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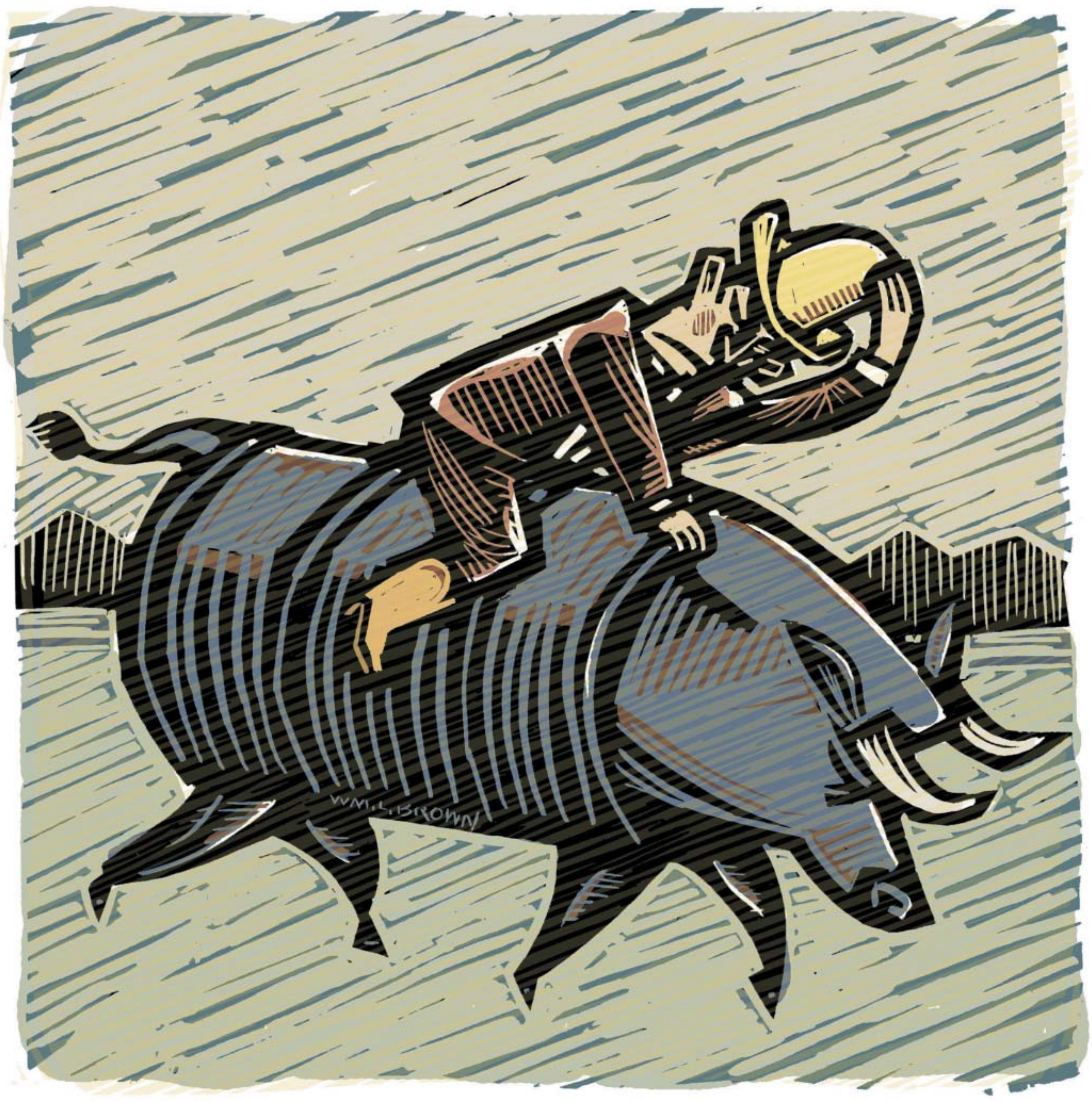

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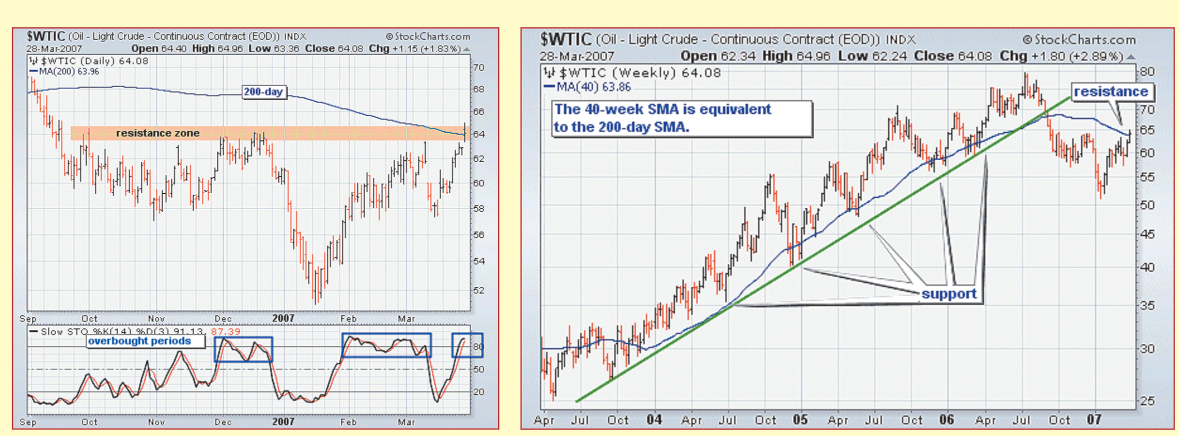

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By John Wang, Ph.D., CTA, eASCTrend Developer

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You can also use sweet spots to get in on a trade if you missed the first entry, giving you a second chance to take advantage of a moving market. Sweet spots help you buy with confidence - and seek to expand your total gain on the trade.

It's our principle-based formulas that give traders the eASCTrend edge. Sign up for your eASCTrend test drive today, and experience the confidence of using intelligent stops and sweet spots.

Dr. John Wang, CEO and co-founder of AbleSys, as well as the creator of ASCTrend indicators and the eASCTrend trading system, holds a Ph.D. in physical chemistry and has been trading commodities since 1990. He is a registered Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) since 1995. **Use this discount code for a 30-day trial with a $20 discount: SCT7MA**

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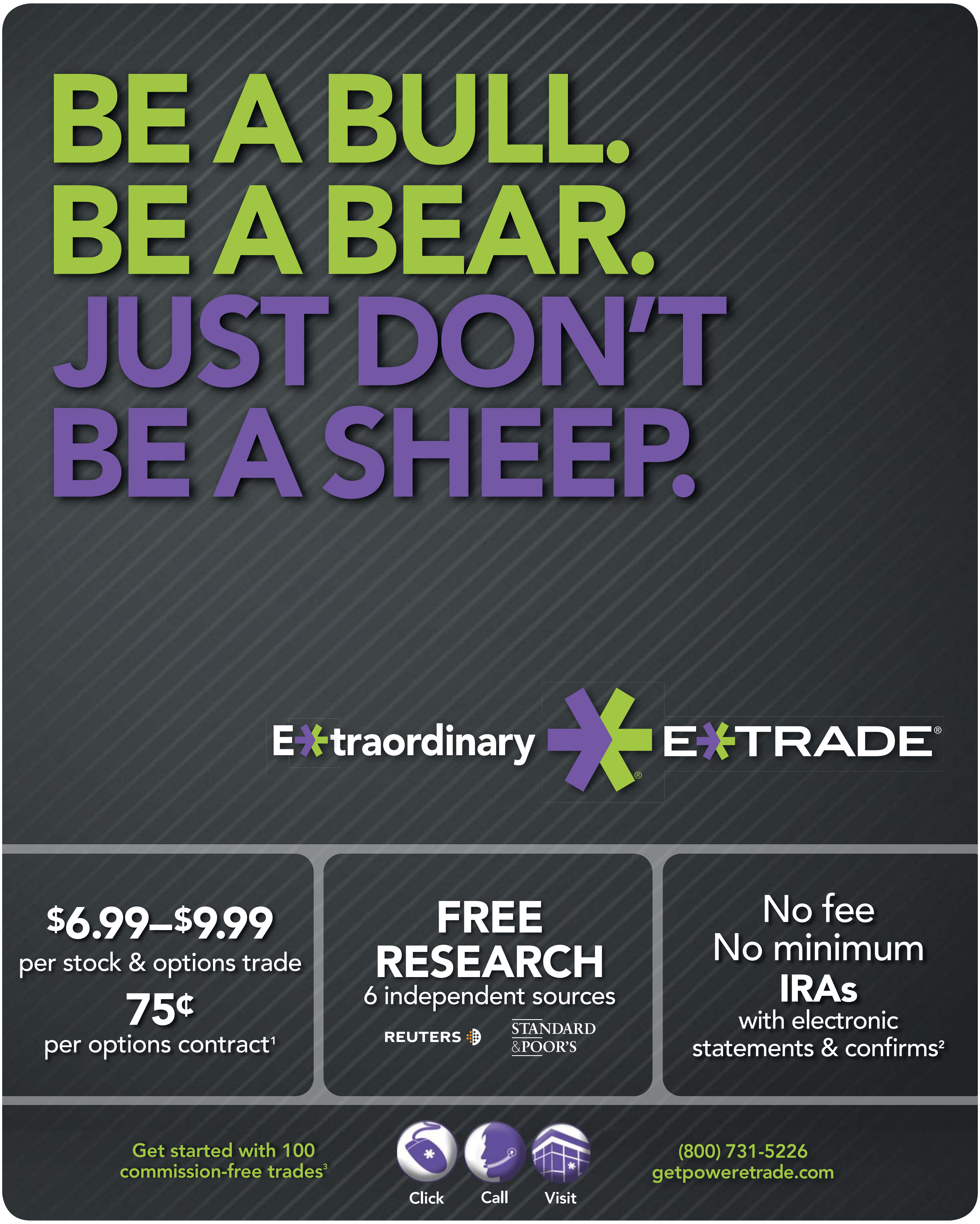

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TRADING NOW

Markets in Japan, South Korea, and China have all shown incredibly strong performance of late. With global markets going up, up, and away, should we be getting weary of an overheated market? Asia is enjoying remarkable growth with strong corporate earnings, strong currencies, and favorable monetary policy. The downside is that inflation could become a problem, which in turn means a tightening in interest rates. Given that the fundamentals are still strong, I wouldn't be averse to considering Asia as a prime area of investment. However, at such lofty levels it is always a good idea to expect the worst. Values could be charging toward a resistance level just as we have seen with indexes in the past. A prime example would be the technology sector in 2000. We saw a similar scenario with gold in the early part of 2006, and we have seen that happen with other commodities such as crude oil.

In this issue of Traders.com, we take a look at many things going on around the world. In "Measured Moves In The Swiss Franc" by David Penn, we look at ways to anticipate targets after breakouts and breakdowns and how they helped Swiss franc traders exit profitably from a turn-of-the-year advance. Then there's "An Ascending Triangle For The Aussie" by Arthur Hill, in which we examine the Australian Dollar Index and what happens when it broke resistance levels in two time frames.

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And there's more to consider in this issue: We look at the real estate market in Canada and the US, the biotech hype and whether we can believe it, how cocoa and sugar are doing, what's happening in gold, what's up in crude oil — there's so much to look at and so much to study. Asia's not the only region to invest in, after all — it's only the beginning.

Jayathi Gopalakrishnan

Jayanthi Gopalakrishnan,
Editor

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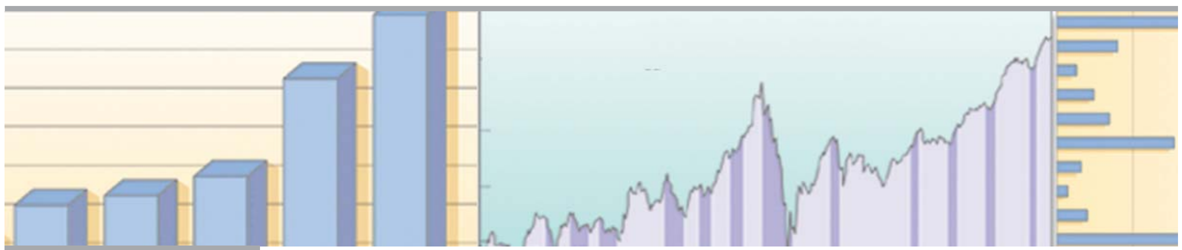

THE CHARTIST

Why So Many Moving Averages?

by Rudy Teseo

So many to choose from...so little time.

If you're a student of technical analysis, it is highly probable that the first indicator you learned to use was the simple moving average (MA). Back before technical analysis computer programs, I used to manually plot a simple moving average of my stock on graph paper. This may sound stone-age primitive now, but it was effective then. Through the years, in my studies of technical analysis, I have found references to no less than seven types of moving averages in the literature. (If you know of more, please email me the details, thank you.) These days, moving averages are the most common indicators used in technical analysis and form the basis of other indicators. For example, the famous moving average convergence/divergence (MACD) is a combination of several MAs.

THE MANY MOVING AVERAGES

When I started studying technical analysis, I was intrigued with the different types of moving averages. Why are there so many? As I learned more about MAs the answer became simple enough: different strokes for different folks. Over the years, technicians and programmers have attempted to improve the MA so it can do a better job of what it's supposed to do. Moving averages smooth data and provide a clearer picture of the trends and reversals of the price of a security. Moving averages together with price, or two moving averages together, are useful for identifying entry and exit points. However, these signals tend to lag as they are based upon past performance. So techniques were developed to produce signals with fewer lags and so with more accuracy.

What makes these moving averages different is the weight applied to the more recent data. The seven types of MAs are:

- Simple moving average = SMA
- Weighted moving average = WMA
- Exponential moving average = EMA
- Triangle moving average = TMA
- Time series moving average = TSMA
- Variable moving average = VMA
- Volume-adjusted moving average = VAMA

▸ ***Simple moving average:*** The SMA treats all data equally and is simply an average of prices for a selected period (days, weeks, months), which changes with each new period. As today's price is added, the oldest day's price is dropped. One of the uses of the SMA, which has the most lag among the moving averages, is as a buy/sell indicator. When the price moves above the MA you buy; when the price moves below the MA you sell. The inherent lag causes you to get in late and out late. Using shorter time periods reduces the lag but leads to more whipsaws.

As with all averages, the time period selected has a great deal to do with the results you attain. The time period you select should fit the (stock) market cycle you are following. Every stock, commodity, and index has a predominant cycle — the rhythmic movement of price swings between highs and lows. Cycles occur in some derivative of the numbers 3 and 4. The predominant cycles are three- to four-week cycles, three- to four-month cycles, six- to eight-month cycles, and three- to four-year cycles. Further, cycle durations are fixed to their corresponding vehicle. If an index has a four-month cycle, it will never be three-month cycle or a six-month cycle. If a stock has a three-month cycle, it will never be a four-month or an eight-month. The ideal MA can be calculated as:

$$MA = (\text{cycle length} / 2) + 1$$

Thus, for a 30-period cycle you would use a moving average of 16. Of course, you have to make sure that moving averages are right for the market you are following. In *Technical Analysis Explained*, Martin Pring states that moving averages are virtually useless in a trading (congestion) range market since they move right through the middle of the price fluctuations and almost always result in unprofitable signals.

▸ ***Weighted moving average:*** The WMA applies more weight to later data through mathematical computations (multiplying previous data by a weighting factor based upon the number of periods in the average). The reasoning is that the latest data has more importance than earlier data. Fortunately, most charting programs have these moving averages built in so you don't have to do the math. Like the SMA, the oldest data is dropped when the latest data is added.

▸ ***Exponential moving average:*** The EMA is more complicated. Like the WMA it gives greater weight to the latest data, but unlike the former two moving averages, it does not drop the oldest data. The type of moving average used in the MACD and the McClellan

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oscillator, the EMA considers all the data in its history. Calculations for this average are even more complex than the WMA. It is calculated by applying a percentage of today's close to yesterday's average. These percentages can be changed (if you own a program that gives you the flexibility to do it), but in most programs the percentage is fixed and the only parameter you can change is the period.

If your program allows you to build custom indicators, the following formula will provide the smoothing constant:

$$SC = 2 / (\text{period} + 1)$$

where SC is expressed as a percentage.

Thus, for a 20-day EMA the latest price is weighted at 9.5% of the total instead of the 5% that it would be in calculating the SMA. If your program requires the input in percentages, this formula will convert any period you want to use into percentage. If you need to convert percentage to period, use the following formula:

$$\text{Period} = (2 / \text{percentage}) - 1$$

The use of this formula can be seen in the MACD. Gerald Appel's original MACD specified 15% and 7.5% EMAs. The industry soon changed this to 12- and 26-day MA, respectively, which are today's default values in almost all charting programs.

- ***Triangle moving average:*** The TMA gives more weight to the middle data. This moving average is actually an SMA of an SMA.

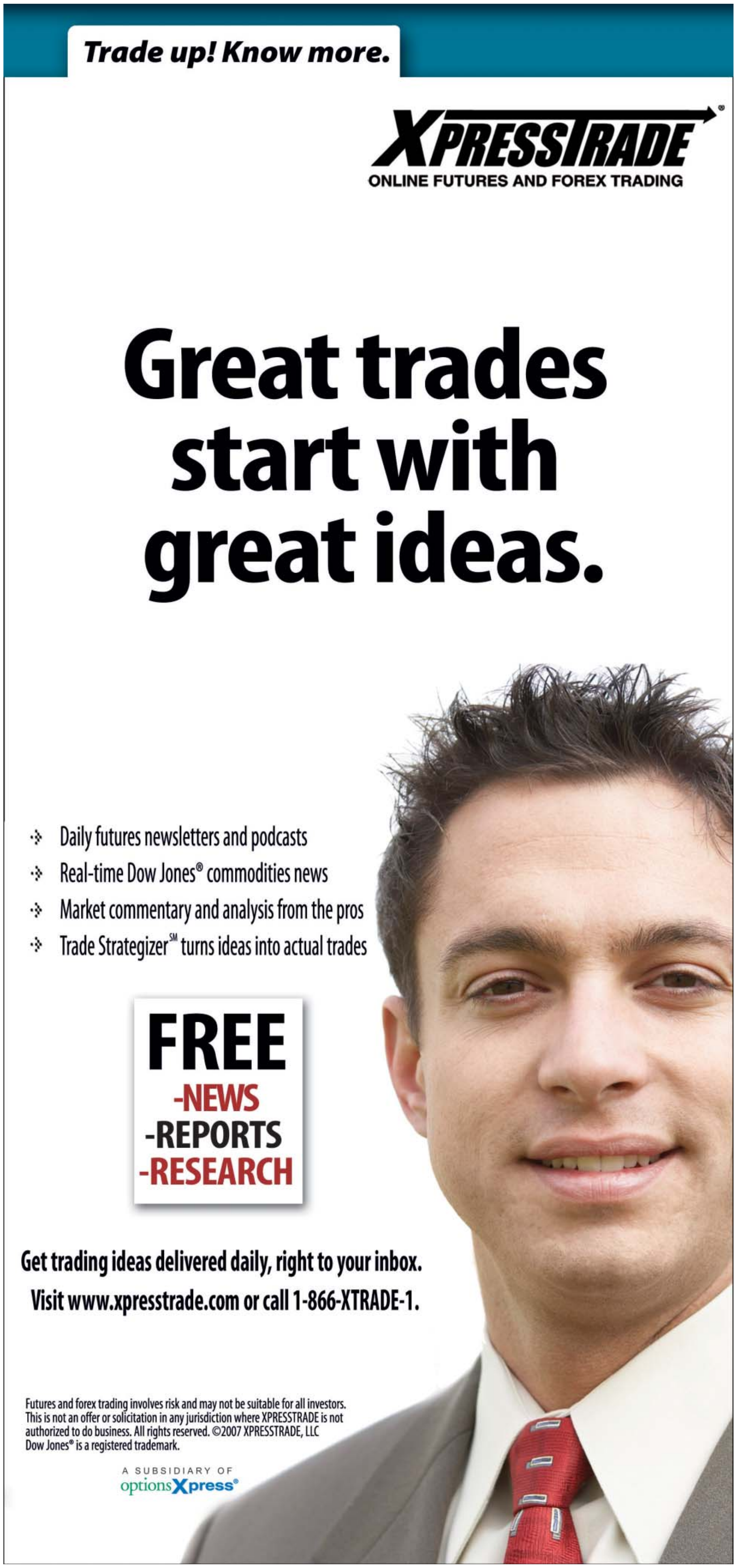
- ***Time series moving average:*** The TSMA is similar to the time series forecast. This indicator displays the statistical trend of a stock's price. This MA does not have as much delay in following price changes as the indicator is fitting itself to the data.

- ***Variable moving average:*** The VMA weighs data according to the volatility: as volatility increases, more weight is given to recent data. This is accomplished by adjusting the smoothing constant (percentage) of an EMA. The more volatile the data, the more weight given to the current data. This automatic adjustment allows the average to perform better in both trading and trending markets. In trading markets there are many whipsaws with an SMA, but fewer with the VMA. In trending markets there is quite a lag with an SMA, but much less with the VMA.

- ***Volume-adjusted moving average:*** The VAMA incorporates a volume weighting into the calculations. The days with the higher volume get the greater weight.

WHICH MA DO YOU USE?

This information is all very interesting, but does it help the technician choose the best type of average? Not in itself. Like most things in technical analysis, where there are options, you have to resort to experimentation and backtesting before you gather enough data to make a decision. One of the popular uses of the MA is the moving average crossover, wherein two MAs are used to identify buy and sell signals. When the fast MA crosses above the slow MA you buy, and when the fast MA crosses below the slow MA you sell. The selection of the periods is your call,



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MOVING AVERAGES	
Periods	**Days**
Very short	2 to 10
Short	11 to 21
Short-Intermediate	22 to 50
Intermediate	51 to 100
Long	101 to 200

FIGURE 1: MOVING AVERAGE PERIODS. Now select a pair from the table that fits your immediate time frame and test it until you have determined that it will produce the trading signals you would like. Try different pairs until you're satisfied you have the best.

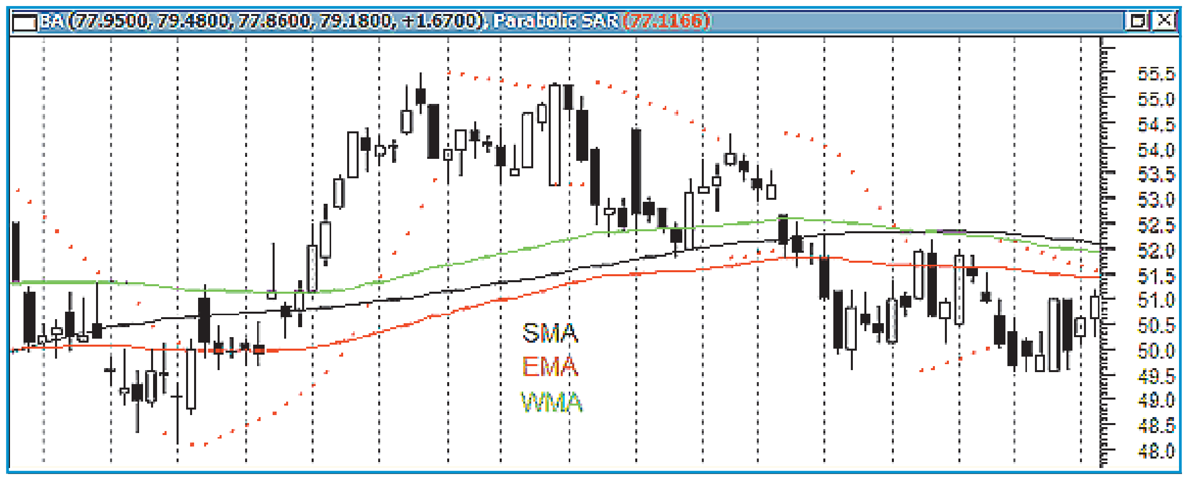

FIGURE 2: BOEING CHART SHOWING THREE DIFFERENT TYPE MOVING AVERAGES

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Moving averages smooth data and provide a clearer picture of the trends and reversals of the price of a security.

based upon the time frame you wish to trade. The table you see in Figure 1 is one I have compiled by averaging many recommendations from texts and articles by recognized authors. It is merely a suggestion, so don't change anything that's working for you.

The typical MA crossover uses one type of moving average with different time periods. But suppose we try two or three different MAs with the same time period as shown in Figure 2. In Figure 2, see the daily chart of Boeing with the three most popular MAs set to 100 days. You get an immediate picture of the different crossovers of the price and the various MAs. An uptrend crosses the EMA before the WMA, and a downtrend crosses the WMA before the EMA. Finding the right combination might allow you to get in a few days (or dollars) sooner, and get out a few days (dollars) sooner. Be aware that the spacing between the averages changes with the stock selected, and that the averages may switch positions.

Finally, I'd like to mention two more moving averages; the double EMA (DEMA) and the triple EMA (TEMA). These were developed by Patrick Mulloy and discussed in his articles in the January and February 1994 issues of *Technical Analysis of* STOCKS & COMMODITIES. The author tested DEMA- and TEMA-modified MACD, and achieved much better results and less lag. ■

This article was originally published on 3/28/2007.

SUGGESTED READING

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Mulloy, Patrick G. [1994]. "Smoothing Data With Faster Moving Averages," *Technical Analysis* of STOCKS & COMMODITIES, Volume 12: January.

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Pring, Martin J. [1985]. *Technical Analysis Explained*, McGraw-Hill Book Co.

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INDEXES

REVERSAL

Classic Trading Signals On The NASDAQ Composite

by Gary Grosschadl

Here are some very clear trading signals, including two reversal patterns.

Tradable: $COMPQ

Charts like this daily one of the NASDAQ reminds us that at times trading does not have to be difficult or complex; you just have to go with the big and obvious signals. There are no convoluted trading theories here that require mathematical formulations or chart patterns that can make your head spin.

Let's start with the first trading signal by way of a common moving average crossover (Figure 1). Traders often comment that when the 50-period moving average crosses over the 200-period moving average, a buy signal occurs. It may not be the earliest or timeliest signal, but it often is a safer signal that still captures a good part of the move. In this case, had the trader acted on this signal and simply stayed with the trade until the 50-day exponential moving average (EMA), a nice gain was captured.

The next signal was a timely one, as it caught the very top of the move. A doji candlestick hitting a new high after a good upleg can often be an exceptional reversal signal. In this example, traders dancing close to the exit sign had two days to heed the potential topping pattern. Confirmation of the doji comes on the next trading day with a lower close. The pain of the large gap down could have been avoided without having read any market news or listening to the myriad of market pundit opinions from here or abroad. That's the big advantage technical traders often have: charts don't lie. Give me a good chart and a great cup of coffee and hold the financial press, please.

The next trading signal came with a bounce off the most important moving average, the 200-period exponential moving average (EMA) (although some traders prefer the simple moving average). This big moving average is often targeted by traders as significant areas of support or resistance. This bounce off the 200-day EMA came with another telling candlestick — an inverted hammer. This is a bullish bottom reversal signal with confirmation the next day. Just to drive that point home, the final pattern here is a three-day pattern called a

FIGURE 1: NASDAQ COMPOSITE, DAILY. There are some great trading signals on this daily chart.

A doji candlestick hitting a new high after a good upleg can often be an exceptional reversal signal.

morning star pattern. This is a major reversal pattern made up of a long black real body followed by a small-bodied candlestick that gaps lower, forming the star. The third candle is a white bullish candlestick that closes well into the first session's black real body.

Several indicators are examined. Note the negative divergences to the index climbing higher via the moving average convergence/divergence (MACD) and the relative strength index (RSI). The RSI is kicking up from a very oversold level of 30 while the stochastic oscillator is very oversold at under 20.

Going forward, the initial trading target is the 50-day EMA currently 2443. The danger going forward is that this could be a bear rally to overhead resistance. Failure there could put this index into failure mode until that moving average ceases to be a resistance level. ■

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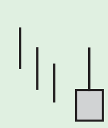
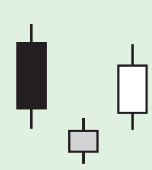


Inverted hammer: A bullish bottom reversal signal with confirmation the next day.



Morning star pattern: A major reversal pattern made up of a long black real body followed by a small-bodied candlestick that gaps lower, forming the star.

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STOCHASTIC OSCILLATOR

A Bear Trap For The Russell 2000

by Arthur Hill

The Russell 2000 broke support on Monday but quickly sprang back to lay the foundations of a bear trap.

Tradable: $RUT

The Russell 2000 established support at 770 with reaction lows in late November 2006 and early January 2007. With these lows, a large consolidation formed and the index broke consolidation resistance at 800 with a big surge in February. This sharp advance further reinforced 770 as a valid support level, but these gains were wiped out with a sharp decline over the last two weeks. The index broke below key support at 770 on Monday and things were looking pretty bleak after this close. See Figure 1.

Technical analysts often apply filters to distinguish false moves from the real McCoy. The support break at 770 was only one day old, and this could have been caused by some excess volatility, a little noise, or a simple overshoot. A typical time filter is three days and this can help reduce bear traps or whipsaws. The downside, of course, is that the signal will come a few days later and this will affect the entry point. The index did indeed close below support at 770, but the ability to immediately recover shows resilience and makes this a bear trap. Moreover, this whipsaw once again reinforces support at 770 and I will continue to watch this area for signs of a breakdown — with a time filter, of course.

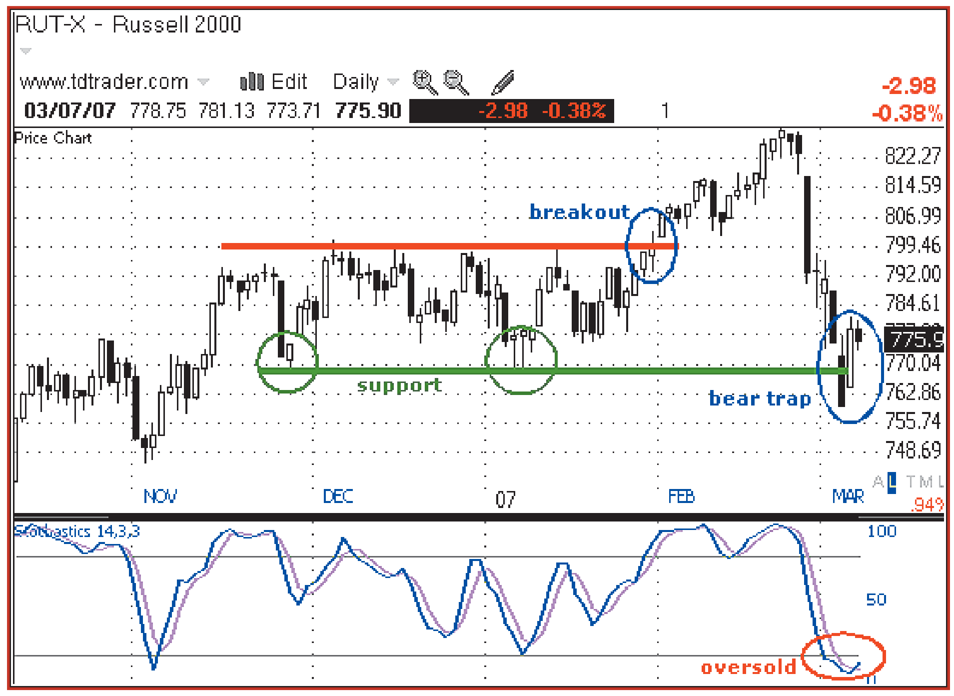

FIGURE 1: RUT, DAILY. The Russell 2000 established support at 770 with reaction lows in late November 2006 and in early January 2007.

What now for the Russell 2000? The bear trap keeps support at 770 alive and this means the overall uptrend is not finished just yet. The stochastic oscillator dipped below 20 last week and remains below 20. This shows an index that is both oversold and still weak. I would wait for the stochastic oscillator to turn up and break above 20 before calling for an oversold bounce. ■

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REVERSAL

The Q's Hourly Double Bottom And Successful Test

by David Penn

March came in like a lion ... with a market bottom in tow.

Tradable: QQQQ

"In like a lion and out like a lamb," goes the old saw about the month of March. But as far as QQQQ investors are concerned, it might be more accurate to suggest that March comes in like a bear and goes out like a bull.

The QQQQ, the tracking stock for the NASDAQ 100 index, peaked near 45.50 in late February and failed to follow through on the higher high it had just set (see my March 2, 2007, Traders.com Advantage article, "The QQQQ's 2B Top"). The QQQQ spent the balance of February in freefall, plummeting to just above 42. The NASDAQ 100 tracking stock then spent the first half of March scuttling along support at the 42–42.50 level, once bouncing as high as 43.25 before falling back toward 42.

This bouncing managed to produce a double bottom in the QQQQ between the initial trough low on March 5 and the second trough low on March 14. The initial trough was lower than the subsequent one and was itself telegraphed as a significant low by the positive divergence in the moving average convergence/divergence (MACD) histogram (see Figure 1).

The peak between troughs was just north of 43.25, which, when the low point of the two troughs (roughly 42.25) was subtracted from it, meant that a successful breakout from the double bottom would create a minimum upside move to the 44.25 level.

This move was precisely what the QQQQ did. Breaking out on March 20, the QQQQ one day later reached the minimum upside target of 44.25 (Figure 2). Shortly thereafter, the market pulled back. But interestingly, the pullback appears to have found support near the 43.25 level, precisely where the QQQQ originally broke out. There is even a modest positive divergence in the MACD histogram on the rest of the breakout level that further confirms the QQQQ's ability to bound higher from that level. The particularly bullish action on Tuesday, following the successful test, seems to indicate as much. ■

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FIGURE 1: NASDAQ 100 TRUST (QQQQ), HOURLY. A positive divergence in the MACD histogram helped warn traders and speculators that momentum to the downside was waning in early March.

FIGURE 2: NASDAQ 100 TRUST (QQQQ), HOURLY. The QQQQ broke out from its double bottom and managed to reach its minimum upside target before pulling back. Note how the QQQQ found support at approximately the same level of the breakout weeks before.

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The QQQQ's Broadening Top

by David Penn

This pattern suggests even more upside for the NASDAQ 100.

Tradable: QQQQ

Writing about broadening tops in the second edition of his book *Encyclopedia Of Chart Patterns*, Thomas Bulkowski notes clinically: "Price trend is upward leading to the formation. Megaphone appearance with higher highs and lower lows that widen over time. Breakout is upward."

This is a perfect description of the broadening top that has defined the movement in the QQQQ since late November 2006 (Figure 1). Compared to their opposite, the symmetrical triangle, broadening tops are a bit more rare, and often confuse chartists at first with their pattern of higher highs and lower lows. However, like the symmetrical triangle, the broadening top is also a "continuation" pattern. This means that whatever trend was in effect when the consolidation pattern developed will continue once the consolidation has run its course.

How do you trade broadening tops? Bulkowski recommends that "once a broadening top appears, buy after the stock makes its turn at the low ... place a stop-loss order 0.15 below the minor low." The trick with this recommendation is figuring out when the stock has actually made "its turn at the low." In the case of the QQQQ — especially in the weekly chart — one big clue that the decline in late February marked "the low" was the fact that the market seemed to find support on the 50-week exponential moving average (EMA) (Figures 2 and 3). On the daily chart, there was support at the 42 level, which corresponded with the lows of the October-November consolidation that contributed to the QQQQ's inability to move lower as the broadening formation was completed.

FIGURE 1: POWERSHARES QQQ TRUST, WEEKLY. The broadening formation in the QQQQ developed over the course of more than three months from late November to early March, when the pattern was complete.

FIGURE 2: POWERSHARES QQQ TRUST, TWO-HOUR. The rally from the low point of the broadening formation in the QQQQ moves toward the top of a trend channel, where some resistance should be expected.

What sort of upside can traders and speculators in the QQQQ look forward to? The measurement rule for broadening tops with upside breakouts is straightforward: measure the formation at its widest point and add that amount to the value at the top of the formation. In this case, that would mean adding approximately four points to the value at the top of the pattern, which is approximately 46. This provides for a minimum upside target of 50 for the QQQQ.

The broadening top pattern can also be seen as a sort of measured move up in which the distance from the summer 2006 lows near 35.5 to the high of the broadening formation can be added to the low of the broadening formation to provide an upside target. Approaching the pattern in this way — the formation low is approximately 42 versus a formation high of approximately 46 — suggests an upside of 52.5, and that the 50 target might indeed be a "minimum" upside destination. ■

Suggested Reading

Bulkowski, Thomas [2000]. *Encyclopedia Of Chart Patterns*, John Wiley & Sons.

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This article was first published on 4/26/2007. See www.Traders.com for more.

FIGURE 3: POWERSHARES QQQ TRUST, WEEKLY. The correction in the QQQQ — and the low point of the broadening top formation — find support at the lowermost of the three moving averages shown: the 50-week exponential.

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GAPS

Mind The NASDAQ Gap

by Arthur Hill

The NASDAQ has been moving higher since mid-March, and the latest gap affirms this uptrend — provided it holds and does not turn into an exhaustion gap.

Tradable: $COMPQ

The recovery is quite remarkable. The NASDAQ declined sharply in February 2007 with a gap and a long black candlestick (Figure 1). The move extended into early March, but the index soon found support and recovered all of its losses over the past six weeks. The recovery rally features a resistance breakout on March 21, a gap in early April, and a gap this week. The most recent surge above 2500 puts the index back in the resistance zone from the January–February highs, and a breakout here would show some serious strength.

However, resistance has yet to be broken and the index is becoming overbought. The NASDAQ was turned back around 2500 in mid-January and late February. The third attempt shows resilience, but it ain't broken yet. For overbought evidence, the stochastic oscillator moved above 80 and remains at lofty levels. This indicator is both overbought and still bullish; look for a move back below 80 to show some weakness. And finally, the index is up over 6% in less than six weeks. The NASDAQ would be up 52% if this rate kept up for a year. This kind of pace shows strength, but it is hardly sustainable.

Despite resistance and overbought conditions, the six-week trend remains up and the most recent gap is holding. I am watching three items for a trend change: the April 16th gap, the March trendline, and the April 11th low. A close below 2490 would fill the gap and make it an exhaustion gap, which would be quite negative. Further weakness below the March trendline and key support at 2450 would reverse the six-week uptrend and reinforce the resistance zone (Figure 2). This would spell trouble for the NASDAQ, and I would then expect a support test around 2350. ■

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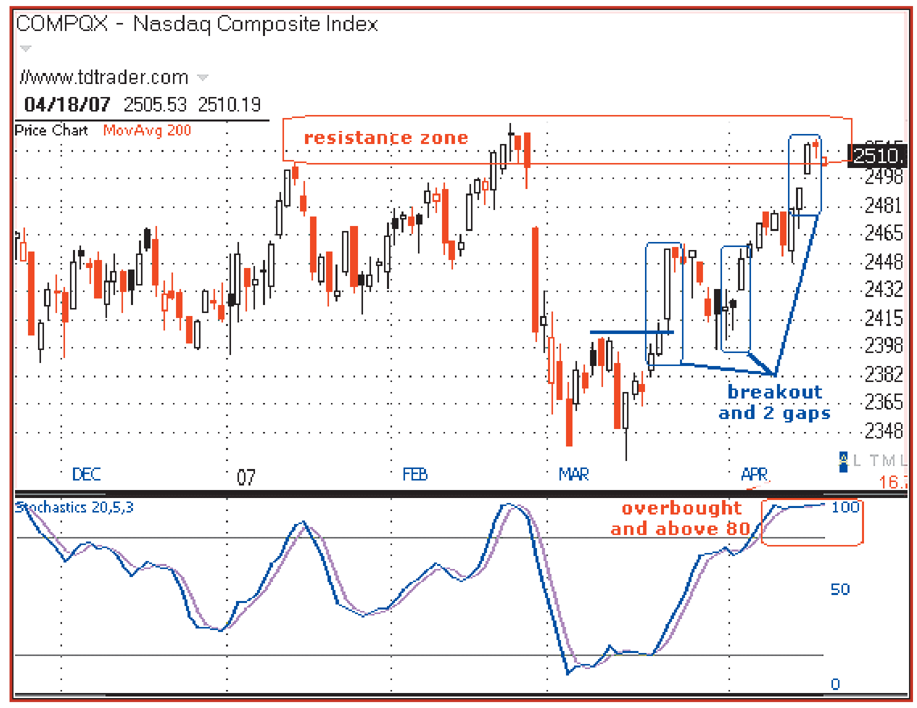

FIGURE 1: NASDAQ. The most recent surge above 2500 puts the index back in the resistance zone from the January–February highs, and a breakout here would show some serious strength.

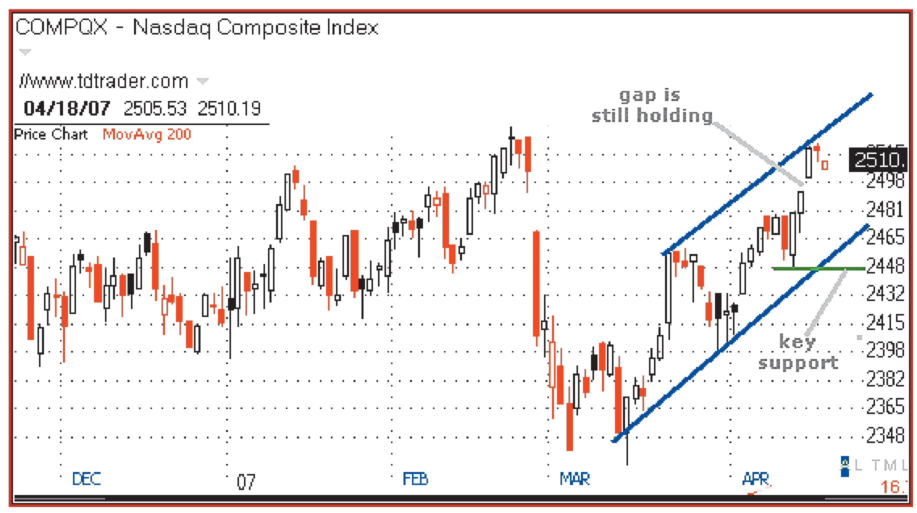

FIGURE 2: NASDAQ. Further weakness below the March trendline and key support at 2450 would reverse the six-week uptrend and reinforce the resistance zone.

BREAKOUTS

BOSO And The S&P 500 Breakout

by David Penn

When does momentum really matter?

Tradable: $SPX

There are two important concepts when it comes to momentum: threshold and reversal. By *threshold*, I'm referring to that point where momentum reaches a level where it is capable of carrying prices further even as that momentum is waning. By *reversal*, I'm referring to that point when momentum carrying prices in a given direction becomes so weak that forces in the opposite direction are able to take control of the market for a given time.

A perfect trader would be able to spot a reversal in a given market, take a position, recognize when that market has reached a momentum threshold, take partial profits and/or add to the position, spot a reversal, take full profits, and take a position in the opposite direction.

One of the things I like about the BOSO approach (see my Working-Money.com article, "BOSO," from October 5, 2005) is that it does an excellent job of indicating when a market has likely reached a momentum threshold. Everyone knows that markets that become overbought often remain overbought for a period, and that markets that become oversold often remain oversold for a period.

So why not profit from this tendency by buying overbought markets and selling oversold ones?

There are caveats to this approach, such as only buying or selling above or

FIGURE 1: S&P 500, DAILY. The positive divergence in the March lows of the S&P 500 was clear in a number of indicators, including the stochastic.

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FIGURE 2: S&P 500, DAILY. The highlighted oval indicates where the S&P 500 passed a momentum threshold, becoming overbought. Also highlighted is the area where the stock market pulled back to support, slipping below the threshold temporarily, before moving back through the threshold en route to higher prices.

below the intermediate-term moving average (20 to 50 period). But when combined with a strategy or method that aims to spot tops and bottoms — whether that strategy or method is pattern-based, cycles-based, or divergence/oscillator-based — the Boso approach can be an excellent complement to a complete trading strategy.

The last bottom I wrote about the stock market was in the QQQQ ("The QQQQ's Hourly Double Bottom And Successful Test," April 5, 2007). But consider a similar example in the Standard & Poor's 500 ("Short-Term 2B Bottom In The S&P 500," March 16, 2007). The double bottom that is a part of that 2B bottom projects to about 1450, while the buy signal from the 2B has the trader long around 1390. See Figure 1.

The S&P 500 rallies up to 1440 with little problem. However, the market begins to run into resistance at that round number and cannot close above it. During that time, the market closes in overbought territory (Figure 2), indicating that it has passed through a momentum threshold to the upside.

The market pulled back shortly thereafter. But a number of important things happened for the trader on the long side of this market. One, the pullback never closed below the intermediate-term moving averages (the 50-period). Two, when the market slipped temporarily out of overbought territory, there was no further follow-through to the downside.

In other words, when the market closed back outside of the overbought zone, it did not close below the low of that session again. In this example, the S&P 500 slipped out of the overbought zone on March 29. The low of that session was 1413. While the market traded lower than that on the following day, it did not close below 1413. The S&P was back in the overbought zone two days later, leading the market to new highs for the advance. Seven days after passing back into the momentum threshold, the 1450 target from the double bottom was reached. ■

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CURRENCY TRADING

Measured Moves In The Swiss Franc

by David Penn

One of the most straightforward ways to anticipate targets after breakouts and breakdowns helped Swiss franc traders exit profitably from a turn-of-the-year advance.

Tradable: USD/CHF

Measured moves and a technique that Stan Weinstein calls the "swing rule" are perhaps two of the fundamental techniques in technical analysis. Although measured moves tend to be continuation patterns when they occur in trends while the "swing rule" is generally employed at potential turning points in the market, both chartist techniques reflect a common conviction: past price action can be directly suggestive of future price action.

As Thomas Bulkowski writes of measured moves in the second edition of his book, *Encyclopedia Of Chart Patterns*: "The measured move ... or swing measurement as it is sometimes called, is an exciting formation because it vividly tells how far ... price is going." Next to the simplicity of spotting such patterns, this is truly what makes both measured moves and swing rules so valuable. Measured moves (both downward and upward) often begin with new highs or lows, and the price action is often swift, with few if any corrections along the way. The move then develops a consolidation. This consolidation, as Bulkowski reminds us, will be either horizontal or mildly directional (rising or falling to retrace a fraction of the previous move), but should not rise or fall so much as to test the previous high or low.

The key measurement to take in the measured move pattern is the distance from the beginning of the move (the low or the high) to the top (in the case of a potential measured move up) or the bottom (in the case of a potential measured move down) of that consolidation. This value can then be added to the bottom (in the case of a potential measured move up) or the top (in the case of a potential measured move down) to project a minimum projection for the resumption of the rally or decline.

The case of the Swiss franc (or, more accurately, the dollar/Swiss franc currency pair) is an excellent example of the measured move at work (Figure 1). The USD/CHF bottomed in early December 2006 near 1.1880. The pair rallied into the end of the month, but much of that rally (the second half of the month) was mostly an upswing in a consolidation. The upper boundary of this consolidation was at approximately 1.2272. This created an initial move of 392 points. If we add 392 to the value at the bottom of the consolidation that is, 1.2113), then we get a minimum upside projection of 1.2505.

Starting on January 3 — the first day of any price action, intraday or otherwise, beyond the upper boundary of the consolidation — the USD/CHF moved up in six of the seven following sessions, making an intraday high of 1.2507 on January 11. The USD/CHF shortly thereafter fell into another consolidation pattern (the first close above 1.2505 did not occur until January 26). ■

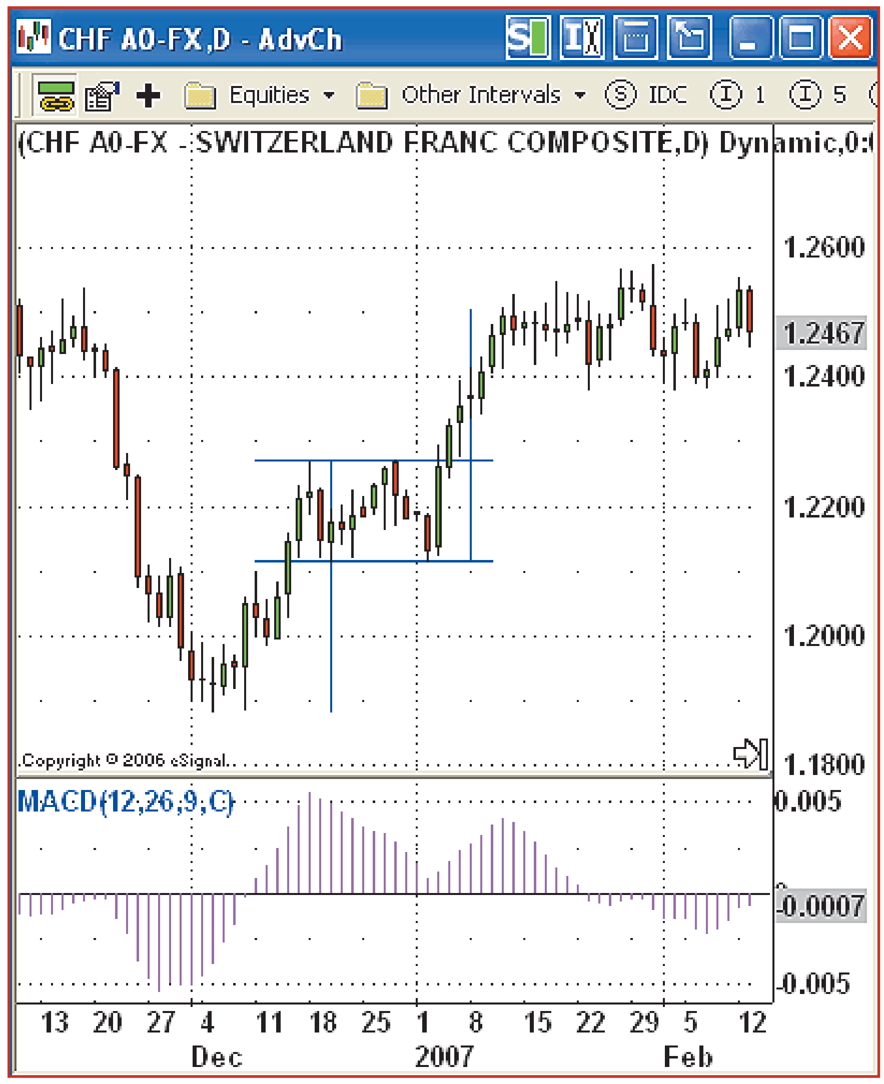

FIGURE 1: US DOLLAR/SWISS FRANC (USD/CHF), DAILY. The rally from the early December lows to the top of the mid-December/early January consolidation is similar in size to the rally from the bottom of that consolidation to the closing high of the rally in January.

SUGGESTED READING

Bulkowski, Thomas [2000]. *Encyclopedia Of Chart Patterns*, John Wiley & Sons.

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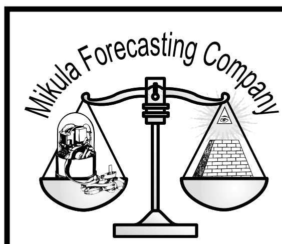

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An Ascending Triangle For The Aussie

by Arthur Hill

With a big surge over the last two weeks, the Australian Dollar Index broke resistance levels in two time frames and looks as though it will be heading higher.

Tradable: $XAD

Let's start with the monthly chart for some long-term perspective (Figure 1). The Australian Dollar Index ($XAD) surged in 2003 and then formed a large ascending triangle over the last three years. There are two reaction highs around 80, a reaction low at 68, and a higher low around 70 (gray arrows). Connecting the dots here gives us a bullish ascending triangle and a breakout at 80 signals a continuation of the 2003 advance. The length of the pattern is added to the breakout point for an upside target around 92.

On the daily chart (Figure 2), the index surged from October to December 2006 and then formed a rather unusual consolidation from January to March 2007 (magenta trendlines). The pattern is not a flag or wedge and looks like a megaphone. Despite the unusual pattern, the decline back to 77 looks like a correction because it retraced 50% of the prior advance and has characteristics of a consolidation. The retracement is normal for a correction, and the choppy nature of the decline shows an even-pitched battle between the bulls and bears (a consolidation).

The surge and breakout at 79.50 broke consolidation resistance and signaled a continuation of the October–December advance. There are now two levels to watch for support. First, broken resistance around 79–79.50 turns into support and a strong security should hold its breakout. A move back below 79 would be negative. Second, the bounces at 77 in late January and early March established key support and a break below this level would reverse the uptrend on the daily chart. ■

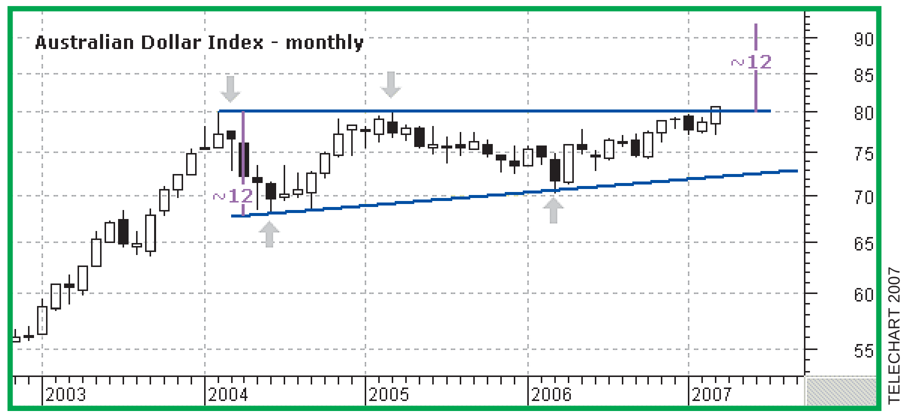

FIGURE 1: XAD, MONTHLY. This index surged and then formed a large ascending triangle over the last three years.

FIGURE 2: XAD, DAILY. The index surged from October to December and then formed a consolidation from January to March 2007 (see trendlines).

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REVERSAL

A 2B Top In The Euro?

by David Penn

Failure to follow through above the December 2006 highs provides an opportunity for correction or reversal in the EUR/USD.

Tradable: EUR/USD

I've been spending more and more time lately looking at foreign exchange charts. While often helpful in getting a broader understanding of what is going on in assets like gold and the US dollar, the forex markets themselves can be a great opportunity for traders in both the short and long term to profit using many of the same basic technical tools and strategies that work for stocks and other chartable markets.

One of the methods I like to look for most frequently is one that works very well on just about every time frame I've tried it with: the 2B test. The 2B test is an excellent screen not only because it often captures the exact top or bottom of a given market, but also because the pattern itself helps traders and speculators see exactly where their risk lies. If you trade a 2B top, for example, and the market moves back up to set a new high, then you know it is time to exit. The same is true with a 2B bottom setup that goes on to record a new low.

2B tests also work well with other indicators. Let a 2B test tell you that a market is reversing direction, and then let your favorite trend-following indicators — be they moving averages, trendlines, the moving average convergence/divergence (MACD) histogram, directional movement, and more — help you stay in the new trend. I like to confirm 2B tests whenever possible with an oscillator like the MACD histogram (the MACDH has both trend-following and overbought/oversold measuring capabilities, making it an ideal indicator for many situations). As I wrote in an article for Working-Money.com recently ("Breakouts, Pullbacks, And Gaming The 2B," January 24, 2007), the 2B test itself can be used to create a time stop to let you know how much time you should give a 2B test to start showing the makings of a winning setup before abandoning it for the next trade.

FIGURE 1: EUR/USD, WEEKLY. The EUR/USD shows clearly the 2B top between the December 2006 and the March 2007 peaks. Failure to follow through beyond the new high created in March will make traders and speculators suspicious of the EUR/USD's ability to move higher in the near term, likely prompting bets to the short side.

FIGURE 2: EUR/USD, DAILY. In addition to the longer-term 2B top between the December 2006 peak in the euro and the March 2007 peak, the negative divergence in the MACD histogram that has developed between the late February and late March peaks is further confirmation that momentum to the upside is likely to wane in the near term.

The 2B top in Figure 1, the weekly chart of the EUR/USD, so far represents an excellent example of this setup as it is likely to be spotted "in the wild." The EUR/USD made a high in December after rallying for a few months, then pulled back and began a scalloped, bowl-shaped correction that lasted into the spring of 2007. However, as prices rallied to test the December high — the other rim of the bowl — they retreated shortly after the new high was made. As soon as the retreat found the EUR/USD falling below the low of the December 2006 session that had featured the initial high, traders and speculators were all clear to bet against the EUR/USD moving higher in the near term.

The bearishness of this 2B top, as many are, is supported by the negative divergence in the MACD histogram. The MACD histogram features lower peaks in February and March (Figure 2), just as prices are making higher peaks. This, too, is a classic signal of a market that will have difficulty moving higher and that might be ripe for a reversal or correction to the downside.

How much time should traders and speculators give the 2B top to play out profitably? Looking back to Figure 1, it appears as if the two peaks are separated by approximately 14 weeks. Based on the methodology presented in the Working-Money.com article I mentioned, this means that traders should be looking to preserve gains or at least limit losses by the seventh week after the pattern is complete. As far as targets go, the low between the February and March peaks, a low of about 1.3072 is one reasonable target, and would represent a 61.8% retracement of the EUR/USD advance from the early January 2007 low. ■

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REVERSAL

Bear Hunting In The Canadian Currency

by David Penn

Looking for a long-term bear market that's showing signs of reversal? Try the USD/CAD currency pair.

Tradable: USD/CAD

One of the most interesting — or haunting — things I've ever read about the markets came from international money manager Marc Faber. Faber observed that if you made a single investment decision at the beginning of each of the past few decades — and maintained that investment throughout the decade — you could have made a tremendous amount of money on a number of markets that had been virtually left for dead.

In summary, Faber observed that if you had bought gold in 1970, held it for 10 years, then sold it and bought Japanese stocks, held them for 10 years, sold them, then bought American stocks (especially tech stocks), held them for 10 years and then sold them, you would have pretty much taken

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FIGURE 1: US DOLLAR/CANADIAN DOLLAR, MONTHLY. The bear market in the USD/CAD has seen the greenback lose more than 30% against the "loonie," as the Canadian dollar is colloquially called, since early 2002. The series of shallower troughs in the weekly MACD histogram beginning in 2004 suggests that momentum to the downside is gradually waning as the Canadian dollar moves closer toward par with the US dollar.

FIGURE 2: US DOLLAR/CANADIAN DOLLAR, DAILY. Positive divergences build as the USD/CAD moves lower, correcting the bounce from the second half of 2006 (see Figure 1).

For the bottom-feeders, the best reason for bullishness lies in the positive divergences that have been developing between the price of USD/CAD and the MACD histogram.

maximum advantage of some of the strongest investment trends of the past 30-plus years with relatively little effort (aside, perhaps, for the exceptional prescience such investment might have required).

This sort of thing occasionally has me looking at long-term, multiyear charts for the kind of jumbotron bear markets that can create real bargains for investors willing to forage through the rubble. With my recent attention to the foreign exchange markets, one such supersized bear market appears to be the market for buying US dollars and selling Canadian dollars, as expressed by the charts of the USD/CAD currency pair.

It would be hard to equivocate the bearishness of the USD/CAD pair. Although the USD/CAD ended 2006 roughly flat to up slightly, it is not at all unfair to suggest that, on balance, the greenback has been falling against the loonie for five years running (Figure 1). The question is whether the current bounce, which began with the summer of 2006 lows, represents the beginning of the end of that five-year bear market, or if it is merely a pause in the midst of a bear market that has yet to run its course.

For the bottom-feeders, the best reason for bullishness lies in the positive divergences that have been developing between the price of USD/CAD and the moving average convergence/divergence (MACD) histogram (Figure 2). These positive divergences began in late 2004 (that is, the first, positive MACD histogram divergence in the monthly chart was between the trough in 2003 and the trough in late 2004) and are clear in both weekly and monthly chart views of USD/CAD.

Along those lines, the MACD histogram provides another potential clue. The size of the MACD histogram peak during the bounce that began in the second half of 2006 was larger — and by a wide margin — than any of the peaks that accompanied previous bounces during the 2002–06 decline. As I wrote for Working Money years ago, the MACD histogram peaks of this sort can often be predictive of a market bottom and reversal to the upside (see my "Post-Breakdown MACDH Extremes," May 19, 2004). ■

SUGGESTED READING

Penn, David [2004]. "Post-Breakdown MACDH Extremes," *Traders.com Advantage*, May 19.

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2B Test Of Bottom In The US Dollar–Swiss Franc

by David Penn

As the US dollar continues its slow-motion, spontaneous combustion before our very eyes, an important test against the Swiss franc looms.

Tradable: USD/CHF

My last two Traders.com Advantage takes on the foreign exchange market examined the possibility of reversal in two major currency pairs: the EUR/USD and the USD/CAD ("A 2B Top In The Euro?" from March 27, 2007, and "Bear Hunting In The Canadian Currency" from April 16, 2007). The former case was an example of a 2B top at work and the latter looked to positive divergences as a signal that a reversal was possible.

Once again I am looking to the 2B test as the potential harbinger of a reversal, this time in the case of the bear market in the USD/CHF. The current leg down in this currency pair began in late January 2007 after the market topped out near 1.2575. This down leg hit a bottom in mid-March and then bounced over the balance of the month and into April. The market, as shown in Figure 1, topped out in the first half of April and began moving down again through mid-month, taking out the March low on an intraday basis.

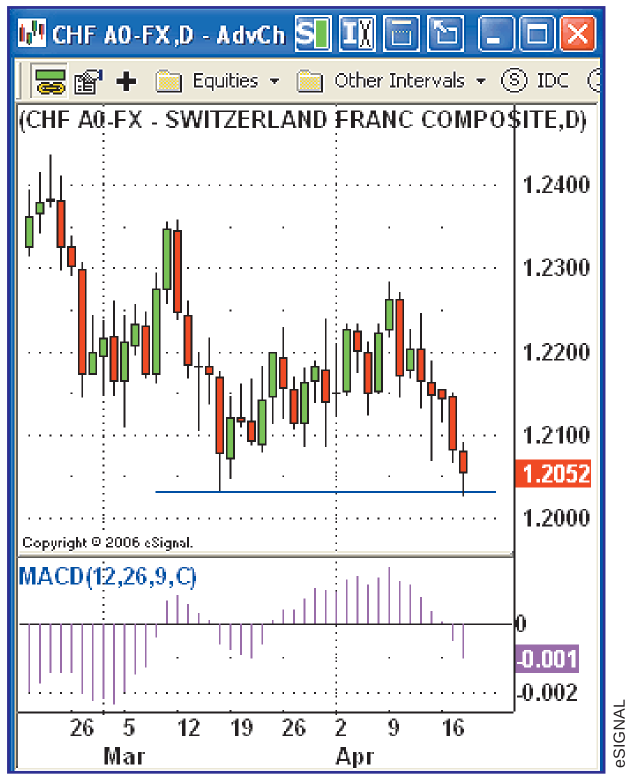

FIGURE 1: US DOLLAR/SWISS FRANC, DAILY. An April retest of the March 2007 lows provides an opportunity for the US dollar to gain on the Swiss franc if the USD/CHF failed to show significant follow-through to the downside. The USD/CHF would then need to rally above the high of the initial low — to approximately the 1.2175 level — for the USD/CHF to be considered having truly reversed.

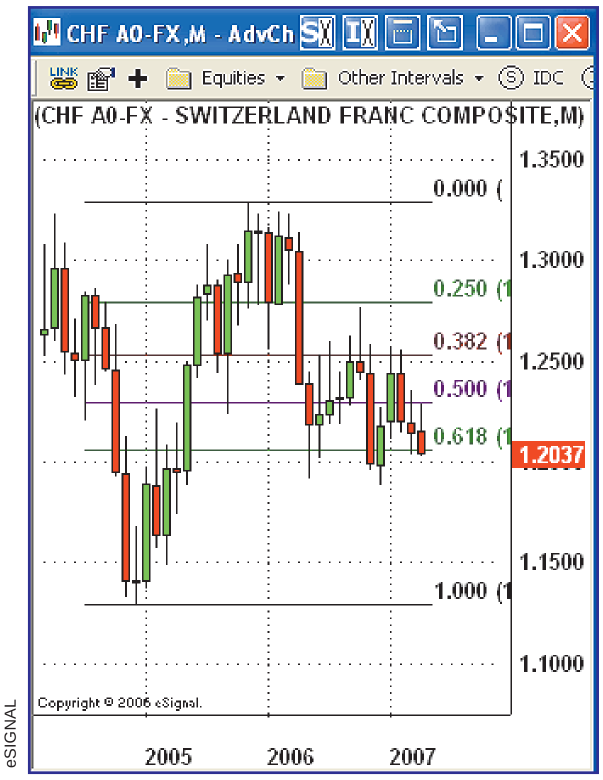

FIGURE 2: US DOLLAR/SWISS FRANC, MONTHLY. It take a monthly view on charts this small, but with this view it is clear to see that the 61.8% retracement level has provided support for the falling USD/CHF on at least two separate occasions during the lows of 2006.

This most recent move down finds the USD/CHF testing the March lows for support. While this is not make-or-break territory for the USD/CHF — the December 2006 lows near 1.1900 wait to provide another opportunity for support for the falling USD/CHF — there is precious little by way of support between the USD/CHF's current level and those December 2006 lows. This suggests that should support at the March 2006 lows not hold, a reunion with the December lows nearly 140 pips further down is possible.

Figure 2, a longer-term monthly look at the USD/CHF, shows both the 61.8% Fibonacci retracement level that has on two previous occasions provided support in the wake of the top in late 2005. This chart also reveals the downside available to USD/CHF should this retracement level — and the 2B test of bottom seen in the shorter-term chart from Figure 1 — do not hold.

What would be required for a successful 2B test of bottom? Not only would the USD/CHF need to show little or no follow-through to the downside beyond current levels (which approximate the March 2006 lows), but also the USD/CHF would need to bounce up above the high of the session that marked the initial March 2006 lows. That level is approximately 1.2175, some 150-odd points higher. Short of accomplishing this feat, the trend in the USD/CHF remains downward and a bet against the pair still more reasonable at this point than a wager in favor. ■

Suggested Reading

Penn, David [2007]. "A 2B Top In The Euro?", *Traders.com Advantage*, March 27.

_____ [2007]. "Bear Hunting In The Canadian Currency" *Traders.com Advantage*, April 16.

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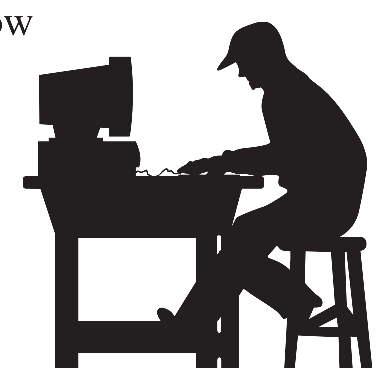

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CHART PATTERNS

REVERSAL

Building A Better Bottom

by David Penn

In the days after the market meltdown, the Standard & Poor's 500 continues to forge a bottom from oversold conditions and positive divergences.

Tradable: $SPX

There are two contradictory impulses in the wake of a market collapse like the one investors and speculators experienced at the end of February. The first is the "buy the panic" impulse, largely borne out of the experience of severe corrections in bull markets like those in 1987 and 1998. The second is the "wait until the smoke clears" impulse. This impulse is generally the product of a bear market psychology in which sharp declines tend to lead only to further sharp declines.

I'd argue that the 2002 correction — shortly on the heels of the 2001 correction — was accompanied by this latter impulse. In hindsight, it couldn't have been more clear that autumn 2002 was a buying opportunity the likes of which hadn't been seen since the mid-1990s. But at the time, those standing on their desks screaming "BUY!" were relatively short in number (Jim Cramer, in his excellent dispatch, "The Exquisite Moment Is Upon Us," from March 17, 2003, was one particularly memorable exception):

> We now are close enough to the war to act. I think the exquisite moment is upon us. The idea behind the exquisite moment is the same as it was in 1991: Wait until 24 hours before the war begins, and buy the weakness of the nervous longs who can't take the pain."

Are you a nervous long? If so, how are you taking the pain of the February meltdown?

I once read a poem by Maxine Kumin titled "Our Ground Time Here Will Be Brief." While I think Kumin had more metaphysical notions in mind (she said the title came to her while waiting on the runway for her plane to take off), that phrase comes to mind as I watch the S&P 500 attempt to build a bottom between 1390 and 1370. The tools of this bottom-building are standard issue: indicator divergences and oversold readings, but the commonness of the equipment is no argument against their utility. The divergences in the moving average convergence/divergence (MACD) histogram and the stochastic are very clear-cut and the signal they are sending — that the time for shorting is over and the time for buying has drawn near — is no less apparent. See Figure 1.

What sort of upside is being suggested by the hourly charts of the S&P 500? There are two ways to gauge potential bounces. The first, most obvious, way is to look for a possible swing rule application based on the location of the nearest resistance and the current low. In this case, we find the nearest resistance level at approximately 1415 and the correction low at about 1375. Adding this difference to the value at the resistance level suggests the potential for a bounce to the 1455 level or almost a complete retracement of the correction.

What makes this interesting is that while there is a significant potential for resistance at the 1415 level, there is precious little resistance in the event that the S&P 500 can rally above that point (see Figure 2). In fact, I suspect there is a small battalion of bears waiting to attack any bulls that think they can drive the market through 1415. As such, any move beyond that level will likely need to attack 1415 more than once.

But should any of those attacks succeed, the subsequent move higher could be too swift for all but the most nimble of traders to exploit. ■

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FIGURE 1: STANDARD & POOR'S 500, HOURLY. Negative divergences in the moving average convergence/divergence (MACD) histogram and the stochastic suggest that the S&P 500 is running out of momentum to the downside in early March. The size of the MACD histogram spike on the bounce in recent days is another sign that a significant move back to the upside is increasingly likely in the near term.

FIGURE 2: STANDARD & POOR'S 500, HOURLY. Any bounce in the S&P 500 is likely to first meet resistance in the 1410 area, which coincides with the 38.2% Fibonacci retracement level. However, there is a dearth of resistance beyond that point, suggesting the potential for further retracement should the 38.2% barrier be breached.

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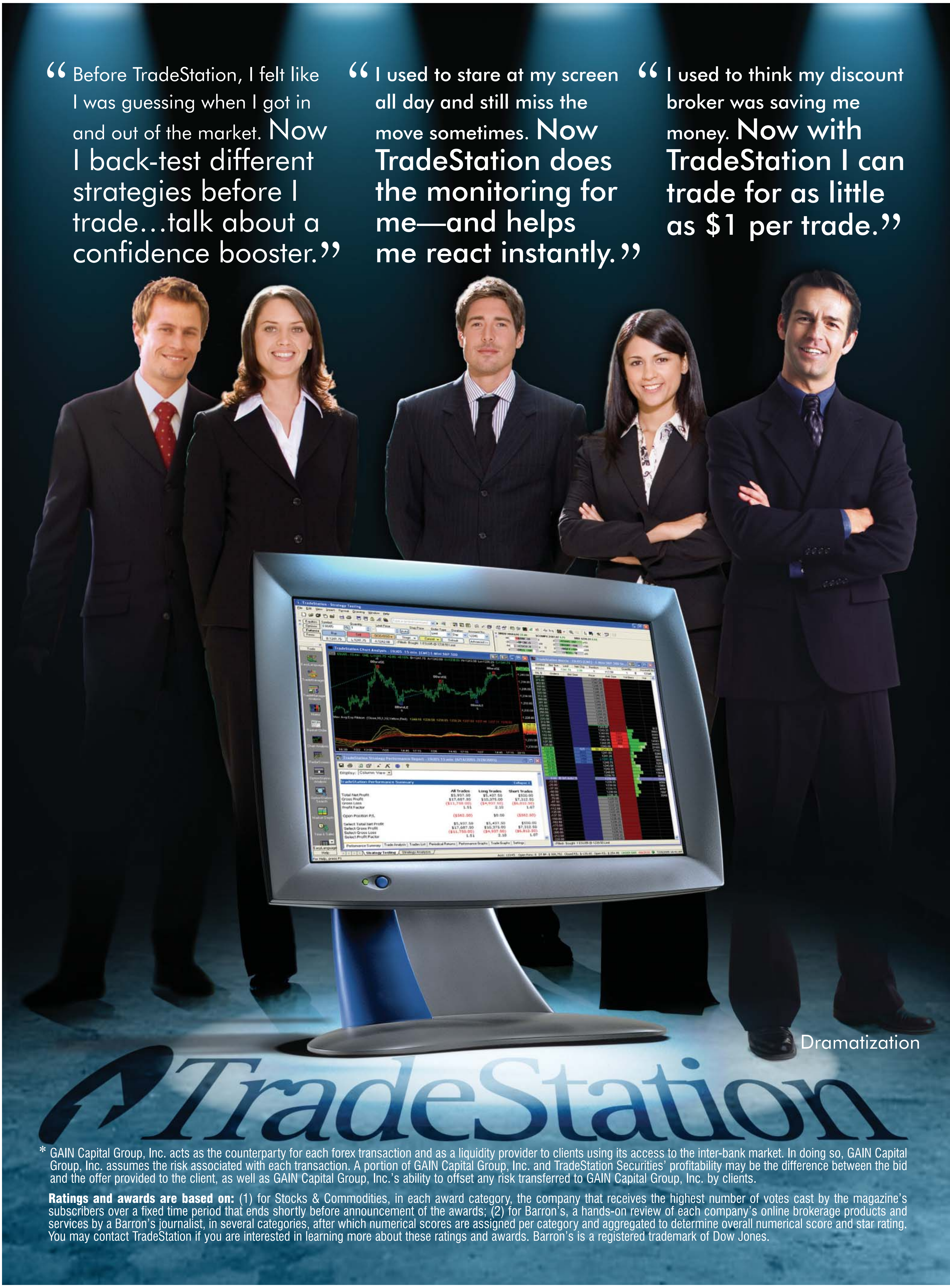
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REVERSAL

Short-Term 2B Bottom In The S&P 500

by David Penn

In another sign of waning momentum to the downside in the S&P 500, a 2B pattern appears.

Tradable: $SPX

Truth told, in spite of my suspicions that an important top would form at around the 1460 level (see my February 28th Working-Money.com article, "Fifth Of A Fifth," for more on that projection), I've been looking for signs of a bottom to the current correction in the Standard & Poor's 500 almost since the market began moving lower ("The S&P 500's Fibonacci Foraging For A Bottom" from February 27, "Betting On The Bounce" from March 1, and "Building A Better Bottom" from March 7).

So forgive me if I post another installment of "The Bottom Is Coming!" A number of commentators have pointed to the dramatic increase in pessimism among investors as the market made its very-long-overdue correction in the early spring of 2007. And that swift shift toward the "end is near" way of looking at the world was part of what made me so eager to find signs that this correction might not be quite all that it is cracked up to be.

This 2B bottom in the S&P 500 is perhaps another initiative in that effort. Two of the better ways of spotting bottoms, in my opinion, are positive divergences in indicators and oscillators like the moving average convergence/divergence (MACD) and MACD histogram and the stochastic on the one hand, and 2B tests of bottom on the other. At present, it appears as if the current correction in the S&P 500 has finally developed examples of both.

Figure 1 shows how the S&P 500 made a low in early March, bounced into resistance at the 1410 area, then moved lower to make a lower low in mid-March. However, there are two factors about this lower low that should alert traders to the potential for upside in the near term. The first is the long "shadow" or "tail" on the candlestick symbolizing the midmonth lower low. This means that the bears were completely thwarted in their effort to move the market lower during the session. The second factor follows from the first. Rather than moving lower in the wake of the lower low in mid-March, the S&P 500 moved higher — so much so that on an intraday basis, the session high from the previous low (early in the month) was bested.

That kind of move is usually enough to trigger a buy signal in the 2B top methodology (buy when the non follow-through from the lower low rallies high enough to take out the high of the previous low). And the context of the positive divergences in two key indicators — the MACD histogram and the stochastic — provides about as much market-moving-higher insurance as a trader can expect (see Figure 2). If nothing else, a trader could use the low of the lower low in mid-March as a mental stop, abandoning the trade if the market reversed its bounce, began to move lower, and eventually moving to make an even lower low later in the month.

What sort of upside might the bounce bring? There is significant moving average resistance at the 1405–1410 level — resistance that blocked the bounce in the S&P 500 when it was encountered in the first half of the month. And it should be expected that the next time the S&P 500 encounters this level there will be some measure of difficulty once again. That said, there is a swing rule projection based on the two troughs in early and in mid-March that suggests the possibility of a move to the 1440–1450 area. This is based on the midmonth lower low near 1360 and the intratrough high at about 1410. ■

FIGURE 1: STANDARD & POOR'S 500, DAILY. The fact that the lower low in March occurred in a session during which buyers were able to close the market far from the lows adds to the likelihood that this 2B bottom will result in higher prices in the S&P 500 in the near term.

SUGGESTED READING

Penn, David [2007]. "The S&P 500's Fibonacci Foraging For A Bottom," *Traders.com Advantage*, February 27.

______ [2007]. "Betting On The Bounce," *Traders.com Advantage*, March 1.

______ [2007]. "Building A Better Bottom," *Traders.com Advantage*, March 7.

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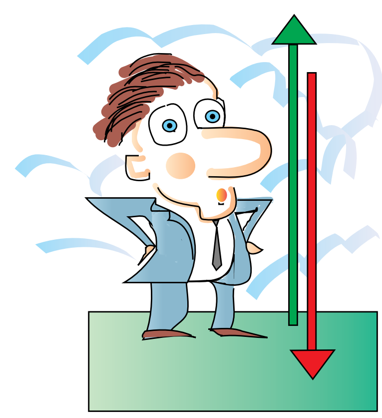

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FIGURE 2: STANDARD & POOR'S 500, DAILY. Positive divergences in both the MACD histogram and the stochastic both help support the case for a bounce in the wake of this 2Bbottom.

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Fed Up?

by Austin Passamonte

Is there a trend bias in weekly chart views?

Tradables: S&P 500, Russell 2000

Since the broad market plunge on February 27, traders and investors have been seeking bottoms at every turn. Have the major indexes printed recent lows that will last, or is this period just a pause that refreshes the sellers?

For the past two weeks, measuring price action from recent highs through subsequent lows sees each lift stall out at the 38% retracement level. That magnet is currently 1414 in the ES contract, with 1425 and then 1438 the next widely watched lines of demarcation (Figure 1). These common retracement levels are followed by literally thousands of traders, with prestaged stop orders to buy or sell clustered around each level right now.

Russell 2000 levels at 801 and 810 areas will see sellers pressing first tests of each mark if/when price action gets there before dropping further first. We can see where the 794 zone has topped out recent upside attempts prior to now. See Figure 2.

Should price action close above the 62% values on a weekly basis, most sellers would cover as buyers step in to wrest control. If the recent trend lower still has plenty of strength, expect 50% retracement to hold high water. It's possible price action could chop sideways inside these grid values, but plenty of market catalysts are straight ahead this week to shake, shock, and awe stock index markets.

Retracement grids are one of the most widely used measures of pending market action. Keeping one eye on the weekly chart and where price action is on the scale tells a lot about current and pending trend action ahead. ■

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FIGURE 1: S&P 500 FUTURES, WEEKLY. Common retracement levels are followed by literally thousands of traders, with prestaged stop orders to buy or sell clustered around each level.

FIGURE 2: RUSSELL 2000 FUTURES, WEEKLY. The Russell 2000 levels will see sellers pressing first tests of each mark if and when price action gets there before dropping further first.

Testing The Breakout

by David Penn

The current correction in the Dow Jones Industrial Average so far reflects little more than testing former resistance for present support.

Tradable: $INDU

In many ways, the mid-March 2007 bottom in the Dow Jones Industrial Average (DJIA) was textbook. Not only had pessimism ramped swiftly in the wake of the market's five-session/540-point collapse at the end of February, but the lower low in mid-March was accompanied by both positive divergences and a 2B bottom setup. That 2B bottom setup (see my Traders.com Advantage article "Short-Term Bottom In The S&P 500" from March 16, 2007) was filled three days after the lower low in mid-March at the 12190 level. Three days later, the Dow industrials were closing above 12460 (see Figure 1).

Since that close, the industrials have begun to consolidate. The range of this consolidation, so far, is roughly 12510 to 12360 — with the latter level also representing the breakout level, which is equivalent to the intervening high between the two troughs in March. There is a significant amount of support at the 12360 level, it seems. This support comes from both the 20-day exponential moving average (EMA) — which previously acted as resistance — as well as at the level of the intervening high. As such, there is a likelihood that, rather than correct sharply lower, the industrials will move sideways along the 12360 support level before vaulting higher again.

Applying the swing rule to the March bottom pattern — a sort of double bottom — suggests that when the industrials again begin moving higher, there is a good chance the current, year-to-date highs will be tested, if not exceeded. With a formation size of about 410 and a breakout level of 12360, the DJIA should be able to rally to at least the 12,770 level, which would make for an interesting challenge to the highs of late February, days before the industrials' minicrash.

Figure 2 shows the DJIA on an hourly basis. We can see how the bounce is, at root, a simple uptrend that has over the past several sessions broken down below the main trendline that has guided the advance. This allows us to use

other trend-indicating tools to understand the progress of the rally and the prospects for any pullbacks.

The 1-2-3 trend reversal test is just one of those trend-indicating tools. Essentially, the 1-2-3 test breaks the trend reversal into three stages. The first stage is the initial trendline break. The second stage represents the attempt by the market to reassert the trend that existed before the trendline break. The third stage occurs when the market fails to reassert the previous

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trend and move beyond the extreme point established in the first stage, the trendline break.

So far, the chart of the hourly industrials in Figure 2 shows clearly that the first stage — the trendline break — has taken place. At a minimum, the second stage has begun. It is hard to tell if the second stage is complete; the bounce and attempt to reassert the uptrend appears to have fallen quite short. In addition, the market has yet to move beyond the low of the initial trendline break. Right now, this is the area worth watching. Given the support nearby below, traders should be on guard for the possibility of a positive divergence — or even another, shorter-term, 2B test of bottom — signaling the end of this short-term downturn as well. ■

SUGGESTED READING

Penn, David [2007]. "Short-Term Bottom In The S&P 500," *Traders.com Advantage*, March 16.

FIGURE 1: DJIA, DAILY. The industrials broke out from their bottom pattern in late March and are spending the balance of the month testing that level for support. Note that this support comes in both the form of the 20-day exponential moving average (EMA) as well as the intervening high between the two lows in early March and mid-March. The 20-day EMA had served as resistance during the industrials' initial attempt to move higher.

FIGURE 2: DJIA, HOURLY. The rally in the industrials makes a short-term top and breakdown beneath its key trendline, setting up a 1-2-3 trend reversal test. In spite of large volume on the sell days since the trendline break, the industrials have yet to take out key support between 12,350 and 12,300.

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WEDGE FORMATIONS

A Rising Wedge For The SOX

by Arthur Hill

The Semiconductor Index bounced with the rest of the market over the past few weeks, but the move looks like a bearish wedge.

Tradable: $SOX

Before looking at this wedge, it often helps to look at the long-term picture first. The Semiconductor Index ($SOX) advanced from July to November 2006 and then consolidated the last few months. The index reached 473 in mid-September 2006 and closed around 478 on March 26, 2007. That is a long time to be moving sideways, and it represents an extended consolidation or stalemate between bulls and bears.

The pattern at work on the weekly chart looks like a flat triangle (Figure 1). The trading range was narrow in the last quarter of 2006 and narrowed a little more in the first quarter of 2007. The next long-term signal is dependent on the resolution of this pattern. A break above 495 would be bullish and a break below 450 would be bearish. Until there is a breakout, traders must look to the swings within this triangle for signals.

I am turning to the daily chart (Figure 2) for swing signals within the triangle, and these signals have not been the easiest to catch. The current swing is up, but the index got hit hard at the end of February. This sharp decline was not quite enough to break the mid-February low, and the upswing held. The index rebounded in March, and this rebound looks like a rising wedge. The bulls have the edge as long as the wedge rises, but this pattern can be bearish and traders should watch price action closely over the next few days.

I am cueing off wedge supports and the stochastic oscillator for a potentially bearish signal. A break below the lower wedge trendline and support at 466 would break the rise of this wedge. This would signal a continuation of the prior decline and target a move below the January low. The stochastic oscillator is also moving higher, and I would wait for it to turn down before jumping on the bearish side. The indicator just moved above 50, and that is the threshold to watch. A move back below 50 would turn the stochastic oscillator down and this would confirm a wedge breakdown on the price chart. ■

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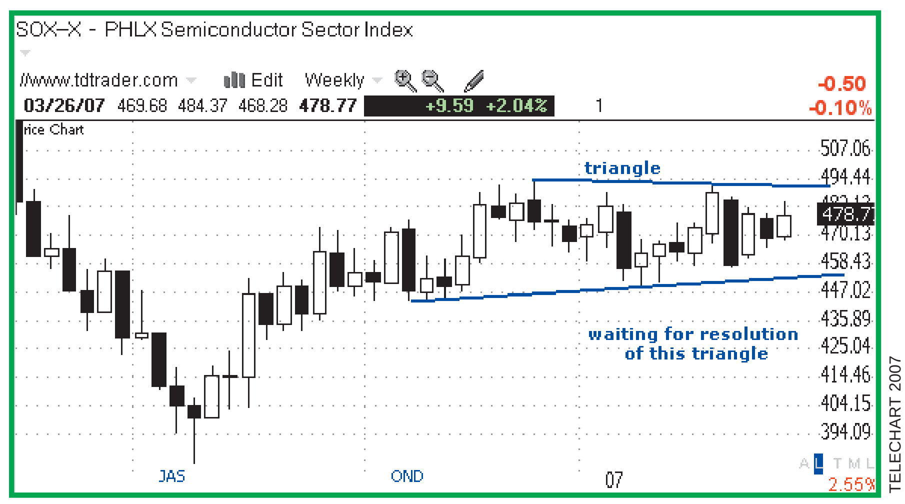

FIGURE 1: $SOX, WEEKLY. The next long-term signal is dependent on the resolution of the pattern seen here.

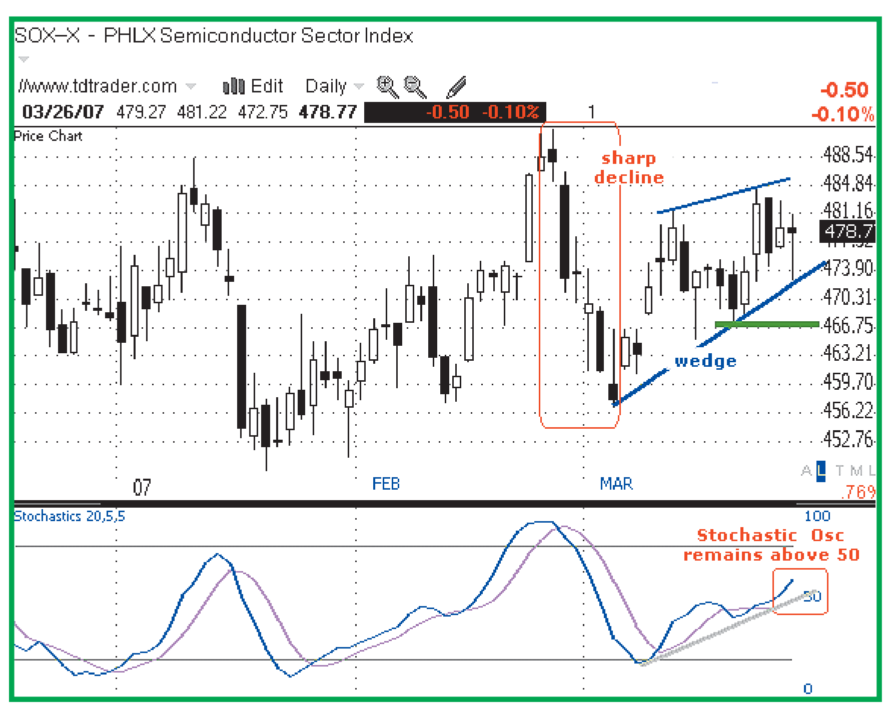

FIGURE 2: $SOX, DAILY. The sharp decline seen here was not quite enough to break the mid-February low, and the upswing held.

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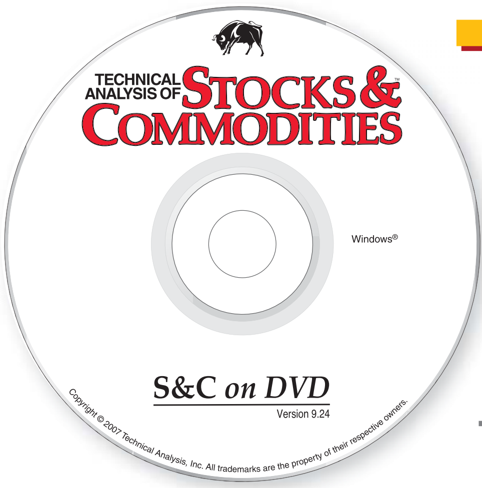

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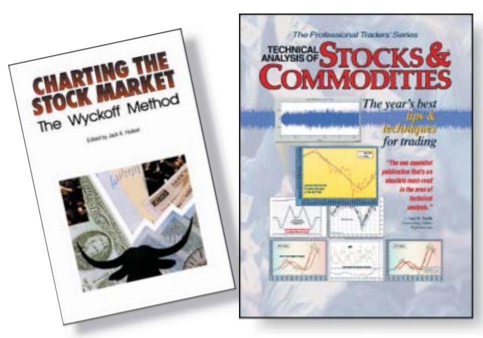

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The Three 2Bs

by David Penn

For picking tops and bottoms, always bet on 2B.

Tradable: ESM7

A few days ago I started working on an article about a 2B bottom I spotted in the 15-minute chart of the June emini Standard & Poor's 500 futures contract (Figure 1). As I've written, in spite of suggesting that an important top would occur in the 1460 area of the index ("Fifth Of A Fifth," Working Money, February 28, 2007), I've been a doubter of the correction virtually since the beginning. This has made me particularly aggressive in looking for patterns indicative of a bottom to the general correction. But it has also made me more than a little impatient with the shorter, smaller correction that has occurred since the market bounced. With regard to the 2B bottom in the 15-minute June emini, I wrote:

> ... [T]he initial low took place during the 15-minute session that began at about 9:45 am EST. The high of that session was at 1430.25. When the bounce from the lower low a day later comes, 1430.25 is the buy stop, which was filled shortly after 2:00 pm EST.

But a funny thing happened on the way to the breakout. While the June emini (ESM7) moved back to the top of its range and briefly exceeded it, the contract was unable to follow through on the second, higher high. In fact, the ESM7 actually ended up lower on a closing, 15-minute basis, in spite of the brief higher high.

I had speculated that, given my time-stop method with the 2B bottom, profits from any trade on this play would need to be taken — or protected — by late morning on Friday (see my "Breakouts, Pullbacks, And Gaming The 2B," Working Money, January 24, 2007) (Figure 2). Unfortunately, the market didn't make it that far. By 9:00 am the June emini was struggling to close above the Thursday high, and shortly after 10:00 am, the ESM7 was actually confirming a 2B top, threatening to send the market back from whence it came.

The June emini S&P 500 might have been headed lower, but it certainly wasn't staying there. Peaking Friday morning and plunging toward midday, the ESM7 actually formed a third 2B, this time another 2B bottom, which suggested that still yet another reversal was in the cards. Key also to the reversal was the exceptionally long lower shadow as the June emini was making its low on Friday. This shows an exhaustive and ultimately failed attempt on the part of the sellers to close the market near the low of the range. The overwhelming volume underscores the exhaustive nature of the effort — and the likelihood that buyers would be able to step in and push the market higher.

This move higher began immediately. Even though the market appeared to merely meander on Monday, a higher low and a subsequent higher high were both established during that session.

Victor Sperandeo, from whom I learned the 2B reversal method, wrote: "Even if you get whipped out two, three, or even four consecutive times, the one you catch will end up making you a bundle." In fact, in a section on chart analysis in his book *Principles Of Professional Speculation*, Sperandeo goes so far as to say: "I recommend you double your position on the second 2B buy after a whip. Make it pay double!" Whether or not you share Sperandeo's confidence in trading 2B tops and bottoms, it is worth taking away that not only do 2B tops often follow 2B bottoms — marking excellent entry and exit points — but also that trades should be ready to give 2B bottoms a second (or even third, apparently) chance. As long as risk can be defined by the second higher high or lower low, the 2B remains among the best ways to trade tops and bottoms in markets on a variety of time frames. ■

FIGURE 1: EMINI STANDARD & POOR'S 500, JUNE FUTURES, 15-MINUTE. The highlighted area shows the initial 2B bottom. The rally from that 2B bottom rallied as high as the peak between the two lows on Wednesday and Thursday but failed to make a higher high on a closing basis. That failure set up a tradable 2B top that sent the ESM7 back to the bottom of the range by mid-session on Friday.

FIGURE 2: EMINI STANDARD & POOR'S 500, JUNE FUTURES, 15-MINUTE. Somewhat irregular, the lower low on Friday morning nevertheless shows the sort of characteristic lack of follow-through to the downside after making a lower low that marks a 2B bottom. Note also the surge in volume on Friday's low, suggesting a selling climax and the opportunity for a bounce.

Suggested Reading

Penn, David [2007]. "Breakouts, Pullbacks, And Gaming The 2B," *WorkingMoney.com*, January 24.

_____ [2007]. "Fifth Of A Fifth," *WorkingMoney.com*, February 28.

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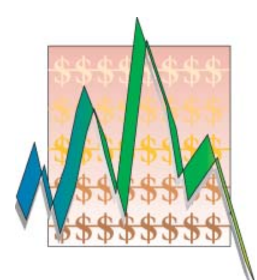

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SECTORS

ELLIOTT WAVE

The Real Estate Market In Canada And In The US

by Jacob Singer, PhC

The real estate market may be in trouble in the United States, with house prices dropping and mortgage companies that gave risky loans facing serious problems, but in Canada, it is still up, up, and away.

Tradable: RTRE-T

The press is full of it. Ex-Fed head Alan Greenspan cannot stop talking about it, and the markets have fallen because of it. Lenders bought into the myth that US housing prices couldn't drop, and buyers bought and bought, lured by subprime lenders who targeted home buyers with a poor credit rating and high debt.

"Wall Street failed to understand that poorly underwritten mortgages would make the market more volatile," said Ms. Wachter, a lecturer of real estate finance at the Wharton School of the University of Pennsylvania.

But what about the Canadian real estate market? Prices in Canada have risen in the same spiral that US prices rose, but where buyers in the US were coaxed into buying by the wild, wild West of the mortgage world, in Canada, mortgage companies remained cautious and stuck to their conservative rules. House prices have risen astronomically, in many instances doubling in two to three years, but mortgage borrowers have not overextended themselves and fallen into financial difficulties. Many buyers who bought to flip may have difficulty in selling, but probably not for long. If interest rates fall as the market falls this could be their savior. This is shown in Figure 1, a weekly chart of the Canadian REIT Index.

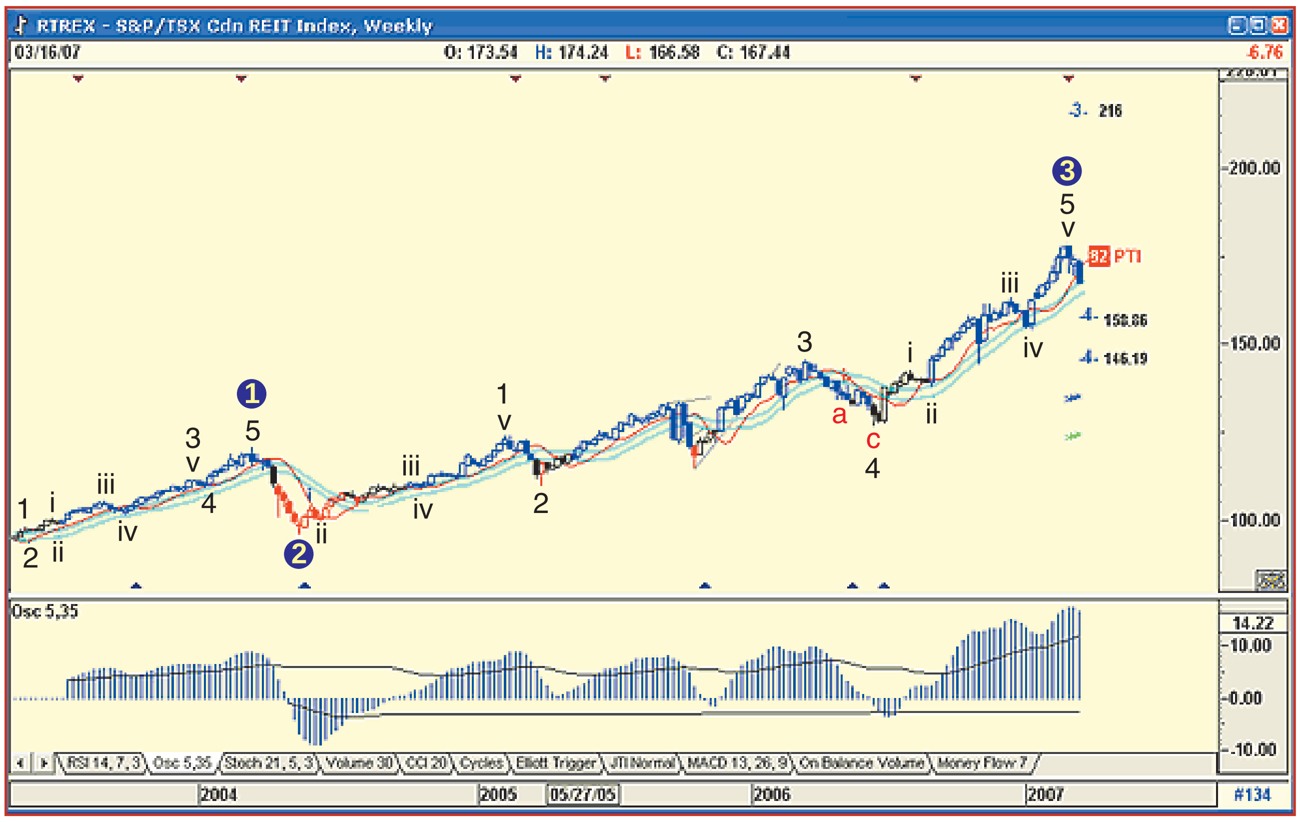

FIGURE 1: CANADIAN REAL ESTATE INDEX, WEEKLY. The wave count shows that the index is a fourth-wave correction.

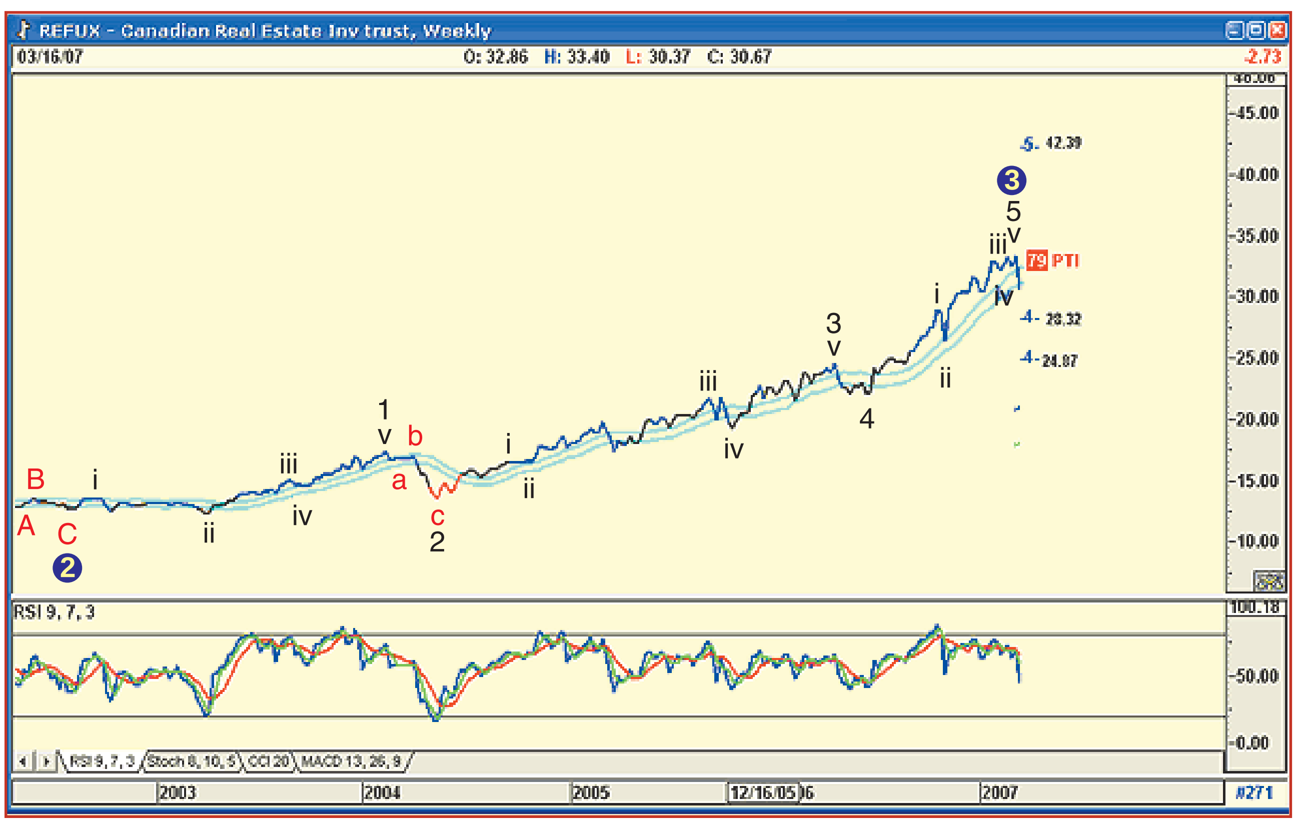

FIGURE 2: CANADIAN REAL ESTATE INVESTMENT TRUST, WEEKLY. The market may decline alongside the US market, but not to the same extent.

Figure 1 is a weekly Elliott wave chart of the S&P/TSX Canadian REIT index. The wave count shows that the index is in a fourth-wave correction, targeting either 158.86 or 146.19 with a probability factor (PTI) of 82%. The chart is suggesting that the wave count could still be in a third-wave rise, and that the target of 216 could be a third-wave top and not a fifth-wave top. This will only be finalized when the fourth-wave bottom is set.

Based on this information, the Canadian real estate market will likely decline alongside the US market as shown by the index, but not to the same extent. The index appears to be in a short-term correction with a very bullish long-term future. Based on the analysis, I suggest buying the index as and when the fourth wave is complete. Better yet, buy the Canadian real estate investment trust (UN -T) as an alternative as it is falling alongside the REIT index shown.

The real estate investment trust is not bound by the recent "Tax on Trusts" announced by the Canadian Minister of Finance; it is falling simply in line with general market sentiment. Figure 2 shows that it is also tracing a fourth-wave retracement, with a 79% probability and a fifth-wave target of Canadian $42.39. The REIT is paying a 3.91% yield at the moment, which will rise as prices drop.

Definitely a good investment as the price reaches and confirms the low of the fourth wave. The falling RSI will confirm a buy signal as it reaches oversold levels. ■

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Buy The Biotech Hype?

by David Penn

Inundated with calls to invest in biotech stocks? There are a few technical reasons why waiting shouldn't be the hardest part.

Tradable: BBH

Biotechnology has been a sector in which a few intrepid traders have targeted as one where more than a few rewards can be found. As an example, this week's top story in *BusinessWeek* is headlined, "More Biotech Bets For The Fearless." Attention should be directed not so much to the "fearless" component of that headline, which only underscores the obviousness of risk when investing in oft-richly valued biotech stocks. Instead, it was the "more" that caught my eye — "more" as in, "'Fearless' or not, we're going to give you more 'bets' to consider."

I last wrote about biotechnology stocks back in the summer of 2006 for Working-Money.com ("Betting On Biotech," June 13, 2006). At the time, I wanted to focus on two things in biotechnology stocks that I thought would be helpful for traders and speculators. The first was the technical condition of the BBH, or biotechnology HOLDRS (Figure 1). The second was the seasonality of biotechnology stocks. The technical condition was one in which the group looked to be making at least a short-term bottom after peaking in the autumn of 2005. The seasonality — per the Hirsches and their *Stock Traders Almanac* — suggested that biotech stocks have a tendency to outperform during the period of July through March.

This approach would have worked well enough for the cohort of biotech stocks collected in the BBH up until late January, when a clear negative divergence in the MACD histogram warned investors that the upside in this group was limited. Shortly thereafter, the BBH slipped from just under 200 to about 175 by mid-March.

The question is whether the lows of the summer of 2006 will continue to hold, providing support in the 170 area. The fact that the negative divergence that anticipated the 2007 correction appeared on the weekly chart (between the October 2005 and January 2006 peaks) suggests that the BBH might have more correction in store than the current dip has exacted (Figure 2). In fact, it would be too much to say that the BBH is approaching a make-or-break point in the spring of 2007.

If the lows from the summer of 2006 provide support, then the case for buying biotechs would be a strong one indeed. However, if those lows do not provide support, then a deeper correction — perhaps one that saw the BBH make a 61.8% Fibonacci retracement of the advance from 2004 to late 2005 rather than the more mild 50% retracement has completed thus far — is something that biotech investors and onlookers should expect. ■

FIGURE 1: BIOTECH HOLDRS TRUST, WEEKLY. A negative divergence in the MACD histogram between BBH's peaks in October 2006 and January 2007 anticipated the sharp correction in the first quarter of 2007.

SUGGESTED READING

Hirsch, Yale; Jeffrey Hirsch; and the Hirsch Organization [2006]. *Stock Trader's Almanac 2007*, John Wiley & Sons.

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FIGURE 2: BIOTECH HOLDRS TRUST, WEEKLY. The correction in BBH had retraced 50% of the bull market before bouncing significantly. Failure to find support as the market moves to retest the 50% retracement level would set up a lower test, most likely at the 61.8% Fibonacci retracement level.

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Tech Stocks And A Distribution Phase

by Paolo Pezzutti

The money flow and the on-balance volume indicate that investors are cautious about investing in tech stocks after the selloff at the end of February.

Tradable: ES NQ

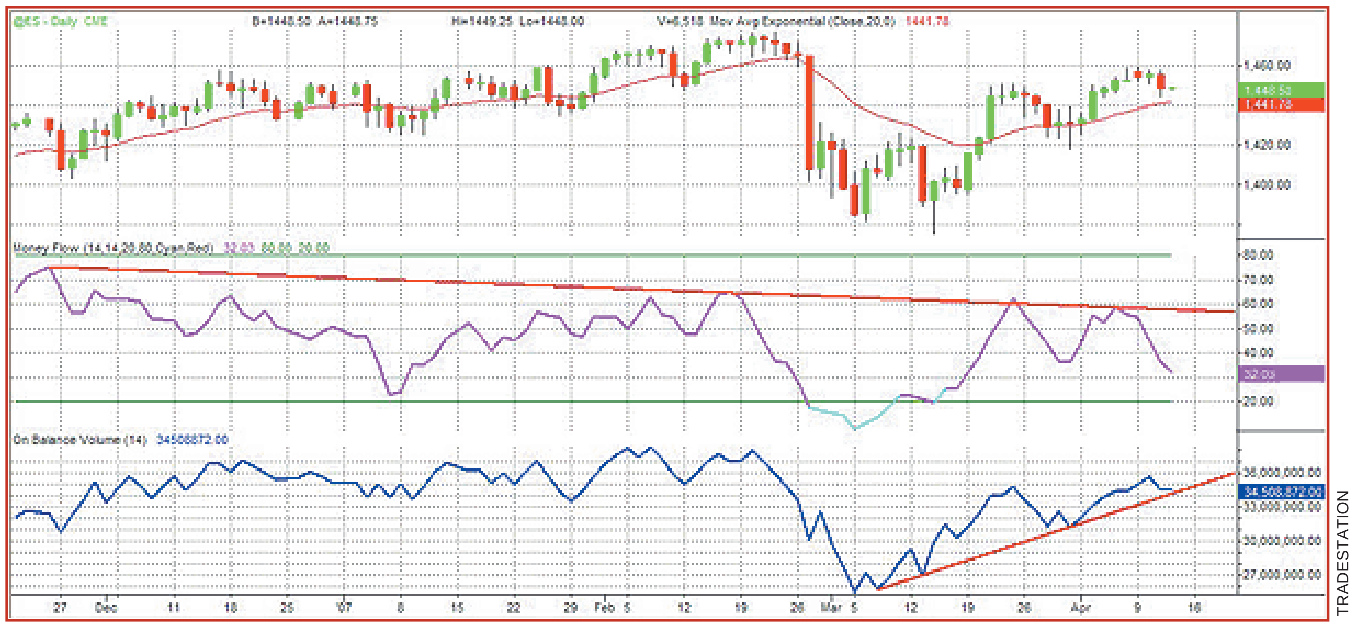

FIGURE 1: EMINI S&P, DAILY. The money flow displays a negative divergence, which is not signaled by the OBV.

FIGURE 2: EMINI NASDAQ, DAILY. Both indicators show negative divergences. Investors have been more prudent after the end of February selloff.

After the March selloff following the one-day market shakeup initiated by the Chinese market, I was expecting a continuation to the downside. Clearly, this has not occurred so far, as markets have recovered most of the losses.

From the fundamentals perspective, the impact of the housing crisis on the US economy is not yet clear. Capital spending is getting lower, and with oil prices still high, the effect on the economy may be worse than expected. The US situation, however, is not having that much of a negative impact on the global economy, which continues to grow at a fast pace. How a trader should position him- or herself with respect to interest rates between the need to control inflation and a slowing economy is difficult to say, and a weak US dollar can generate inflation. A process has begun that will project new countries and areas as important actors on the global scene. The western countries will find benefits as new markets for consumers and infrastructure develop.

However, current imbalances cannot find smooth solutions. Adjustments are usually fast and painful. We saw in May 2006 last year the first signs of what could happen, then again last month in March 2007.

Currently, buying the selloff has provided good returns in accordance with statistics of similar past events, but emerging markets represent the weak ring of the chain. They have overextended their gains; they are not mature and are therefore speculative. A change of risk assessment about these markets might generate high volatility.

Technically, after the selloff, we have seen a recovery characterized by low volatility. Small daily ranges on up days, although an eight-day consecutive streak has been printed, indicate that the public is not putting fresh money into the market. Nonetheless, prices have gone up very close to the top. Could this be a distribution phase? Actually, it seems that the market does not have great potential to the upside.

In Figure 1, you can see the emini S&P daily chart. I used the money flow indicator (pink) to assess the possibility of an ongoing distribution phase. The money flow is built around the "average price," which is calculated using the average of the open, close, high, and low of a bar. Positive money flow occurs when the current bar's average price exceeds the previous bar's average price. It is calculated by multiplying the current bar's volume and its average price. The positive money flows are then summed over a specified number of bars and divided by the sum of all the specified money flows.

The formula is:

Money flow =
100 * Sum of positive money flow / Sum of all money flow

In the same chart I have inserted also the on-balance volume (OBV) (blue in the figure). The OBV distinguishes between up volume and down volume. When prices close lower one day than they closed the day before, the volume is considered down volume and assigned a negative value. When prices close higher than they closed the day before, the volume is considered up volume and assigned a positive value. OBV is a running total of down volume and up volume.

In a healthy trend, the indicators track the price action. When a divergence between price action and the indicator occurs, it can be a signal that the market trend is about to change.

At the daily level the money flow displays a short-term divergence in coincidence with the last pivot high. The OBV moved comfortably along a rising trendline. Overall, the S&P is not highlighting significant elements to assess that a distribution phase is ongoing.

The situation is different in Figure 2, where you can see the emini NASDAQ. Here, both indicators show negative divergences developed during the last month. Investors after the selloff have been more prudent in putting their money into technology stocks.

The long-range candle to the downside printed on February 27 indicated that prices would continue to move to the downside. However, the retracement has been significant, displaying that this market uptrend is very resilient. That is why, in summary, I would not expect excessive weakness, but rather a sideways move to develop from here with volatility more to the downside and a retest of the lows in the near future. In fact, for the moment I see the markets trapped to the upside by weak fundamentals with some concerns from emerging markets, which could open a negative longer-term phase. ■

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The Sweet Suffering Of Sugar

by David Penn

Will sugar find a bottom in springtime?

Tradable: SB, SBK7

When I last wrote about sugar for Traders.com Advantage ("The Sugar Triangle," August 25, 2006), the commodity had broken down severely from a symmetrical triangle in May 2006. With sugar prices still in free fall, I wrote in August:

> ... As far as the minimum downside projection in sugar is concerned, mission accomplished. At this point, sugar has retraced just a bit more than 50% of its rally from the February 2004 lows. A likely finishing point might be a Fibonacci 61.8% retracement, which would take sugar closer to the 11-cent level, and potential support in the form of the November 2005 correction lows.

Referring back to the chart, we can see that this 11-cent level — and the 61.8% retracement level — proved relatively effective in providing support to the falling market.

Some of the sideways action in sugar futures late in 2006 and into 2007 may be attributed to a waning momentum to the downside. As Figure 1 shows, a significant amount of support begins to appear as sugar futures move down toward the 9–8 cent area. It should also be pointed out that sugar's bear market has lasted at least a year, which should be a long-enough period of time for a certain complacency (or despondency) to develop on the part of traders who've seen nothing but lower sugar prices over the past several months. So far, the correction in sugar (basis continuous futures) has retraced approximately 61.8% of the advance from the 2004 lows.

When you look more closely at the near-month sugar futures contracts such as the July contract, the prevailing bearishness surrounding sugar becomes all the more apparent. Figure 2 shows the long slow slide in sugar futures since late September, as the July contract spent several agonizing months sliding from 12 cents to 10. This slide is characterized also by the positive divergences in the moving average convergence/divergence (MACD) histogram, which suggest a slow-motion loss of momentum to the downside.

Beyond the divergences, which have been in effect since December 2006 and became more pronounced as the market moved lower in the first few months of 2007, it could be argued that a month-to-month 2B bottom was developing (February low versus March low). Even though the lower low on March 15 was exceeded the following day, March 16 did not show the sort of determination on the part of the sellers (the market closed above the open and fought off an intraday effort to move prices lower) that would readily qualify the session as having significant follow-through to the downside. In order for that 2B bottom to be realized, July sugar would have to bounce above the 10.4-cent level, which represents the high of the initial low (on February 7).

There are also some seasonal considerations that make a spring bottom a timely one for sugar traders. According to the *Commodity Trader's Almanac 2007*, edited by Scott Barrie, sugar typically gets hit in April due to the intricacies of the global harvesting schedule. Buying sugar in May after the "April breaks" and riding that position into June — especially when price appreciation in May is strong — is one of strategies that traders should keep in mind when trying to game the end of sugar's multimonth decline. ■

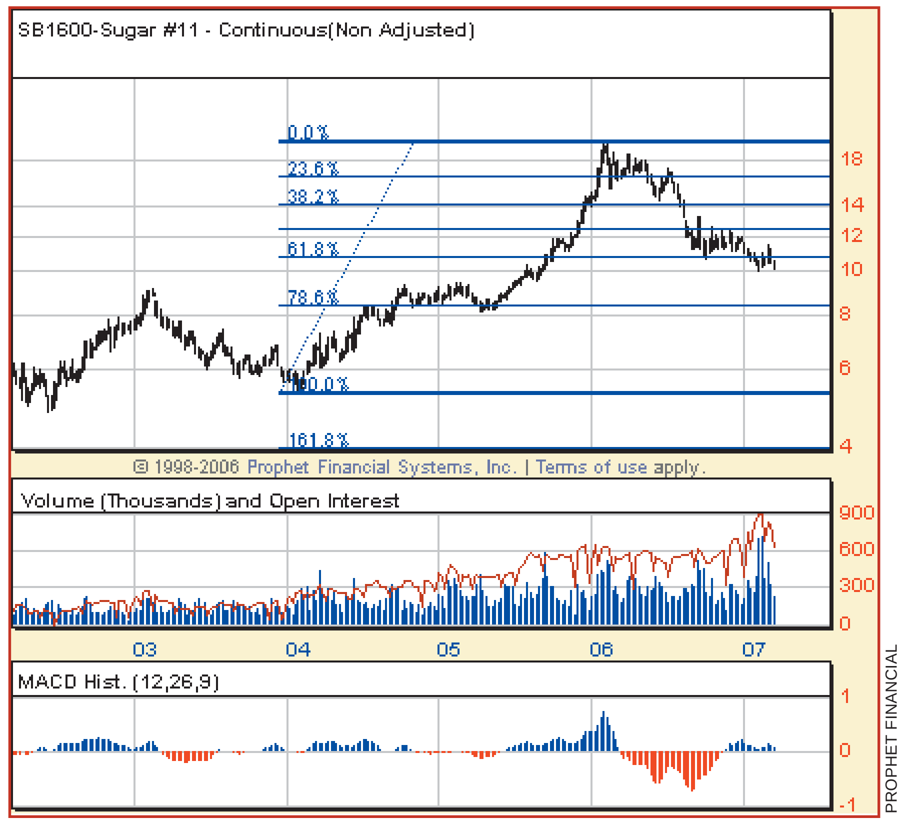

FIGURE 1: SUGAR, CONTINUOUS FUTURES, WEEKLY. The bear market in sugar began early in 2006 and continued throughout the year as the commodity fell more than 40%. Note how sugar has found support at and around the 61.8% retracement level.

FIGURE 2: SUGAR, JULY FUTURES, DAILY. Positive divergences in the MACD histogram have been growing since December, when the first higher low in the histogram against a lower low in price was recorded. The likelihood of sugar finding a bottom at these levels is greatly enhanced by the positive divergence.

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Penn, David [2006]. "The Sugar Triangle," Traders.com Advantage, August 25.

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Cocoa's Spring Offensive

by David Penn

After putting in a seasonal bottom in October, cocoa futures continue to ramp higher into March.

Tradable: CC, CCN7

While there are a number of swing trading approaches that work very well with commodities, it cannot be denied that an awareness of seasonal tendencies in the commodities can be a great benefit to anyone looking to trade them, short term or long. Seasonal tendencies can help put a bull market, bear market, or sideways consolidation into the sort of perspective that can make it easier for a trader to pursue or abandon a trade that might seem to have a poor risk/reward when viewed from the chart alone.

Here's an example. The moving average convergence/divergence (MACD) histogram can be used to set up swing trades by looking for instances when a market pulls back to support (that is, past price support, trendlines, moving averages) and the MACD histogram makes either a P-p-P or M-m-M pattern (see my Working Money articles, "Trading the Histogram," Parts I and II, for more on the MACDH). Looking back over the past six months in July cocoa, there were a number of opportunities to make this sort of trade. The most recent one occurred on March 8 after CCN7 had pulled back to the 50-day exponential moving average (EMA) and then bounced higher. With an entry at about 1825.50 and a stop somewhere between 1780 (a $500 per contract stop) and 1773 (the low of the March 8th session when the P-p-P pattern was completed), a cocoa trader would have enjoyed a gap up breakout on March 20 into which at least a portion of the profitable trade could have been sold. See Figure 1.

No sentiment, no seasonals — nothing but the chart and the indicators.

Will there be further long-side swing trades in cocoa? By considering some of the seasonal factors in cocoa — and looking at long-term charts — we can get some sense of where cocoa might be headed and when (Figure 2). This can help a trader adjust his or her expectations as potentially significant seasonal turning points draw near.

Cocoa has some interesting historical trends. The commodity tends to bottom in October, according to Scott Barrie's *Commodity Trader's Handbook*, which is the beginning of harvest season. The market for cocoa often shows strength into the summer months — particularly July — which is a "between mid-crop and main-crop" harvest time. Barrie also suggests that the rally from the October lows can be a powerful one. Only in January has cocoa shown a higher dollar per ton monthly performance since 1987 than in November.

How can those trading cocoa factor this into their planning? Barrie points out another potential turning point, in April, when cocoa historically (at least since 1987) has shown a tendency to sell off (only in September and October does cocoa fare worse). Given the strength in cocoa since bottoming in mid-October 2006, traders who are long cocoa should be wary for the possibility of a reversal should negative divergences begin to appear. See Figure 3. ■

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FIGURE 1: COCOA, JULY FUTURES, DAILY. The P-p-P pattern in the MACD histogram in early March sets up a swing buy in July cocoa. The blue horizontal line represents the stop-loss level — equal to the low of the session during which the P-p-P was completed. Note also the increase in volume.

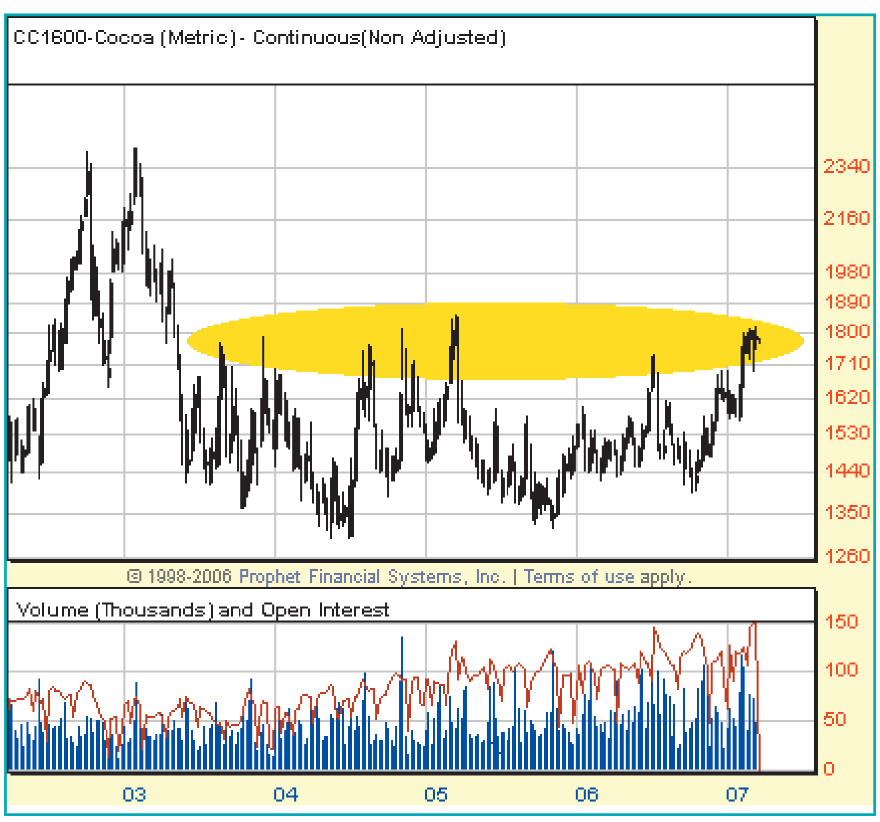

FIGURE 2: COCOA, CONTINUOUS FUTURES, WEEKLY. The range between 1700 and 1800 has provided effective resistance to rallies in cocoa for the past three years.

FIGURE 3: COCOA, JULY FUTURES, DAILY. Negative divergences build in both the MACD histogram and the stochastic as cocoa pushes toward new highs.

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Bank Index Under Test

by Chaitali Mohile

$BKX is on moving average support but under previous high resistance. So although technical conditions on charts are positive, the resistance might change the picture.

Tradable: $BKX

The Philadelphia Banking Index ($BKX) began its bullish rally from mid-December 2004. After gaining about 20 points on this rally, the bank index made a high of $121 on March 20, 2007. Since then, the index has corrected sharply, losing some gains during the previous bullish rally. It violated the support of the 50-day moving average and an additional 200-day MA. The newly formed resistance added with negative world clues when during last month, $BKX failed to perform.

On reaching the 50-day MA resistance, the index retraced to its previous low pivot and consolidated, forming a double bottom (Figure 1). A double bottom is a bullish indication, conveying a possible upside move in the index. Accordingly, the bank index traveled five points, from 112 to its previous high of 117. The previous high is a major resistance by itself in the bullish rally, so this high may result in either a consolidation or a dip in the bank index.

A double bottom is a bullish indication, conveying a possible upside move in the index.

The stochastic oscillator has failed to move above 80 as the price was under the resistance of the 50-day moving average. Currently, the stochastic is 65, indicating plenty of bullish room for the index. The average directional movement index (ADX) (14) slips to 25 from 30, with +DI crossover from below. This is a bullish indication, indicating a developing uptrend.

So both indicators highlight positive signals for $BKX to move ahead of its resistance line. With this indication, if the bank index moves ahead, its individual stock might see a good bullish rally. Now let's find what signals we get from the weekly chart (Figure 2).

The stochastic (10,7,3) dipped from the 80 level to 20, with the index correcting from 121 to 112. Figure 2 shows that the index stands on perfect support of the 50-day moving average. The bullish run during last week made the index touch its previous high at 117.5. The stochastic at 37.11 is giving a bullish signal by turning above 20. The ADX (14) has marginally moved below 20, indicating the possibility of consolidation in an uptrend. A strong uptrend will regain its strength if the ADX moves 25.

Considering both the daily and weekly charts, the $BKX is likely to continue its bullish rally. The previous high might make the index dip to its 50-day MA support in the daily frame. Traders might see an attractive bullish rally in banking stocks on violating this resistance by $BKX. ■

FIGURE 1: $BKX, DAILY. The bank index faces previous high resistance that can lead to consolidation.

FIGURE 2: $BKX, WEEKLY. $BKX has a strong bullish support of 50-day moving average, but the previous high pivot may react like a dictator.

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REVERSAL

Transports Hesitate At The Top

by David Penn

Are the Dow transports failing to confirm the new highs in the Dow industrials?

Tradable: $TRAN

FIGURE 1: DOW JONES TRANSPORTATION AVERAGE, DAILY. The month of April finds the Dow transports struggling to sustain the breakout above the February highs. An effort to short the transports (using the exchange-traded fund IYT as a proxy) based on the 2B criteria would have been filled, only to have been stopped out in the next session as a new intraday high was reached.

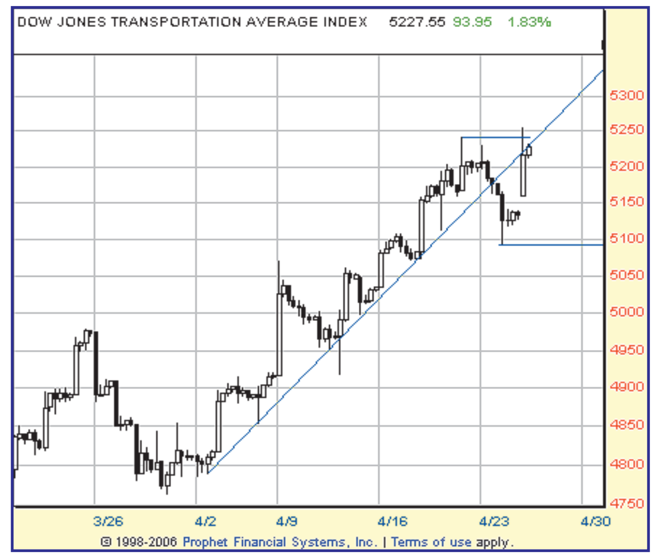

FIGURE 2: DOW JONES TRANSPORTATION AVERAGE, TWO-HOUR. A 2B top is created as the transports break down below and then temporarily rally above their April trendline. Based on the trendline break and subsequent bounce (a 1-2-3 reversal setup), traders can focus on the 5250 level as key resistance and the 5100 level as critical support.

With all the attention being paid to the Dow industrials' assault on the 13,000 level, less attention has been paid on the Dow transports, which also recently made a new, all-time high in mid-April. For while the industrials marched strongly beyond the February highs — the biggest technical barrier to the 13,000 level — the transports' move beyond its February 2007 highs so far has been less than impressive (Figure 1).

It is hard to imagine a market looking more like a top than the Dow transports in April. While the March–April advance does not seem to have resulted in the sort of negative divergence in the moving average convergence/divergence (MACD) histogram that is often a clear sign that a top of some significance has developed, the transports' hesitation to show follow-through to the upside after breaking the February highs should make speculators concerned about the near-term staying power of the $TRAN.

Given the trading in late April, where long shadows on candlesticks to the upside are matched by long shadows on candlesticks to the downside, there is a strong possibility that the transports will move sideways, consolidating their swiftly gotten gains, rather than break down in a collapse every bit as vertical as the advance was. Watching to see whether the transports break free from the 5250–5100 range (see Figure 2) will likely let traders know if a consolidation — perhaps the "handle" to the particularly deep March "cup" — is in the cards. ■

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ELLIOTT WAVE

Waving The Gold

by David Penn

Competing theses on gold nevertheless suggest going lower before higher.

Tradable: GC, GCM7

Preparing for a conference call on precious metals, I ended up developing two different takes on the gold market. The first take, the correction thesis (Figure 1), points to a gold market that is only halfway through a fourth-wave, double-3 type of Elliott wave correction. The second take, the October bottom thesis (Figure 2), suggests that on an intermediate-term basis, the downside for gold is over. What is interesting about these two takes is that both indicate that gold should be weaker in the short term, but in the intermediate to longer term, the bull market in gold is likely to resume.

Gold bulls are no less impervious to greed than bulls in any other market, and much of the time when I think of gold proponents I get a strange sense of entitlement, as if gold has been knocked as an investment for so long that now gold bulls are due for their propers, as the kids say. To that, I say: Check the chart. If there is anyone who has not granted gold the respect it deserves, then that is respect not worth waiting for. Gold has been in a solid bull market since testing the bottom in early 2001 — the beginning of the Bush era almost to the week. And after a largely sideways correction in 2004–05, gold went on a tear, rallying from between 425 and 450 during the correction to nearly 723 by the early summer of 2006.

So while gold bulls should welcome a correction, the question remains just what kind of correction gold is experiencing right now.

Figure 1 shows the correction thesis. It takes the rally from the 2001 lows to the peak in May 2006 as a wave 3 advance. Since that peak, gold futures corrected, then retraced approximately 61.8% of that correction before moving back down to test the lows of the initial move down. To my eyes, this pattern is reminiscent of a flat for two reasons. One, the B-wave retraces at least 61.8% of the A-wave, and two, the C-wave does not move beyond the low point of the A-wave. This correction also seems to pass the "right look" test as mentioned by Robert Prechter and A.J. Frost in their Elliott wave classic, *The Elliott Wave Principle.*

If the correction thesis is correct, then gold is a little more than halfway through its correction. With the x-wave complete, all that remains is for gold to develop another "three" correction. This "three" could be another flat, a triangle, or a zigzag. And there is the possibility that gold — depending on the psychology of those in the gold market — will develop a "triple three" rather than a double three. But for now, the correction thesis is limited to the possibility of a double three, which would mean a test of the 575 level.

FIGURE 1: GOLD, CONTINUOUS FUTURES, WEEKLY. My correction thesis posits that gold futures are in a fourth-wave, double-three correction. The first "three" appears to have taken the form of a flat. The wave labeled "x" represented the intermediary wave between the first "three" and the second "three" to come.

Interestingly, the flat portion of the correction in gold (per the correction thesis) lasted for about five months. If the second three lasts approximately the same amount of time, and we add that five months to the end of the intermediary x-wave (which topped in February), then we get a fourth-wave bottom sometime in summer 2007. What makes this particularly interesting is that gold and silver stocks are known to outperform seasonally from July through September, according to the research of the Hirsches in their *Stock Traders' Almanac*.

Just something to keep in mind as

FIGURE 2: GOLD, CONTINUOUS FUTURES, WEEKLY. The October bottom thesis suggests that the gold market bottomed in October 2006 and has just completed a five-wave movement to the upside. The current softness in gold prices in this scenario is reflective of a wave 2 decline that should find support before reaching 575. The 600 level looks like one likely source of support, should gold continue to decline.

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the year plays out.

The October bottom thesis is similar to the correction thesis in many ways. Both takes see the market as having made a wave 3 top in May 2006, and to have experienced a flat style correction from May 2006 to October 2006. The difference is whether you view the rally from the October bottom as a three-segmented affair or a five-segmented one (Figure 3). If you view it as the former, then the correction thesis seems more likely. However, if you view it as the latter, then the possibility of an October bottom and a new bull trend upward increasingly appears as the more probable interpretation.

Looking closely at the rally from the October bottom, and noting that the rally topped out just as it was closing in on the May 2006 highs, makes me believe that if you subscribe to the October bottom thesis, then it is likely that the first five waves up from that bottom were completed in February 2007. As such, the market should embark upon a three-segmented, A-B-C correction en route to finishing a wave 2 that would correct the previous wave 1. As a wave 2, this correction should significantly retrace the previous wave 1 — meaning that continued movement lower, perhaps testing the 61.8% retracement level near 600, should be in the cards over the next few weeks.

Under no circumstances, according to the October bottom thesis, should the wave 2 correction take out the October 2006 lows on a weekly closing basis. If it did, then that would be one good reason for moving (or keeping, depending the thesis you are rooting for) focus to the correction thesis. ■

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Frost, A.J., and Robert Prechter [1985]. *Elliott Wave Principle,* New Classics Library.

Hirsch, Yale, Jeffrey Hirsch, and the Hirsch Organization [2006]. *Stock Trader's Almanac 2007,* John Wiley & Sons.

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FIGURE 3: GOLD, JUNE 2007 FUTURES, DAILY. Here's the five-wave advance from the October 2006 bottom as seen through the lens of the October bottom thesis. The March 2007 bounce appears at this point to be the second B-wave of a corrective A-B-C pattern.

REVERSAL

The Gold Correction

by David Penn

Divergences tell the tale of the March bounce in June gold.

Tradable: GCM7

There were a few additional thoughts on gold that I didn't want to cram into my earlier article on the subject, "Waving The Gold." While those thoughts aren't Elliott wave–related, they do support the "lower before higher" case that suggests that the correction in gold has room to run.

June gold has been pretty faithful to the limits of Fibonacci retracement. The correction itself bounced shortly after breaching the 61.8% Fibonacci retracement of gold's advance from early January to late February. And the current correction appears to have topped just as it was testing the other key Fibonacci retracement at 38.2%. Note that this retracement level also coincides with gap resistance from the early March portion of June gold's decline. (See Figure 1.)

FIGURE 1: GOLD, JUNE FUTURES, DAILY. The late February/early March correction in June gold retraced just over 61.8% of the rally from the January lows. The bounce that began in March appears to have run into resistance at another Fibonacci retracement level, 38.2%.

FIGURE 2: GOLD, JUNE FUTURES, 15-MINUTE. A positive divergence in the MACD histogram signaled a key low in the decline of June gold. But the rally that followed has been accompanied by a growing negative divergence in the same indicator, increasing the likelihood that the move higher will be corrected.

The intraday line chart of June gold in Figure 2 shows not only the positive divergence in the moving average convergence/divergence (MACD) histogram that led to the bounce, but also the lengthy and growing negative divergences that threaten to end the advance. Moving average support (in red and blue) remains a possibility, and the consequence of the negative MACD histogram divergences could be sideways trading rather than movement that is sharply downward. Yet given the sharpness of the initial correction from the late February high, and the sharpness of the early March bounce today, traders could be forgiven for hoping for a more lasting meaningful correction — as opposed to a V-shaped one — that might produce a more lasting move higher to the February highs and beyond. ■

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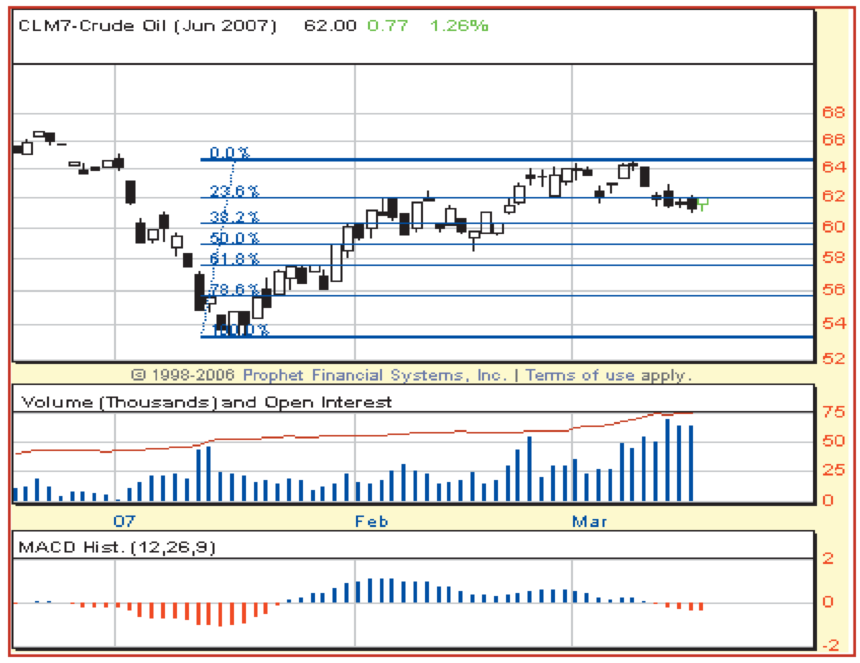
FIGURE 1: CRUDE OIL, JUNE FUTURES, DAILY. The consolidation from mid-September through the end of December forms a layer of resistance that blocks crude oil's initial rally off the January 2007 lows. Note how that failure at resistance is accompanied by a negative divergence in the MACD histogram.



PROPHET FINANCIAL

FIGURE 2: CRUDE OIL, JUNE FUTURES, DAILY. A 50% correction in the rally off the January 2007 lows would find June crude oil testing the lows of February. If June crude moves lower, there is support at the 61.8% retracement level near 58 from the highs of late January that could stem any decline.

June Crude Rally Retreats At Resistance

by David Penn

Three months' worth of price consolidation prove a barrier to crude oil's attempt to move higher in early March.

Tradable: CLM7

The June crude oil contract topped back in the late summer of 2006 and has been in a bear market ever since. This bear market has seen June crude fall from its August 2006 high above $80 to a January 2007 low south of $54. See Figure 1.

The only interruption in this bear market was a consolidation that developed between $68 and $63 from mid-September to late December. And it is this consolidation that has blocked — at least for the time being — the first significant rally attempt in crude oil in many months.

Arguably, this consolidation range was twice tested for resistance. June crude rallied into early February, then failed short of 63. That level represents the lower boundary of the consolidation range from September to December. The market pulled back to below 60 before making another push higher in the second half of February. This second time, June crude managed to penetrate deeper into the consolidation range, reaching as high as 64 in the first few days of March before once again retreating.

Will the correction be sharply lower — or more sideways? While the negative divergence in the moving average convergence/divergence (Macd) histogram means that a correction of some variety is likely, there is a good chance that any correction will be relatively mild. There is the potential that June crude will find support somewhere between the 38.2% Fibonacci retracement level just north of 60 and the 61.8% Fibonacci retracement level just south of 58 (Figure 2). Although not shown, it is worth noting that the rally off the January lows retraced 38.2% of the decline from the August 2006 peak before running into resistance.

In addition, it is worth remembering that June crude has been in a bear market since August 2006. While lower crude oil prices seem likely in the near term, any move lower would only hasten the moment when crude oil finally bottoms. On balance, crude oil tends to have favorable seasonality in the late spring moving into the summer "driving and air conditioning" season. A spring bottom in crude oil would go a long way toward paving the way for higher crude oil prices come summer. ■

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MOVING AVERAGES

Crude Charges Into Resistance

by Arthur Hill

Even though the recent surge in oil shows tremendous strength, crude is quickly becoming short-term overbought and entering a resistance zone.

Tradable: $WTIC

On the daily chart (Figure 1), West Texas Intermediate Crude (WTIC) is entering a resistance zone from the 200-day moving average and the October–December 2006 highs (Figure 1). Oil formed a large consolidation last year with support at 58 and resistance at 64. The consolidation breakdown was bearish, but crude rallied all the way back to the October–December highs.

The stochastic oscillator is both bullish and overbought as long as it remains above 80.

This rally is impressive, but resistance around 64 is just as impressive because this area stymied WTIC in October, November, and December.

In addition to resistance, the stochastic oscillator moved above 80 and became overbought. This is not necessarily bearish; it just warns bulls that prices have moved far and fast in a short time frame. The indicator is both bullish and overbought as long as it remains above 80. A dip below 80 would show some weakness, and a dip below 50 would be short-term bearish for WTIC. The 50 level is the centerline for the stochastic oscillator, and this separates a bullish bias from a bearish bias. Momentum is generally bullish above 50, and momentum is generally bearish below 50.

Now let's turn to the long-term chart for some perspective (Figure 2). Instead of the 200-day moving average, I overlaid the 40-week moving average. This covers the same time frame (40 weeks multiplied by 5 days = 200 days) and is essentially equal to the 200-day moving average. The 40-week moving average offered support throughout the multiyear advance. WTIC broke below this moving average with a sharp decline in the summer of 2006, and this moving average now becomes resistance. WTIC moved back to this moving average over the last few weeks, and I would expect resistance and/or a pullback soon.

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FIGURE 1: WTIC, DAILY. Here, West Texas Intermediate Crude is entering a resistance zone from the 200-day moving average and the October–December 2006 highs.

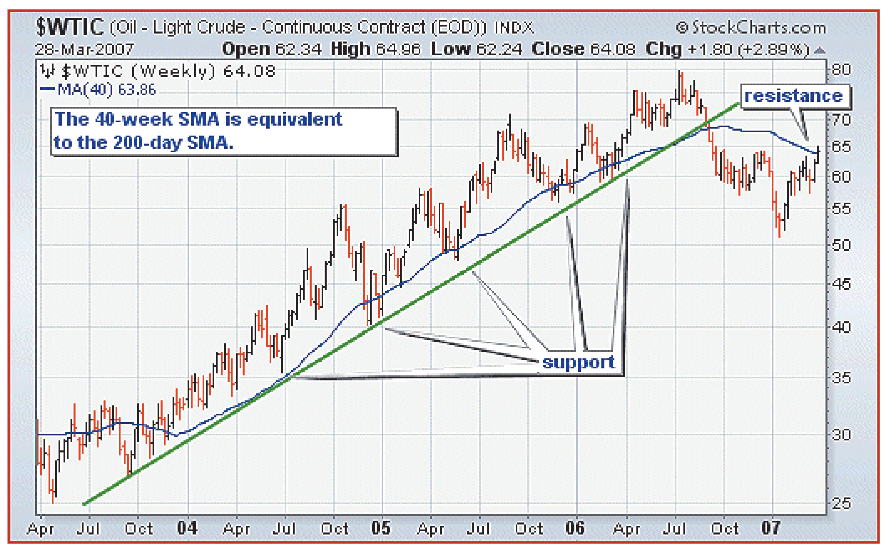

FIGURE 2: WTIC, WEEKLY. WTIC broke below this moving average with a sharp decline in the summer of 2006 and this average now becomes resistance.

CHANNEL LINES

Oil Hits A Resistance Zone

by Arthur Hill

West Texas Intermediate Crude is currently enjoying a nice rally, but the advance has reached a resistance zone and further gains could be difficult to come by.

Tradable: $WTIC

West Texas Intermediate Crude (WTIC) broke key support at 68 with a sharp decline in the second half of 2006, setting the bearish tone for the long-term trend (Figure 1). The drop from 80 to 51 was no ordinary decline, as WTIC returned to levels not seen since the first half of 2005.

The decline extended into early 2007 and formed a falling price channel (Figure 1, gray lines). The channel breakout around 60 is medium-term bullish, but I view this as a countertrend rally. The decline to 51 created an oversold condition that can only be alleviated with a bounce or a consolidation. WTIC chose to bounce back with a move back above 65. The move looks impressive on the daily chart (Figure 2), but the advance pales relative to the prior decline (80 to 51). The move retraced 50%–62% of the prior decline and met resistance just below broken support. This is where we would have expected a corrective rally to fizzle,

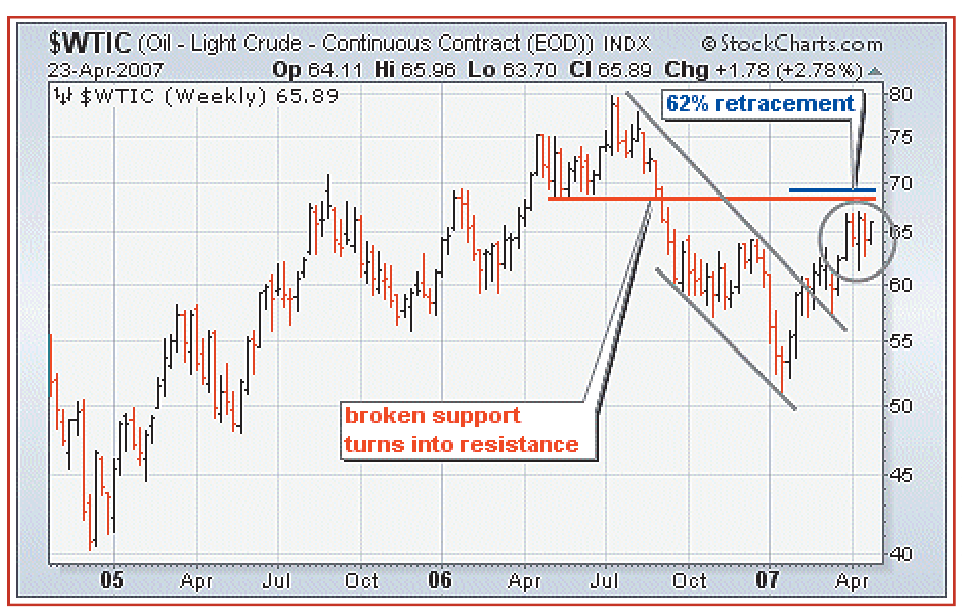

FIGURE 1: WTIC, WEEKLY. West Texas Intermediate Crude broke key support at 68 with a sharp decline in the second half of 2006. The decline extended into early 2007 and formed a falling price channel (gray lines).

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and WTIC stalled the past few weeks (gray circle).

Even though the current rally looks like a corrective advance, the medium-term trend remains up and we should respect this trend as long as it holds. The advance over the last few months carried oil back above the 50-day and 200-day moving averages. The move formed a rising channel, and there is a reaction below 61.35 earlier this month. A move below the lower channel trendline and support at 61.35 would reverse this uptrend and call for a continuation of the previous decline (80 to 51 on the weekly chart). I would then expect a move below 51.

I am also focusing on the relative strength index (RSI) for evidence of a trend change. The indicator bottomed in mid-January and has been rising the last few months. The RSI moved above 70 in late March and formed a lower high in April. WTIC actually forged a higher (closing) high in April, and the RSI now has a negative divergence working. Despite waning momentum (in the RSI) in April, the overall trend remains up as long as support at 50 holds. A break below 50 would turn momentum bearish, and this could be used to confirm a support break in WTIC. ■

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FIGURE 2: WTIC, DAILY. Even though the current rally looks like a corrective advance, the medium-term trend remains up.

SUPPORT & RESISTANCE

Gold Meets Resistance

by David Penn

Are the gold stocks saying something important about the potential for new highs in gold?

Tradable: GC, GCM7, $HUI

FIGURE 1: GOLD, JUNE FUTURES, WEEKLY. The 700 level is one of three resistance levels that June gold will need to surpass en route to new, all-time, contract highs.

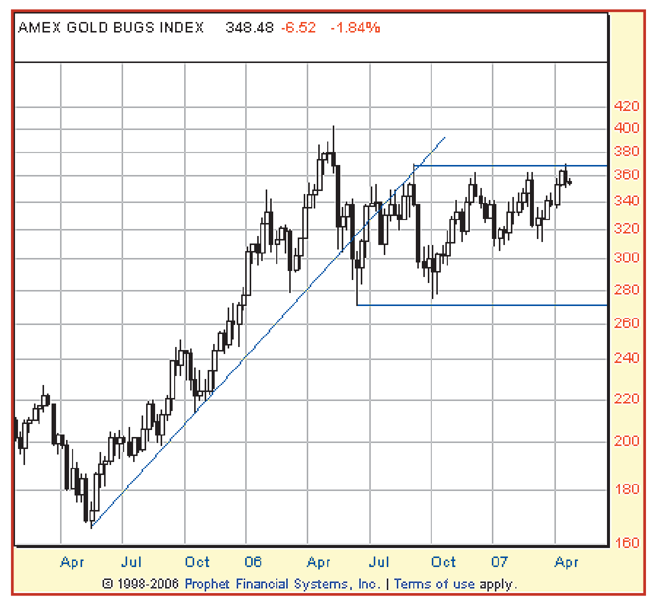

FIGURE 2: AMEX GOLD BUGS INDEX, WEEKLY. Trapped in a wide-ranging correction for at least three quarters, the $HUI is currently testing the top of that range for resistance. The high in the spring of 2006 — an all-time high — looms some 40-odd points higher.

I've been somewhat skeptical of gold's ability to move higher without significant pullback. Back in late February, I wrote that whether or not you believed that gold bottomed in October 2006, or had still more room to the downside, both instances involved gold moving lower before moving higher ("Waving The Gold," Traders.com Advantage, March 8, 2007).

While it may turn out to be that an important bottom was created in October 2006, the "lower before higher" case proved incorrect, as gold futures put in a low in late February 2007 and began moving steadily, if modestly, higher. With the correction ending near 640, gold futures managed to climb more than 50 points (basis continuous futures) by late April.

There are two levels of resistance that bear watching. The first, more immediate resistance level can be found in the contract for June gold (Figure 1). Here, gold had been moving steadily higher in an attempt, ultimately, to take out the recent February highs and the 700 level. These February highs have already been bested by both the continuous futures contract and the index of unhedged gold stocks, the $ HUI. However, the fact that the June gold contract is struggling to clear the 700 hurdle seems to dove-tail with the fact that both the continuous futures and the $HUI are fighting to move beyond an earlier, arguably more crucial resistance level in the form of the May 2006 highs (Figure 2).

The progress of continuous gold futures and the $HUI vis-à-vis the February 2007 highs suggests that June gold will eventually surpass the 2007 highs — though that is by no means certain. But I suspect the progress of June gold will be very much tied to the progress of these other two markets. If the $HUI and/or continuous gold futures fail to make new highs vis-a-vis 2006, then it is likely that June gold will fail as well — and perhaps as early as its attempt to take out the 2007 highs.

A great deal rests on the ability of gold to set new highs. It has been argued that the sideways motion in gold stocks has had to do with the fact that investors are not completely convinced that the Federal Reserve is about to move from a rate-raising posture to a rate-cutting one. The thinking on this is clear: If the Fed moves to cut short-interest rates, adding liquidity to an economy that many think is already super-saturated, then gold is likely to move aggressively to the upside. If, on the other hand, the Fed adopts a more hawkish tone with regard to inflation, gold is much more likely to fail at tests of new highs, possibly even reversing and heading significantly lower.

What is interesting is that virtually all of the major economies of the world are far more concerned about inflation — to the point of openly talking about short rate increases — than the Federal Reserve appears to be. In fact, it appears as if American economists have become convinced that there is no way the Fed can raise rates even if it wants to without crashing the economy. This, perhaps, adds more bullish bias to the fortunes of gold. But traders should make the yellow metal prove it by taking out near-term resistance and showing a little follow-through to the upside first. ■

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MARKET UPDATE

The Dollar And Deflation

by David Penn

As the dollar moves toward a test of long-term lows, fears of inflation have completely eclipsed the possibility of a reversal in the greenback.

Maybe it was hearing still yet another commentator point to a chart of gold and begin ridiculing the possibility of the global economy slipping into a deflation that got me hauling out my long-term charts of the dollar, gold, and key international currencies such as the euro and the yen.

One thing you can say about the inflationist argument — other than it has the Church of What's Happening Now on its side — if the dollar is about to be "sacrificed" for the sake of the economy, then we will not have to wait much longer to see the blood from that fatted calf. Currently trading in the low 80s (basis the US Dollar Index), the greenback is once again moving ominously close to some major historic lows.

The nearest of such lows is the late 2004 low near 80.48. This low came at the end of a vicious bear market in the dollar that began early in 2002 with the greenback (basis continuous futures) at approximately 120. Before the 2004 low, this level had been repeatedly tested as the dollar was bottoming in the early 1990s — specifically in early 1991, mid-1992 when the greenback technically found a bottom at 78.43, and in the spring of 1995, when the 1992 lows were tested.

So if the dollar is going to hell in a handbasket, it could be argued that it is as closer to departure time as it has ever been.

But one thing continues to stymie my appreciation of the inflationist argument, an argument that says that gold will continue rising into the quadruple digits, that the dollar will be ruined, and that hyperinflation will swallow the economy ... and that is a chart of the gold price since 2000. Gold has already rallied more than 287% in the seven years from historic lows in the summer of 1999 to near-historic highs in the summer of 2006. In fact, gold has almost completely retraced its secular bear market decline from the all-time high in January 1980 spike north of 850.

It may be possible for the gold market to be on the verge of a move still higher, up into the hyperinflationary stratosphere. But it would be a mistake to not realize that a certain significant amount of appreciation has already taken place in gold, and that it may be a market more primed for correction than for further, even more vertical gains.

WHAT IS DEFLATION?

I've written about deflation before. And one of the most frustrating things about the topic is hearing deflation-skeptics cry out, "Where is the deflation?" as the gold price rises. To be concerned about deflation, to worry about deflation as a likely, if not probable, outcome of our current economic practices, does not make a person blind to a gold chart that looks increasingly like the NASDAQ circa 2000. In fact, it could be argued that a soaring gold price — along with a stock market that is moving higher on balance — are perfectly logical precursors to a deflationary shock.

What is deflation? If inflation refers to the situation of "too much money" chasing "too few goods" and services, then deflation, at its most simple, can be considered an example of the opposite: "too little money" chasing "too many" goods and services. How can there be "too little money"? By now, most have heard of Federal Reserve Board chairman Ben "Helicopter" Bernanke's widely shared notion that should the US economy ever find itself with "too little money," the availability of a technology called a "printing press" would help stave off a deflationary crisis. As such, the idea of having "too much money"

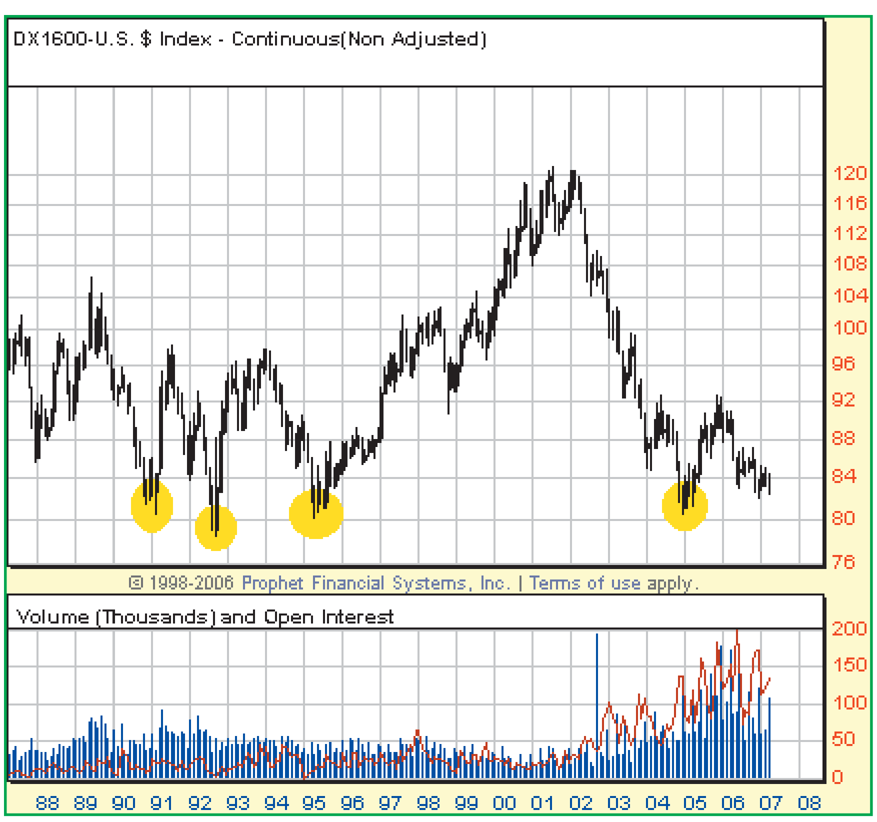

FIGURE 1: US DOLLAR INDEX, CONTINUOUS FUTURES, MONTHLY. On four other occasions over the past decade and a half, the greenback has flirted with the 80 level, each time bouncing back strongly.

FIGURE 2: GOLD, CONTINUOUS FUTURES, MONTHLY. The bottom in 1999 and retest in early 2001 signaled an end to the disinflation that characterized the boom in financial assets — stocks and bonds — of the late 1990s.

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driving prices higher is relatively easy for most to understand — even if you didn't live through the inflationary 1970s.

However, an economy can also have "too little money" vis-a-vis the demand for money, making the currency in which the demand is denominated in relatively more valuable than the assets that can be purchased by that currency.

An easy way to explain this would be to consider a person who has too many credit cards or other debt obligations. A "debt" is a promise to pay at some future date. It represents a "demand for money." The more a person — or a municipality or a nation-state — carries in debt, the greater his burden to provide the currency the debt is denominated in at some point in the future. That presents little problem much of the time, as the proceeds from borrowed money (or what is called *self-liquidating credit*) are sufficient to repay the loan, plus interest, along with providing whatever profit or return the borrower anticipated.

But when the proceeds of the borrowed money are lacking, or when there is an overabundance of borrowing that is not geared toward productive purposes (also called *non self-liquidating credit*), an inability to repay in cash leads to cash being more highly valued relative to other assets.

I think this notion of deflation or, more specifically, debt-deflation is important because without it, it becomes hard to imagine the government not being able to simply "printing press" its way out of a truly towering mountain of debt at particularly the government and individual levels. As Rick Ackerman, publisher of *Rick's Picks* and one of the most articulate commentators on the topic of deflation, has put the problem of the "printing press" solution:

> Inflate-or-die long ago reached the point of diminishing returns ... In the early 1990s, I did a piece for Barron's that focused on the relationship between debt and GDP growth. At the time, we were getting about 38 cents' worth of growth for each dollar borrowed at the margin. I thought this spelled disaster, unable to imagine at the time that ten years hence, we would be borrowing as much as $6 in a fiscal quarter to "create" a single dollar's worth of growth.

Ackerman concludes: "The fact that we have increased borrowing in the last several years by trillions of dollars to produce so faint a "recovery" should be telling you something."

The Faces of Deflation

Back in the spring of 2002, I wrote an article for *Working Money* called "Gibson's Paradox," which provided a comparison between the market for Japanese government bonds and the Nikkei index in the 1990s. That comparison revealed a rising market for bonds and a falling market for stocks. Bond yields were leading stocks lower.

However, the past four years have been characterized by rising gold prices, rising long-term interest rates and rising stock prices. As such, it is hard to characterize the past four years as anything but an inflationary (or at least money expansionist) episode. This movement, in which stock prices and bond yields are moving in the same direction, is the exact opposite of what we saw in Japan during its deflationary episode in the 1990s.

As such, I want to focus on what deflation looks like in the charts. Most of us have a sense of what is supposed to happen in a deflation from the brief deflationary panic of 2002: asset values fall, the burden of debt in real terms becomes greater — even if interest rates remain low in real terms, and the currency in which most of the debt is denominated becomes more valuable. So, translating these "faces of deflation" into charts, we should expect bear markets in stocks and gold (after all, you can't pay a mortgage with a stock certificate or a bar of gold) and bull markets in both the dollar and in US Treasury notes.

Look at the charts of those four asset classes in the spring of 2007, and it would be little surprise why there is so little support for the deflationist cause. Both gold and the stock market (the latter as measured by the Standard & Poor's 500) have been in bull markets for years and were as early as spring and autumn 2006, respectively, flirting with all-time highs. By contrast, the US dollar is perennially on the ropes, dipping toward all-time lows in late 2004 and again in the autumn of 2006. The market for US Treasuries has been similarly bearish for the past few years.

It is complacency in the face of these trends that interests me most, the sense that both gold and the stock market — which have already enjoyed enduring bull markets — will only continue to do so. And while the pessimism in the bond markets is less pronounced than that of the market for dollars (where pessimism is all-pervasive), the fact that Treasury notes have finished down for four years in a row is not lost on anyone.

The long and short of this is that if we can find technical reasons for these trends to reverse, for tops in gold and the stock market and bottoms in the bond and US dollar markets, then the case for deflation will have the sort of technical foundation that will be hard for the inflationists to deny. Of course, it will not be until the bond markets are soaring, pushing long-term interest rates into the ground as investors clamor for the safety of dependable, cash-generating assets, even at historically low rates, and the dollar is similarly arcing higher, before people see the threat of deflation in the way they currently see the threat of inflation.

But if we are able to see the shift as it happens, to see the technical foundation for the inflationary case give way, then we will be in a much better position both to protect ourselves from deflation's discontents, as well as to profit from the new opportunities created, especially in the early stages of the shift.

Bouncing Bonds?

I've written a great deal about the dollar, the stock market, and gold for Traders.com Advantage —

FIGURE 3: 10-YEAR TREASURY NOTE, CONTINUOUS FUTURES, WEEKLY. The bear market in the 10-year Treasury began in June 2003, some eight months after stocks bottomed in October 2002.

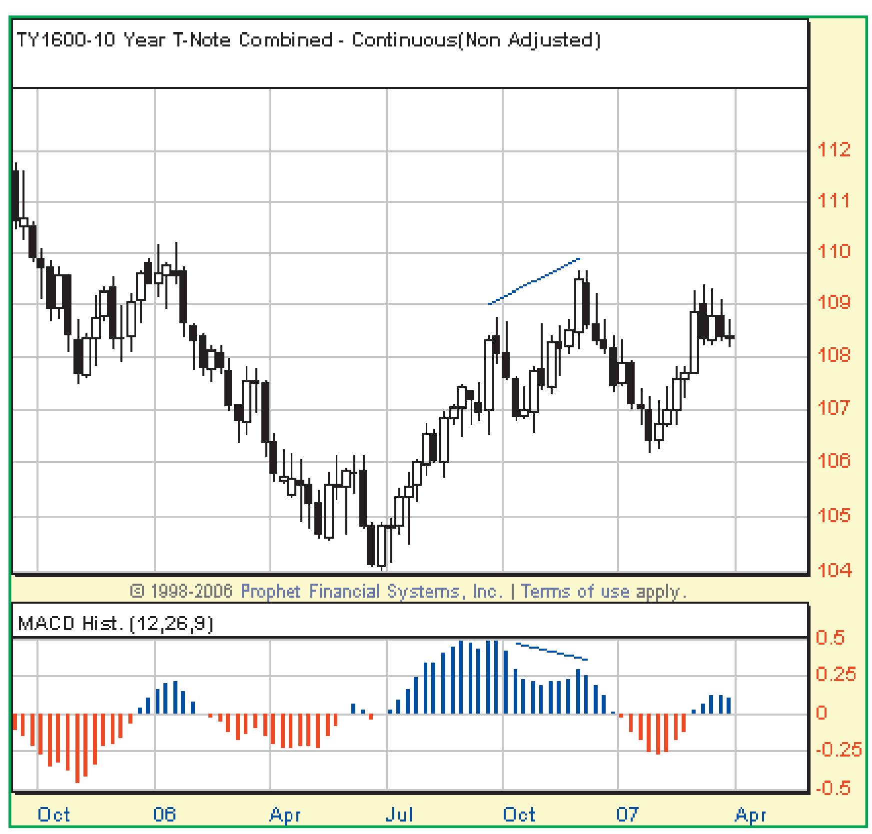

FIGURE 4: 10-YEAR TREASURY NOTE, CONTINUOUS FUTURES, WEEKLY. The negative divergence at the top of the Treasury note rally that began in the summer of 2006 anticipates the market's failure at the resistance level of 110.

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so much so that here I'd rather focus on the bond component of the potentially deflationary picture. For many years it was argued that the bond market was the true arbiter of the economy, insofar as the country's capacity to borrow is paramount to its financial fortunes in the modern economy. That "strategic location" and the sheer size of the bond market make it an obvious place to look for clues that the economy's inflationary tendencies over the past few years might be reversing themselves before our eyes.

The most interesting technical development in the long-term bond market charts — charts that reveal a clear downward trend in the bond market since a peak in the spring of 2003 — is the negative divergence in the weekly MACD histogram that developed in the second half of 2006. This divergence — which was mirrored by a positive divergence in the long-term chart of the $TNX, or 10-year Treasury yield index — is important for one particular reason. Focusing on the bond side of the mirror (rather than the yield side), we can see that the Treasury note market bottomed in the spring of 2006. This bottom was anticipated by a series of higher lows in the moving average convergence/divergence (MACD) histogram going back to the first such positive divergence in the spring of 2004.

The bounce from the 2006 bottom has yet to take out a previous high (the high from January 2006 would be the first such milestone). But in the course of the post-negative divergence correction, the T-note market has established a higher low in the first few months of 2007. The question is whether the correction anticipated by the negative divergence — a negative divergence between the September and December 2006 peaks — has been resolved by the December 2006 to February 2007 decline. If it has, then we should expect the Treasury note market to continue moving higher and eventually take out the January 2006. This would be a critical step in building the case for a move higher in bond prices, an argument that would have to be won before the deflationary case could even get a proper hearing.

It is worth noting that the negative divergence in the bond chart is miniscule compared with the positive divergences that have been building since the spring of 2004. So the long-term bet remains that a bottom in the bear market in bonds that began in mid-2003 is still in the making. That doesn't prevent further correction and a retest, for example of the 2006 lows.

In fact, even if the 2006 lows were exceeded to the downside, the case for a bottom in bonds would remain valid as long as the series of positive divergences remains intact. Given my suspicion that both the stock and gold markets have another surge higher before they make more enduring tops, it would not surprise me in the least if the bond market did indeed make that test of the 2006 lows.

This assumes that the markets move in sync, which is not always the case. Even markets that are tracking one another often lag by days, weeks, or even months — sending off confusing signals to traders, speculators, and investors alike.

Consider, for example, the relationship between stocks and bonds over the past four years. The 10-year note topped in mid-June 2003. Stocks, however, had bottomed months earlier in October 2002 and managed to test that bottom in March 2003, and while bonds were moving largely sideways between October 2002 and March 2003, bonds rallied into their top precisely as the bull market in stocks was getting under way.

So it could be reasonably argued that there was as much as a seven-month lag between the stock and bond market's interpretation of the economy going forward. This is understandable, insofar as markets are no better than the human beings who trade them. But it is worth remembering as both the bond and dollar markets forage for bottoms in 2007, even as the stock and gold markets look poised to continue moving higher. ■

This article was originally published on 4/27/2007.

SUGGESTED READING

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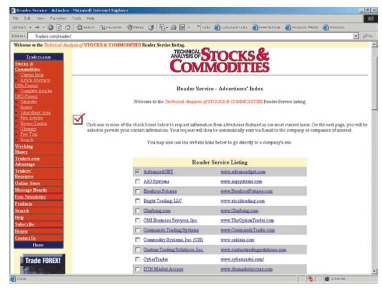

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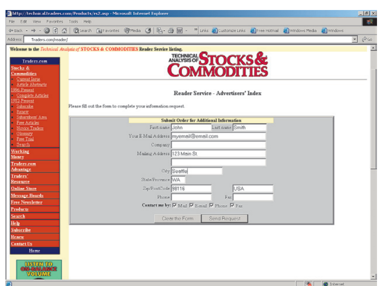

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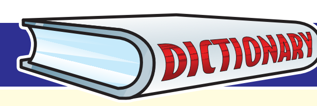

Average Directional Movement Index (ADX) — Indicator developed by J. Welles Wilder to measure market trend intensity.

Bollinger Bands — Developed by John Bollinger. Bollinger Bands widen during increased volatility and contract in decreased volatility, and when broken, are an indication that the trend is powerful and may continue in that direction.

Convergence — When futures prices and spot prices come together at the futures expiration.

Divergence — When two or more averages or indices fail to show confirming trends.

Directional Movement Index (DMI) — Developed by J. Welles Wilder, DMI measures market trend.

Elliott Wave Theory — A pattern-recognition technique published by Ralph Nelson Elliott in 1939, which holds that the stock market follows a rhythm or pattern of five waves up and three waves down to form a complete cycle of eight waves. The three waves down are referred to as a "correction" of the preceding five waves up. Fibonacci ratios are applied to the price spans and price targets may be projected.

Exchange-Traded Funds (ETFs) — Collections of stocks bought and sold as a package on an exchange, principally the American Stock Exchange (AMEX), but also the New York Stock Exchange (NYSE) and the Chicago Board Options Exchange (CBOE).

Exponential Moving Average — A variation of the moving average, the EMA places more weight on the most recent closing price. The formula for calculating EMA is: EMA = (Today's closing price * k) + (Yesterday's moving average * (1-k)), where k = 2/(n+1); n = no. of periods.

Fade — Selling a rising price or buying a falling price. Forexample, a trader who faded an up opening would be short.

Flag — Sideways market price action that has a slight drift in price counter to the direction of the main trend; a consolidation phase.

Head and Shoulders — When the middle price peak of a given tradable is higher than those around it.

Lag — The number of datapoints that a filter, such as a moving average, follows or trails the input price data. Also, in trading and time series analysis, lag refers to the time difference between one value and another. Though lag specifically refers to one value being behind or later than another, generic use of the term includes values that may be before or after the reference value.

Moving Average Convergence/Divergence (MACD) — The crossing of two exponentially smoothed moving averages that are plotted above and below a zero line. The crossover, movement through the zero line, and divergences generate buy and sell signals.

Overbought — Market prices that have risen too steeply and too fast.

Overbought/Oversold Indicator — An indicator that attempts to define when prices have moved too far and too fast in either direction and thus are vulnerable to a reaction.

Oversold — Market prices that have declined too steeply and too fast.

Relative Strength — A comparison of the price performance of a stock to a market index such as the Standard & Poor's 500 stock index.

Resistance — A price level at which rising prices have stopped rising and either moved sideways or reversed direction; usually seen as a price chart pattern.

Retracement — A price movement in the opposite direction of the previous trend

Simple Moving Average — The arithmetic mean or average of a series of prices over a period of time. The longer the period of time studied (that is, the larger the denominator of the average), the less effect an individual data point has on the average.

Smoothing — Simply, a mathematical technique that removes excess data variability while maintaining a correct appraisal of the underlying trend.

Stochastics Oscillator — An overbought/oversold indicator that compares today's price to a preset window of high and low prices. These data are then transformed into a range between zero and 100 and then smoothed.

Support — A historical price level at which falling prices have stopped falling and either moved sideways or reversed direction; usually seen as a price chart pattern.

Swing Chart — A chart that has a straight line drawn from each price extreme to the next price extreme based on a set criteria such as percentages or number of days. For example, percentage price changes of less than 5% will not be measured in the swing chart.

Trading Range — The difference between the high and low prices traded during a period of time; in commodities, the high/low price limit established by the exchange for a specific commodity for any one day's trading.

Trend Channel — A parallel probable price range centered about the most likely price line. Historically, this term has been used to denote the area between the base trendline and the reaction trendline defined by price moves against the prevailing trend.

Trendline — A line drawn that connects either a series of highs or lows in a trend. The trendline can represent either support as in an uptrend line or resistance as in a downtrend line. Consolidations are marked by horizontal trendlines.

Triangle — A pattern that exhibits a series of narrower price fluctuations over time; top and bottom boundaries need not be of equal length.

Volatility — A measure of a stock's tendency to move up and down in price, based on its daily price history over the last 12 months.

Underlying Instrument — A trading instrument subject to purchase upon exercise.

Underlying Security — In options, a stock subject to purchase upon exercise of the option.

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