because subsequent cyclical action is likely to repeat what happened before.
4. Most markets have an erratically identifiable shorter cycle of approximately four weeks or 20 market days, with longer cycles of multiples of four weeks. The perfect shorter cycle, sometimes known as the *trading cycle* because of its use for entering and closing out positions, would be for the market to go

up for 10 market days and then down for 10 market days. When, however, a market sets up a pattern of, say, five-week cycles, that pattern is likely to continue.

5. Longer and more powerful cycles consist of a number of trading cycles, with prominent lows often occurring at 8-, 16-, and 24-week intervals. A strong bull market might go up for 18 weeks and down for 6 weeks. A relentlessly declining bear market might go up for 3 weeks and down for 21 weeks.
6. Cycle theory often comes together with seasonal patterns, notably in field crops, with a distinct and fairly regular annual cycle. Sometimes there are also notable half-annual cycles of 24 to 26 weeks.
7. Within any identifiable cycle, an early low is bullish, and a late high is also bullish. The point is that money can't wait to get in, so it moves early and keeps on coming so that the inflow ends late. Turning this around, a low occurring late or one disappearing altogether is bearish, and an early high is also bearish.
8. Cyclical highs wander for a pastime and are unreliable. Nevertheless, it is useful to look at timing for a cyclical high when you are already looking to exit a long position or to enter a new short sale.

   A notable exception to apparent unreliability over the very long term has been a high in the stock market occurring in April or May. Then it may not necessarily go down much into a cyclical low occurring ideally in October, but it may have difficulty going up much in the summer months (discussed in Chapter 16).
9. It can happen that a market top occurs near the exact time when a market low is expected, and this phenomenon is known as a *cyclical inversion.*
10. There is a recurring and curious phenomenon, not scientifically based but more reliable than the probabilities might suggest, that some exogenous event often happens when cyclical or seasonal patterns suggest that a market turn is due. Then a market that is already extended in the direction of the trend may reverse very smartly. Of course, a sharp reaction is the standard outcome when many traders are surprised. And caught flat-footed.

Coffee Makes Lows on Time

Figure 14-1 shows the daily chart for May 2007 coffee, with stochastics and the 20-day cycle superimposed from the day of the major low in September 2006.

The figure also shows the moon phases, with the day of the surge in October occurring on the day of the new moon and the one in April occurring just before

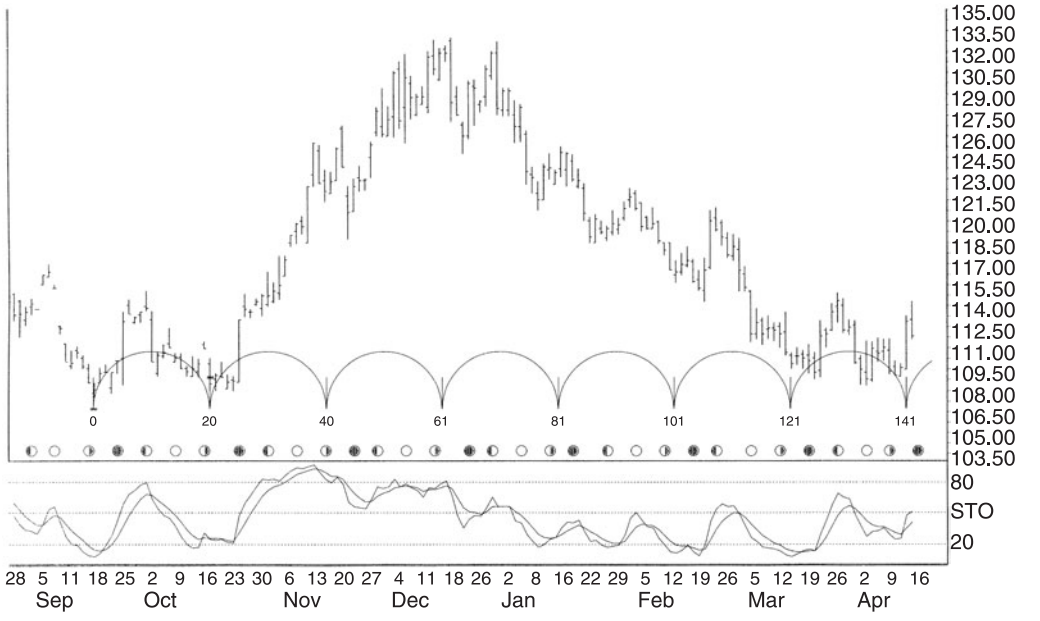

Figure 14-1 Daily chart for May 2007 coffee, with 20-day cycle and stochastics

the new moon. The low in April occurred at 141 days, or at seven weekly cycles. Although the cycles on this chart are obviously quite erratic, this chart is actually quite a good representation of cyclicality. Unusually, it was almost of more use in suggesting crests on which to sell than lows on which to buy or to cover short positions.

It is noteworthy that the big retracements during the big move up were short-lived until the market finished topping out. Then the rallies were short-lived, although some of them quite sharp, during the downward phase. In April, the market was clearly trying to take a stand with a double bottom four weeks apart and at the same level as the September double bottom.

As discussed in Chapter 15, the commitment of the big fund managers to this market finally shifted from net long to net short at the April low. With their bias toward the long side of the market regardless of the major direction, the funds held their maximum long position in November but were still quite long well into January.

The October to May Stock Market Trade

There is an amazingly reliable seasonal trade to buy the stock market in the last week of October and to sell on the last day of April. I have covered this phenomenon in

considerable detail for more than a hundred years with long-term statistical tables in my stock market book, *The Streetsmart Guide to Timing the Stock Market.*[1] The apparent reason is that mutual fund sales fall off significantly during the summer months, and therefore, the money isn't there to drive up prices, and it's money that makes the pony go. There is a cyclical low due in October, which may be accentuated by tax-loss selling. Then the money flows start coming back again bountifully, and the market goes up.

Some people have recommended advancing the date to buy to the first of October. However, some of the most violent declines have occurred during that month. Therefore, it pays, on balance, to go through that potentially dangerous period unless the indicators are overwhelmingly positive. Then, November and December should show solid gains with limited risk of loss.

It does not follow that the period from May to October invites short sales, although the market does sometimes go down. It also sometimes goes up. The point is that there is overwhelming statistical evidence that the stock market tends to go into a period of sideways market action, and you need a good reason during this period to hold stock indexes long or to put new money into any individual stocks. Also, you have to beware of the cyclic and seasonal potential for a sharp decline in September and October, for which there may be a prime opportunity for a substantial but short-lived trade on the short side. Traditionally, a decline in the autumn has made a cyclic low from which the market then could go up strongly into the New Year, and often for many months.

Soybeans and the Harvest Low

As a result of the dramatic expansion of ethanol and biodiesel, the overall price level of grains and other field crops may have moved to a higher level and may stay there, but most likely the seasonal pattern of a harvest low will continue. The big runup in the price of beans beginning in the final quarter of 2006 occurred despite big crops in the northern and southern hemispheres and record carryover stocks. This market action demonstrated the principle that markets look ahead to concerns other than immediate supply-and-demand fundamentals when there is a perception that things may change.

[1] Colin Alexander, *The Streetsmart Guide to Timing the Stock Market*, 2nd ed., (New York: McGraw-Hill, 2005).

In any case, for past repetition and the statistical probability of its continuing in the future, it is hard to beat the regular drum beat of market lows in North American grains, specifically for soybeans in November, give or take a month or two. At harvest time, supply is most plentiful, and in a year of good crops, storage is least readily available, whereas demand remains fairly constant. Some growers have to sell right away because they have limited storage capacity of their own, some sell because they need the money, and some sell because it pays to deliver right off the field. So far, so good, but what actually happens to prices?

The monthly continuation chart for soybeans shows arrows below the bar for November of each year between 1991 and 2006, except for the two years 1997–1998 and 2000–2001 (Figure 14-2).

There was no identifiable low when the market was declining relentlessly from the preceding great height in 1997, and there was no follow-through in 2000 despite a very strong monthly Lindahl price rule to buy. In 13 of the 16 years there was an identifiable low in or around the last day of November. In some of those 13 years, as in 1993–1994, the following rise in price was quite small and of short duration, but in others it was huge. During the longer period from 1971, there were 24 clearly identifiable lows in 36 years around November, or exactly two-thirds of the time.

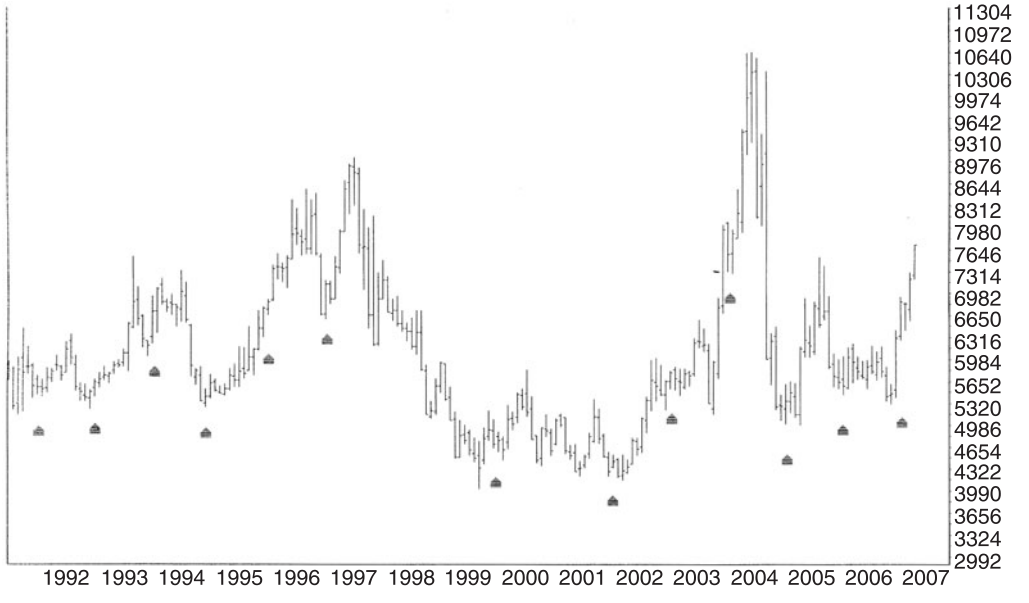

Figure 14-2 Monthly continuation chart for soybeans, 1992 to 2007

Looking at the soybean chart, these features stand out:

1. There is a very solid floor at around the $5 level.
2. There is a bankruptcy-level low at around the $4 level—unlikely to recur but indicative of how a solid floor can develop.
3. The latest breakout level in 2007 is the 2006 high at about $6.20, which may be the new and lasting floor level.
4. When the price is already quite high in November, this does not mean that it cannot go much higher still, as notably in 1996–1997, 2003–2004, and in 2006–2007.
5. You cannot blindly buy soybeans in November, but you can look for a trade on the long side of this market about that time.
6. Contrary to what you might expect from cycle theory, during the limited period covered by this chart, there is no statistically greater expectation of gains when the low comes early.
7. There is no statistically reliable basis for establishing when a top might occur. However, there is considerable evidence of a recurrent weather-driven surge in price during the spring and early summer, with the July 4 weekend sometimes pivotal either for a top or an extension.
8. *Beans in the teens* has never happened. Yet. The price briefly hit $12.90 in the massive runup in 1973.

There is a similar pattern of important seasonal lows in wheat in the general time frame of June to August, with July preferred. In recent years, lows in corn have been more erratic, sometimes occurring a month or two before soybeans. Despite the preponderant significance of the market for corn, soybeans tend to be the market leader. The general rule used to be that it takes soy meal rather than the soy oil to sustain a good bull market in soybeans. This may have changed with the added demand for the oil for biodiesel.

There are other seasonal forces affecting different markets with varying degrees of reliability, and some of them change over time. Many of them express the principle that the price of straw hats is low in winter and rises to a peak around the peak of the holiday season. Then it goes down. For example, the market for heating oil may peak in November or December rather than at the time of peak consumption a month or two later because that's when the entire pipeline leading to consumption is at its fullest. On the other hand, there is also a counterintuitive time of high demand for diesel for automotive use during the summer, and diesel is almost the same as heating oil. Similarly, the price of lumber falls off in late summer as home building slows before winter.

Other Seasonal Patterns

Here are a few more seasonal patterns that have been reliable enough in the past to see what happens in these markets as they approach the time for a possible turn. When, for example, there is a prominent low expected for lumber in October, it stands to reason, of course, that there may be a good short sale in August and September just as much as there might be an opportunity to buy around the time of the expected low.

1. Lumber tends to make an important low in October, around the low point for construction. Prices then rise into the new year as production slows in conjunction with dealers preparing for the next year's construction season.
2. There is moderately reliable evidence that copper goes up from late summer into late winter and then sells off, presumably as a result of higher demand from manufacturers after the holiday season in the northern hemisphere.
3. Live hogs sometimes sell off in the August to October time frame as the period of high consumption of pork drops off in parallel with increased supply, with the ideal low in mid-October.
4. Petroleum prices tend to peak between October and December as wholesalers finish filling their tanks for winter. There is also a period of high demand for energy during the summer months for air-conditioning. Contrary to what you might expect, there is also a bulge in demand in summer for diesel, the equivalent of heating oil, by transportation companies. Therefore, on the basis of anticipated demand, these moves are likely to be some time ahead of the high delivery times, say, in August/September and February/March.
5. Gold and silver tend to make a high, or at least to pause in a bull market, toward the end of the first quarter or early in the second quarter, and to go up toward the end of the year, making a pattern that resembles the one for the stock market.

Statistical Trades Need Caution

You have to approach with great caution the seasonal trades that some analysts recommend. Look at old textbooks on technical analysis, and you will find claims for seasonal patterns that may have worked once but don't seem to have continued working subsequently. Also, you often see it said that during a certain time frame a market has gone up or down nine times in the past 10 years or with some

such other apparent statistical credibility. While this empirical evidence may be correct, and it can alert you to a possible trade, you still need to have confirming technical indicators to venture a trade. In addition, there should be some underlying reason for the concept that makes sense. Often, of course, there may exist such a reason, although you don't divine what it is until later.

One problem with supposedly reliable trades at a certain time is that many statistical claims derive from the arbitrary law of runs rather than from sound statistical methodology or supply-and-demand fundamentals. Statistical probability theory really requires a record for what happened 100 or more times, with a reasonable level of credibility deriving from a sample of 30. Anything less may simply result from random aberrations unless you also find an underlying reason for what happens. Subject to these reservations, there are some good seasonal and cyclical trades with good credibility over the long term.

CHAPTER
15

Commitments of Traders: Who Trades What and How Much?

Money Makes the Market Move

Money and the correspondingly superior aggressiveness of buyers or sellers drive changes in price. Following on from this principle, it is useful to know how much money is driving a market and where it comes from. Enough of this information is available for futures markets to be useful.

When new money is coming into the market, open interest expands, and expanding open interest normally reinforces a trend in price. (Open Interest numbers for the previous day are published daily by market news services and in major newspapers. They are also included in the Commitments of Traders reports, discussed below.) When open interest is contracting, it means that traders are taking money off the table and withdrawing from the market. Sometimes, smart-money traders start withdrawing from the market before a change in the price trend. They include those that entered their positions at a good price, having gathered what they saw as the low-hanging fruit, and are now content to bank their profits. Therefore, you need to be suspicious of a price trend when open interest is contracting, as happens more often toward the end of a bear market than a bull market. On the other hand, peak open interest often occurs at market tops, when there is no limit to enthusiasm for the long side of the market, and smart, well-financed accounts take the other side of buying driven more by emotion than economic justification.

Interpretation of open interest is always somewhat arbitrary but it pays to keep an eye on it so as to get an approximate idea of the overall health of a price trend.

This indicator works on more or less the same principle as the on-balance-volume indicator that is so useful for trading stocks, although it is of limited use for trading futures. You need to pay attention when there is a new record for open interest, and also when there is a record long or short commitment for any category of traders, and particularly when there is a record percentage committed to one side of the market or the other. Typical of how a market can reverse violently was the dramatic rally the Japanese yen in July 2007, which followed an immense bulge in the short positions to a record level held by the noncommercials, and a corresponding record long position held by the commercials.

An exception to the standard interpretation of contracting open interest occurs just before First Notice Day or, for contracts settle in cash, just before contract expiry. Then open interest may contract significantly without meaning anything for the future direction of the market. Some long-term holders withdraw from the market until they see which way the wind is blowing. The build-up in open interest then resumes over the next couple of weeks or so.

The Commitments of Traders (COT) Reports

Every Friday, the Commodity Futures Trading Commission (CFTC) publishes the Commitments of Traders (COT) breakdown showing which groups of futures traders hold the long and short positions. It is available at the Web site www.cftc.gov/cftc/cftccotreports.htm. The COT reports come both with and without inclusion of options positions (Figure 15-1). The combined futures and options reports, consisting of more data, are more efficient and allow for less aberrational statistical error. There are four categories, the *noncommercials* (large accounts and now mostly the funds), the *commercials, index traders,* and the *nonreportables* (small traders). Currently, the CFTC publishes the subsector for index traders only for 12 agricultural markets. For the rest, the listings combine the numbers for the commercials and the index traders. Disregard the listing for *spreading*, which consists of traders having an equal number of long and short contracts in different delivery months. Below each category is the actual number of contracts held long or short, and near the bottom of the table is the percentage of the total held by each category of trader. There are substantial differences between markets and there are also significant seasonal variations in some markets. Despite these challenges, interpretation of COT is increasingly useful when you look at the numbers in their historical perspective.

The actual numbers are important when there are substantial changes, but most of the time it is sufficient to look at which category of traders holds what percentage of net long and net short positions. Then you can see the trend in those

COT – Supplemental report - option and features combined positions as of March 27, 2007

	Reportable positions											
	Non-commercial			**Commercial**		**Index traders**		Total		**Nonreportable**	
	Long	**Short**	Spreading	**Long**	**Short**	**Long**	**Short**	Long	Short	**Long**	**Short**
CORN - CHICAGO BOARD OF TRADE											
CFTC Code #002602						**Open interest is 2,047,064**					
Positions											
	289,343	**61,132**	632,052	**505,174**	**1,024,362**	**379,863**	**11,921**	1,806,432	1,729,467	**240,632**	**317,597**
Changes from: March 20, 2007 (Change in open interest: –22,656)											
	–10,173	1,046	–5,843	–8,328	–22,455	9,512	1,460	–14,832	–25,792:	–7,824	3,136
Percent of open interest represented by each category of trader											
	14.1	**3.0**	30.9	**24.7**	**50.0**	**18.6**	**0.6**	88.2	84.5:	**11.8**	**15.5**
Total traders: 816 Number of traders in each category											
	222	128	263	312	373	26	13			672	686:

Figure 15-1 Commitments of Traders breakdown

net positions and when and at what level of extremity those net numbers have coincided with trend reversals in the past. Look at the changes both from the previous week and over time. With the ever-increasing flow of money into futures markets, it has become increasingly difficult to know what level constitutes an extreme but the general principle of seeing what has happened in the past remains helpful. Sometimes, reversals occur again at the same extreme level where they happened in the past, and at extreme levels the reversals can sometimes be dramatic.

Figure 15-1 shows how the CFTC presented the COT numbers in the "Supplemental Report, Combined Futures and Options Positions," for corn on March 27, 2007.

The Commercials

The CFTC defines commercials as those traders normally capable of taking delivery, as opposed to others who might do so only exceptionally, but not normally. Any speculator can, for example, take delivery of a copper contract and hold the metal in storage, but that is unusual. Within the commercials are essentially three subsets. The first is the hedging community, or the trade, who are the producers and users of the underlying futures contract. The second is the professional market-making community, including floor traders. The third, for the 12 markets

for which the CFTC does not separate them out, includes most of the index traders, discussed below, with the others counted as noncommercials.

In theory, although less so in practice, hedgers should be on the right side of the underlying fundamentals of the market. They employ analysts who pore over the numbers for estimated supply and demand, and attempt to use this work to forecast prices, sometimes far into the future. Some hedgers are long-term traders. A mining company, for example, might want to enter a large long-term short position so as to lock in the price of expected future production. The secured pricing then permits budgeting for the margin between expenses and revenue. A selling hedge may even be a condition of financing for the mine. Similarly, a builder might buy lumber futures so as to lock in that component of construction costs.

Hedgers can also be short-term traders, aiming to profit from short-term swings in the market. When these producers think the price is high, they add to their selling hedges, and they may cover them on dips in price. When, on the other hand, users think the price is low, they add to long positions, and they may take profits by selling into rallies. Market reports often comment that speculative buying was capped by trade selling, or vice versa for buying on declines. However, despite what ought to be the wisdom of hedgers, it happens remarkably often that they get the market badly wrong.

Many among the professional market-making community are very short-term traders and 10 minutes may be a long-term trade. They make much of their money by taking the opposite side of a surging market or one that is plunging. It often happens that there is a big move on the open as a result of some major news announcement. These traders may be taking the other side of the stops and of trades entered by those expecting, often wrongly, that the market will gap away and keep on going. When the market settles back after the initial surge, these traders cash in their profits. They are seldom badly wrong about the market for long. When they hold positions overnight, they have a high level of confidence in the market continuing in their favor. As a result, they contribute significantly toward a strong close in one direction or the other, when they refrain from taking profits, let alone taking the other side of the immediate thrust going into the close.

The third subset of commercials in markets for which the numbers are not counted separately, the index traders, consist almost entirely of accounts holding long positions for the long term and, mostly, regardless of market fluctuations. For them, the idea is that over the long term commodity prices are always rising. Accordingly, they are long-term investors and most of them want to be long a basket of commodities. For all practical purposes index traders hold almost no contracts short. To some extent index traders and the other commercial traders offset one another in a rising market. In a declining market, index traders may not be heavy sellers, but they may not support the market either.

In theory, the commercials, other than index traders, know more about the market than anyone else, and they do not intentionally lose money. When selling into a rising market, they may be prepared to go on scale-up selling, but in a strong market they make sure that they get paid a good price for doing so. At major tops and bottoms, the commercials tend to be overwhelmingly on the right side of the market, although the hedgers among them may have suffered considerable losses in the meantime. For them, however, these losses are offset by the better prices at which they do business for the underlying commodity, the *actuals*.

When the commercials hold a notably large number of contracts on one side or the other, there may be a condition for a major reversal in price, although COT provides little help in knowing when that might happen. Some markets tend to have more commercials on the buy side most of the time, and some markets more on the sell side. The commercials tend to be weighted more or less heavily short most of the time in metals markets, but the weighting is much more evenly spread in many other markets. The commercials, for example, are almost always heavily short platinum and palladium but that does not mean that those markets are always vulnerable to a decline. To get an overview of what the commercials are doing, it is imperative to look at the historical record and to factor in, as best you can, what the index traders are doing.

The Noncommercials (The Funds)

The noncommercials mostly consist of the big hedge funds. Some of them hold positions for the long term and some are short-term traders. The key element is their flexibility and readiness to hold positions either long or short. Funds taking a longer-term view are mostly trend-followers, and they tend to make the market go. Having, as they now do, almost unlimited capital relative to the commercials, they can push markets around in the intermediate term whether the supply-and-demand fundamentals justify those moves or not. However, in time the fundamentals always prevail. The trend of the noncommercials' commitment to any given market is likely to coincide with the price trend at least until it reaches an extremity, particularly when the trend is up. However, when the trend is down, they may be slow to get out and a substantial proportion of their net long positions may go down with the ship. As a result, the bottom of the market may not come until they are fairly heavily net short.

There is a tendency for the funds to establish huge positions, and there is a reasonably reliable pattern of their doing their business over a period of three days. When, therefore, you can get into a market on the first day of major fund positioning, you can sometimes ride on their coat tails for the next two days.

The urgency of their buying or selling and the size of their positions lead quite often to their being resoundingly wrong at major market turns. However, their capacity for pushing markets to extremes being so great, their COT numbers seldom suggest when they might have invested so heavily that they run out of firepower.

Although the funds have almost unlimited money, they do not have unlimited tolerance for losses. Once a market starts turning seriously against them, there can be a full-scale charge the other way, as the market runs their stop losses or as they dump their positions regardless of price. Some individual hedge fund losses have run into the billions of dollars when markets have turned the other way.

Nonreportables

The role of the nonreportables, or the small traders, has little significance overall, and it varies from market to market. On balance, they tend to make money despite what you might expect. Small traders do a lot of homework, and some of them make money consistently.

The weekly continuation chart for the Canadian dollar shows some of the weightings for the noncommercials at extremes (Figure 15-2).

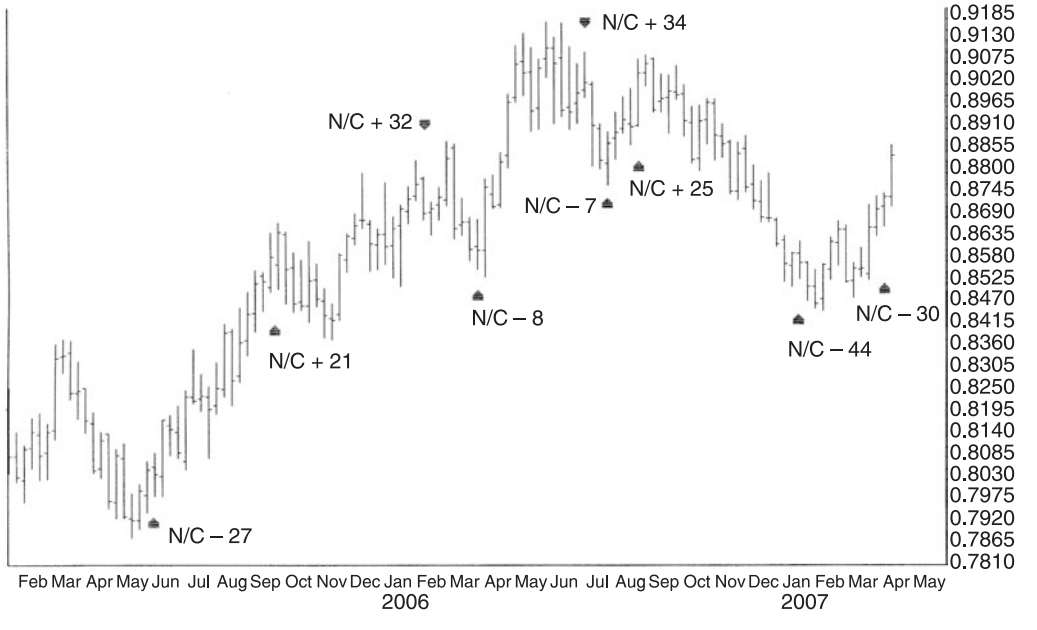

Figure 15-2 Weekly continuation chart for the Canadian dollar, 2006–2007

When the weighting of noncommercials has been even slightly net negative, the market generally has gone higher, and when they have been substantially net short, the market has gone up substantially, notably from the lows in June 2005 and February 2007. Extreme high readings have tended to occur above 20 net long, with reading at the top of the market plus 34.

COT and the Copper Market

You can get an idea of how the apparent allocation of commercials' positions may be skewed by looking at copper (Figure 15-3).

In February 2005, the commercials held a net short position of 34 percent of the total contracts, the noncommercials (the funds) were net long 30 percent, and small traders were net long 9 percent. Within the commercials' net short position were the index traders holding longs, offsetting mining companies such as Phelps Dodge holding short positions. According to the market commentator at Nesbitt Burns, Donald Coxe, many mining companies hedged future production with massive short positions priced well under $3. When the price was heading toward $4,

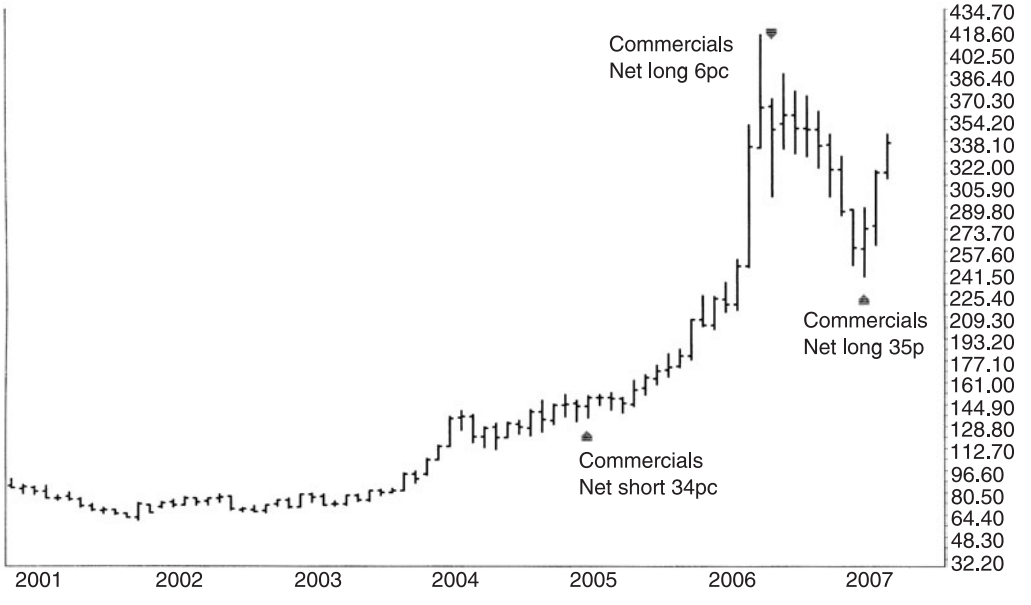

Figure 15-3 Monthly continuation chart for copper, 2001–2007

it was enough for those companies simply to finance the losses on their hedge book rather than to add contracts to their short position, which ideally they should have done. With speculative capital getting a free ride on cheap money from Japan, and the hands of mining companies tied, the stage was set for one of the all-time great bull markets and corresponding short squeezes. At the top of the market in May 2006, the commercials, combining those competing interests, actually were net long 6 percent of the total open interest in the market. Only some brave and astute fund managers among the noncommercial large traders held a net short position of just 8 percent, with the small traders net long just 2 percent of the total.

Exceptionally, open interest in copper actually peaked in November 2005, at some 115,000 contracts, when the price was around $2.07. That was long before the eventual peak in price in May of the following year, at $4.15. By then open interest had declined to about 85,000 contracts. The lesson here is that few traders wanted to be short unless they had to be, as some mining companies thought they had to be. The decline in open interest came early because the mining companies were caught so glaringly flat-footed. On the ensuing decline in price, open interest continued to fall, whereas it should have increased in a full-fledged bear market based on sound fundamentals—that is, a sustained increase in production and a sustained decline in demand.

At the bottom of the copper market in February 2007, the numbers had reverted closer to what you might have expected before the involvement of index traders. The noncommercials (the funds) were net short 30 percent; the small traders were almost flat, net short 2 percent; and the commercials were now heavily on the long side at plus 35 percent. With real commercials as well as index traders now heavily net long, the stage was set for the price to rally from a low of $2.38 to a level well above $3 in just a few weeks. The nonreportables' massive short covering, as well as some of them entering new long positions, would have fueled this huge advance. You would not necessarily have been able to judge the extent of that huge upward surge in copper, but you would have known that the conditions were in place for it to happen.

As part of the overall review of the potential for copper, you should have been looking for information on the supply-and-demand fundamentals. Then you should have known what copper inventories on the London Metal Exchange had been doing. They reached their near-zero low in January 2005 and rose steadily to the beginning of February 2007, and then the rise in stocks decisively broke its own uptrend line—just as the price was to surge upward again. To see what is happening with base metals inventories and prices generally, you can go to the superb Web site at www.kitcometals.com.

Cattle and the Supplemental Report

In 2000, the total open interest in live cattle had been around the 100,000 level. By March 13, 2007, it had increased to 331,580 contracts. The index traders held 109,044 contracts long, or 33 percent of the total open interest, and just 1,355 short. Their holding of long positions roughly equaled the total open interest a mere half dozen years earlier. A cursory look at the daily chart for June 2007 live cattle on March 12, 2007, suggested that they were following the nursery rhyme and heading on their way to the moon (Figure 15-4).

The next day, for which the CFTC collected the numbers, the market started falling, and from top to bottom during the next five days the market declined by almost 6 cents, or some $2,200 per contract. The decline to the eventual low before a tradable upturn, although no more than a fake rally, was to be just over 7 cents. Significantly, the market made its high at 99.82, just a few ticks short of the magic round number of a dollar, confirming the importance of round numbers as a potentially substantial resistance level and therefore also as a target level for taking profits.

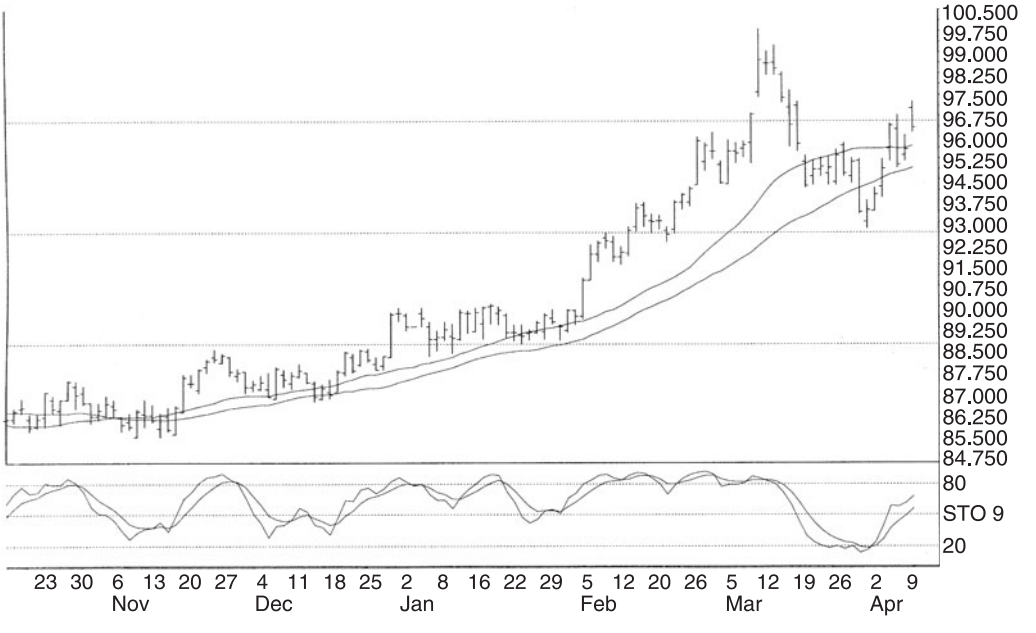

Figure 15-4 The daily chart for June 2007 live cattle, with stochastics, and 25- and 40-day moving averages

Corn and the Supplemental Report

Similarly, the index traders held 379,863 contracts long corn, or 19 percent of the total, on March 27, 2007, ahead of the "Planting Intentions Report" to be published before the open on March 30. After the announcement, corn was to go down by two consecutive limit moves of 20 cents, marked with the down arrow (Figure 15-5).

This was to something of an equal and opposite reaction to the January crop production report when the market went up by a limit move, marked by the up arrow, building on anticipatory strength, with almost an island bottom, before the announcement. In March, it turned out that growers stated an intention to plant far more corn than most people had estimated and hence the dramatic reaction in the market. Moving-average convergence/divergence (MACD) and moving averages were already indicating the direction clearly.

Assuming that the index traders carried the same number of contracts long on the Friday as they had held when the numbers were tallied for the close of the previous Tuesday, these traders alone incurred a loss of almost a billion dollars on that news alone. The real commercials, on the other hand, holding a net short position of 51 percent of the total, garnered well over a billion dollars in profit on their short position.

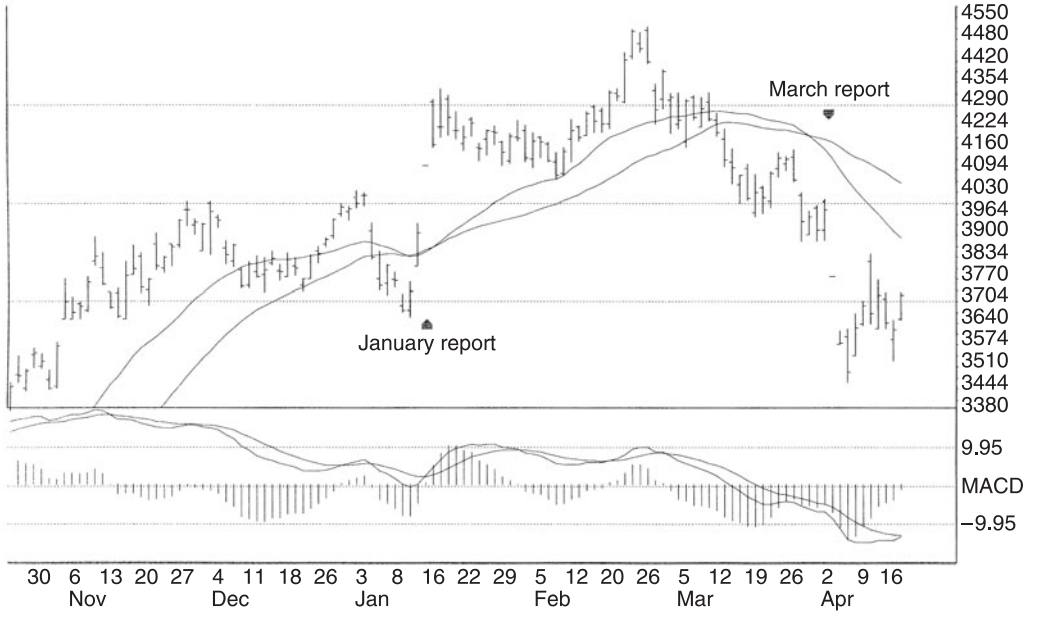

Figure 15-5 Daily chart for May 2007 corn, with MACD, and 25- and 40-day moving averages

Following the report, the nonreportables reduced their long positions by 67,000 contracts and added 7,000 shorts. The commercials reduced their short positions, taking profits, by 46,000 contracts and added 50,000 longs, for a shift of nearly 100,000 altogether. The redoubtable index traders shed a mere 18,000 contracts and added 3,000 shorts, whereas there was little change in the net position for small traders, who went into the report with a small net short position and came through it with essentially the same small net short position. As was predictable, the corn market made its low the day after the two limit moves down and then rallied significantly, although not to the level before the report. Overall, the commercials made money both ways. The small traders also made money both ways, although not much. The funds and the index traders lost an enormous amount of money both ways.

In sum, COT can be a reasonable indication of contrary opinion, suggesting that there may be an opportunity to make money by following the smart money and, above all, by not getting too carried away on the same side of the market when speculative capital is overly weighted one way or the other. COT is by no means a timing indicator, establishing only the potential for a shift. However, other technical indicators may point the way ahead of a dramatic move, as they did for corn before the "Planting Intentions Report."

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CHAPTER 16

Stock Indexes: The Prime Vehicle for Day Traders and Position Traders

The Long-Term Trend Is Up

Subject to the reservation that stock indexes can go sideways interminably or behave as erratically as any market, much of the time they are one of the best vehicles for futures traders, whether you have a longer, shorter, or intermediate perspective. Many futures traders focus exclusively on stock indexes, and even those who would never think to trade futures can benefit from knowing about the forces driving stocks. The overall trend for stocks is up, and therefore, the default trade for the long term has to be up. Of course, the swings can be immense, and as with all markets most of the time, bull markets tend to last far longer than bear markets. However, you can make more money more quickly, if not necessarily with lower risk, on the short side of the market.

For day traders, the great thing about stock indexes is that fluctuations frequently have plenty of amplitude to take a piece out of the middle between an entry signal and an exit signal. There are traders who make several trades in a single day, and some do well. Ideally, however, and following the principle of letting profits run, even a day trader should be prepared to hold a profitable trade overnight or for as long as it takes to develop an exit signal. For traders with an intermediate perspective, stock index futures respond with enough regularity for cycles to be useful to a four-week cycle, as well as multiples of four weeks. You have to find a prominent low and set up the cycle tool with the best fit. As with other futures markets, the 20-market-day default setting works well as a guideline, and you may

expect the market to return to that 20-day cycle even when it has been erratic and has skipped a beat or two. For long-term position traders, stock indexes have seasonal and cyclical patterns that last for several months or longer with reliability established by remarkably solid empirical evidence over the long term.

Stock Index Challenges

Despite the obvious attraction of trading stock index futures, there is one seriously negative factor that futures traders have to consider, although not sufficiently to be deterred from trading them. Every average, by definition, consists of several or many components. Most of the time, any stock index consists of the good, the bad, and the indifferent. Some stocks may be going up and others down, and the average therefore may not do what you expect. It seldom happens, for example, that more than about 27 of the 30 Dow Jones Industrial Average stocks go up or down on a given day, and the ratio is more usually nearer to 2:1 in whichever direction. Therefore, every stock index is almost always hobbled to some extent. When it is not, the force of the thrust may be at or near a climax, setting the index up to go the other way. To some extent, you may be able to get around this objection by trading futures on individual stocks, although, in that case, you may be better off simply to trade the shares directly. In fact, when stock indexes are bullish—but subject to the reservation that there is constant rotation in strength between sectors and individual stocks—it may be an excellent time to buy specific stocks that are doing well, in the expectation that they may really run and outperform the indexes.

Another challenge when trading stock index futures that occurs much of the time in both bull and bear markets is that apparent changes in the intermediate- and short-term trends often fall into place near the extremity of a retracement. You may think that a more serious move is starting, only to find that the market snaps back and gets going again in the direction of the major trend. The practical effect tends to be that those trading for the very long term make money but have to live through significant retracements. Day traders and those having a near-term perspective also have plenty of opportunities on both sides of the market. However, trading stock index futures is sometimes inordinately challenging and subject to corresponding whipsaws for traders aiming to go with an intermediate-term flow.

Secular Stock Cycles

When the wind of cycles is behind you, the probabilities are normally much more favorable, even for traders having a shorter-term perspective. If you know where you are with cycles, then you look for technical indications to trade on the long

side of the market when the longer-term cyclical forces are upward and for trades on the short side when the longer-term cyclical forces are neutral or downward. On balance, it pays to remember that large and surprising surges tend to come in the direction of the trend and of cyclical forces.

As with seasonal and cyclical fluctuations in the price of agricultural products, there are reasons for the apparent cyclicality of the stock market. The reasons may not always prevail on market action, but this does not negate the fact that their influence exists. There also appears to be a very long-term business, stock market, and investment cycle based on demographics that lasts approximately 50 to 60 years. Given the immensity of industrial development and the small amount of statistical data available, it is difficult to arrive at any statistically credible conclusions. However, there appear to have been "baby" booms and "baby" busts in the past, and the top of the stock market in 1999 resembled the one in 1929. Demographic statistics suggest the possibility that there could be more to the downward cycle in the big picture than the recession and bear market that ended in the fall of 2002. It may be, for example, that the forces driving all forms of consumption, from homes to holidays, will run out of steam when aging retirees have to cash in savings to finance a slowing lifestyle. In the meantime, the rally from the low in October 2002 resembles to some extent the advance in stocks that began in 1932 and peaked in 1937.

The Four-Year Presidential Cycle

Foremost among conditions for a prominent low and, more erratically, for a prominent high is the four-year presidential cycle for the stock market. During an ideal cycle, you would be long the market for just 26 months in every 48-month cycle, or just over half the time, and looking to be short or flat the rest of the time. The empirically optimized time to buy is the last week of October two years before the next presidential election. The empirically optimized time to sell is the first week of January after the presidential election.

There is a regular rhythm that sets up a pattern for a rising stock market during the year of a presidential election. Incumbents want to win if they are seeking reelection or to secure a successor from their own party. This political imperative mandates delivering as much of the unpopular strong medicine as possible during the first year or two of the four-year term and as much of the good stuff as possible heading into the election. At the time of this writing, there may not be much of the usual good stuff for President G. W. Bush to deliver, but that situation does not override the empirical evidence and validity of the application of this principle going back for more than a century. By no means all cycles work, and you have to consider the cyclical forces as just one component of the trading challenge.

Table16-1 shows that market action in the presidential cycle has had only one really big failure over a period of more than a century, namely, at the time to buy in 1930.

Table 16-1
The Presidential Cycle: When to Buy and Sell

Parameters:

1. Buy the Dow Jones Industrial Average in the last week of October, two years before the next Presidential election.
2. Sell in the first week of January after the Presidential election.

The table shows the Dow Jones Industrial Average compared with the result using this Buy/Sell timing, with 1898 = 100 for both.

				% Gain 1898 = 100		
Buy Date	**Buy Price**	**Sell Date**	**Sell Price**	**(Loss)**	**Dow**	**Buy/Sell**
1898	55	1901	70	27	127	127
1902	60	1905	65	8	118	137
1906	95	1909	85	(11)	154	122
1910	83	1913	83	-0-	151	122
1914	53	1917	96	81	174	221
1918	86	1921	74	(16)	135	185
1922	96	1925	121	26	220	233
1926	158	1929	304	94	552	452
1930	190	1933	59	(69)	107	140
1934	93	1937	182	97	330	276
1938	151	1941	133	(12)	242	242
1942	107	1945	154	44	280	349
1946	171	1949	175	2	318	355
1950	225	1953	292	29	536	459
1954	363	1957	499	37	907	629
1958	539	1961	622	15	1130	723
1962	570	1965	869	52	1580	1099
1966	809	1969	925	14	1681	1252
1970	754	1973	1,031	37	1875	1716
1974	633	1977	978	54	1778	2642
1978	792	1981	980	24	1781	3276
1982	995	1985	1,189	19	2162	3898
1986	1,851	1989	2,131	15	3874	4483
1990	2,346	1993	3,268	39	5,941	5942
1994	3,850	1997	6,567	71	11,943	10,655
1998	8,592	2001	10,662	24	19,390	13,212
2002	8,397	2005	10,608	26	19,291	16,647
2006	12,116	2007	13,465*	11	24,486	18,478

* To June 6, 2007—Technical exit signal day for sell-in-May watchers

Otherwise, it has worked with sufficient reliability to constitute one of the most valuable big-picture indicators for market timing. The table shows that the net result for a buy-and-hold strategy versus a buy-and-sell strategy using the presidential cycle is extremely similar for more than a century. The point for futures traders is to look more attentively to go long during the favorable periods and to sell short or stand aside during the less favorable times.

Curiously, the cycle has not worked as well as in earlier times since 1994, although it was resoundingly successful in avoiding most of the bear market decline into the low in 2002, and also in catching that low almost exactly at the bottom. The sale in January 2005 averted a full year when the Dow went down about 10 percent and then rallied back to the level where it began in January. In so far as the presidential cycle fell short it was that the advance due to start in October 2006 was signaled by market action in July, and at that time you could have already started looking for a low in the market. The point is still valid that the presidential cycle is likely to continue to work in the future, particularly when used in conjunction with other technical indicators. You have to bear in mind the foremost adage of risk management, that there is nothing more important than avoiding serious losses. For that, the presidential has proved invaluable for more than a century.

Sell in May and Go Away—Then Buy in the Autumn!

Independently of the presidential cycle, there is considerable validity to the saying, "Sell in May and go away." The sell-in-May timetable calls for selling on May 1 and buying in the last week of October. As with presidential cycle, however, the practicality of real-time use means that you look for entry and exit signals in the general time frame for action. Let profits run beyond the exit time until there is an exit signal. Buy within the time frame, whether early or late, when there is a solid buy signal. Seasonally, a higher risk of owning stocks and a lower prospect of gains have extended throughout the summer and well into October. Athough there have been many good summer rallies, their occurence has been statistically unreliable, especially given the high probability of a substantial decline in September and October. At the resulting low stocks have often seemed to be heading down forever, but almost always that has been a prime time to buy, not sell. Some of the biggest declines into a significant low have occurred in October, including 1929 and 1987. The prominent lows in October 1990, 1998, and 2002 all coincided with presidential-cycle buy points that were exceptionally successful.

However, when the market has been declining sharply, it has been much safer to time an entry at the end of October rather than earlier in the month. You might

get in at a better price earlier in the month, but the risk of a return to the low or of a new low is less by the end of the month. Less obvious as to the exactitude of timing, in the single year out of the four of the presidential cycle, you should be prepared to sell in the first week of January unless the market continues moving up. At the very least, it pays to keep moving a stop higher in case weakness hits the market.

The cause of strength in the stock market from October and through the winter appears to be that money to invest may be more plentiful then. Most corporate bonuses are paid between December to March, and a large portion of this is saved, with a sizable amount invested in stocks or stock funds. On the other hand, October appears to be the time when most losing shares are sold, with an impact primarily on stocks that have gone down but also taking down all stocks as investors offset profits as well. In a year when the stock market generally has declined, there may be a significant selloff in September and October, followed by a substantial rebound as net selling gives way to net buying.

Starting at the end of October 1950, an assumed $10,000 invested in the Dow only during the six favorable winter and spring months would have grown to $620,256 by May 2006. On the other hand, starting on the last day of April 1950, $10,000 invested only during the unfavorable six months would have grown to just $12,047 by the end of October 2006. "There are periods where you are not going to get all of the gains," according to Jeffrey Hirsch, editor of *Stock Trader's Almanac*, "but you miss 90 percent of the losses."[2] According to his newsletter, using moving-average convergence/divergence (MACD) as an entry and exit signal (much as recommended in Chapter 6 but using different indicators) multiplies by three times the profit from investing only during the favorable months.

The results for the sell-in-May cycle from 1897 to 1950 show an almost equal performance for the favorable and unfavorable periods. However, there were considerable gains during the favorable periods and much smaller gains, when there were gains, during the unfavorable ones. The comparison is skewed by the fact that most of the huge gains from the favorable six-month periods were given back during the two favorable periods within the bear market from 1929 to 1932. For the period between 1897 and 1928—that is, excluding the big bear market—an assumed $10,000 increased to $106,900 by investing only during the favorable winter and spring months, and $10,000 increased to just $23,000 by investing only during the other six unfavorable months.

[2] *Barron's*, April 25, 2005.

As one would expect, the most favorable (or least unfavorable) years for owning stocks from May to October are those when the presidential cycle is also favorable, and the least favorable, those when the timing for the presidential cycle is adverse. When the presidential cycle is unfavorable, but depending on chart signals, it may be better to sell earlier in the year, as in 2005, particularly if you own stocks representative of the general market.

Remarkably, if you bought the Dow in accordance with the seasonal cycle at the end of October 1929 (and disregarding the adversity of the presidential cycle), you would have bought just a few days before the low for the crash and would have made a small profit by selling at the end of April the next year as the market was beginning to slide again. Worst of all but exceptionally, buying at the end of October 1930 would have got you in at 191, and the seasonal cycle would have had you sell at 151 at the beginning of May. The resulting 21 percent loss would have been painful but not devastating. However, a purchase in October 1931 resulted in a 45 percent loss—the biggest loss for as long as records are available.

The High-Tech Cycle

Much of the time the Nasdaq 100 Stock Index is the prime vehicle for futures traders, and it has its own seasonal tendencies toward strength and weakness that more or less overlap the other seasonal cycles. Although in recent times the Standard & Poor's (S&P) Midcap Stock Index and the Russell 2000 Stock Index have been the strongest, over time it is the Nasdaq 100 that has had the greatest volatility and the greatest potential for great trades in both directions. Therefore, it is likely to continue to be worth paying special attention to this market.

The seasonal pattern for the Nasdaq 100 has been starting at the end of September, although it can start early, and running to the end of January. The optimal entry occurs when there has been pronounced weakness some time in this general time frame and when stochastics turn up from a low extremity. Alternatively, you buy strength when you can when the general market is strong. There appears to be a fundamental rationale for this trade, with investors being optimistic about the important pre-Christmas electronics buying period. The trade then ends before the Las Vegas Consumer Electronics Show and before the reporting of fourth-quarter results. Then the season for interest-boosting news winds down until the autumn. Depending on how the technical indicators are developing, there may be opportunities to sell the Nasdaq 100 short during the unfavorable period.

Factors Affecting Stocks

When there is a general optimism about the market, even for mistaken reasons, the market will go up. As with other technical indicators, you don't have to know why people feel good about buying and holding their stocks. It is enough to know what they are doing. Similarly, the market will go down when there is general pessimism. Both optimistic inclinations and pessimistic sentiment tend to last for a long time until they reach an extremity. Extremities occur when the majority have already placed their bets on a rising market or have thrown in the towel in disgust on a decline.

The current readings from several followers of market sentiment are printed each week in the "Market Laboratory, Economic Indicators" section of *Barron's*. There is only so much that an ordinary investor can be expected to do without turning the operation into drudgery, but it can be worth the time and patience to chart one of these sentiment indicators. The Investors Intelligence service is currently doing this job for free. Updated charts are available at their Web site (www.market-harmonics.com/free-charts/sentiment/investors_intelligence.htm).

Other valuable Investors Intelligence services are available only by subscription. Broadly speaking, for Investors Intelligence, a reading of bullish sentiment (percentage of bulls) in the range between 40 and 60 percent is constructive. (The source data derive from the recommendations of market advisors who, in the aggregate, are totally wrong at major tops and bottoms!) A reading above 60 percent is excessive. A reading below 45 percent is quite negative. A reading below 40 percent is starting to be extreme, and a level at or below 30 percent is so excessive that you can be fairly confident that most of the heavy selling has been completed. As with most indicators, including price, the trend is as important as absolute levels of enthusiasm. Except at extremes, rising sentiment means that money is going into stocks, and vice versa when sentiment is declining.

Mutual Funds as a Contrary Indicator

Mutual funds almost make a religion out of telling their investors to reject any form of market timing as part of their investment strategy, although some individual fund managers churn stocks for a pastime—the exact opposite of Warren Buffett's approach to investing. Nevertheless, mutual funds themselves have an impact on market timing. Their cash inflows have run consistently at a lower level between May and October, with a reliable dead zone between the beginning of July and the end of September. The stock market tends to go up during the months when mutual fund inflows are highest, and it tends to go sideways or down during the

months when inflows are lowest. Therefore, there is a high probability that mutual funds contribute to making the sell-in-May timetable work, and they tend both to buy and to sell at bad times during the year.

What mutual funds are doing compares with other measures of market sentiment when cash levels are at an extreme, whether high or low. As with other indicators, the direction is important until an extremity is reached. A steady inflow of cash for new investment is bullish, and a steady outflow is bearish: The more cash on hand, the more mutual funds have firepower with which to buy stocks. Fortunately, it is possible to calibrate extremities. For a long time it was considered bullish when mutual fund cash balances rose above 10 percent of assets. In 1990, mutual fund cash balances reached almost 13 percent just as the major bull market was about to get under way.

It used to be considered bearish when mutual funds held less than 8 percent of their assets in cash, but recent market behavior has led to a lowering of the number required for a bearish interpretation because too much firepower had already been invested in stocks. There have been just three times in market history when mutual fund cash reached a low of 4 percent of assets: 1972, 2000, and mid-2005! After the low in cash in 1972, the Dow fell by 45 percent from its then-record high. After the low in cash in 2000, the Dow fell by 38 percent from its then-record high.

Source data for mutual fund cash balances are widely available on the Internet and are published in the first edition of the month of *Barron's*.

Bonds, Forex, and Stocks

Although not normally recommended for long-term passive investment except for those needing the income, it is worth noting that bonds and interest-rate futures sometimes do the opposite of what the stock market is doing. During the bear market from 2000 to the fall of 2002, there were times when the long side of interest-rate futures was a less erratic trade than the short side of stock indexes and provided as good a reward for the risk, if not a better one. Paradoxically, however, stocks tend to go up when interest rates are declining—and bonds, therefore, are also going up.

Stocks also tend to go up when bonds are going down because rising interest rates normally mean that business conditions are good. It takes a big dose of rising interest rates or else a recession to take the wind out of the sales of the stock market altogether. There was such a big dose of higher interest rates during 1999, and eventually, it did in the stock market, which, as much as anything else, succumbed under the weight of its own excesses anyway.

Contrary to what you might expect, the stock market tends to go up when the U.S. dollar is going down, but only provided that interest rates are not simultaneously high and rising fast. This was what clobbered the stock market when it crashed in 1987. There are two fundamental reasons for a declining dollar to boost stocks. The first is that stocks are becoming progressively cheaper for foreigners. The second is that the declining currency automatically makes U.S. goods and services cheaper for overseas buyers, and it automatically increases profits from overseas subsidiaries.

The S&P Midcap Leads the Way

In recent years it has been very much a market of stocks rather than having the overall market moving in unison. The indexes have moved erratically higher, with the S&P 400 Midcap Index and the Russell 2000 Small-Cap Index leading the way (Figure 16-1).

Within the major indexes there have been remarkable disappointments as many bellwether stocks have languished. The list of laggards has included the shares of such great companies as Johnson & Johnson, General Electric, and, in

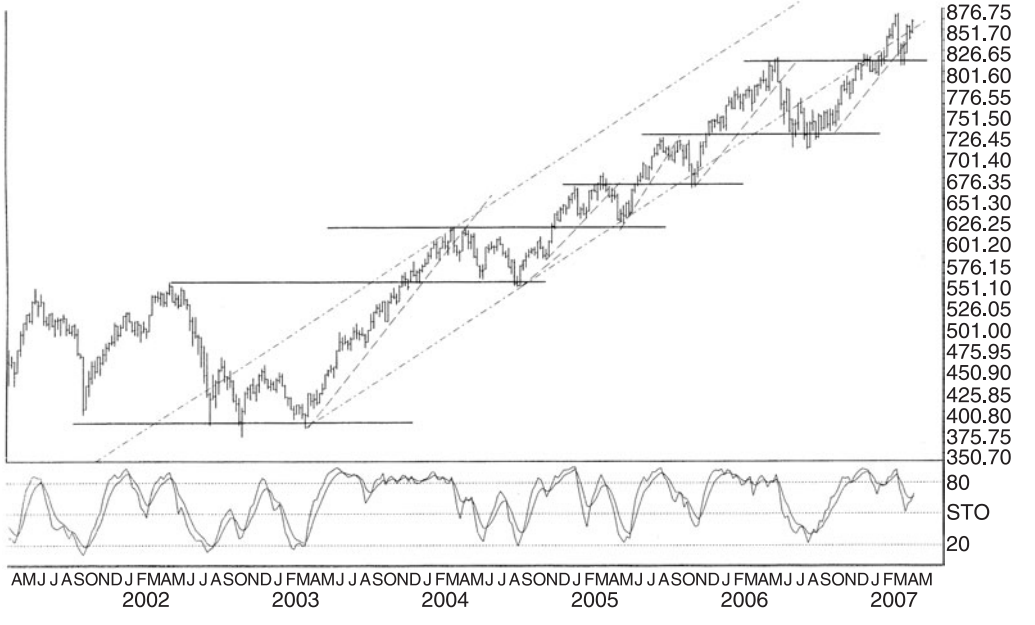

Figure 16-1 The S&P 400 Midcap weekly chart, with stochastics

technology, Dell. Looking at their stock charts, you would never know that there has been a bull market in stock indexes since the low in 2002. Within the universe of stocks, there was a proprietary bubble in home builders and then a corresponding bust, but overall, the indexes have continued moving erratically higher.

Another part of the challenge for anyone taking an intermediate position rather than either a long-term position or that of the day trader has been that sharp declines have been occurring intermittently. Then, just as you might suppose that the party is over, with an intermediate downtrend established, the indexes have found support and worked higher again. In sum, very big patterns and cyclical forces have more or less worked, and there has never been a lack of short-term opportunities. However, the environment for trading stock indexes has been challenging and is likely to remain so.

The weekly chart for the S&P Midcap Stock Index between 2002 and 2007 shows some of the challenges as well as the opportunities during this period. The overall trend has been strongly upward. However, the fluctuations on the way have constantly led to the breaking of tight trend lines, and in 2006, the major uptrend line from the 2003 low was broken decisively. Stochastics have been some help at suggesting lows, but they have been of little use to suggest when a sharp selloff might occur, let alone how far it might go.

Similarly, cycle theory has been somewhat less useful than you might normally expect in that the major low at the bottom occurred in March 2003, and another good leg up began in April 2005, just when sell-in-May theory would have had you out of the market. There has been a tendency for lows due in October to come early, but this has not negated the potential of buying in October anyway. You just missed part of the move. Very erratically, there has been something of an eight-week cycle, or 40 market days, with almost exactly eight weeks between various prominent lows, including the ones in January and March 2007.

The one indication that has proved really reliable has been the application of horizontal-support theory, which worked well at the fourth low in 2003. After that, previous highs have done a good job of acting as support on declines, building a fairly good upward staircase.

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CHAPTER
17

The Entry Checklist

The Need for the Checklist

The *entry checklist* (Figure 17-1) has been developed so as to bring together, in a tabular format that fits on a single page, a collectivity of indicators described in this book. Using this checklist, you can get a strategic overview when looking at monthly and weekly charts—to evaluate whether a market may be worth trading. The columns for the daily and intraday charts help toward the tactical overview—whether to pull the trigger on a trade.

It may seem that the 24 points on the entry checklist are rather a lot. The challenge is that there are so many possible combinations of factors contributing to market action that reducing the number sacrifices much that can be important. There is no escaping the fact that it takes diligence to find the best trades when the entry is timely and vigilance to avoid losing trades. It is worth emphasizing the point that even a single contract traded can make or lose a significant amount of money. You would not buy a house or a car without undertaking a thorough evaluation, and it makes no sense to buy a stock or to make a futures trade on a whim. Even an experienced airline pilot flying a small plane for pleasure uses a checklist before taking off.

It is the rule rather than the exception that there are always elements of ambiguity when deciding on a trade. Nevertheless, the principle is solid that the best and most reliable trades seldom come without strong confirming signals. An unavoidable corollary is that it is all too easy to get into low-probability trades

ENTRY CHECKLIST

Market _____ Buy/Sell _____ Price _____ Date _____

Indicators: ✓ X	Month	Week	Daily	60-Minute
1. Price-Rule Signal				
2. Price — M/W Zigzag (1/2)				
3. 25-Bar MA Direction				
4. 40-Bar MA Direction				
5. Rev. at MA/trendline				
6. Trendline Break				
7. Gap (1) Island (2)				
8. Gap: 3 Bars Open				
9. Reversal Pair (1/2)				
10. Lindahl/Dbl Reversal				
11. Outside Bar				
12. Price Bar Action				
13. Weekly Reversal				
14. MACD Turn—M/W (1/2)				
15. MACD Crossover				
16. MACD Histogram				
17. MACD Baseline				
18. %K Turn—M/W (1/2)				
19. %K Cross %D				
20. %K Turn from 80/20				
21. %K Level 80/20–90/10 (1/2)				
22. Adv. Channel Line				
23. Support/Resistance				
24. Bollinger Bands				
Total Confirming				
Total Negative				
Net Confirming				

Check: Backwardation _____ USD _____ COT _____ News _____ Weather _____

FND _____ Friday Close _____ Month-end _____ Stop Loss _____

Retracement Support/Res. Levels _____

Figure 17-1 The entry checklist

when the risk looks more manageable, whereas it can take some courage to establish a good-sized position when there are strong signals. Once you get into a troublesome trade, it inevitably follows that it ties up both emotional and financial capital. Worst of all, holding an underperforming trade may make it difficult or impossible to take on a new position when a superior opportunity arises later on. It is remarkable how often it pays to get out of a marginal trade instead of waiting for the expected favorable market action that never comes. A new run through the checklist should tip you off to do so.

Using the Checklist

The entry checklist is set up so that you can put a check, cross, or pass against the separate indicators in each column for the monthly, weekly, daily, and 60-minute charts. The monthly chart may not be all that useful for markets having shorter cycles—mostly agricultural markets—except to show long-term historical highs and lows. However, it is invaluable to look at the big picture on the monthly chart for most other markets. For trading purposes, the weekly chart generally defines the major direction, although occasionally the daily chart may justify a trade.

After seeing what each indicator is doing, add up the checks and crosses and get the net number. Trades having long-term and substantial prospects generally have both the weekly and daily charts coming in with net numbers of 10 or higher and sometimes over 15. Markets can make sudden and substantial moves when there are very low net readings, and apparently perfectly signaled trades can backfire. Nevertheless, on balance, the probabilities are favorable when there is a preponderance of favorable indicators and when there are few to suggest a market going the other way or one that is excessively stretched and liable to rebound. Almost every negating indicator calls a prospective trade into question and requires very specific evaluation.

Here are specific comments on each of the items on the checklist:

1. *Price-rule signal.* Price rules suggest, subject to other confirming indicators, that a market has set up to follow through right away or very soon in the indicated direction. If you don't have a price rule, you should almost certainly wait until there is one—if only on an intraday chart.
2. *Price M/W—zigzag.* Don't forget to look at the line chart! Zigzags confirm direction and may either show coiling action or, alternatively, the momentum of a market in motion. Count 1 for an M or a W and 2 for an established zigzag with three or more turns. If you don't have a zigzag in the direction you want to trade, there may be an above-average risk that what you want

to do won't work. In that case, count this indicator as negating. Beware of trading in the direction of a single turn occurring after a significant retracement.

3. *25-bar moving-average direction*. Confirming or negating according to the direction of the 25-bar moving average. It is not significant whether price is above or below the moving average.
4. *40-bar moving-average direction*. As for the 25-bar moving average.
5. *Reversal at moving average/trendline*. As we saw in Chapters 7 and 11, a turn at a retracement point within an established trend has such a high probability of working that a successful trader could restrict entries to this occurrence. Note the word *reversal*. You need confirmation that the market is in fact stopping and turning here, not that it has merely reached a level where it might stop.
6. *Trendline break*. A break is, of course, the opposite of a reversal at the trendline—a failure to turn where expected. It may set up the condition for taking a trade in the opposite direction.

   The breaking of a trendline on a closing basis is a reliable indication that a trend may have ended and that it may be in the process of reversing. At the very least, it shows that a market is running out of momentum. A broken trendline relatively seldom occurs without a prior setup, manifested by flagging momentum on stochastics and failure to reach the channel line, as well as powerfully adverse price bar action, often establishing the start of an adverse zigzag. Breaking a trendline, depending on its duration and rate of incline, all but amounts to a mandatory exit signal and counts as a signal to trade the other way, depending on how the turn occurs. Perhaps paradoxically, there is frequently a return move "to kiss the trendline goodbye." Once the trendline break is confirmed by a kiss and failure, the probabilities are increasingly favorable for trade in the signaled new direction.
7. *Gap/island (1/2)*. All gaps in the direction of the trend count as favorable indicators unless the market has extended so far that a new gap may represent the climactic exhaustion of a move. Gaps are additionally convincing when there are several of them in the same direction within a consolidation, and in addition, an overbought or oversold stochastics reading suggests that the market may be setting up to reverse.

   An island, particularly when there is a complete gap between the most recent bar and the one preceding it, gives a powerful indication of exhaustion and a corresponding trend reversal. An island may consist of several bars. Count an additional point for an island.

   Sometimes there is a gap above the current price and a gap below. All adverse gaps constitute a call for caution, and you may have to judge whether the adverse gap could result from exhaustion or signifies a potentially impenetrable barrier.

When evaluating a market that trades overnight, look at the day-session-only chart for potentially significant gapping from one day to the next.

8. *Gaps/three bars open*. This is a prime indicator of market action, strongly suggesting that the price will keep moving in the indicated direction. However, you need judgment when interpreting it. The most advantageous situations generally occur when buying from an oversold condition in an established or a potential bull market, or vice versa when selling. Ideally, there should be a consolidation after the initial gap, rather than a runaway, and then a strong day when you enter—often on about the third or fourth day after the initial gap. This pattern is additionally likely to be successful when occurring after a jump over the moving averages. The point is that unfilled gaps stand the test of time so that although this indicator is most applicable to the daily chart, it is still valid on the weekly and 60-minute charts.
9. *Reversal pair*. This includes the pattern that Ensign charting software identifies as a *key reversal pair* and you can set it up to color-code accordingly. Also include regular closing-price reversals and high/low reversals, if not color-coded, in the count. It is remarkable how often there is more than one reversal within a congestion area, and the probability in favor of success increases exponentially with each one. Therefore, add points for each new one.
10. *Lindahl/double reversal*. This item gives additional weight to item 1, price rule, and item 9, reversal pair. Price rules 5 and 6 have a particularly high probability of success because they suggest that any unfinished business in the process of setting up for a move has been completed.
11. *Price-bar action*. This is the most subjective item on the checklist. You want to look at the overall pattern of recent bars. If, for example, there has been a succession of many bars closing in the upper half of the range and there appears to be room for the market to go higher, the probabilities favor an upward extension by price, and vice versa for the probabilities in favor of a downward extension. On the other hand, it can happen that a succession of closes near the top of their range but without net gains in price may be exhausting buying power. This action may mean that the market is setting up for a collapse.

    It is remarkable how often a trend reversal can begin with one or two violent bars in the opposite direction to the apparent trend as a result of aggressive profit-taking, running of stops, or aggressive money wanting to establish new positions at an apparently favorable price. Sometimes, on the other hand, you can see that a market has gone down only erratically and grudgingly on a major retracement but, on resumption of the uptrend,

market action is orderly, often with steadily trending MACD. Then there may be a lower-risk entry even after the market has come some way from the bottom.

12. *Outside bar*. An outside bar adds weight to a price rule and may, of itself, invite a new entry to trade in the direction of a strongly moving market.
13. *Weekly reversal*. When price has exceeded the previous week's high or low and is trading through the weekly unchanged price, count an addition point on the weekly chart regardless of where the current price is relative to the range for the current bar. Also count an additional point when evaluating the daily chart or an intraday chart.
14. *MACD turn—M/W (1/2)*. Count a point, either for or against a trade, for a single turn in the direction of fast moving-average convergence/divergence (MACD). Count an additional point for an M or a W.
15. *MACD crossover*. Count a point in favor of a trade when fast MACD has crossed over slow MACD in the direction of the intended trade, and count a negative point when it is the wrong side of the track.
16. *MACD histogram*. This is an indicator requiring judgment, but it is still a useful tool. Count a point, either for or against a trade, for a favorable or unfavorable shape of the histogram. For example, when you want to go long, the histogram should have been in decline and should now be pointing up, having left behind either a spike or a basing pattern at the bottom. To some extent the histogram serves the function of an overbought/oversold oscillator, showing how far it has extended in the past before turning.
17. *MACD baseline*. MACD above the baseline indicates a bull market for the time period of the chart you are looking at, and below indicates a bear market. However, this interpretation may be in the process of changing if both MACD lines are inclining strongly back toward the baseline, having been far beyond it, especially when there is a new M or W. Count a point accordingly or pass.
18. *%K turn—M/W (1/2)*. Any turn by the stochastics fast line in the direction of the trade is a confirming signal. Failure to do so is a strongly negating indicator. Count a second confirming point for an M or a W. %*K* is the most valuable indicator for near-term momentum, and it is almost mandatory to have it onside, at the very least, on the 60-minute chart. There is a powerful stochastics signal when basing or topping action generates an M or W and particularly when its development occurs after %*K* has been above 80 or below 20 when making its first turn.

    It is often useful to draw a trend line on stochastics and MACD.

19. *%K 80/20 crossover*. %*K* crossing %*D* is a confirming signal, and failure to do so is a negating one, although with the caveat that the crossover often occurs late.
20. *%K turn from 80/20*. When a market is oversold and the major trend is up, there is a confirming indication to buy when %*K* has been under 20 and crosses above 20. Similarly, there is a confirming indication to sell in a bear market when %*K* has been above 80 and returns below 80. The indication is particularly strong when there is a W in %*K* at a low level to buy or an M at a high level to sell.
21. *Adverse %K level*. This is the opposite situation to the preceding item. Count 1 adverse point when %*K* is above 80 and a new long position is being considered and 2 adverse points when the level is above 90. The corresponding adverse levels for a proposed short position are 20 and 10. At the 90/10 level, at least some correction is probably imminent in all but a runaway market.
22. *Adverse channel line*. However strong a market, there is a high probability that further potential is limited and that a retracement could start at any time when price reaches a channel line. Count a negative point when price is at or near a channel line. (Some traders may be looking to trade in the opposite direction when price reaches the channel line, although this would be a contratrend trade.)
23. *Support/resistance*. Count a confirming point when you expect price to rebound from identifiable support or resistance. Count a negating point when trading in the expectation of a breakout. In such a case, you have to weigh the likelihood of failure to follow through, and the likelihood of failure may, on its own, be great enough to embargo the trade.
24. *Bollinger bands*. Count positive, negative or neutral. This indicator is useful when it flattens and rounds out to contain price after a retracement. However, it tells you nothing about how far a strongly trending market might go. A strong market will keep the outer boundary line pointing in the direction of the trend. Then the likelihood of an imminent turn may be small until the outer band clearly starts to lose speed and round out.

Other Points to Check

Backwardation or market inversion. Normality is for the price of deferred contracts to be higher than for the nearbys. When the nearbys trade over the deferred, it generally means that there is pressure of demand for immediate delivery and an expectation that supply and demand will be in better

balance later on. Many of the strongest bull markets occur when the nearbys stand at a premium to the deferred contracts, although you have to consider the market-specific circumstances. It often happens that agricultural markets have erratic premiums and discounts related to temporary or seasonal influences.

U.S. dollar. Every long position in U.S. futures markets is a short position against the U.S. dollar because that is what you use to buy it with. Similarly, every short position is a long position against the U.S. dollar. The relative strength of the U.S. dollar is important to consider when trading internationally traded commodities and, of course, foreign currencies.

Commitments of Traders. Check the Commitments of Traders numbers, as discussed in Chapter 15.

Fundamentals/news. This is a catch-all for evaluating your assumptions about the supply-and-demand fundamentals. Check on any potential news announcements that may affect market action—anything from crop reports to monthly unemployment numbers. You may want to avoid trading just before a major news announcement in case the market reaction is the opposite of what traders expect. When an announcement produces less than traders generally expect, there can be a violent move against the trend. Even when the news confirms traders' expectations, too many people may have traded on the outcome, with the result that profit-taking overwhelms what you might expect to happen. Remember the adage, which is often manifested by market action ahead of an announcement: "Buy on rumor; sell on news!"

Weather. When trading agricultural markets, particularly field crops, check the potential impact of weather. The general rule is that weather patterns, once established, tend to continue. High-pressure areas, representing clear skies and hot temperatures in summer and cold temperatures in winter, tend to remain fairly immobile. Low-pressure areas keep following on one another and bring clouds and rain or snow depending on the season and latitude. However, you have to beware of a sudden change.

First notice day (FND). You need to know when holders of long positions are liable to receive a delivery notice and when speculative holders of long positions must get out or roll forward. It seldom pays to buy the delivery month contract with less than a week or 10 days before FND. Some brokers require an exit or a rollover three days before FND so as to avert all risk of your receiving a delivery notice. You can redeliver it, but it costs time, money, and inconvenience to all concerned. When the price is high enough to invite profit-taking, or when the market is in a downtrend, there may be a significant decline around FND if it is unattractive for speculators to

maintain their place in the market by rolling positions forward. You can stay short through FND, and then most brokers would have you out three days before contract expiry.

Friday close. A strong close on Friday has an above-average probability of following through on the open on Monday when other indicators confirm a trade. To some extent, there is an exception when precious metals and petroleum contracts close strong on a Friday. Many traders have a justifiable aversion to carrying short positions over the weekend in case there is some dramatic political development that boosts prices when they can't do anything about their positions. It often pays to get out of losing, underperforming, or ambiguous trades on the Friday close. If there is no strength on the Friday close, the probabilities are lower that there will be strength on Monday. If you get out, you can start afresh the next week and not have to worry about the trade over the weekend.

Month-end. There is often severe turbulence around month-end, and there can be abrupt reversals of previous market action. Many big hedge fund managers even up their books at month-end or, alternatively, enter new positions in the expectation of what they think will happen during the next month.

Stop loss. For every trade, you need to identify the stop-loss level if the trade fails to perform as expected and exceeds the amount of money you are prepared to commit. This is an essential step in evaluating how many contracts to trade.

Retracement/support levels. You need to make sure that you have thoroughly checked out where the support and resistance levels are, what potential the trade may have, what retracement you can tolerate if the market goes against you, and most important, therefore, where the stop should be.

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CHAPTER
18

Stops: Theory and Practice

The Mechanics of Stops

A stop order serves as insurance against disastrous losses and also, when it is moved closer to the current market price, to protect capital once a trade starts going your way. A *sell stop*, for example, is an order to sell if the price goes down and reaches the designated price. Assume that you bought wheat at $3.95, expecting the price to go up, ideally well past $4.00. You might decide that the prospect of gain on which the trade was predicated, and the overall chart pattern, justifies risking 6 cents if the market fails to go up as expected. Therefore, you enter a sell stop, an initial protective stop (IPS), at $3.89. Any retracement back to $3.89¼ keeps you in the trade, but the moment the price hits or exceeds $3.89, the stop is activated, and the broker sells out the position at the best obtainable price. If the market falls away with a gap and opens below the stop, say, at $3.87, it still activates the order, and you get the best available price, even if it is significantly beyond what you thought you were risking.

Similarly, a *buy stop* is an order to buy at the best available price when the markets goes up to a certain level and trades at the designated price. The idea is that if the market goes that far, then it may go farther still—or at least not down. A buy stop protects a short position in case it starts going up beyond your tolerance instead of going down, as expected when you entered the trade.

A stop order also can serve to enter a new trade, and you might want to use it when a market appears to be setting up to break out of a consolidation such as an

ascending or a descending triangle—you are fairly sure that you want to get into a trade, but you don't want to hang around waiting for a surge in price that may never happen.

The Theory of Stops

It is useful to remember that someone takes the other side of every trade. Although the activation of a stop may be your loss or your lesser profit, for someone else it offers opportunity. Every activated sell stop puts a position into the hands of someone wanting to buy low, and every activated buy stop puts one into the hands of someone who wants to sell high. They may be right. Therefore, you need to take considerable care when placing stops in case you are simply inviting other traders to take your trade at their price. Running stops and making the market surge is not necessarily the same thing as bringing new money into that side of the market, and it is new money that makes for the staying power of a move. Of course, even an unsustainable move can go a long way, which makes it inordinately challenging to place a stop. There may be an immense book of stops to activate, and the activation of those stops may feed on itself as well as bringing new money into the surge. This is one reason why the closing price may give more of an indication of potential staying power than you get from intraday fluctuations, even substantial ones. To some extent, the difficulty involved in placing stops, and the corresponding risk, is somewhat less when you manage to buy into a market that appears to be finishing a correction or one that is cresting after a rally.

Much of the time, for traders confident in the major trend and taking a longer-term view, the whole business of stops should be academic. Good homework confirming a strong entry signal should deliver a trade that does not threaten the stop. Of course, the time of greatest stress occurs before the trade develops a cushion of profit. Until then, it needs monitoring constantly, with a view to getting out on the first day of market action negating the entry signal rather than waiting for the stop to be hit. Even if a trade starts acting badly, there is often plenty of time to act on an exit signal before the trade takes off and runs the stop. In Chapter 19 there is an exit checklist designed for getting out of a trade that can no longer be justified. Another way of looking at a trade is to see whether, on the basis of most recent market action, the entry checklist still supports the trade.

Seemingly contradicting to the concept of getting out of a disappointing trade quickly, it generally pays better in the long run to be prepared to live with some harassment with new trades rather than to be constantly suffering relatively small losses and then having to figure out how or whether to go back in. If, for example, you are going long, there may be another round of selling to put in a secondary

low before the market can go higher. It is remarkable how you can act on what seems at the time to be a really good signal, but the market still has to retrace to kiss the support or resistance level goodbye one more time before the trade gets under way. If the stop takes out your trade on a blip, and the expected move resumes anyway, the new entry may well be at a worse price than where you were stopped out. It is then psychologically challenging to go back in, although that may well be the right thing to do if your original homework was in fact sound.

Although there are some really great short-term traders, there is considerable evidence that most really successful traders are successful by finding really powerful trades and staying with them for as long as they can be justified. This approach tends to produce huge profits when you are right, and it also can produce large losses when you are wrong. Nevertheless, the balance of reward to risk tends to favor taking a longer view, provided that you can in fact find sustainable long-term trades.

The Australian Dollar and the Challenge of Stops

The 120-minute, 24-hour chart for the June 2007 Australian dollar illustrates the challenge of placing effective stops (Figure 18-1).

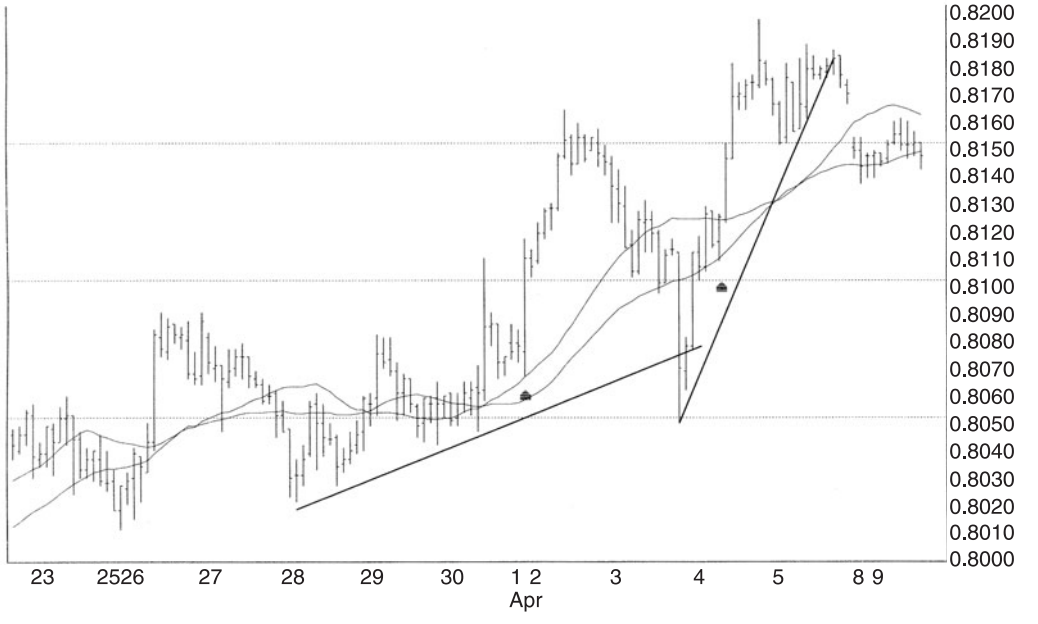

Figure 18-1 Australian dollar 120-minute, 24-hour chart

There are arrows below each of two potential entry points on the basis of this chart, with the entries predicated on the assumption that the weekly and daily charts strongly favored being long this market.

A couple of days after the first entry, the market was to plunge 130 points from the new high for the move. It fell past the entry point, and near the bottom, it broke a fairly reasonable trend line. True, the market was near likely support at the bottom, but looking at this intraday chart in isolation, it would have been hard to stay in.

Then, the same day the market rebounded, making a huge outside up day. Just a couple of days later, the market opened on Sunday night with a gap down, and the price failed to rally over the next 24 hours. Then it took off again like a rocket and never looked back. Traders can argue for a pastime about taking profits *while they are there* and various tactics for placing stops. However, the Australian dollar daily chart, covering the same period as the 120-minute chart, demonstrates that if you do good homework and identify what you believe to be a well-founded trade, then you give it reasonable room to fluctuate without giving up on it (Figure 18-2).

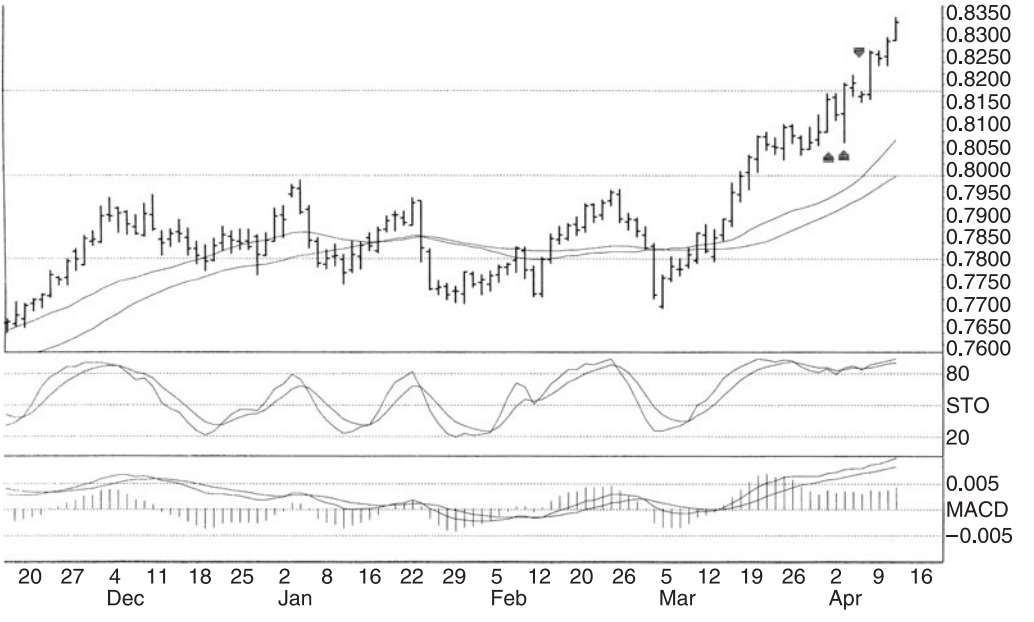

Figure 18-2 Australian dollar June 2007 daily chart, with 25- and 40-bar moving averages, stochastics, and MACD

The two assumed entries are marked with up arrows, and the down arrow marks the day when the market gapped down; just for that one day it failed to close the gap. Note that the Australian dollar had been going sideways for four months before the breakout in mid-March. The duration of this base building strongly reinforced the probability that this market could go a fair way before having a significant correction, let alone a trend reversal.

There is the rule of thumb that any trade losing money is one where you have made a mistake, whether long and wrong or short and caught. Some traders, mostly those with a short-term orientation, live by the rule of never taking a loss home overnight. There is no doubt that cleaning out losing trades has advantages. It clears the mind for evaluating the next trade, possibly in a completely different market and possibly one in the opposite direction in the market where you have just taken a loss. In all likelihood, too, the discipline of closing out losing trades at the end of the day will result in keeping most losses small. On the other hand, there are also major disadvantages to closing out a trade just for the reason that it is losing money. It may only be that you got a poor entry and that a small setback in price against you does nothing to violate the technical case for the trade. The Australian dollar illustrates the merits of looking to add to a position on a retracement rather than getting stopped out.

The Close-Only Stop

Since it is an inherent characteristic of markets that they fluctuate, sometimes quite violently but without necessarily establishing a new direction, it often pays to use a stop based on the closing price for the day, a *close-only stop* or *stop close only* (SCO). More specifically, the idea behind using an SCO rather than an ordinary stop is that you are prepared to tolerate one really serious day of adverse market action, but only one. However, all exits require discipline, and the SCO requires even more because of the discretionary element involved in pulling the trigger to get out of the market.

The prerequisite for using the SCO effectively is to establish beforehand exactly which support or level constitutes the one that you do not want to see exceeded. It is all too easy to see one level broken, but then there is the next one that you expect to contain the price after all. The rule therefore is to assume that if one barrier is broken, the probabilities favor a test of the next one and probably its breaking too.

The single-bad-day approach also allows for use of the exit checklist in Chapter 19 so as to get out no later than the open of the next day. In practice, most exchanges no longer accept the SCO, but this by no means negates the concept that the

optimal time to close out a trade or to enter a new one is often right on the close of the day session. The idea of an SCO is that you see where the support or resistance level is, and you expect it to hold. If the price is beyond your level of tolerance going into the close of the day session, you get out then or as soon as possible in an evening session or on the open of the next day session.

What you don't want to happen is for the market to go through your stop-price level during the day only to rebound, leaving you behind. Assuming that indicators such as stochastics and MACD are favorable for a trade, the probabilities generally favor their influence overriding temporary aberrations in price. Much of the time, as illustrated by the challenge when trading the Australian dollar, the close-only stop provides the best compromise for the conflicts between the need to protect capital and the need to get out of a trade before it runs into serious trouble.

It is worth noting that activation of an SCO often occurs in conjunction with a good signal to go the other way, if only for a short-term trader, and it does so on the first prime day for the entry. Accordingly, it is valuable at all times to consider the case for doing the opposite of what you think you should.

The Initial Protective Stop

An alternative to the SCO is to find where to put the stop for activation any time. You expect the high or low to hold on which the trade was predicated. Following on from this assumption but given the complexity of chart patterns that can occur, there may be several choices available. The two most basic and readily identifiable stop points are

1. A level just beyond the price rule used to pull the trigger to enter the trade. An initial protective stop placed any closer may just be an invitation to get the stop knocked off.
2. A level just below the last significant upside reversal for a long position or just above the last significant downside reversal for a short position.

The Profit-Protecting Stop

Useful as the SCO is, particularly when a trade is profitable, it may be asking for trouble to use it to protect a long position when stochastics are at a high level or to protect a short position when stochastics are in the basement. It seldom happens that a really substantial adverse move comes out of nowhere without prior

warning and usually from an identifiable support or resistance level. Nevertheless, it can happen all too easily that you overlook or underrate the warning signs only to see the market charge beyond all apparent reason, such as a $1 move in silver or 10 or 20 cents in copper.

There are a couple of things to look for when trying to balance the need to protect a profit and the imperative of staying with a good trade until it shows, by market action, that it may be time to go. When you see a strong reversal bar with the trend, say, an outside bar or a reversal pair, it works well most of the time to put a stop just beyond that extremity from which the last surge with the trend took off. Sometimes, you can see where price and a trend line might intersect and put a stop there.

When to Use a Tight Stop

The general rule is to let profits run and to cut losses short. When you have a profitable trade entered at a good price in a strongly trending market, you need to give the trade room to fluctuate and not get jostled out prematurely. Again, the general principle is that you should be looking to add contracts to a profitable position on a retracement, not take them off. As a reminder, you almost certainly want to stay in a trade that is trading steadily within the confines of the 10-day moving average and the 25- and 40-bar moving averages on the day-session 60-minute chart. The same thing goes for trend lines containing price fluctuations unless the market is pushing against obvious resistance such as channel lines.

Sometimes, however, there really are times when you do not want to give a trade room to move against you—particularly one that is losing money. Then you need a tight stop. When you review a trade before the open next day, there may be enough ambiguity to keep you in the trade, but only provided that the ambiguity pivots toward a resolution in your favor during the next trading day. Candlestick charts are particularly useful for seeing the ambiguous market of a single bar. Indications of ambiguity include

1. *Adverse trending MACD*—normally on the daily chart, but also look at the 60-minute.
2. *After apparent failure to follow through on a surge*. It is always difficult to tell the difference between a normal bounce or ripple, after which the price will continue in the indicated direction, and an exhaustive turnaround that starts the market moving violently in the opposite direction. Therefore, you may have no choice but to enter a tight stop and let the market tell you whether to retain the trade. Particularly ominous is a second failure to follow

through after a surge in price if it stops around the same price level as the previous surge.
3. *An inside day after a surge.*
4. *Any adverse gapping action, even a single day.*
5. *You have a good profit, and the market seems to be able to keep on going, but you suspect that there could be a sharp reversal at any time.* Stochastics could be at an extremity, or the price could be pressing against potential support or resistance of some consequence.

Placing the Tight Stop

Positioning of a tight stop should almost always be just beyond a round number. There is almost always some readiness to do business with buying toward a round number below the market and with selling toward a round number above the market. Therefore, you may as well make sure that there is enough commitment in the market to take the price that much farther. Stop levels to consider when placing a tight stop include

1. An identifiable spike on the 60-minute chart
2. The previous day's high or low
3. The nearest identifiable support or resistance
4. The closing price for the previous week

Never Add to a Losing Position!

Although there is a rule cast in bronze that you should not, must not, and never do add to a losing position, there is still good, if hypothetical, logic in the proposition that a retracement within an established trend provides the opportunity to add to a position rather than to get knocked out. However, the imperatives of real-time trading dictate that this is one case where many overriding practical considerations trump apparently good logic. The first is that having got the timing wrong once, the probabilities incline toward getting it wrong again—every trade losing money has its timing wrong. The second is that adding to a losing position may result in increasing the eventual loss you have to take. Third, and perhaps most important, is that adding to a losing position is a manifestation of stubbornness and arguing with the market, a force infinitely bigger than you are. However right you may or may not be about the underlying forces that ought, rationally, to be driving the market, you can never say it too often about a

losing position that markets frequently remain irrational far longer than you can remain solvent.

The Psychology of Getting Out

Some people let stops do the work of decision making, and this is an approach that works, more or less. This approach is no substitute for using the exit checklist to see whether you are entitled to be in a trade at all. It happens frequently that an underperforming trade may in fact be setting up to go the other way altogether. It bears repeating, constantly: *Remember how much money you can make when you are right*. This is as good a psychological bromide as exists to assist in getting out of a losing trade or when banking a small profit that was once a big profit—better that, of course, than letting a big profit turn into a loss, any loss, let alone a big one.

There is one attitudinal aspect of taking a loss that you may find helpful. If you have done the right things and the trade just doesn't work, then you have to congratulate yourself rather than lamenting the loss. It is an absolute certainty that you will have some losses. The objective is not to avoid losses entirely, which cannot be done, but to take them when they are manageable. It is an essential and unavoidable exercise in paying dues, and it is also an exercise in paying disaster-insurance premiums.

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CHAPTER 19

Getting Out of the Market: The Exit Checklist

Good Exits Take Discipline

Exits are far more challenging than entries, and all formulas for getting out of the market are extremely imperfect. There are serious conflicts much of the time when, for example, a trade appears to be running out of steam and in fact it may be doing no more than consolidating prior to the next leg of the move. It is all too easy to get it wrong both ways. Either you get out too soon, on a blip, and the market keeps on going without you, or you give the trade room to move and get out at the worst possible price on a retracement. There will be times when this checklist or any other exit mechanism will take you out of a trade just when you should be putting on more contracts rather than liquidating a good trade at a bad price.

Despite these challenges, this chapter establishes criteria that work well on balance. For one thing, it provides objective criteria to counter an emotional attachment to a trade. Even if your assumptions are right, there may be too much money already riding on what you think ought to happen. Another thing about assumptions is how easy it is to overlook adverse market action that at first sight looks to be no more than routine market action. Negative indications can start developing stealthily, and therefore, it pays to run a check when there is any ambiguity at all—just in case. Success over the long term requires perpetual vigilance, and you have to ask the question constantly, "What could go wrong?" As a matter of discipline, you should evaluate every trade every day, including

stop placement. Then you should be able to get out of a trade, whether at a profit or a loss, at a better price than by waiting for the stop to be hit.

It is all too easy to pay so much attention to exits that you never stay in the really big trades that make futures trading worthwhile. When a good move is under way, it takes serious discipline to stay in a really good trade and then, eventually, to believe what you see when the signals turn negative. It is all too seductive to bank a good profit when, for example, soybeans have gone up by a dollar in a week. Even if they then set back 30 or 40 cents, the probabilities may well incline in favor of the market going up another dollar, if not two or three. Thus a setback of 30 or 40 cents may have little significance in the scheme of a major bull market in soybeans.

One unavoidable component of the challenge of exits is that there really are differences between markets. Financial, petroleum, and metals markets, for example, can have dominant trends lasting for several years, but major moves in agricultural markets may last only a few weeks or months. The principles of technical analysis remain valid for all markets, but you have to adapt their use for charts of longer or shorter duration for markets having longer or shorter cycles, as well as for your own tolerance for adverse fluctuations. In addition, of course, reliance on longer-term charts for entries and exits produces fewer trades, with both bigger profits and bigger losses. Using shorter-term charts results in far more trades that deliver smaller profits and smaller losses. Regardless of your time horizon, it is imperative to coordinate an assessment based on both short- and longer-term charts.

The Preemptive Exit

Even within what appears to be a bigger move, there is a place for preemptive exits in case of further damage that necessitates an exit. As discussed in Chapter 8, the risk increases exponentially for a long position when the %*K* stochastic is above 80 on the daily chart and even more so when it is at 90 or higher. For a short position, the corresponding numbers are 20 and 10. Overbought and oversold levels begin at 70 and 30 for the widely watched nine-period relative strength index (RSI). Even in a strongly trending market, there may then be a high probability of a significant setback coming out of the blue and for no readily foreseeable reason except that the market is very extended.

The remedies for protecting capital and avoiding losses, in the event of a sudden and sharp retracement, include setting a tight stop or using day-trading techniques (discussed in Chapters 22 and 23) to get out if the market starts faltering. The trouble is that once a setback starts, the market may get away from you. Then it is difficult to know how to handle a trade when logic suggests support levels, but

momentum and market action make it very unclear whether they will in fact hold. The essence of a preemptive exit on the basis of an intraday chart is to get out when there is a new *entry signal* to trade in the opposite direction to your trade. This does not mean that a new trade going the other way is justifiable—the overriding principle is that surprises tend to come in the direction of the major trend. However, it does mean that the immediate probabilities have turned unfavorable. Sometimes a contratrend trade is readily identifiable, but you have to be very nimble, with short-term expectations, and ideally, there should be a strong indication of exhaustion, such as an island.

One thing to bear in mind about all markets all the time is to ask yourself the question, "What are the floor traders doing?" They make their living by taking the other side of trades where there is excessive exuberance, however well justified that exuberance might be in the bigger picture. Their perspective may be extremely short-lived, but that's not the point. Someone has to take each side of every trade, and you can't both be right.

Be Intolerant of Losing Trades

When you are losing money, the temptation is to think that you have only to hang in because of poor timing rather than that you were wrong. Apparent logic often falls short in futures markets. Like the proverbial stuck record, you can repeat the saying that markets can remain irrational far longer than you can remain solvent. This is one vital reason for not adding to a losing position. It is self-evident on the margin run, as manifested by the loss, that you got it wrong once, and the probabilities increase rather than diminish that you will get it wrong again. Therefore, it pays hand over fist to be extremely intolerant of losing trades and, at the very least, to make sure that the stop is in the right place.

It is amazing how often a trade that is never going to be any good or one that will take an interminable time to come on side for you starts going the wrong way from the outset. It is also remarkable how ambiguous signals develop well before the stop is hit to negate the positive indicators that led you into the trade in the first place. The consolation for taking a loss, whether large or small, is to remember how much money you can make when you are right.

Every trader makes mistakes sometimes, entering a trade that later fails to qualify. It may not be losing money, but you are stuck in a market going nowhere. More often than not, the trade fails to improve with time, and it ties up mental and financial capital for no good reason, even if it does not actually lose money. It seldom pays to keep a trade that has a significant number of negating indicators. Therefore, you might as well get rid of it and look for another one.

Let Profits Run

The corollary of intolerance of losing trades is to try to avoid getting jostled out of a winning trade prematurely. Markets can bolt, buck, and swerve, like a bronco, although there is a lot more profit still to come in a trade. You have only to look at the chart for a market that has gone a long way to see how profitable it would have been to ride it out. However, closer examination also shows just how easy it would have been to get knocked out of the trade and then how difficult it would have been to get back in. During a relatively routine longer-term trade, the June 2007 Japanese yen decline from 8,749 to 8,100 over a period of three months, for a total move of about 650 points. On the way there were two convulsions of about 150 points that did nothing to damage the downtrend.

Letting profits run does not, of course, mean marrying a trade. Even the most successful trade has its beginning, its middle, and its end. You can't stay in any trade forever, although you might, theoretically at least, have stayed long stock indexes for several years throughout the 1990s. A statistical curiosity of letting profits run, however, is that you can have a high percentage of losing trades as long as there are also some of those huge winning trades that futures markets deliver every year in one sector or another.

Prime Indications to Stay in a Trade

Since it is imperative to make good profits when you have a good trade, it follows that you need guidelines for staying in those good trades and not getting taken out by temporary and aberrational setbacks, even quite big ones. Accordingly, here are some guidelines for overriding the inclination to get out prematurely. Sometimes, of course, these guidelines let you down, but on balance, they serve to reinforce the principle of letting profits run. The extension of this principle is that profits can and should be large and losses manageable, if not necessarily small.

The first criterion is not actually a guideline as such, but rather a reminder that you really need to have an idea from the long-term continuation charts, the monthly as well as the weekly charts, where the market you are looking at might be in the bigger picture. Even if it is a major bull or bear market, you should have an idea how far the retracements might go. You should be prepared to bank profits or enter a tight stop when price is at the outer extremity of a range or a channel because it is unmanageable to withstand a setback of $10 in crude oil or $50 in gold. Then you may be able to get back in when the big picture is favorable again.

Reasons to Stay

On the principle that you want to stay with the trend likely to remain in force, criteria for staying in a trade normally include the following:

1. A clear three-point trend line remains unbroken.
2. A gap on the daily chart remains unfilled—it is amazing how often there can be what seems like a savagely adverse day, in isolation, but support or resistance at a gap holds firm.
3. Strongly trending moving-average convergence/divergence (MACD) is not faltering.

Flashing-Light Alerts

These flashing-light alerts for a possible exit stand out for all durations of charts:

1. Stochastics %*K* at 90 or higher for a long position and at 10 or lower for a short position.
2. The market is pressing against a channel line, or beyond it, and stochastics are extended.
3. A second adverse turn by the MACD fast line (an M or a W)—depending on overall market conditions, there may be an entry to take a trade in the opposite direction.
4. In grains, watch the weather like a hawk during the growing season. Forecasts can turn even the most strongly entrenched trend in grain markets—a violent turn may or may not set up a new direction, but weather can trump the apparent immediacy of technical indicators, and you don't want to stand in the way of a sharp reversal.

Mandatory Exits

The counterpart of compelling criteria to retain a profitable trade is the mandatory exit (or near-mandatory exit because you can't abdicate all judgment), which, on occasion, may even justify a trade in the opposite direction. The objective of mandatory exit signals, when they occur, is to make a really good and timely exit so as to maximize profit or to minimize loss before a more serious adverse move in price gets going.

1. An island reversal.
2. A gap, two bars open, and a strong adverse close—the counterpart of the three-bars-open entry signal.
3. A broken trend line—there is often some judgment required to assess which steeper or less steep trend line to heed, and you can't avoid these conflicts. Nevertheless, even a steep trend line, when broken, is often the precursor of a significant setback. The break shows that the market is losing momentum.
4. A second substantial key reversal within a formation, ideally with a lower second high when you are long or a higher second low when you are short.
5. A triple adverse zigzag on the daily chart.
6. A triple adverse zigzag and adverse trending action in %*K*, particularly when the market has gone a long way and there has been an overbought or an oversold condition.
7. Achieving a long-term chart objective such as gold and silver reaching a prominent high standing for many years, as occurred in 2006—an extremely rare occurrence, but all the more important for that.
8. Adverse trending MACD after a significant move in price, especially an M or a W—this is more a condition than a precise trigger-pulling indication.

Using the Checklist and the Exit Count

When it is not obvious whether to stay in a trade or get out, which is much of the time, the *exit checklist* (Figure 18-1) does a fair job at reversing the process from the entry checklist. Many of the criteria are based on momentum and consequently suffer from the unavoidable weakness that the checklist may get you out just exactly when enough of a setback has occurred to complete a retracement. Nevertheless, you can always get back into a trade as and when the indicators are favorable to do so.

Note the suggestion that you use the exit checklist so that a checkmark signifies a point in favor of getting out and an X signifies one to stay in the trade. Obviously, you can do the opposite, as long as you are consistent.

It is impractical to establish an arbitrary count on the exit checklist on which a decision to get out of a trade pivots. There are just too many variables, and in the final analysis, judgment rules. Of course, one component of judgement which may be compelling is to consider the case for a trade in the opposite direction. At climactic tops and bottoms, this case may have a lot of merit. A net exit count much above 7 or 8 on the daily chart is normally a call to get out, and one at 10 or higher almost invariably dictates a mandatory exit.

EXIT CHECKLIST

Market _____ Date _____

Indicators: ✓ X	Daily	60-Minute
1. %K 80/20-90/10		
2. %K Turn		
3. %K Crossover		
4. %K Turn from 80/20-90/10		
5. Supp/Res/Target		
6. 25-bar moving average direction		
7. 40-bar moving average direction		
8. Gap(s)		
9. Gap – 2 Days Open		
10. Key Reversal		
11. Outside Bar		
12. Reversal pair (1/2)		
13. Dble Rev/Lindahl (1/2)		
14. Price M/W-Zigzag		
15. Price Bar Action		
16. Rev. at Channel		
17. Bollinger Bands		
18. Weekly Reversal		
19. MACD Turn		
20. MACD Crossover		
21. MACD Baseline		
22. Moving average/trend line holding		
23. Stop/resistance holding		
Total to Exit		
Total to Stay		
Net Exit (Stay)		

Check: Backwardation _____ USD _____ COT _____ News _____ Weather _____

FND _____ Friday Close _____ Month-end _____ Stop Loss _____

Retracement Support/Res. Levels _____

Figure 19-1 The exit checklist

It is useful to approach exits with the mind-set that you can't expect to get more than a piece out of a market move and sometimes only a small one or else a loss. Either way, the guiding principle is to remember how much you money you can make on those few really big winners that you succeed in entering at a good time and a good price.

1. *%K level: 80/20–90/10*. Stochastics provide one of the best available technical indicators of vulnerability to a setback. Interpreting them is less subjective than many other indicators, and therefore, they help to enforce disciplined trading. A long position is vulnerable to a retracement when %*K* is at a *high* level, and a short position is vulnerable when %*K* is at a *low* level. The reverse of this is that a high stochastic level may suggest that a short position can turn back onside.

   Count a single point for %*K* at the 80/20 level depending on whether you are long or short and an additional point for a 90/10 level. Except in an exceptionally powerful move, a 90/10 level is almost always a sign that a market is so far extended that a retracement can occur at any moment, potentially a powerful one.
2. *%K turn*. This is the old standby, where any turn against a trade sets up a warning of a possible impending retracement. A single turn counts no more than a single point unless other things are happening. A third turn setting up an adverse M or W almost always sets up a mandatory exit, and on occasion it may signal a trade in the opposite direction.
3. *%K crossover*. %*K* crossing %*D* confirms the validity of a turn. By the time %*K* makes an adverse crossover, it is likely that you may well have closed out a trade.
4. *%K turn from 80/20–90/10*. Count a point against the trade when %*K* has been above 80 or below 20 and returns below 80 or, accordingly, above 20. The extreme reading will have shown strong pressure, but easing pressure often, on its own, signals the start of a retracement. Count an additional point if it happens a second time. Count yet another point if %*K* turns after having exceeded 90/10 within the past 10 days.
5. *Support/resistance target*. By no means always, but frequently you can tell when price reaches a conspicuous objective, whether a horizontal support or resistance line, or a channel line, or a notable previous high or low. Depending on the prominence of the target level, as well as market action, it is sometimes appropriate simply to get out, to watch for the potential for a reversal to develop, or at least to enter a tight stop. Make the judgment call if you stay in as to whether reaching this level rates just one or an additional second point in favor of an exit. In a strongly trending market, there is

usually only a little hesitation before price breaks through and goes on to the next level.

6. *25-bar moving-average direction*. If the direction is opposite to the direction of the trade, you may well be on the wrong side of the market. Exceptionally, there might be other reasons to hold the trade so that adverse moving-average direction does not amount, on its own, to a mandatory exit.
7. *40-bar moving-average direction*. As for the 25-bar moving average.
8. *Gaps*. Gaps tend to be lethal when a market has already gone a long way, and a single adverse gap may justify an exit in an extended market. Count the number of adverse gaps. As always, look for gaps on the basis of opens versus closes and not just a complete separation between bars.
9. *Gap—2 days open*. Unlike the entry signal, the three-days-open gap rule, it generally pays to act on just two days to exit, even when price does not close strongly against a trade.
10. *Key reversal*. Note the definition of a key reversal in Chapter 3. A single strong reversal may not signal the end of a move, but it can do so depending on how powerful it is.
11. *Outside bar*. An outside bar by no means always signals the start of retracement, but it shows that at least for the duration of that bar there was strong pressure to go the other way.
12. *Reversal pair*. A double adverse reversal, whether a closing-price reversal or a high/low reversal. It is remarkable how often reversal pairs are themselves duplicated and therefore the additional point count for a second occurrence. When the second one has a lower high for a long position or a higher low for a short position, it almost always signals an exit.
13. *Double reversal/Lindahl*. This is essentially a duplication of item 5, adding additional points for an exit.
14. *Price M/W zigzag*. Don't forget to take the time to switch to the line chart to see how it is shaping up. You really need a minimum of a complete M or W in order to count this as an indicator to exit, but it is close to mandatory to do so when the formation is clear. Count an extra point to get out when there is a triple-bottom or triple-top zigzag.
15. *Price-bar action*. This one may require considerable subjectivity in interpretation. Look to see whether individual bars have been closing near the opposite end of the range to the trend or have been pushing out and failing to follow through. Also look for key-reversal-type action, which signifies climactic exhaustion and a corresponding setup for the market to go the other way.
16. *Reversal at channel*. This is essentially a duplication of item 5. You need a very powerful market to suggest that price will slice through a major channel line,

but there are many minor indications that are not so clear. Some of the most savage retracements occur when price reaches toward a channel line but doesn't get there. Instead, adverse indicators, including price action, start turning against a trade before the price gets that far.

17. *Bollinger bands*. Here, too, you need judgment. A strongly moving market will hug the outer Bollinger band. Watch when it starts to roll over against the direction of the trend and price starts losing speed. Bollinger bands are particularly useful when the trend is not particularly strong.
18. *Weekly reversal*. On its own, one weekly reversal may not signal the end of a major move, but it certainly sets up a warning that there is pressure in the market to take a stand against the trend. A second adverse weekly reversal, a double reversal, or an adverse Lindahl price rule almost dictates a mandatory exit. Count an adverse weekly reversal any time price is the adverse side of the previous week's close, on the assumption that it will complete either a closing-price or a high/low reversal at the end of the week.
19. *MACD turn*. A turn in MACD is likely to happen later than on in %*K* because it is slower to respond. Even a single turn indicates that momentum may be turning against the trade. An adverse M or W in MACD is very likely to indicate a trade in the opposite direction. Count a second point against the trade for a second adverse turn.
20. *MACD crossover*. A MACD crossover adds credence to the possibility that a retracement of some consequence may be starting. It seldom pays to trade against an adversely trending MACD except, occasionally, at the end of a retracement, as suggested by indicators that respond more quickly.
21. *MACD baseline*. This is an important big-picture indicator suggesting whether the major trend is up or down. MACD above the baseline suggests a bull market, and below, a bear market. However, you have to interpret this indicator with reference to the overall shape and history of the pattern. Count this indicator negative—that is, with an X—to stay in rather than to exit, when you are on the right side of the major trend.
22. *Moving average/trendline holding*. This is one of the most important pivotal indicators, counting either positive, to exit, or negative, to stay. In order to facilitate a timely exit, use a steeper trend line rather than wait for price to travel to one that is less steep—which is all too likely to happen once it breaks a steep line. When price is pressing against a trend line and you expect that it may hold, count it negative, to stay. However, the break of a trend line may well call for an immediate exit. Moving averages require more judgment, but a rebound in the direction of the trend normally suggests adding to a position rather than getting out of one. The best trades

seldom go much beyond the 40-day moving average, and penetration may suggest lack of potential even if there is a rebound.

23. *Stop/resistance holding*. Here, too, a successful test of support or resistance may well suggest that you should stay in a trade rather than exit prematurely. However, violation of the identifiable support or resistance probably signals an abrupt and mandatory eviction from the trade. Beware of assuming the validity of support or resistance deriving from what may be an exhaustion gap—noting, of course, that these gaps occur when stochastics are very extended!

Other Points to Check

Backwardation or market inversion. The wind may be with a bull market if the nearby futures trade above the deferred and in the face of a short position.

U.S. dollar. Every long position in U.S. futures markets is a short position against the U.S. dollar because this is what you use to buy it with. Similarly, every short position is a long position against the U.S. dollar. The relative strength of the U.S. dollar is important to consider when trading internationally traded commodities and, of course, foreign currencies.

Commitments of Traders. Check the Commitments of Traders numbers, as discussed in Chapter 15.

News/fundamentals. This is a catch-all for evaluating your assumptions about the supply-and-demand fundamentals. Check on any potential news announcements that may affect market action—anything from crop reports to monthly unemployment numbers. You may want to avoid trading just before a major news announcement in case the market reaction is the opposite of what traders expect. When an announcement produces less than traders generally expect, there can be a violent move against the trend. Even when the news confirms traders' expectations, too many people may have traded on the outcome, with the result that profit-taking overwhelms what you might expect to happen. Remember the adage, which is often manifested by market action ahead of an announcement: "Buy on rumor; sell on news!"

Weather. When trading agricultural markets, particularly field crops, don't forget to check the potential impact of weather. The general rule is that weather patterns, once established, tend to continue. High-pressure areas, representing clear skies and hot temperatures in summer and cold temperatures in winter, tend to remain fairly immobile. Low-pressure areas keep following on one another and bring clouds and rain or snow depending on the season and the latitude. However, beware of a possible sudden change.

First notice day (FND). You need to know when holders of long positions are liable to receive a delivery notice and when, therefore, speculative holders of long positions must get out or roll forward. High prices are vulnerable toward FND when speculators have abnormally large long positions.

Friday close. It is always a good time to check every trade going into the close on Friday to see whether you really want to carry it over the weekend. A strong close on Friday has a high probability of following through on the open on Monday. However, an ambiguous close on Friday often sets up a market to go against you.

Month-end. There is often severe turbulence around month-end, and there can be abrupt reversals of previous market action. Many big hedge fund managers even up their books at month-end or, alternatively, enter new positions in the expectation of what they think will happen during the next month.

Stop loss. Even if you are staying in a trade, you almost certainly need to consider entering a stop and assessing how much you might tolerate in the event of a retracement.

Retracement/support levels. You need to make sure that you have thoroughly checked out where the support and resistance levels are, what potential the trade may have, what retracement you can tolerate if the market goes against you, and most important, therefore, where the stop should be.

CHAPTER
20

Case Study: Buy

Buy April 2007 Blendstock Gasoline

Gasoline provides a textbook example of the complexity that can arise in identifying a really good trade and in putting the pieces together to make a timely entry. It illustrates well the point that you need to do thorough homework in order to put the pieces together at the exact moment when the entry is timely, the potential reward substantial, and the risk manageable.

In the first weeks of 2007, you could see that there might be a low in place in the petroleum market, with automotive gasoline the strongest member of the complex. After many months of stocks running above the level of the previous year according to the American Petroleum Institute, petroleum inventories were beginning to lag behind the previous year. The supply-and-demand fundamentals could, therefore, be coming back onside. Technically, the monthly line chart looks as if there is a serious resumption of the uptrend with a good W (Figure 20-1).

On the other hand, there is a bear market designation on the weekly chart (Figure 20-2).

The daily chart had been ambiguous but was developing a potential new uptrend (Figure 20-3).

At the other end of the spectrum, the 60-minute chart has developed an ascending triangle, one of the most powerful chart patterns when other indicators are confirming (Figure 20-4).

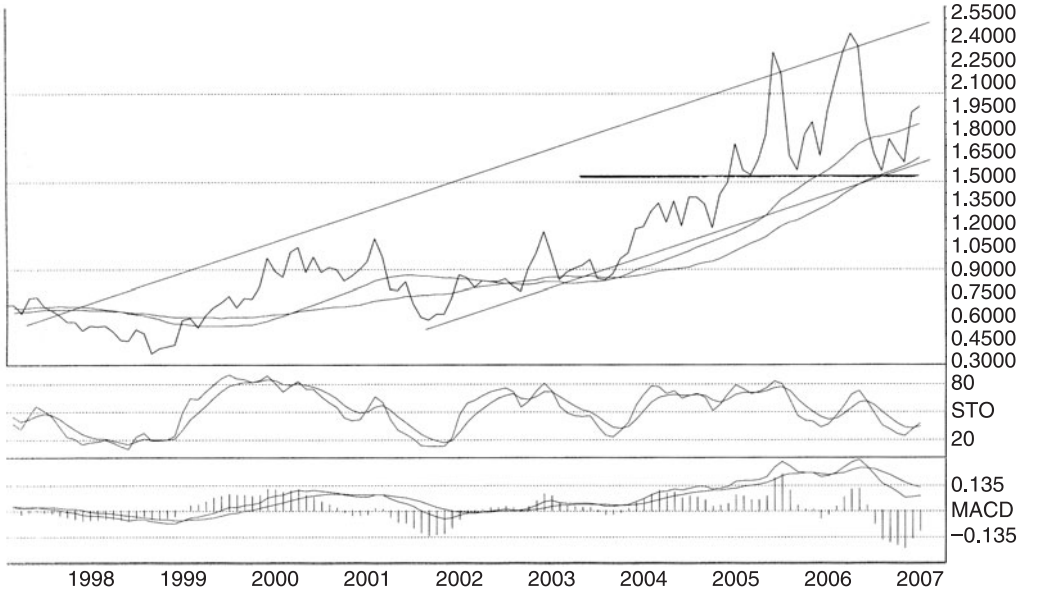

Figure 20-1 Monthly continuation line chart for blendstock gasoline, with stochastics and MACD and 25- and 40-month moving averages

Figure 20-2 Weekly continuation chart for blendstock gasoline, with stochastics and MACD and 25- and 40-month moving averages

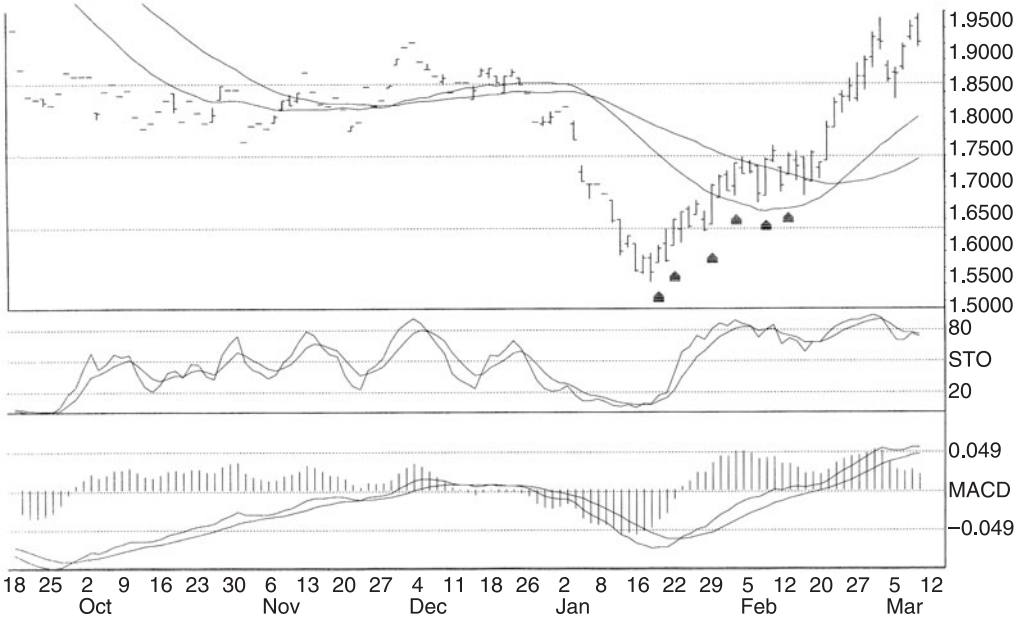

Figure 20-3 Daily chart for blendstock gasoline, with stochastics and MACD and 25- and 40-month moving averages

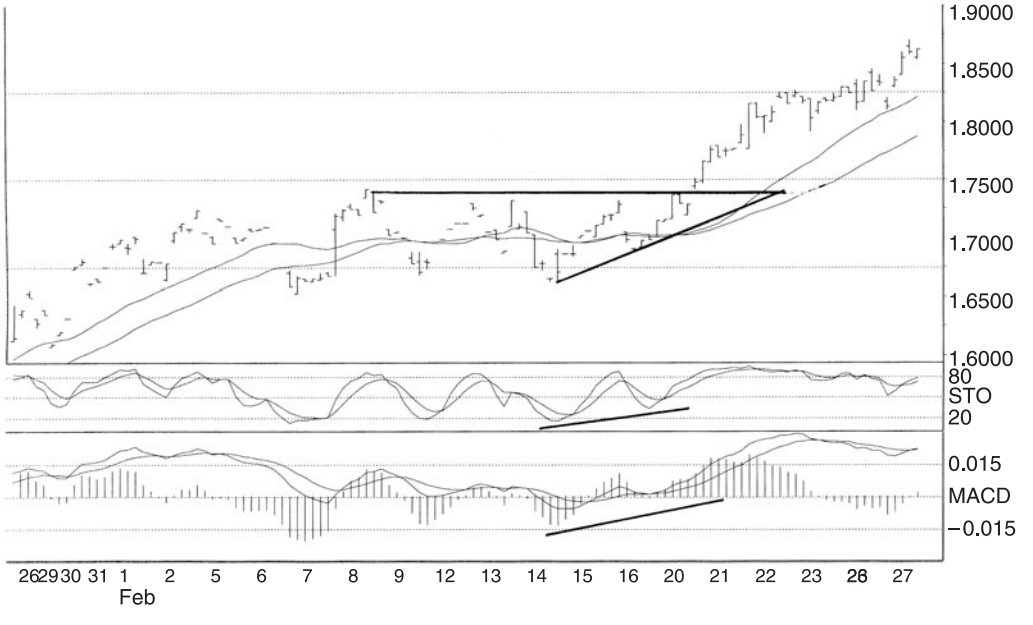

Figure 20-4 Sixty-minute chart for blendstock gasoline, with stochastics and MACD and 25- and 40-month moving averages

The monthly line chart for gasoline appeared to have almost rock-solid support at the $1.50 level, which also coincided with $50 for Texas intermediate crude oil. Initially, there seemed to be no rush to buy just because the price had tested a support level successfully, but the market was starting to look interesting, with a textbook W starting to form on the monthly line chart. Perhaps remarkably in view of the huge and long-lasting retracement, the 25- and 40-month moving averages were still solidly onside, with market action delivering a turn at these moving averages as well as the long-term uptrend line. Ideally, the monthly chart might have stochastics coming on side as well as moving-average convergence/divergence (MACD), but this can take far longer than is reasonable to justify a futures trade when assuming a major trend reversal at support. In any case, the price managed to come in textbook fashion to the rising uptrend line, having also in textbook fashion turned down twice from the upper channel line[1] (see Figure 20-5).

Buy Gasoline off the Monthly Chart

1. *Price-rule signal.* Confirmed. No, but may be developing.
2. *Price zigzag.* Confirmed. Yes.
3. *20-bar moving-average direction.* Confirming.
4. *40-bar moving-average direction.* Confirming.
5. *Reversal at moving average/trendline.* Confirming.
6. *Trendline break.* Not applicable.
7. *Gap (1), island (2).* Not applicable.
8. *Gaps: three bars open.* Not applicable.
9. *Reversal pair (1/2).* Not applicable.
10. *Lindahl/double reversal.* Not applicable.
11. *Outside bar.* Not applicable.
12. *Price-bar action.* Confirming.
13. *Weekly reversal.* Not applicable.
14. *MACD turn—M/W.* No.
15. *MACD crossover.* No.
16. *MACD histogram.* Confirming.
17. *MACD baseline.* Confirming.
18. *%K turn—M/W (1/2).* Confirming.
19. *%K cross %D.* No.

[1.]The monthly and weekly continuation charts shown here result from merging the old harbor unleaded contract with the blendstock gasoline contract, which superseded it.

ENTRY CHECKLIST

Market *April 2007 XRB* Buy/Sell *Buy* Price *17660* Date *2/21/07*

Indicators: ✓ X	Month	Week	Daily	60-Minute
1. Price-Rule Signal	X	✓	✓	✓
2. Price Zigzag (1/2)	✓	✓	✓	✓
3. 25-Bar MA Direction	✓	X	✓	✓
4. 40-Bar MA Direction	✓	X	X	✓
5. Rev. at MA/trendline	✓	✓	✓	✓
6. Trendline Break	—	✓	✓	—
7. Gap (1) Island (2)	—	—	—	✓
8. Gap: 3 Bars Open	—	—	—	—
9. Reversal Pair (1/2)	—	—	✓	—
10. Lindahl/Dbl Reversal	—	—	✓	—
11. Outside Bar	—	—	—	—
12. Price Bar Action	✓	✓	✓	✓
13. Weekly Reversal	—	—	—	—
14. MACD Turn—M/W (1/2)	X	✓ 2	✓	✓ 2
15. MACD Crossover	X	✓	✓	✓
16. MACD Histogram	✓	✓	✓	✓
17. MACD Baseline	✓	X	✓	✓
18. %K Turn—M/W (1/2)	✓	✓ 2	✓ 2	✓ 2
19. %K Cross %D	X	✓	✓	✓
20. %K Level 80/20–90/10 (1/2)	—	—	—	—
21. %K Turn from 80/20	—	—	—	—
22. Adv. Channel Line	—	—	—	—
23. Support/Resistance	✓	—	—	—
24. Bollinger Bands	✓	✓	—	✓
Total Confirming	8	13	15	16
Total Negative	4	2	1	0
Net Confirming	4	11	14	16

Check: Backwardation ✓ USD ✓ COT ✓ News ✓ Weather ✓

FND ✓ Friday Close ✓ Month-end ✓ Stop Loss *169.50*

Retracement Support/Res. Levels *171.00 166.25*

Figure 20-5 Entry checklist

20. *%K level 80/20–90/10 (1/2).* Not applicable.
21. *%K turn from 80/20.* Not applicable.
22. *Adverse channel line.* Not applicable.
23. *Support/resistance.* Confirming, with support holding rock solid.
24. *Bollinger bands.* Confirming.

Buy Gasoline Off the Weekly Chart

1. *Price-rule signal.* Confirming.
2. *Price zigzag.* Confirming on the April-specific contract.
3. *20-bar moving-average direction.* No.
4. *40-bar moving-average direction.* No.
5. *Reversal at moving average/trendline.* Confirming.
6. *Trendline break.* Price has broken the intermediate downtrend line.
7. *Gap (1), island (2).* Not applicable.
8. *Gaps: three bars open.* Not applicable.
9. *Reversal pair (1/2).* Not applicable.
10. *Lindahl/double reversal.* Not applicable.
11. *Outside bar.* Not applicable.
12. *Price-bar action.* Confirming.
13. *Weekly reversal.* Not applicable. The market has been too strong for price to go below any weekly lows.
14. *MACD turn—M/W.* Yes, with a W.
15. *MACD crossover.* Confirming.
16. *MACD histogram.* Confirming.
17. *MACD baseline.* No. Not yet even close to signifying a bull market.
18. *%K turn—M/W (1/2).* Yes, both.
19. *%K cross %D.* Confirming.
20. *%K level 80/20–90/10 (1/2).* Not applicable.
21. *%K turn from 80/20.* Not applicable.
22. *Adverse channel line.* Not applicable.
23. *Support/resistance.* Not applicable. There is a key level right here, with price on the point of breaking out.
24. *Bollinger bands.* Not applicable.

Buy Gasoline Off the Daily Chart

1. *Price-rule signal.* Confirming.
2. *Price zigzag.* Confirming.

3. *20-bar moving-average direction.* Confirming.
4. *40-bar moving-average direction.* No. Not yet confirming but shaping up.
5. *Reversal at moving average/trendline.* Confirming. There is a tight new uptrend line with a new ascending triangle.
6. *Trendline break.* Confirming, with the downtrend line now broken, as seen on the weekly chart.
7. *Gap (1), island (2).* Not applicable.
8. *Gaps: three bars open.* Not applicable.
9. *Reversal pair (1/2).* Confirming though a bit ambiguous.
10. *Lindahl/double reversal.* Confirming, although a bit ambiguous.
11. *Outside bar.* Not applicable.
12. *Price-bar action.* Strongly confirming, but only if it actually breaks out and stays broken out.
13. *Weekly reversal.* Not applicable.
14. *MACD turn—M/W.* Confirming.
15. *MACD crossover.* Confirming.
16. *MACD histogram.* Confirming.
17. *MACD baseline.* Confirming.
18. *%K turn—M/W (1/2).* Confirming for 2 points.
19. *%K cross %D.* Confirming.
20. *%K level 80/20–90/10 (1/2).* Not applicable.
21. *%K turn from 80/20.* Not applicable,
22. *Adverse channel line.* Not applicable.
23. *Support/resistance.* Not applicable, assuming a good breakout from the ascending triangle.
24. *Bollinger bands.* Not applicable.

Buy Gasoline Off the 60-Minute Chart

1. *Price-rule signal.* Confirming.
2. *Price zigzag.* Confirming.
3. *20-bar moving-average direction.* Confirming.
4. *40-bar moving-average direction.* Confirming.
5. *Reversal at moving average/trendline.* Confirming. Bouncing off the assumed new small trend line forming the diagonal for the ascending triangle.
6. *Trendline break.* Not applicable.
7. *Gap (1), island (2).* Confirming, although somewhat unclear because of the thin liquidity.
8. *Gaps: three bars open.* Not applicable.
9. *Reversal pair (1/2).* Not applicable.

10. *Lindahl/double reversal.* Not applicable.
11. *Outside bar.* Not applicable.
12. *Price-bar action.* Confirming and very good.
13. *Weekly reversal.* Not applicable.
14. *MACD turn—M/W.* Confirming and good for 2 points.
15. *MACD crossover.* Confirming.
16. *MACD histogram.* Confirming.
17. *MACD baseline.* Confirming, just crossing now.
18. *%K turn—M/W (1/2).* Confirming and good for 2 points.
19. *%K cross %D.* Confirming.
20. *%K level 80/20–90/10 (1/2).* Not applicable.
21. *%K turn from 80/20.* Not applicable.
22. *Adverse channel line.* Not applicable.
23. *Support/resistance.* Not applicable.
24. *Bollinger bands.* Confirming. The lower band has been containing price perfectly and rounding out (not shown).

Other Points to Check

Backwardation. Not applicable—an ordinary carrying-charge market.
U.S. dollar. The U.S. dollar appears to be holding, but it is certainly not strong and could weaken, thus favoring the trade.
COT. Commitments of Traders shows the nonreportables net plus 9 and potentially adding to their position. They could add a lot more. However, the commercials are a bit heavy on the short side at –9.
News. All news in the petroleum market has a tendency toward the long side. Gasoline stocks are down year on year and potentially could tighten.
Weather. Not really a factor.
First notice day (FND). FND not due for another month, intentionally trading the April contract with expiration of the March just a few days away.
Friday close. Not applicable.
Month-end. Not applicable.
Stop loss. 169.50—a bit far out but okay for disaster insurance.
Support levels. 171.00 and 166.25.

Comments

There were, as there almost always are, some conflicts to address when considering this trade. Nevertheless, the conjunction of technical action and tentative but

apparently reasonable assumptions about the supply-and-demand fundamentals suggested that the net probabilities in favor of the trade were very good. Most encouraging was the fact that the retracement from the record high had been so huge as to wash out any excess in speculative sentiment. Also, there had been enough basing action to suggest that this market had finished establishing the foundation for a worthwhile advance.

What Happened

The gasoline market was to move fairly smartly out of the gate on the surge out of the ascending triangle, although it was not to accelerate as one might have hoped ideally. After a rollover into the May contract, it was to keep moving steadily but erratically upward, contained by a 10-bar moving average on the daily chart, except for a single adverse close. From an entry at 1.766, the price was to move to the 2.140 level by the end of the first week in April, for a gain of more than $15,000 on a single contract. On the way, there were what would have seemed at the time to be some significant fluctuations, such as from $1.940 down to $1.815, having a range in money of $5,250 but still doing no serious technical damage. This trade illustrates, therefore, the imperative of making a good entry so that you can withstand significant fluctuations occurring within a strongly trending market. On the evidence of this and much similar market action in futures markets generally, it is hard to refute the case for looking for major trends and for giving trades room to move.

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CHAPTER
21

Case Study: Sell Short

Sell March 2007 Copper

Copper had made one of the greatest of all bull market moves for any market at any time, rising from a low at 60.90 cents in 1999 to a peak at $4.16 in May 2006. It seemed obvious that the $4 level was absurdly high regardless of the supply-and-demand fundamentals, but on the way up the same could have been said of $2, $3, and finally, $4. You do not try to sell short such a strong market until it has its back well and truly broken, and even then, there is the risk of the market taking yet another run for the top. Bull markets die hard! Nevertheless, coiling action with a declining bias was developing toward the end of 2006. In addition, an important switch had occurred recently from backwardation to a carrying-charge market. This is to say that the nearby futures were no longer trading at a premium to the deferred—a characteristic of a strong bull market that had prevailed throughout the bull market. The checklist shows the case for selling short (Figure 21-1).

Sell Copper Off the Monthly Chart

The monthly continuation chart for copper shows a textbook example of an even distributional bar pattern with successively lower highs for the months of July to November and, in addition, a small downward acceleration. Also, each of these monthly bars had a slightly lower low (Figure 21-2).

ENTRY CHECKLIST

Market *March Copper* Buy/Sell *Sell* Price *309.45* Date *Dec. 12 2006*

Indicators: ✓ X	Month	Week	Daily	60-Minute
1. Price-Rule Signal	✓	✓	✓	✓
2. Price Zigzag (1/2)	✓	✓	✓	✓
3. 25-Bar MA Direction	X	✓	✓	✓
4. 40-Bar MA Direction	X	X	✓	✓
5. Rev. at MA/trendline	—	✓	✓	✓
6. Trendline Break	✓	—	—	✓
7. Gap (1) Island (2)	—	—	—	—
8. Gap: 3 Bars Open	—	—	✓	—
9. Reversal Pair (1/2)	—	—	✓	—
10. Lindahl/Dbl Reversal	✓	✓	✓	—
11. Outside Bar	—	✓	✓	—
12. Price Bar Action	—	✓	✓	—
13. Weekly Reversal	—	✓	✓	✓
14. MACD Turn—M/W (1/2)	✓	✓	✓	✓
15. MACD Crossover	X	✓	✓	✓
16. MACD Histogram	V	—	✓	✓
17. MACD Baseline	X	X	✓	—
18. %K Turn—M/W (1/2)	2	✓2	2	✓
19. %K Cross %D	✓	✓	✓	✓
20. %K Level 80/20–90/10 (1/2)	2	—	—	—
21. %K Turn from 80/20	✓	—	—	—
22. Adv. Channel Line	—	—	—	—
23. Support/Resistance	—	X	—	✓
24. Bollinger Bands	—	—	—	✓
Total Confirming	11	14	18	14
Total Negative	4	3	0	0
Net Confirming	7	11	18	14

Check: Backwardation ✓ USD ✓ COT ✓ News ✓ Weather ✓

FND ✓ Friday Close ✓ Month-end ✓ Stop Loss *316.50*

Retracement Support/Res. Levels _____

Figure 21-1 Entry checklist

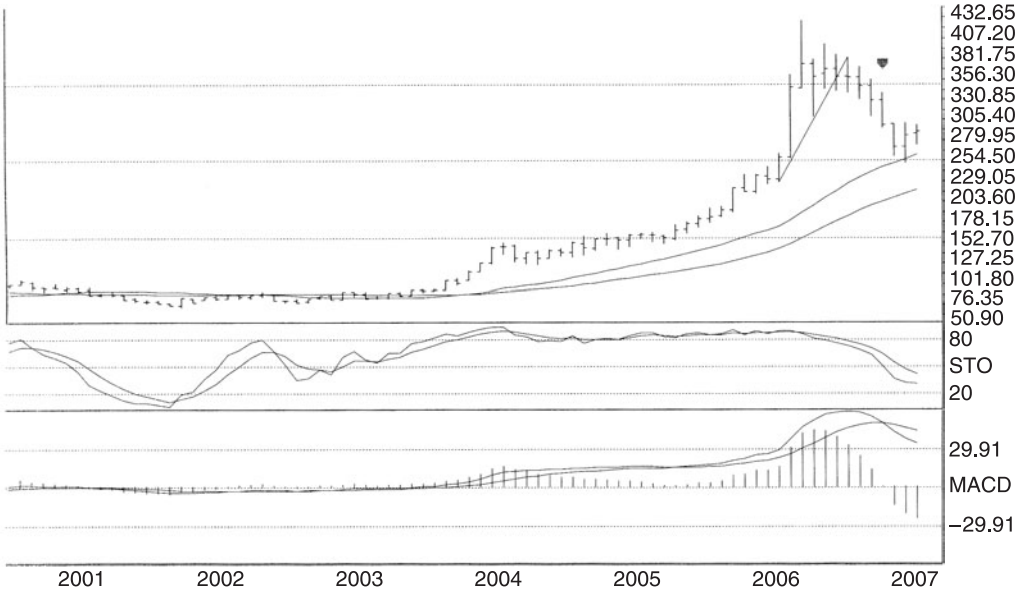

Figure 21-2 Monthly continuation chart for copper, with 25- and 40-month moving averages, stochastics and MACD

1. *Price-rule signal*. Confirmed.
2. *Price zigzag*. Confirmed.
3. *20-bar moving-average direction*. No.
4. *40-bar moving-average direction*. No.
5. *Reversal at moving average/trendline*. Not applicable.
6. *Trendline break*. Confirmed.
7. *Gap (1), island (2)*. Not applicable.
8. *Gaps: three bars open*. Not applicable.
9. *Reversal pair (1/2)*. Not applicable.
10. *Lindahl/double reversal*. Confirmed.
11. *Outside bar*. Not applicable.
12. *Price-bar action*. Somewhat unclear. Not applicable.
13. *Weekly reversal*. Confirmed.
14. *MACD turn—M/W*. Confirmed.
15. *MACD crossover*. Confirmed.
16. *MACD histogram*. Confirmed.
17. *MACD baseline*. No.
18. *%K turn—M/W (1/2)*. Yes and 2 points.

19. *%K cross %D*. Confirmed.
20. *%K level 80/20–90/10 (1/2)*. Confirmed for 2 points.
21. *%K turn from 80/20*. Confirmed.
22. *Adverse channel line*. Not applicable.
23. *Support/resistance*. Not applicable.
24. *Bollinger bands*. Not applicable.

Sell Copper Off the Weekly Chart

The weekly chart carries forward in more detail the incipient waterfall that the monthly chart was suggesting. There were significant ripples on the way, but the trend was clear, and it was gathering speed, as shown also by the downtrend established by moving-average convergence/divergence (MACD) (Figure 21-3).

1. Price-rule signal. Confirmed.
2. Price zigzag. Confirmed. Yes, textbook!
3. *25-bar moving-average direction*. Count positive, although with some ambiguity. This moving average is declining on the weekly continuation chart but

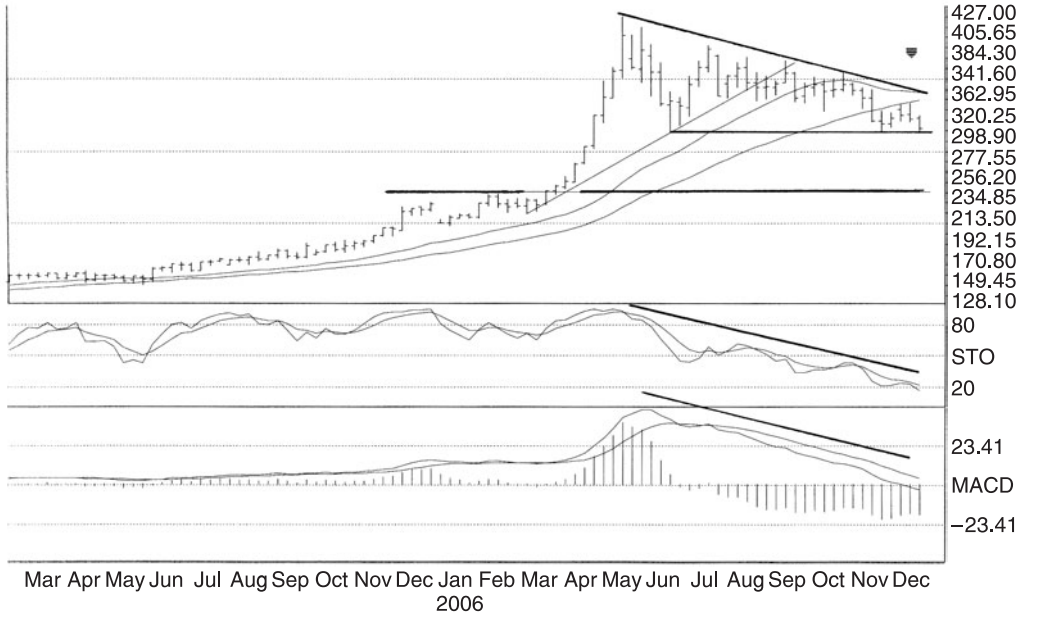

Figure 21-3 Weekly continuation chart for copper, with 25- and 40-week moving averages, stochastics and MACD

no better than flat on the March-specific contract. Price is below this moving average and has consolidated there, suggesting that traders are unwilling to rally the market again.

4. *40-bar moving-average direction*. Count negative.
5. *Reversal at moving average/trendline*. Leave blank—nothing to say.
6. *Trendline break*. Price has violated several uptrend lines, each one shallower than the last, and has just gone through a third one.
7. *Gaps: three bars open*. Not applicable.
8. *Gap, island*. Not applicable.
9. *Reversal pair*. Not applicable.
10. *Double reversal/Lindahl*. Lindahl price rule completed.
11. *Outside bar*. Yes, completed the previous Friday.
12. *Price-bar action*. You could hardly wish for anything better.
13. *Weekly reversal*. Yes, completed the previous Friday.
14. *MACD turn—M/W*. Yes. Count 1 point—a possible 2.
15. *MACD crossover*. Not applicable.
16. *MACD histogram*. Not really applicable. Looks good to count affirmative, although in isolation it looks a bit oversold.
17. *MACD baseline*. No. MACD could just be going through the zero baseline.
18. *%K turn—M/W*. *%K* has just made a new downturn and has established a clear downward zigzag. Count 2 points.
19. *%K crossing %D*. Confirmed.
20. *Stochastics level 80/20–90/10*. Not applicable. *%K* is now approaching an oversold level, although at 24 it is not oversold.
21. *%K turn from 80/20*. Not applicable.
22. *Adverse channel line*. Not applicable.
23. *Support/resistance*. There is some minor support that could cause a bounce.
24. *Bollinger bands*. Not applicable.

Sell Copper Off the Daily Chart

The daily chart for copper shows market action confirming what the monthly and weekly charts were suggesting, with an optimal moment to pull the trigger on a new short sale now likely to follow through right away or without much hesitation (Figure 21-4).

1. *Price-rule signal*. Confirmed.
2. *Price zigzag*. Confirmed.
3. *20-bar moving-average direction*. Confirmed.

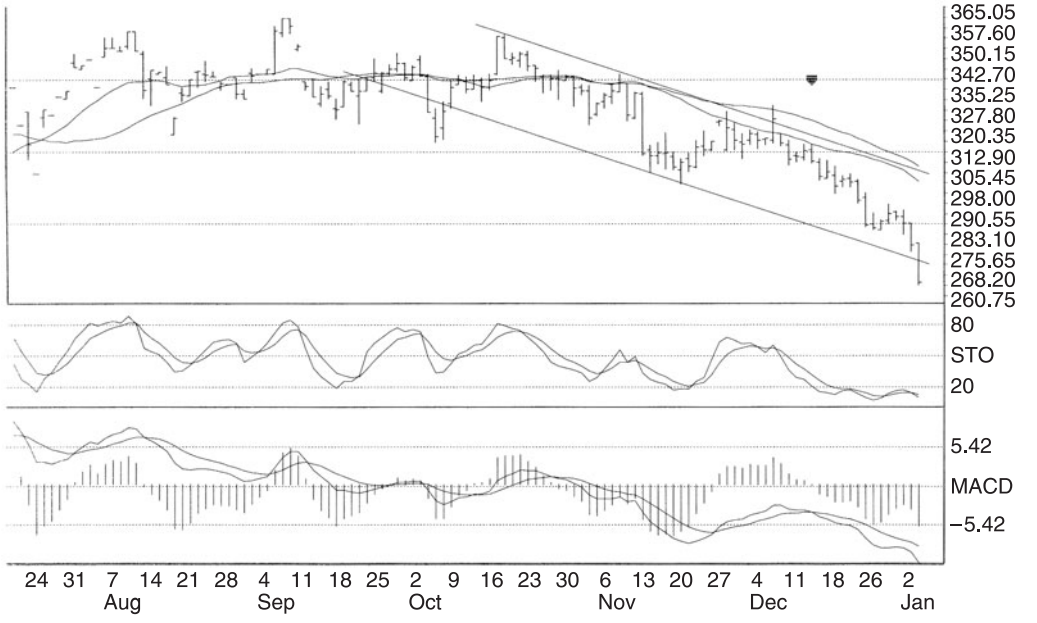

Figure 21-4 Daily chart for March 2007 copper, with 25- and 40-day moving averages, stochastics and MACD

4. *40-bar moving-average direction*. Confirmed.
5. *Reversal at moving average/trendline*. Yes, both. After plunging 22 cents on November 11, the market went sideways for a full month, with a final spike on December 5 going through the downtrend line and the 15-day moving average.
6. *Trendline break*. Not applicable.
7. *Gap (1), island (2)*. Not applicable.
8. *Gaps: three bars open*. Yes. Textbook!
9. *Reversal pair (1/2)*. Yes.
10. *Lindahl/double reversal*. Confirmed.
11. *Outside bar*. Not applicable.
12. *Price-bar action*. Yes. You could hardy get more convincing action.
13. *Weekly reversal*. Yes, the previous Friday.
14. *MACD turn—M/W*. Confirmed.
15. *MACD crossover*. Confirmed.
16. *MACD histogram*. Yes, the histogram bars are in steady descent.
17. *MACD baseline*. Confirmed.
18. *%K turn—M/W (1/2)*. Yes, and count 2 points to confirm.

19. *%K cross %D*. Confirmed.
20. *%K level 80/20–90/10 (1/2)*. Not applicable.
21. *%K turn from 80/20*. Not applicable.
22. *Adverse channel line*. Not applicable.
23. *Support/resistance*. Not applicable, although the weekly continuation chart shows support at the current level, and therefore there may be some turbulence.
24. *Bollinger bands*. Not applicable.

Sell Copper Off the 60-Minute Chart

The 60-minute chart was now confirming the exact moment to pull the trigger. The chart presented here stops at that final decision-making bar on December 12, 2006 (Figure 21-5).

1. *Price-rule signal*. Confirmed.
2. *Price zigzag*. Confirmed.
3. *20-bar moving-average direction*. Confirmed.
4. *40-bar moving-average direction*. Confirmed.

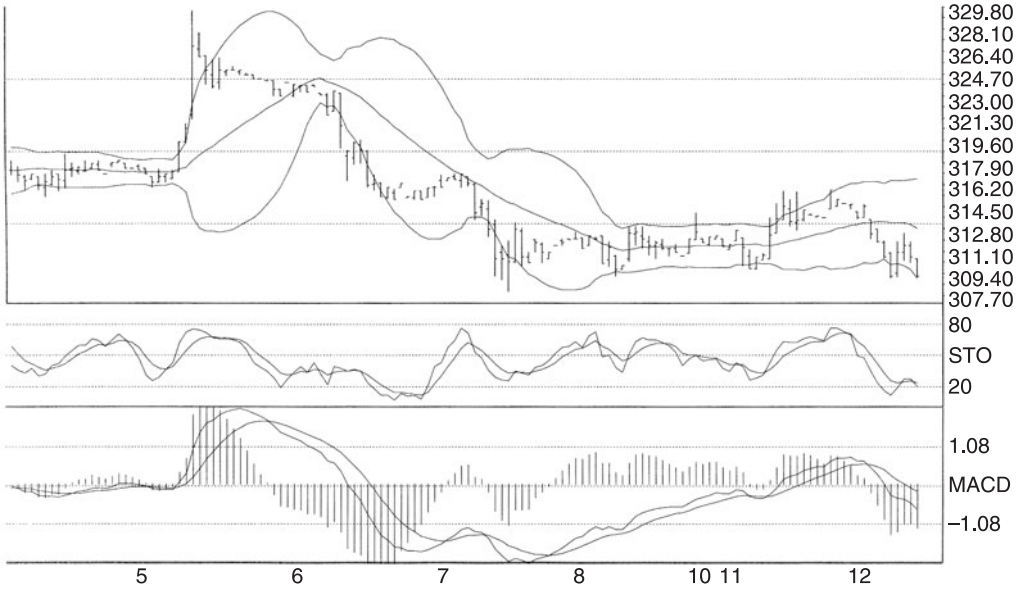

Figure 21-5 Sixty-minute chart for March 2007 copper, with Bollinger bands, stochastics and MACD

5. *Reversal at moving average/trendline*. Not applicable.
6. *Trendline break*. Not applicable. The rally preceding the latest selloff hardly qualifies.
7. *Gap (1), island (2)*. Not applicable.
8. *Gaps: three bars open*. Not applicable.
9. *Reversal pair (1/2)*. Not applicable.
10. *Lindahl/double reversal*. Not applicable.
11. *Outside bar*. Not applicable.
12. *Price-bar action*. Confirmed.
13. *Weekly reversal*. Confirmed.
14. *MACD turn—M/W*. Confirmed.
15. *MACD crossover*. Confirmed.
16. *MACD histogram*. Confirmed.
17. *MACD baseline*. Confirmed.
18. *%K turn—M/W (1/2)*. Confirmed.
19. *%K cross % D*. Confirmed.
20. *%K level 80/20–90/10 (1/2)*. Not applicable.
21. *%K turn from 80/20*. Not applicable.
22. *Adverse channel line*. Not applicable.
23. *Support/resistance*. Count this confirming, although there is very minor intraday support from the previous week. Offsetting this is the fact that price has now closed below a shallow new uptrend line.
24. *Bollinger bands*. Confirmed. Here is the Bollinger band coming into its own. It now looks as if price went up to test the upper Bollinger band, failed, and turned down. The question now is whether the declining lower band and price will go down together as they did for some of the time in the preceding week.

Other Points to Check

Backwardation. After a long period with the market inverted, it now looks, at last, as if the tightness in supply has dissipated.

U.S. dollar. The U.S. dollar appears to be holding, which is neutral for the trade.

COT. Commitments of Traders shows the nonreportables net –24 and the commercials net long 30. These numbers allow room for the funds to get more short and the commercials more long but are not particularly bearish, suggesting the need for caution.

News. Stocks have been building on the London Metal Exchange, and there is no reason to suppose that the buildup will stop.

Weather. Not a factor.
First notice day (FND). FND is months out.
Friday close. Not applicable.
Month-end. Not applicable.
Stop loss. 315.00.
Support levels. 315.75, just above two daily highs, including today's high, of the outside down day.

Comments

The daily chart shows a steady decline over the next couple of weeks with an accelerating plunge toward the $2.60 level. However, this chart disguises what at the time would have seemed quite dramatic fluctuations if all you watched were the 60-minute chart. On December 13, the price followed through to a low of 302.60 from 309.45. Then it rallied the next day to a high of 309.70, actually exceeding the close on the entry day by a few points. A nervous person might well have been jostled out of the market despite all the indications that there was a strong downtrend in force, with a month-long consolidation completed.

In the event, the last plunge shown on the daily chart was to be the last of the big declining days, although the price was to work erratically lower to an eventual low at $2.38. As the market worked more grudging lower, MACD started showing a long time before that final low that the momentum had gone out of the decline. If you go back and look at the weekly chart, you can see that the only level of support evident as a target for the decline was at the $2.34 level, the high going all the way back to February 2006, and at the low, copper essentially achieved this objective before rallying almost to $2.90.

Also, you can see that in the three months of September, October, and November, copper essentially traded in a box having an amplitude of 60 cents, between $3.01 and $3.61. Accordingly, this methodology also projected a target in the $2.40 range. It is hard to see in hindsight, as it would have been at the time, how any more sophisticated approach would have suggested a more likely eventual target for the move. The Fibonacci projections were to $2.63, the 1.618 level, and to $2.40, again, the 2.00 level. It turned out that there was to be support and resistance between about $2.40 and $2.70 as the market was making its low.

As always, however, mathematical attempts to project a price target depend on both starting points and the geometric assumptions. If you assumed a top of the range at the July high on the continuation chart at $3.83 rather than the September high on the March-specific contract, you get a different number altogether to

work with. Such are the hazards of Fibonacci and Elliott wave projections when looking forward rather than looking backward.

What Happened

March copper was to keep on declining without significant interruption until January 8, when it made a low at $2.47 and then rallied to $2.70. The market then moved erratically sideways before plunging to an eventual low at $238.50. Then it found its feet for a dramatic rebound, just when you might have thought that a new bear market was well and truly entrenched. The daily chart was to establish a new uptrend, taking the price back to the $3.40 level in April—far beyond the entry price for this trade. There was nothing wrong with the assumptions justifying the short sale, but the way the trade unfolded illustrates the principle that every trade has its beginning, its middle, and its end. When it ends, and you may not know for certain that it has ended until later, it is mandatory to heed strong exit signals. The renewed advance in copper was unusual but only in the sense of all markets all the time being predictably unpredictable. As to the forces that drove copper down and then up again, most likely there was a fairly standard mass liquidation of long positions by funds and speculators. Then, for certain, there was massive short covering by mining companies lifting hedges put on earlier at prices below $3. Of course, the market will have attracted more short covering by speculators and hedge funds, and the new upturn fed on itself. Interesting too is the fact that copper inventories on the London Metal Exchange made a high around the time of the market low.

CHAPTER
22

Short-Term Trading Techniques I

Advantages and Disadvantages

There are both significant advantages and significant disadvantages to day trading as a regular and intended approach, and there are strong opinions for and against short-term trading. Regardless of your time horizon, day-trading techniques are invaluable for securing a good entry into a market that you already know you may want to trade and for getting out of a market that you expect could start to retrace. The assumption is that a new trade should go to a profit almost immediately, and if it fails to do so, you are prepared to bank a small and manageable loss rather than risk a bigger one. Once the trade becomes profitable, assuming that it does, you can lengthen your time horizon, if you want to, on the principle of letting profits run. If you make trading decisions on the basis of what happens at the end of the day session, the balance of the evidence may seem to have become increasingly favorable. On the other hand, the market may have come an inordinately long way in the process of generating that evidence, possibly so much so that there is too much of a good thing. Then the market may not, after all, follow through.

A successful short-term trader needs very specific and fine-tuned tactics, but regardless of your perspective, you still have to measure the size of the big picture on the longer-term charts. Otherwise, it is uncanny how market surprises—accidents, if you're on the wrong side of the market—tend to occur in the direction of the major trend. It is obvious, therefore, that you have to know which way that is.

As should not have to be said, the prime opportunities to trade long or short occur primarily in the direction of the major trend. Secondarily, the nimble day trader may find great trades both ways at cyclical turning points when a market is conspicuously overbought or oversold.

Optimal entries occur relatively seldom in any market on the daily charts and even less frequently on the basis of the weekly charts. However, there are frequent opportunities to enter on the basis of intraday charts, and sometimes they provide the only practical way to get into a strongly trending market. Otherwise, you may feel that you have to sit on your hands with increasing frustration as a market charges and it seems ever less manageable to enter a new trade with a reasonable risk. Day-trading techniques should get you into trades that start making money almost right away, or else you are back out of the market very soon. Once a trade is making money, the challenge of whether to bank a profit or to hold out for more is one that is relatively easy to handle. Essentially, this decision then relies on letting profits run until your criteria for getting out of a trade activate an exit signal.

The Case for Longer-Term Trading

There is a fundamental contradiction in the underlying rationale for day trading and short-term trading. It is one thing to get out of a market the same day because you made a mistake or because the market failed to act as you expected. However, it is almost certainly another, less good thing simply to get out of the market just because the trading day is ending and when the practical effect may be to cut a profitable trade off at the knees. Besides, when there is a strong close, a substantial move often occurs between the close of one trading day and the open of the next.

A strong and long-lasting trend is what makes futures trading really worthwhile, and you have to question why you would look for any other kind of market to trade. Obviously, there will be many false starts when you try to get into a major long-term trade, but this fact does not for one moment detract from the overriding advantage of looking for them. The corollary of trading a strongly trending market is that it can be forgiving for the longer-term trader getting on board at a poor entry price. For the short-term trader, a bad entry almost axiomatically connotes a loss, potentially a bad one. Logically, in a strongly trending market, you should use any retracement, which you expect to give back only a little in price and to be short-lived, as an opportunity to add to a position rather than to get jostled out of a great trade. The probabilities are against you if you expect to get back in at a better price on a retracement than where you got out.

There is a further compelling reason for taking longer-term positions rather than getting in and out of a market one or more times in a day: Commissions and the spreads can kill you, even when commissions are low and when, thanks to the rapidity of electronic trading, spreads are narrow. The net profit on what appears to be a very good and reliable trading system can shrink drastically when commissions and slippage are factored in.

The Case for Short-Term Trading

Despite these reservations, there are good reasons in favor of day trading or, more specifically, for having a shorter-term perspective for entries and exits. Foremost among them is the fact that markets move in surges, followed by periods of consolidation, if not necessarily big retracements. Logically, you may as well look to get into a trade as a surge is starting and to get out when it finishes. Then you don't have to hang around waiting for the next surge to start, which may not happen (although, when the overall trend is strong, it may come out of the blue and leave you behind). Another good reason for a shorter-term perspective is that you can stop and start trading at any time, taking a break to mow the lawn or to go on a vacation without having to worry about trades that you aren't watching. Yet another reason is that the disciplined day trader should seldom take a bad loss because stops and signals to reverse a position should prevent any single trade getting away on you very far. Of course, you may not want to reverse your position if you have confidence in the major trend, but a day trader does not want to wait around when there is a signal to trade in the opposite direction.

There is a rough rule of thumb that the distance of follow-through is likely to be greater on completion of a signal on a longer-term chart than one of short duration—thus, greater on a daily-bar signal than one on the 15-minute chart. Similarly, however, the amplitude of a potential retracement is similarly likely to be smaller on a shorter-term chart. The essence of successful day trading, therefore, is to line up charts of differing duration so as to optimize the entry into a trade that makes money right away and then continues on its way. In the absence of very specific day-trading techniques, the apparent advantage of entering new trades on the basis of intraday chart action may be offset by the fact that apparent strength early in the day often fades going into the close. The primary antidote for potential failure is to try to buy strength as it is starting on an intraday chart rather than when stochastics are already overbought, and vice versa when selling. In sum, many of the best entries require the psychology of looking for aberrational retracements in the expectation that the market will continue in the direction of the major trend.

Reverting to the case for taking a longer view, however short-term your perspective, it seldom pays to override the axiom that you should let your profits run and cut your losses short. At the best of times, there is a considerable risk that any but the most remarkable short-term trading system will incur quite a lot of small losses that offset some of the expected gains. The only known way to live with many small losses over the long term is to make sure that there are correspondingly large gains from the trades that are successful. It is one thing to cut losses short but quite another to cut short profits. Since many of the best moves occur when there is a strong close and the market keeps on going the next day, often with a gap, why would you want to leave that money on the table? Particularly since the arrival of around-the-clock trading, the distance between the open the next day and the close of the previous day's day session can be substantial. By then, of course, the market may have become short-term overbought or oversold, and some short-term trading approaches would have you looking for an exit rather than chasing a runaway market. On the other hand, cutting losses short is the proverbial no-brainer for the short-term trader. In practical terms, it almost certainly requires never, ever violating the rigid rule: *Don't take a loss home overnight!*

All futures traders have to come to terms with an apparent paradox, particularly when taking a shorter-term view. It may seem that the opportunities in futures markets are numerous, as they are. However, the exact optimal moment for entering a new trade or for closing one out requires very precise timing so as to maximize the potential reward with the most manageable risk. The remedy for a missed trade, therefore, is most likely to be to wait for a new signal, possibly in an entirely different market, rather than to chase a market when the optimal entry has been missed. To that extent, futures trading requires enormous discipline. It requires patience to wait for those precise moments to pull the trigger and it takes courage to enter a trade when you don't yet know whether the new-found wind in the sails of the market will follow through as expected. The personal challenge of finding courage is to think in terms of the saying, "Believe the technicals!" Foremost among those technical indicators for the day trader to believe is a turn from an extended level and then a newfound direction in stochastics.

Buy Low and Sell High

There are essentially two kinds of short-term trading opportunity, as indeed there are for longer-term trades. In short-term trading, however, the distinctions are important, and you have to internalize both the methodology and the psychology. The most popular short-term approach is intentionally to buy into weakness as it is ending and to sell into strength as it is tiring—the other approach is to buy

strength and to sell weakness when you expect follow-through (discussed in Chapter 23). A foremost requirement for buying low and selling high is to identify the support and resistance levels and potential turning points. Once the market reaches the extremity where you want to do business, if it does, then you don't wait around for too much confirming action before jumping in.

In order to buy low and sell high at expected turning points, it is essential to set up the weekly, daily, and intraday charts so that you can see where those supports and resistance levels are, as well as the corresponding potential targets. It is all too easy to overlook channel lines, gaps on the day-session charts, and other barriers that may justify looking for an entry or, even more important, deterring one that is marginal. But you don't want to overdo it so as to make the chart unreadable. Some day traders make their charts so cluttered that you end up not being able to see the wood for the trees.

Pivot Points Forecast Highs and Lows

There is hardly a more useful tool available to the day trader or when you are looking for an entry, an exit, or a stop point than the equation for forecasting the next day's range. It produces numbers that may seem arbitrary, but they express the underlying forces of immediate momentum. Most floor traders and market makers do this calculation and have it marked on their trading cards. Although otherwise there may be no apparent chart-based barriers or other discernible criteria, it is remarkable how often a market reaches these pivotal levels and then turns. When there is a conjunction of predicted highs and lows and an identifiable support or resistance level, there may be a prime entry point, and you may not need to wait for confirming price action.

The equation is expressed in various ways, but here is how to use it readily with a calculator. H is the previous day's high, L is the previous day's low, and C is the close. First, you need to calculate the central pivot point x, and then you can calculate PH and PL, the predicted high and predicted low, respectively.

$$x = (2C + H + L)/4$$
$$PH = 2x - L$$
$$PL = 2x - H$$

There is a variant that simply adds the previous day's close without doubling it, and then the divisor is 3, not 4. There is often little difference in the result. However, a doubling of the weight given to the close is preferable because of the additional significance of the closing price, particularly when there is a strong close one way or the other.

It can be scary to enter an order in advance to buy at such an apparently arbitrary low or to sell at such an apparently arbitrary high, and you may well not want to do so without additional confirming indications. Nevertheless, you can be certain that others are watching these numbers. Also, failure to hold within these numbers may signal a sharp extension once the price goes through one of them. Accordingly, this calculation has its place for entering stops both as a means of getting out of an existing trade and for entering a new one on a potential surge through a known barrier or the day's forecast high or low.

Gaps for Day Traders

Some of the best opportunities to buy low and sell high—but not, obviously, at the absolute extremity—occur when stochastics are at an extremity, and the opening price for the day session gaps away from the previous close.

The criteria to trade on a gap opening occur when

1. Stochastics are or have been recently at a level of 20/80 on the daily and/or 60-minute charts.
2. The gap is in the direction of the major trend as defined by the weekly chart, and—an important qualifier—the bigger the gap, the better.
3. The market has reached a support or resistance barrier, where a turn is likely.

These parameters also work well for getting out of an existing trade

The Bollinger Band Approach

The Bollinger band approach is good for buying low and selling high rather than waiting for so much confirming market action that the entry may be nearer to the end of the move than its beginning. There are certain mandatory criteria for markets worth day trading. Foremost is that there must be good liquidity so that you can get efficient and timely fills. Most of the time, markets fitting these criteria include stock indexes and currencies, but all markets have big runs from time to time, and day-trading techniques can get you into a trade when it is timely. Ideally, a market worth day trading should, in the big picture, have a clearly defined trend, if not necessarily a strong one, so that there is a pattern of swings within the major trend. Much of the time, stock indexes meet these criteria, although there is considerable rotation over time in their respective strength or weakness among the different indexes. During the 1990s, the Nasdaq 100 was really the only market

to trade. Between 2003 and 2007, it was hard to beat the Standard & Poor's (S&P) Midcap and the Russell 2000 indexes, using the electronic minisized contracts for their liquidity rather than the full-size contracts.

Assuming that you decide to trade the S&P 400 Midcap Index, the first thing to do is to determine the direction of the major trend and to look at the overall pattern of market action. Between April 2003 and February 2007, this market had been in a steady uptrend with few major retracements, although there had been some moderate and constrained retracements every so often. It was reasonable to assume that this trend would continue until there were substantial signs of the pattern changing. After determining the major trend on the basis of the weekly chart, you need to lock the applicable trend lines and support and resistance levels on the weekly, daily, and intraday charts—the word *lock* means that each line carries forward from a chart of one time frame to others of different time frames. In addition, you may want to look at anything significant apparently showing up in the bigger picture as a result of various Fibonacci projections and retracements, although for the most part momentum oscillators will find and take care of those levels independently.

On the basis of these assumptions, you should be looking primarily for trades on the long side of the market, although you could have an open mind toward short sales in the event of strong signals. Although the approach described here works for day trading, assume that you continue to hold a trade overnight when the market is going your way and until there is a short-term exit signal.

Market Entries

Given the prerequisites of a market worth trading for the short term, a system based on the following methodology has proved successful in the past and is likely to continue to be profitable in future:

1. For stock indexes, see the 400-tick chart. A tick chart consists of market action by trades rather than by time, as with a conventional bar chart. As such, it expresses better the underlying thrust of buying and selling pressure. However, it is also useful for comparison with ordinary bar charts of different durations, and to get a handle on underlying momentum or for very short-term fine-tuning. The 60-minute chart is useful most of the time in most markets, particularly on the day-session-only chart. For around-the-clock charts, you get some of the same picture from a 120-minute chart.
2. For markets other than stock indexes, compare market action on the 60-minute chart and, for those markets trading overnight, the 120-minute

chart so as to get the required overview for a setup. Then use price rules and technical indicators on the 15-minute chart for pulling the trigger on entries and exits.

3. Use Bollinger bands to show where price may be holding at potential tops and bottoms. Look to trade in the opposite direction, away from an outer band, when it is flat or rounding and price then starts to move away from it. Assuming a long position, once the price starts moving away from the outer band and crosses the median 20-bar moving average, price ideally should hold above it. The immediate target is the upper outside band. If the market is to continue higher still, the upper outside Bollinger band and price should work higher alongside each other until the move tires. Then price should start going sideways, and the outer Bollinger band will roll over. Depending on how long the consolidation lasts and on action in the moving-average convergence/divergence (MACD) and stochastics oscillators, there may be an opportunity for a new short sale. However, you are, of course, far more ready to pull the trigger on an exit than on a new entry.
4. MACD is the prime trend-confirming indicator when a trade may be developing, and it should itself be trending in the direction of your trade.
5. Stochastics confirm the potential for a turn from an oversold or an overbought condition prior to the market turning the other way. Ideally, there should be a W in %*K* to confirm a buy signal and an M to confirm a short sale. It is remarkable how often there is a prime entry at the exact moment when %*K* completes an M or a W.

The Stop/Exit

Exits are particularly challenging for the day trader, but the general rule is to hold a trade overnight only when you expect the market to follow through immediately when the market opens the next day. It stands to reason that a market ending the day with an ambiguous close is likely to fluctuate around that closing price, and likely reaching toward the forecast high or low for the next day. Therefore, you might well be able to achieve a better entry price on a new position than by staying in a trade. Also, by clearing the decks, you have the option of looking for a trade, possibly a better one, in an entirely different market.

Depending on market action, there may be a case for taking a profit when a market reaches a known barrier, such as the day's forecast high or low or an identifiable level of support or resistance, particularly when stochastics on the 15-minute chart reach an extended level.

Subject to these overriding guidelines, the following more specific criteria are effective for day-trade exits when used in conjunction with most day-trade entry techniques:

1. The initial protective stop is
   a. Beyond the price rule signaling the entry.
   b. A close beyond the close of any gap left behind.
2. Move protective stops to a level just beyond any conspicuous spikes.
3. Exit on a close below a clear trendline, particularly when MACD and stochastics are trending adversely.
4. There is, almost axiomatically, an exit signal when there is a signal to trade in the opposite direction even if you do not want to reverse the trade with a new entry as well as an exit.
5. Depending on your time horizon, the first exit signal may occur on completion of an adverse M or W on the 15-minuite chart.

   Once a trade starts making money, it almost always pays to give the trade some room to fluctuate, on the principle of letting profits run.
6. Exit on a Friday close unless the market is so strong that it would justify a new entry.

Day-Trading the S&P Midcap Index

The 400-tick chart for the S&P Midcap index shows market action in mid-February 2007, with price on top, stochastics in the middle, and MACD below (Figure 22-1). This chart was selected at random at the time of writing this chapter. The simulated results make no allowance for variations in judgment calls that one might have made in real-time trading or for slippage and commissions. The chart serves, therefore, only as a very rough-and-ready guide to implementation of a day-trading or short-term trading strategy. Notwithstanding these reservations, however, it is fair to assume that the overall approach may be implemented profitably.

At 13:36 at *A*, price was clearly consolidating to make a potential double bottom, and MACD was now developing a strong uptrend. Price had tested the lower Bollinger band and turned higher, providing for an assumed entry at 848.60. The trend remained strong until completion of a double top in stochastics at *B* and a rollover in MACD, with completion of a price rule to sell at 853.00. The case for going short is poor given the short duration of cresting action.

At *C*, there is a new entry signal to buy after price dug into the lower Bollinger band and held. The market soon ran into resistance at the level of the previous

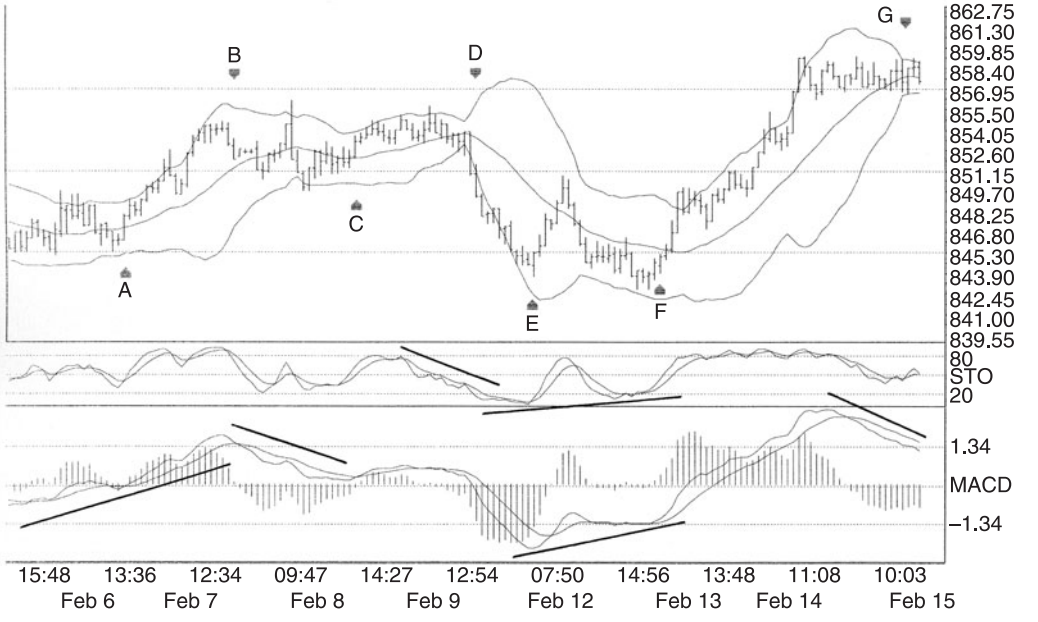

Figure 22-1 The 400-tick chart for the S&P 400 Midcap Index, with Bollinger bands, Stochastics and MACD

high from which the price had turned down, and there was a powerful exit signal at *D*. The case for selling, with a confirmed failure at the top and down-trending MACD and stochastics, was strong enough to justify a short sale, in addition to closing out the long position. At *E*, there was a strong outside up bar with price pulling back away from the lower Bollinger band. In addition, it was clear that %*K* had reached an extremity where the price might be expected to hold, if not necessarily to turn higher without doing some more work.

By the time the market arrived at *F*, it had done more work, and both stochastics and MACD were now trending higher even as price had made a slightly lower low. With a good price rule to buy and price holding just above the lower Bollinger band, you can assume a signal to buy. This trade came out of a sufficiently washed-out condition to sustain a powerful and long-lasting move up until the market appeared to be running out of steam at *G*, where we assume an exit signal. In the event, market action resolved with a further upward extension, and a short-term trader was faced with the dilemma of whether or not to chase a trade that was running, although slowly, in an overbought condition.

The following are the results for the assumed trades:

February 6, buy at *A*	848.60	
February 7, sell at *B*	853.00	Plus 440
February 8, buy at *C*	853.20	
February 9, sell at *D*	850.90	Minus 230
February 9, sell at *D*	850.90	
February 9, buy at *E*	845.80	Plus 510
February 12, buy at *F*	845.00	Plus 1,390
February 15, sell at *G*	858.90	
Net		Plus 2,110

The standard approach to day trading must begin with consideration of the weekly and daily charts before going to the intraday chart, but here, reverse the process for the purpose of the postmortem, even more than for the purpose of looking forward. The intraday chart begins at the up arrow on the daily chart and ends at the down arrow (Figure 22-2).

One of the necessities of day trading is to attempt a projection of how far a market might go before running into barriers of support and resistance. In textbook

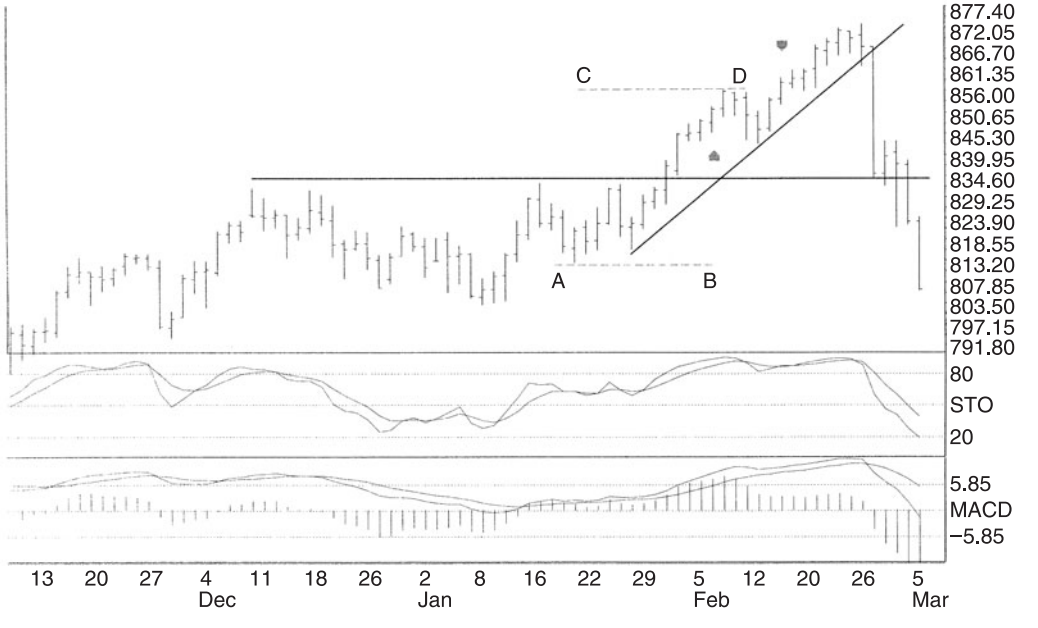

Figure 22-2 Daily chart for S&P 400 Midcap Index, with stochastics and MACD

fashion, the S&P Midcap projected almost exactly as far above the breakout level as it had come from its last low before breaking above it. Since %*K* hit 95, some turbulence was to be expected and possibly a more substantial retracement. In the event, the retracement was very moderate, although at the end of the period on the intraday chart it appeared as if another one might be about to start. In fact, the market was to consolidate for a couple of days and then make a substantial thrust to the eventual top, where, again, %*K* reached to 95. The second reading at that elevated level should have suggested the possibility of another retracement, and it could well have enabled a day trader both to get out of a long position and to get short in good time for the ensuing crash.

A Near-Term Entry for Soybeans

The daily chart for March 2007 soybeans shows this market in a the course of an apparently sustainable bull market (Figure 22-3).

The last bar shown on the chart is at the lower end of a small retracement within a consolidation that has lasted for 11 days. There had been a longer consolidation

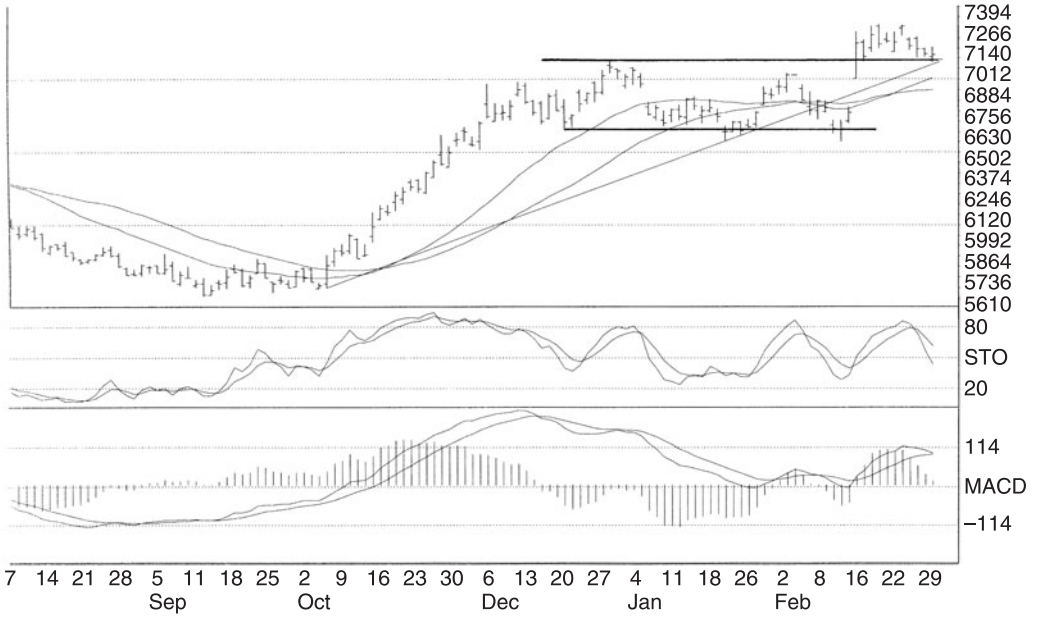

Figure 22-3 Daily chart for March 2007 soybeans, with 25- and 40-day moving averages, stochastics and MACD

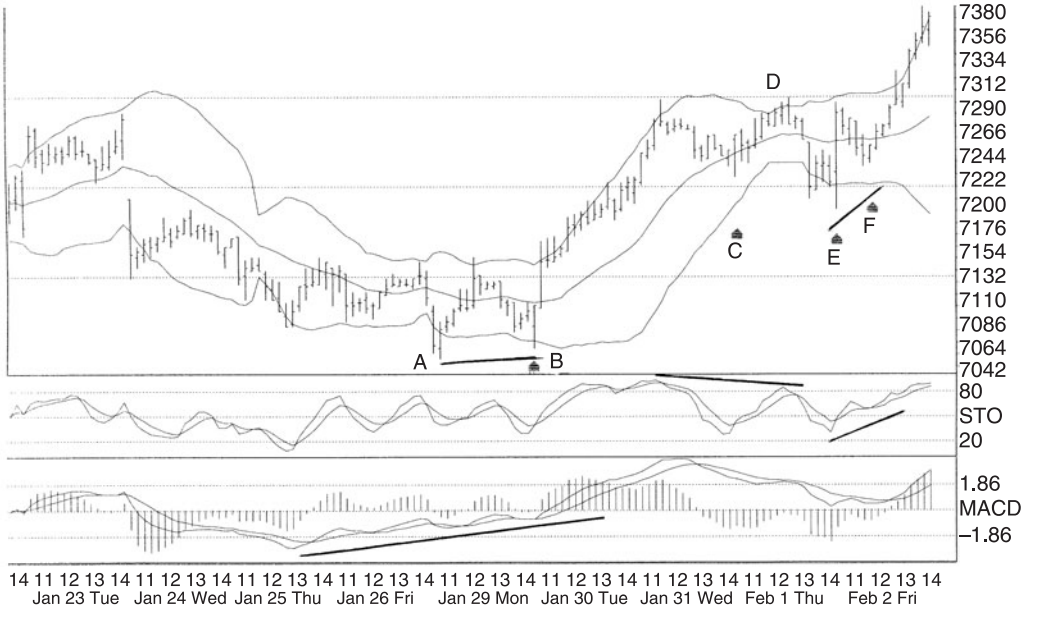

Figure 22-4 Fifteen-minute chart for March 2007 soybeans, with Bollinger-bands, stochastics and MACD

between the support line *ABC* and the potential new one *DE*. Price had come back exactly to the top of the breakout level, with the breakout achieved with the huge gap. There was a potential trend line going through the low at *B*, with the strong reservation, of course, that price had gone through it at *C* before rebounding so strongly. The question now was whether there might be a good entry for a new trade on the long side of the market.

The 15-minute chart for March soybeans picks up from the daily chart at *B* with a low open, continuation through the lower Bollinger band, and then a strong upside reversal and continuing strength (Figure 22-4).

In the process, there was a textbook secondary test of the previous low at *A*. By this time, MACD on the 15-minute chart was trending strongly upward, even as price action was ambiguous. In the event, the gain on the day was to be 11.5 cents, and a new leg up was starting, although not without some mild turbulence.

You might have acted to buy on the marked outside up bar at *C* even though the retracement was only to the median 20-bar moving average. By that time, however, stochastics were potentially cresting, and the major thrust in MACD was dissipating—hence the setback that began at *D*. In the scheme of things, there was to be a relatively small setback, but a strict day trader might have been rattled.

Then came the big outside up bar the first of the day at *E* that induced an upturn in both %*K* and MACD. Even more compelling was the reversal at *F*, by which time it was all systems go! The chart ends at the end of that day's trading.

In fact, soybeans were such a strong bull market that you could buy pretty well anywhere and make money if you held on. There was a fairly easy 60 cents in the move from the initial entry on the intraday chart at *B*. This intraday chart shows how to take advantage of favorable intraday market action to achieve a timely entry at a good price. Nevertheless, you still have to ask yourself why you would want to be constantly getting in and out of such a strongly trending market. You should be looking for places to buy on dips, not sell, and to be entering new trades or adding, not lightening up on a good trade prematurely.

CHAPTER
23

Short-Term Trading Techniques II

The Moving-Average Approach

The moving-average approach combines elements of the Bollinger band approach with elements of the entry techniques for longer-term trades based on the major trend. It is particularly effective for entering a trade when there is already a setup on the basis of the entry checklist for a market that you expect you would like to enter. Using the intraday chart strongly reinforces the odds in favor of getting into a trade just as it is starting to go on the basis of the daily entry signal.

There is an almost unlimited number of considerations for day trading that work some of the time, but there is hardly one more important than to make sure that the overall picture is favorable on the weekly and daily charts for the intended trade. Except for occasional and conspicuously inviting contra-trend trades at an obvious extremity, a good short-term speculation should, almost axiomatically, have the potential to develop into a longer-term trade. Successful short-term trading should seldom deviate far from the following approaches that work well most of the time for entries. They are largely a recapitulation of the concept of price and moving averages converging, discussed in Chapter 7 and tabulated on the entry checklist in Chapter 17. For stops and exits, it is hard to beat the parameters laid out in Chapter 22.

1. Compare the 60-minute chart with what is happening on the daily chart and for markets trading overnight also look at the 120-minute chart.

For markets trading around the clock, the day-session chart often gives a better indication of underlying forces, but the 24-hour chart often provides exact entries and exits, particularly at the beginning of the day session or when a timely entry or exit has been missed at the end of the day session.

2. On the intraday charts as well as on ones of longer duration, look for development of the chart patterns that work, described in Chapter 13.
3. A favorable market condition for a trade often occurs when:
   a. a retracement may be ending;
   b. stochastics have been at an extremity;
   c. the market has reached a support or resistance level; and
   d. price gaps on the open in the direction of the major trend—and in the opposite to the retracement that has apparently run its course.
4. A common condition for a successful trade occurs when:
   a. the 25- and 40-bar moving averages have an established incline on the 60-minute chart, with price holding above them for an intended long position or holding below for an intended short position; and
   b. price and the moving averages converge and then the market shows that it can hold and turn there with a price rule.
5. Having a slightly lower probability of success but, sometimes, more long-term potential, there may be a prime entry at the start of a new trend when:
   a. price crosses the moving averages on the 60-minute chart;
   b. price consolidates with a return toward or to meet the moving averages; and
   c. for the entry, there is a strong bar in the direction of the new trend.

   Note, however, that the probabilities are no better than marginal unless the moving averages are now pointing in the direction of the intended trade—there is a high probability that the market will have to do more work to bring the direction of the moving averages onside, and that may not happen at all.
6. Use the 15-minute chart for most entries, using a price rule to pull the trigger. Normally, you need 15 minutes of data to make sure that strength in the bar confirming the entry is more than just a blip. The 5-minute chart works well for fine-tuning entries when your confidence in the intended trade is high. There may be a valid entry on the basis of any intraday chart but reliability increases when there is a conjunction of confirming action on more than one chart.
7. Best of all when there is confirming action from stochastics, with an M or a W, and MACD, as for the setup on the entry checklist, discussed in Chapter 17.
8. Reliability also increases when a market has marked time long enough for MACD to establish its own trend on the 15-minute chart in the direction of the intended trade.

9. There is often an optimal entry at the exact moment of completion of a key reversal or an outside bar occurring in conjunction with a turn at the moving averages.

   (A powerful bar suggesting resumption of the thrust in the direction of the major trend may trump the lack of confirming action by MACD on an intraday chart.)
10. You can exit and reverse with a trade in the opposite direction when the signals are strong enough to justify doing so.

Day-Trading Soybeans

The daily chart for May 2007 soybeans shows this market potentially turning up in March right at the assumed trend line from the January low (Figure 23-1).

This chart shows stochastics now trending upward. Fast MACD has just turned up at the level of the zero baseline, and the MACD histogram suggests that this market may be coming out of a significant low.

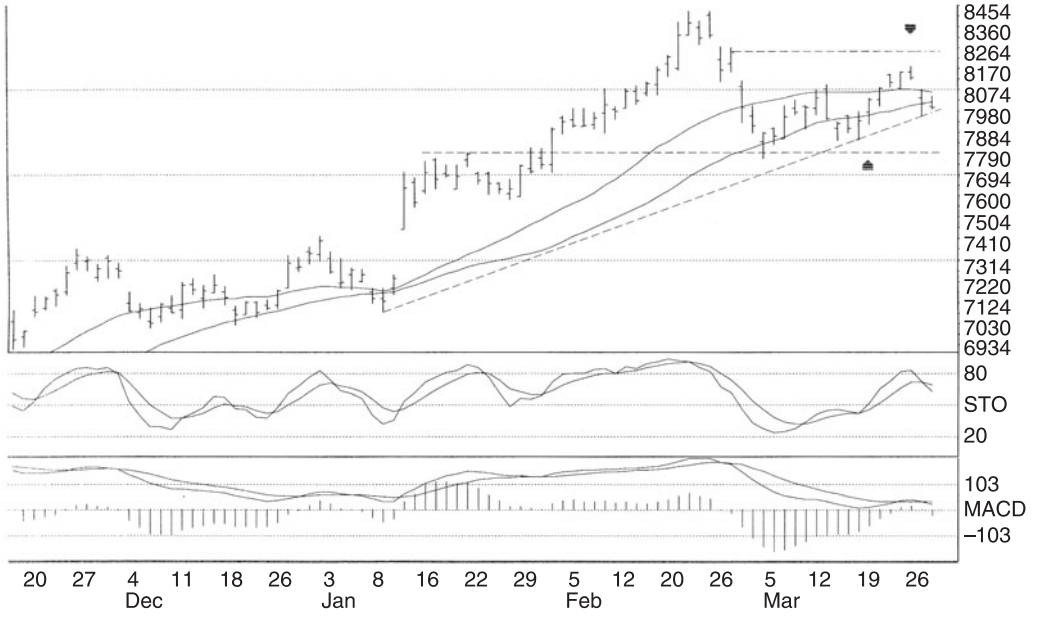

Figure 23-1 Daily chart for November 2007 soybeans, with 25- and 40-day moving averages, stochastics and MACD

Figure 23-2 Fifteen-minute chart for November 2007 soybeans, with 25- and 40-bar moving averages, stochastics and MACD

The 15-minute bar chart shows MACD, on the bottom, steadily trending upward as price was bottoming out (Figure 23-2).

Similarly, there was a pattern of higher lows in %*K*, with the peak-momentum low well below the 20 percent oversold level. Then there were several erratically occurring lows, mostly at higher levels than one another.

Price jumped over the moving averages and then settled back. On the open on March 19, the market gapped higher with the ideal buy point at the arrow, from a level right at the now-rising 25- and 40-bar moving averages. The chart pattern was something of a ragged ascending triangle—one of the strongest and most reliable formations, but better when regular and compact. From there, it was a steady rise all the way, with retracements holding right at the excellent and clearly defined trend line, as well as holding above the moving averages. However, the market achieved peak momentum for %*K* at a level that turned out to be about the halfway mark for the move. Then MACD, which had been steadily trending upward, started trending steadily downward.

Finally, on the Friday close, at the downward arrow the market fell away decisively, having failed just short of a significant gap that is evident on the daily chart. It closed below the uptrend line and below the 15-bar moving average, although

right on the 40-bar moving average. There was no longer any case for a short-term trader to stay in the trade, and there was now one of those relatively rare cases for an outright reversal of the position from long to short.

It turned out that the market was to gap down on the open the following Monday, and it went into a savage selloff, one that was potentially climactic. There were a couple of choices for an exit point, with one marked with the arrow where the price crossed over an assumed second trend line rather than the initial high of the bounce on Monday morning.

The Day-Trade Entry for Lumber

The daily chart for May 2007 lumber shows a market in a clear downtrend, with a rally apparently just completed and a downturn at the declining moving averages (Figure 23-3).

You had to assume that fast MACD would complete the apparent rollover and downturn that seemed to be in the making, but all the other indications strongly confirmed the potential for the market to go lower, including the fact that there

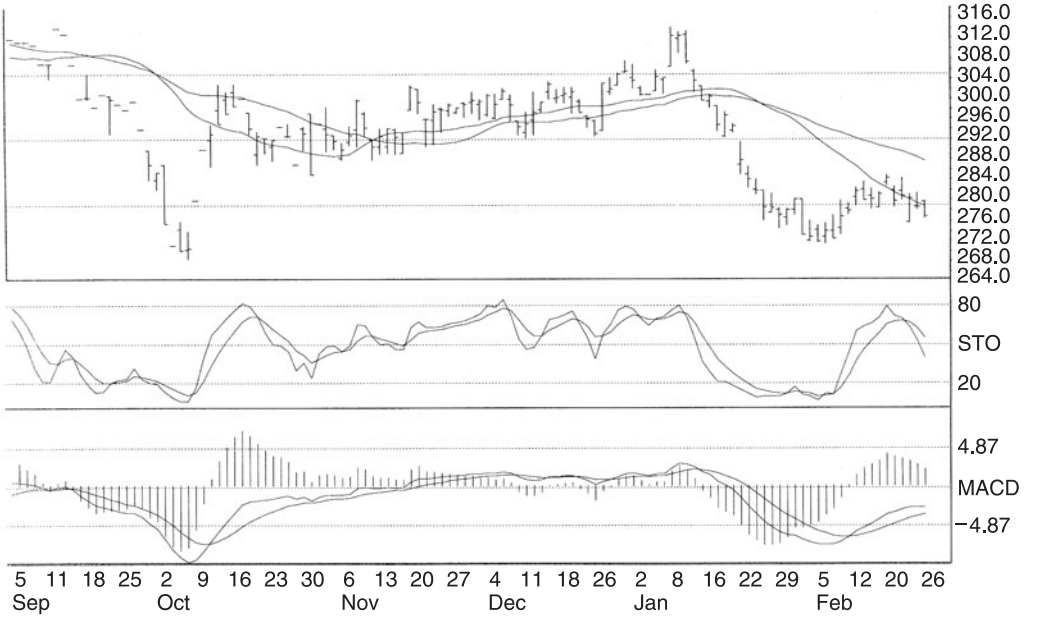

Figure 23-3 Daily chart for May 2007 lumber, with 25- and 40-day moving averages, stochastics and MACD

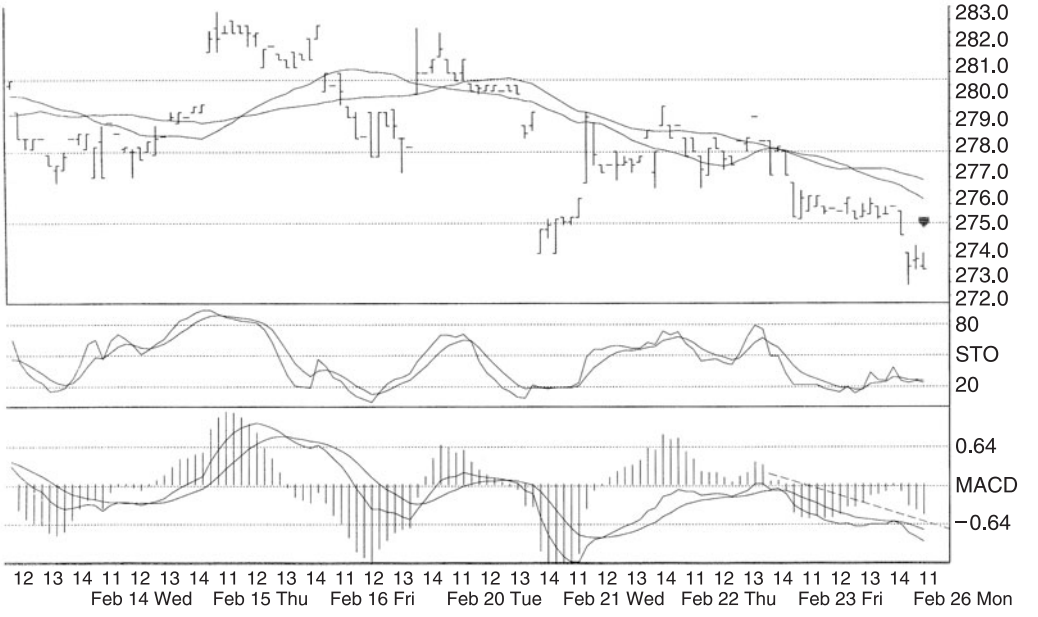

Figure 23-4 Fifteen-minute chart for May 2007 lumber, with 25- and 40-bar moving averages, stochastics and MACD

had been a gap down from the top of the rally and completion of a daily rule 5 Lindahl sell signal. There also was a new three-day gap formation.

The 15-minute chart for lumber shows the exact bar where you might have considered an entry, the third 15-minute bar of the day, with a low close and a new downturn in %*K* (Figure 23-4).

Not shown on these charts is what subsequently happened. The price collapsed more than $20 over the next seven market days and did so almost without interruption, falling by more than two limit moves altogether.

This 15-minute chart is also interesting for the way that it shows how the market was not well set up for an earlier trade on the short side on either of the big gaps down. MACD was trending down very well. However, on the first gap down, the moving averages were going erratically sideways. Once the price had crossed below the moving averages, the price was to fluctuate rather violently, and in the process, %*K* was to reach a very oversold level. It was easy to envision the possibility of a retracement, although it was surprising that it rallied quite so far and so violently. On the second big gap down, price action was also erratic, with a low made on the open. Then the market tested the low and rebounded like a scalded cat. The suggested entry marked with the arrow shows the market acting much more evenly and reliably—characteristics that you need to look for.

Every trader has a different personality, and every trading opportunity presents its own potential risks, rewards, and challenges. The approaches to short-term trading described in this chapter and the preceding one certainly will not work all the time, but the general principles are reliable both for short-term trades and as the entry mechanism for longer-term trades.

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CHAPTER
24

Final Thoughts

The Psychological Challenge

Once you have command of profitable trading techniques, you may, nevertheless, have to take command of yourself. It follows for most people that success inspires confidence, and confidence leads to success and more confidence and more success. It is important, therefore, not to reverse these forces so that losses sap confidence or, indeed, that success leads to destructive overconfidence and recklessness.

Since futures trading is as much a psychological challenge as a practical one, it helps enormously if you have the kind of personality that makes a good poker player. Then you should be able to roll with both the inevitable losses and stay in the market when a really big trade is going your way. For many people, futures trading on paper or in the abstract looks easy, but something happens when they trade real money. The challenge is like the difference between walking on a line drawn on the floor and trying to do the same thing on a beam 10 feet above the ground. Essentially, the challenge is the same, except for the introduction of vertigo and fear of loss. Another way of looking at futures trading is to try to look at it the same way as you might look at a game of bridge or Monopoly. It is a certainty that by no means every deal will work out, but playing consistently with good methodology is certain to lead to success on balance. The main thing is to have the fortitude to know that you can combine confidence and discipline.

Capital Management

A major part of the challenge is capital management. A rough rule of thumb is to divide your trading capital into 10 units and then to trade one of those 10 units at a time in any given market. Sometimes, you can get into a trade with an anticipatory entry at a good price, and then it may be reasonable to add to the position when confirming action comes through. Overall, the probabilities tend to favor making the same allocation of capital to every trade unless your total capital either rises or falls by 25 percent. Then you may want to adjust the allocation up or down.

Many of the very best trades seem inordinately hard to take at the time. For example, the market has raced out of the starting gate, and you fear a retracement despite the fact that this may be the trade most likely to follow through and, even more important, the one least likely to backfire. Alternatively, you may see really good topping or bottoming action and then find yourself unwilling to believe that the trade has any potential because it doesn't seem to be doing anything. Then it gets going after all, and the risk seems unmanageable once the market is in motion.

There are two really good books about the psychology of trading, and it would be superfluous for this book to duplicate what has been done already so well. First and foremost, a relatively unknown gem with a pedestrian title is *Viewpoints of a Commodity Trader* (Greenville, SC: Traders Press, 1997), by Roy W. Longstreet, former chairman of Clayton Commodity Service, Inc. The second recommended book for psychology and attitude is *Trading Rules: Strategies for Success* (Chicago, IL: Longman Financial Services, 1990), by William F. Eng.

Buy the Strong, Sell the Weak

There is almost a solid-gold rule that you should buy the strongest market and sell the weakest. In recent years it has been as important to buy the strong currency and not the weak—to buy the euro or the Australian dollar and absolutely not the Japanese yen. Currency pricing is established in part by trade flows but just as much, and sometimes even more so, by comparative interest rates. It can happen that there is simultaneous foreign selling of U.S. interest-rate instruments, raising U.S. interest rates, and also selling U.S. dollars. However, the general rule is for the U.S. dollar to trade higher when interest rates are rising and when futures such as bonds are falling, and vice versa.

With interest rates in Japan close to zero and rates of 5 percent or more available elsewhere, it was obvious which ones to buy and which not. In the event of the U.S. economy slowing, the U.S. dollar could be hit with the doubly negative forces of lower interest rates and adverse trade figures. Precious metals may seem

to be an alternative currency, and they often trade in the opposite direction to the U.S. dollar. However, you still have to trade them on their own technical merits and to bear in mind that high prices can induce more production. It does not necessarily follow that the forces of supply and demand will favor gold and silver over currencies from which a good interest yield is available. Also, precious metals are notorious for huge swings in price based on emotion-driven extremes of optimism and pessimism.

In the agriculturals, it may seem logical that there should be a better prospect of gain and lower risk by buying wheat when soybeans are moving higher and wheat is lagging. Or heating oil when gasoline is charging higher. Or soybean meal when soybean oil is skyrocketing. There is almost invariably a reason for current strength, as well as for it to continue. Consider, for example, the relationship between soybean meal and soybean oil. They both come from the whole bean. When there is high enough demand for the oil to push its price sharply higher, there will be a corresponding demand for beans from the crushers. However, the processing of beans produces not only the oil that is in demand but also the meal, which already may be in surplus. Crushing more beans simply means adding to that oversupply. Therefore, oil and meal prices actually can go in opposite directions while the bean itself goes sideways. However, specifically in the soybean complex, there can be short-term contradictions to the rule to buy the strong and sell the weak. There is such a large constituency that spreads, simultaneously buying oil and selling meal, or vice versa, that a pronounced thrust in the spread can lead to a rebound just when you least expect it. As for the beans themselves, there is an informal rule that you really want to see the meal lead the way for a major move.

Similarly, crude oil is the feedstock for both gasoline and heating oil (which is essentially the same as diesel). There is a certain amount of flexibility in processing capability to produce more of one than the other, but only by a few percentage points. High demand for one cannot but lead to more production of both products. It still may not be enough for the one in high demand, but the production will not decline for the one more plentifully supplied.

Despite the imperative of buying the strong and selling the weak, it pays to watch both the strong and the weak within a market sector and indeed to differentiate altogether between market sectors. It sometimes happens that stabilization and a corresponding buy signal in the weaker market will provide the impetus for a new surge in the market that has been leading the way. If, therefore, beans are marking time in a bull market and wheat is going down, a new buy signal for wheat may be just what you need to see in order to buy some more beans, not wheat. Leaders go on leading, and laggards go on lagging. The same principle applies to stock indexes, meats, metals, and markets generally.

Trade the Nearby Futures

There is also a near-golden rule that you should trade the nearest active futures contract if a market is worth trading. Only go forward a month when you are past the midpoint of the month prior to the delivery of the expiring contract. This is to say that you should trade May soybeans at least until mid-April before going into the July contract.

There may, very occasionally, be special reasons for trading a deferred contract in markets such as grains and soybeans when there is a very good reason to trade the new crop in or about to be in the ground rather than the one in the bin. A special reason, when buying, might be that the deferred contract has exceeded a notable high, but the nearby contract has not yet done so.

The greater market fluctuations and the best liquidity are almost always in the nearby contract. What you think you might gain by holding on for a longer term and by paying less in commissions on rollovers, you may well lose because of smaller gains and a bigger spread between the bid and ask prices.

A Trend in Force Feeds on Itself

During a major market move, it is easy to think that enough is enough and that price should stop and reverse. The chart for sugar shows just how far a market can go, in both directions, once a major move is under way. During the course of such a move, you may have to keep on pinching yourself and repeating: *Believe the technicals!* Believing the technicals also requires another easily overlooked consideration. You have to consider the fact that the image area of the chart comprises the extent of the range achieved so far. The top of the bottom of the image area on the chart that you see is by no means the limit of what the price may end up doing. Particularly in a rising market, it may look as if the market is volatile and that the market swings are both large and potentially climactic. It may turn out that those swings will come to look like blips or noise when looking back from an eventual high or low.

The extent and longevity of the bull and bear trends in sugar is relatively unusual for an agricultural market. However, this market illustrates well the point, that there is no market so high that it cannot go still higher, and no market so low that it cannot go down more—although in commodity futures markets, unlike a stock like Enron, not to zero. One reason why agricultural markets sometimes keep on going is because weather patterns tend to keep on going. If there is a drought, it is likely to intensify. High-pressure areas tend to move little, and they lead to clear skies and lack of rain. On the other hand, low-pressure areas keep following

on, one after another, bringing precipitation. The practical effect of weather patterns on crops is that the small crop gets smaller, taking prices ever higher. The big crop gets bigger, taking prices ever lower: *Rain makes grain!* Despite the rule, however, a weather pattern can change both drastically and suddenly, as every sailor knows, and every farmer too. As always, both weather and markets depend on probabilities, not certainties. In sum, you can trust the technical indicators when looking at the big picture, but you cannot be complacent about any bull market in U.S. agricultural products. The efficiency and productive capacity of farmers in the United States come through in all but the more dire circumstances. It takes a lot of really bad weather and a lot of really outstanding demand to curtail production substantially and to keep prices inordinately high for long.

In a somewhat similar vein, some market moves really do feed on themselves. Some analysts estimated that there was a premium of $15 per barrel in the price of oil as it approached $80 per barrel that was attributable to speculative demand and hoarding. When you expect the price of gas to be higher tomorrow than it is today, every consumer will drive with a full tank. When you see the price of gas going down, there is no rush to top up when it might be cheaper tomorrow. Cumulative hoarding or dishoarding all along the supply line can have a really remarkable impact on price. It is not just the doing of exploitative oil companies.

Metals are easy to hoard and dishoard, which tends to magnify the swings in metal prices. It seldom happens that the price of any commodity remains for long far above the cost of marginal production, and for this reason, it is improbable that the price of gold and silver will ever go, in real terms, to such astronomical heights as some people predict. There is, however, a curiosity of mining that is a bit like the immediate impact of weather on producing crops. The general rule is, of course, that high prices lead to more production—of anything. In the near term, however, high metals prices can lead to less production, not more. With the same milling capacity, a mining company will process lower-grade ore when it is profitable to do so in order to prolong the life of the mine. The opening of new mines and the expansion of milling capacity take years to bring on stream, with the result that it can take a long time for supply to catch up when it is overtaken by demand. Recycling and rationing by price goes only so far.

Currencies exemplify how a trend that can feed on itself. However far a currency market may seem to have gone already, it can go farther still. Capital flows and interest rates drive currencies, two forces that can conflict with each other. The point, however, about a declining currency is that the decline is itself inflationary, and inflation lowers the value of the currency. Conventional economic theory states that a lower currency stimulates exports and restrains imports, but conventional theory has its limitations. Reduced to its simple terms, a country having a constantly and substantially depreciating currency should, after an

initial deterioration in its trade balance, have a thriving export business and shrinking imports. Over the years, Mexico has shown that more is necessary than currency depreciation to redress a trade imbalance and to promote prosperity. On the other hand, a rising currency increases its underlying value, and it is likely, at least to some extent, to be deflationary. The skyrocketing Japanese yen in the early 1990s did not destroy Japan's ability to export, largely because most inputs, such as oil and steel, priced in U.S. dollars, became cheaper. Therefore, the price of exports was held down by those factors, and Japan remained competitive in world markets.

Limit Moves and Panic Selling

Limit moves, or the equivalent in huge moves in markets not having limits, should lead to more limit moves. Notwithstanding the principle that a powerfully trending market should feed on itself, it often happens that a market that has made one or more limit moves may have the effect of putting in place a buying or selling climax. Very few speculative traders want to or can tolerate a series of adverse limit moves, so the pressure from activating stops makes the move feed on itself regardless of any economic justification for the amplitude of the move.

There may be a prime opportunity to enter at least a quick trade by taking a long position when panic selling runs its course in a market with bullish fundamentals. You can sometimes tell when the inevitable rebound is starting, with new shorts now scrambling for cover. It is more challenging to enter a short position when limit moves finish running their course, even when there is no fundamental justification for the thrust.

Competition among Products

All field crops compete for acres, but the cure for high prices is high prices. High prices lead to more production and rationing of demand. Therefore, apparently unstoppable high prices may become unsustainable regardless of apparent supply-and-demand fundamentals. The weekly continuation chart for sugar shows the immensity of its bull market from the 5-cent level in 2004 to almost 20 cents and then back under 10 cents (Figure 24-1).

Demand for ethanol was burgeoning, but Brazil's capacity for growing more sugar than seemed possible at the market top turned shortage into surplus in fairly short order.

Within the grain complex, there can be competition when prices get out of line. Lower-quality, or feed, wheat competes with other feedstuff, and even higher-grade

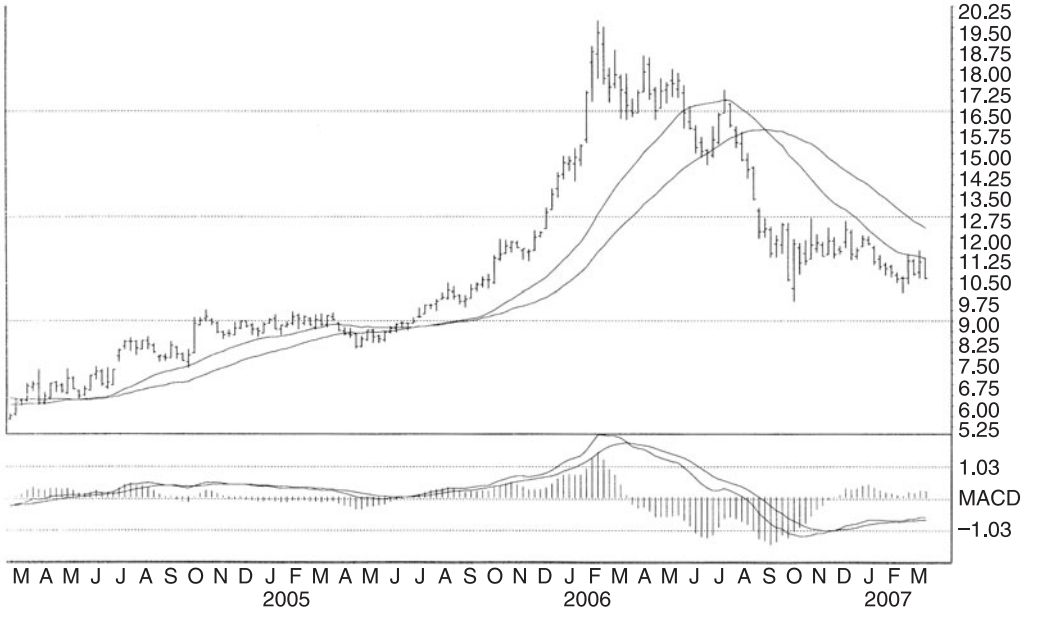

Figure 24-1 Weekly continuation chart for sugar, with 25- and 40-week moving averages and MACD

wheat can cut into demand for corn when it is cheap enough. You might think that corn and soybean meal would be interchangeable, but they are to a lesser extent than you might suppose. Corn is a high-energy concentrate (lots of starch, only about 8.5 percent protein, and low in some key amino acids such as lysine), whereas soybean meal is a high-protein concentrate (44 to 48 percent protein depending on the processing method with a very good amino acid profile). You mix them together to balance the diet for protein, amino acids, and energy in order to meet nutritional needs. Chickens and pigs need high-quality natural protein such as soybean meal. Cattle can use lower-quality proteins such as cottonseed meal and even nonprotein nitrogen because of the microbes in their rumens (the first of four stomach compartments). Virtually all these diets also contain some source of calcium and phosphorous; salt; trace minerals such as copper, zinc, etc.; and vitamins. In sum, you can substitute barley, milo, or wheat for corn, and you can substitute peas and canola meal for soybean meal.

All meats are to some degree competing with each other, but they are somewhat separate markets with different long-term patterns for expansion and contraction in supply. It does not necessarily follow that you can buy highs because the price of cattle is soaring. One of the wild cards for the meats is the structure of the poultry industry, for which there is currently no futures market. In recent

years, there have been huge fluctuations in the supply of poultry, with a corresponding impact on all meat prices. With more concentration in all sections of the meat-producing industry, there has been better discipline than there used to be. At one time, there were really extreme booms and busts, but enormous fluctuations may be less likely in the future. The United States has immensely efficient agricultural producers altogether. Looking farther ahead, however, it is hard to believe that levels of efficiency and competitiveness will not improve in many countries that now are major importers—countries such as Russia and the countries of the former Soviet Union, as well as Mexico. In China, massive expansion of meat production is progressing decisively, with correspondingly increasing consumption of feed. India cannot be far behind.

In recent times, higher feed costs have tended to raise the price of deferred hog contracts in the expectation that more breeding stock would be sent to slaughter, thereby contracting the supply later on. On the other hand, higher feed costs depress the price of cattle in both nearby and deferred contracts. In any case, the eventual result of higher feed costs must be squeezed profit margins for producers, less production, and higher prices. Logically, all higher pricing, whether in petroleum or anything else, must be inflationary, even when offset to a significant extent by low offshore labor costs. Watch the Reuters/Jefferies CRB index (the CRB) for overall price trends in commodity prices and as a guide to underlying demand for commodities generally.

The Function of News

It is a truism that money makes the market go, but it is less glaringly obvious that smart money tends to move relatively early in a move of any duration. Smarts begin on the trading floor and among the professionals making the market. They can see when orders are starting to dry up and when the immediate surge may be ending. Then they load up so as to be in position when the inevitable rebound gets under way.

Professional market-makers tend to be on the right side most of the time, and they tend most especially to be on the right side of the market before a market-moving announcement. Often you can tell beforehand from technical action which way money is moving prior to an announcement. On the news, many of those same professionals will be happy to bank their easy winnings and leave it to the newcomers to assume the risk that further rewards may be limited, if they come at all. Not only that, but consider the situation where there has been a major market-moving announcement prior to the open. The professionals are certain to react by wanting to milk the news for all that it is worth. They are in a position to

establish the opening price that suits them best and that discounts the value of the news. It happens often, therefore, that market-moving news has the practical effect of having its maximum impact on the open. You need to exercise extreme caution, therefore, in acting on news unless the market itself is clearly wrong-footed. Subject to confirming indications, it may be both reasonable and profitable to buy on bullish news when the market is down and to sell on bearish news when the market is up. But beware of buying on bullish news when the market is already overbought or selling when it is already oversold.

Buy the Rumor, Sell the News

Markets generally set up correctly beforehand to follow through on the actual announcement of news if it is going to move the market. Examples of market-moving news include crop reports and the monthly employment numbers. However, remember the adage: "Buy on the rumor, and sell on the news!" Following through on this axiom, in the real world of futures trading it is remarkable how often an apparently unstoppable bull market puts in its high on the announcement of bullish news such as a favorable crop production report. Or how a market puts in its low on bearish news such as a quarterly pig crop report showing greater than generally expected herd expansion. There always comes a time in due course when everyone in the know has maxed out, and smart money is going the other way. Remember, too, Joe Granville's great line: "If it's obvious, it's obviously wrong!"

There is another popular saying that a market that is strong should go up on bullish news, and one that is weak should go down on bearish news. If it fails to react as the news suggests that it should, then maybe it will go the other way. In practice, however, markets by no means always respond right away according to this wisdom. The initial reaction may indeed seem to contradict the news, but its impact may appear in price action a couple of days later. It can be that too many people already anticipated the news correctly, and then the market has to digest the rebound from those traders wanting to bank the profit from getting it right. They have bought on the rumor and then have sold on the news, or vice versa.

In a sense perhaps contradicting the apparent smarts of knowledgeable traders is the immediate impact of weather in New York and Chicago. When, in winter, it gets really cold in New York, you can expect the price of heating oil to rise regardless of the supply-and-demand fundamentals. When it rains in the summer in Chicago—even just a local thunderstorm—expect the price of grains and soybeans to come down with the rain.

Seemingly contradicting this interpretation of the immediate impact of news on short-term fluctuations, the underlying supply-and-demand fundamentals

really do matter. When, for example, petroleum inventories are rising week after week or falling week after week, the stocks data form their own trend. Market reaction may be slow to respond and erratic, and it may overreact temporarily when there is a surge one way or the other. However, the supply-and-demand fundamentals, based on real supply and actual use, drive intermediate- and long-term trends, whereas day-by-day market action and, most particularly, intraday market action are the result of many trading decisions that may be random and driven by emotions, stops, and factors that have little bearing on an established trend, when there is one.

Good Luck!

This brings us back to the proposition that is the foundation of this book and of all successful trading: There are few things more important than having parameters with which to define the major direction, whether up, down, or sideways. Assuming, then, that you correctly identify a major uptrend or a major downtrend, the probabilities favor making money. Reasonably often things will even turn out all right when you get into a trade at a bad price. Nevertheless, good luck comes to people already doing the right things.

Good trading, and good luck!

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About the Author

Colin Alexander retired in 2000 after 10 years of publishing *The Five Star Bulletin,* a popular advisory service for futures traders. This service was consistently rated in the top 10 by *Commodity Traders Consumers Report.* In 1998, he launched the successful stockscom.com advisory service for buying stocks and selling stocks short. He sold the service at the end of 2000, soon after telling subscribers in September to sell all stocks except the oils. For the rest of that year he told them repeatedly, *"It's not too late to sell!"* Mr. Alexander is author of several trading books, including *Capturing Full-Trend Profits in the Commodity Futures Market,* the widely acclaimed *Five Star Futures Trades,* and *The Streetsmart Guide to Timing the Stock Market,* of which McGraw-Hill published the second edition in 2006. He has an M.A. in politics, philosophy, and economics from Magdalen College, Oxford, and lives in Ottawa, Canada.