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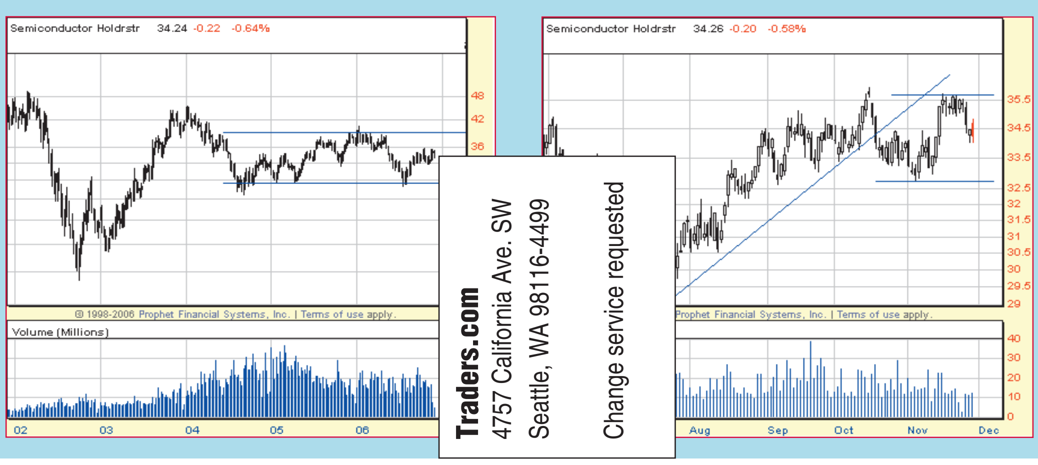

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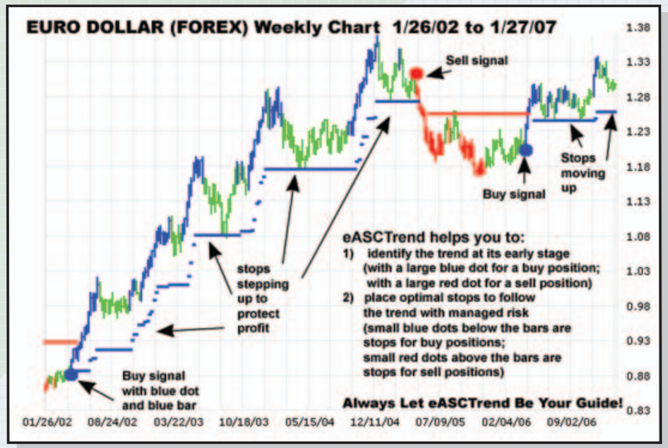

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By John Wang, Ph.D., CTA, eASCTrend Developer

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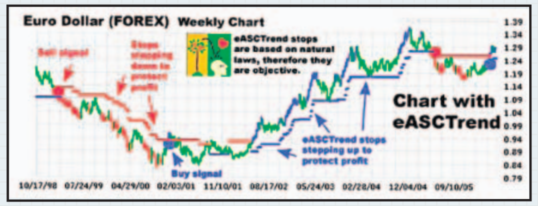

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It's our principle-based formulas that give traders the eASCTrend edge. Sign up for your eASCTrend test drive today, and experience the confidence of using intelligent stops and sweet spots.

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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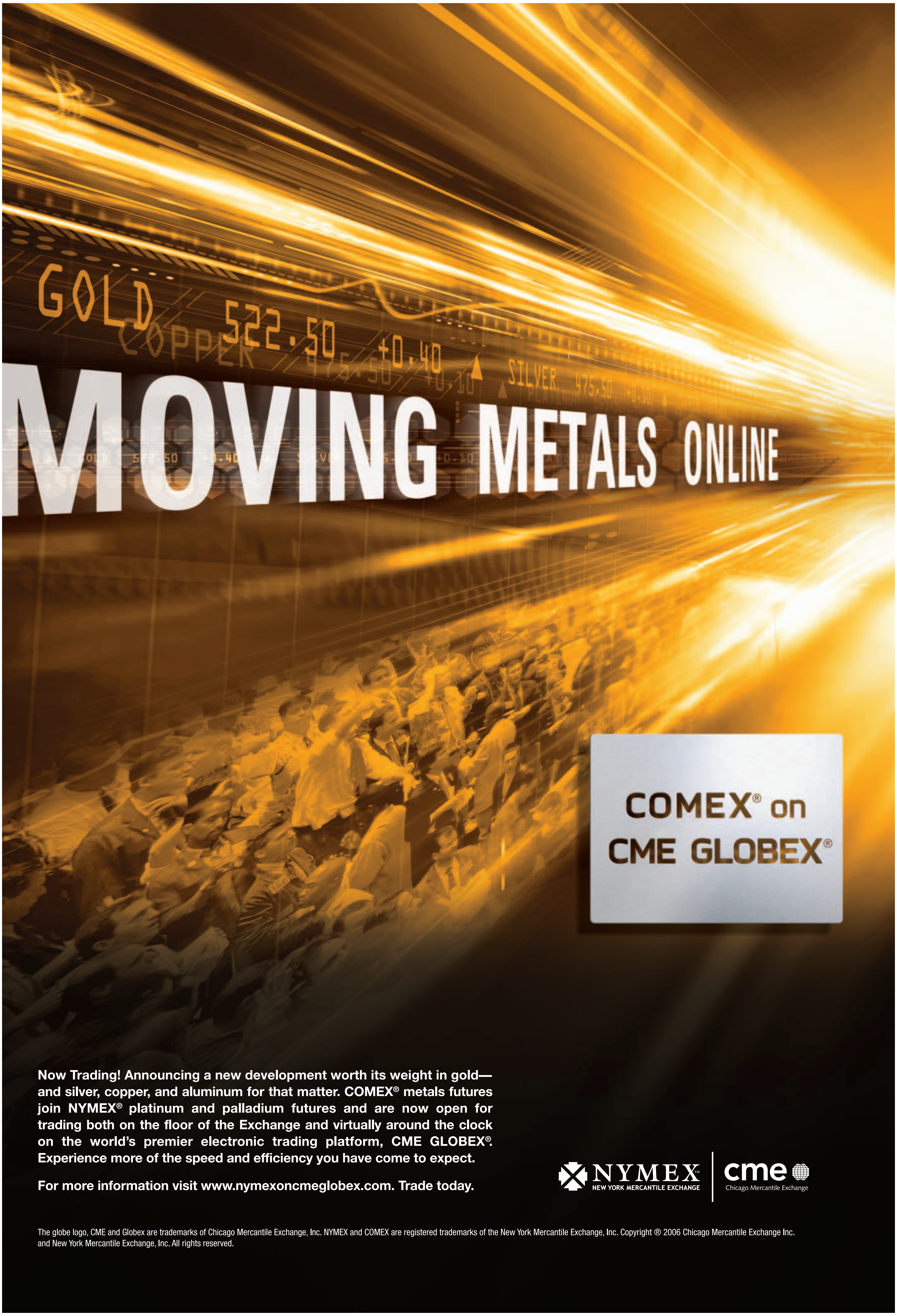
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TRADING NOW

The bulls just keep going, and going, and going. With another quarter of strong earnings behind us, it looks like the trend is still intact. The Dow Jones Industrial Average, the Standard & Poor's 500, and the NASDAQ Composite show no signs of a reversal in their bullish trend. But in spite of the strength in the US markets, investors are turning to overseas markets for their investments. According to *The Financial Times*, in 2006 92.5% of all US equity fund inflows went into international equities. That's a significant percentage, which shouldn't come as a big surprise given the fast growth rate of emerging markets such as China and India. Who *wouldn*'t want to chase such a fast-growing segment?

This is why it's always good to keep an eye on the bigger picture. With easy access to the global markets you have more options, and with more options, you have more products to trade. In this issue of **Traders.com** we bring you articles that cover the broader indexes and specific sectors, as well as how to use different technical indicators. For example, we have articles on the metals and energy sectors, both of which are useful for conducting intermarket studies. We have articles on the technology sector, which, in spite of the bursting of the technology bubble of 2000, still remains very close to our hearts even now.

Arthur Hill offers "Short-Term Moment Of Truth For The Dow" on page 14, for example, and "NASDAQ Channels Higher," while David Penn's "Copper Cracks," on page 20, and Black Gold Is Back," on page 22, is certainly food for thought, as is his "Sideways Conductors" (page 36). Gary Grosschadl's "eBay Tests Overhead Resistance," on page 44, gives us a peek at what the company has in store.

And that is only a fraction of the useful articles you'll find here and at our online publications, *Traders.com Advantage* and *Working Money*, or even STOCKS & COMMODITIES magazine. Take a look at our website and see what we have to offer. Check us out — that will enable you to:

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What will the future hold, no one can say for sure. Will investors continue to look overseas, or will they find yet another venue for their capital? We have so many options now, it's hard to choose what we should go for. We try to give our readers an idea of what the world of investing and trading has to offer.

Jayanthi Gopalakrishnan

Jayanthi Gopalakrishnan,
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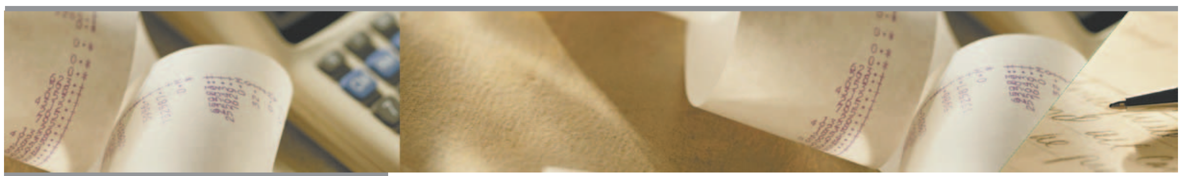

THE OPTIMIZED TRADER

Trading The MACD Histogram

Part I

by David Penn

As good as the moving average convergence/divergence is, adding the histogram might make it even better.

One of the first trading methodologies I ever cobbled together was based on the moving average convergence/divergence histogram, also known as the MACD histogram (or even the MACDH for short). I won't pretend my selection of the histogram came as the result of a scientific survey — though there was enough trial and error to make me feel as if some sort of canvassing of available indicators had certainly taken place. If anything, I was moved to spend more time getting to know the MACDH after reading this entry from Alexander Elder's excellent trading primer, *Trading For A Living*:

> MACD-Histogram offers a deeper insight into the balance of power between bulls and bears than the original MACD. It shows not only whether bulls or bears are in control, but also whether they are growing stronger or weaker. It is one of the best tools available to a market technician.

And later, under the heading "The strongest signal in technical analysis":

> Divergences between MACD-Histogram and prices occur only a few times a year in any given market, but they give some of the most powerful messages in technical analysis. These divergences identify major turning points and give "extra-strength" buy or sell signals. They do not occur at every important top and bottom, but when you see one, you know that a major reversal is probably at hand.

If that's not an endorsement, then I don't know what is. I'm not sure if Elder feels as strongly about the "MACD-Histogram" today in 2006 as he did back in 1993 when *Trading For A Living* was completed, but the indicator itself continues to have adherents. For example, Raghee Horner, forex trader and author, has used the MACDH as a general indicator to determine whether a market is bullish and ripe for buying or bearish and ripe for selling.

I've written about the MACD histogram before for Working-Money.com, particularly about what I referred to as "MACDH extremes," which can often be helpful in determining intermediate-term direction after major market moves and when dealing with consolidations. Here, however, I want to talk about a few of the basic ways that traders can and have used the MACD histogram in order to trigger trade entries as well as determining directionality.

Meet Mr. MACD

What exactly is the MACD histogram? What is its relationship to the moving average convergence/divergence indicator known as the MACD?

The MACD was developed by trader Gerald Appel, who also publishes the *Systems And Forecasts* newsletter. Although the MACD appears with two lines that converge and diverge relative to each other, the indicator is actually created using three lines. Writing in his book *The Visual Investor*, John Murphy explains how the MACD is constructed:

> The first line (called the MACD line) is the difference between two *exponentially smoothed* moving averages of the price (usually 12 and 26 periods). The computer subtracts the longer average (26) from the shorter (12) to obtain the MACD line. A moving average (usually nine periods) is then used to smooth the MACD line to form a second (signal) line. The result is that two lines are shown on the chart, the faster MACD line: and the slower signal line.

Buy and sell signals using the MACD are similar to those using other pairs of moving averages. When the fast MACD line crosses above the slow signal line, a buy signal has been issued. Conversely, when the fast MACD line crosses below the slow signal line, a sell signal has been issued. Approaching the MACD this way means that the trader will tend to be on the right side of the trend when following the signals. As I'll show later, there can be other tools that traders will use — from moving averages to trendlines to the MACD histogram — to determine whether the trend they may have received a signal to follow is one of significant duration, as in a bullish or bearish context. (See Figure 1.)

For now, suffice to say that the MACD can be used on a variety of time frames using this simple crossover methodology. In addition, while John Murphy notes that some traders have elected to use different values for buy signals and sell signals, he underscores that for most traders, the 12, 26, 9 values will work for both bullish and bearish signals.

There are two other ways that the MACD can be

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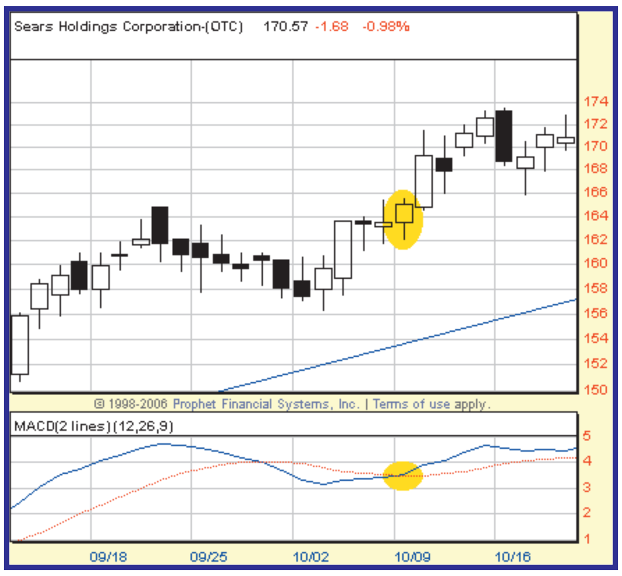

FIGURE 1: SEARS HOLDINGS CORP., DAILY. The basic MACD is shown here, along with one of the more common buy signals that can be derived from it. The highlighted section in the indicator window shows where the faster MACD line (in blue) crossed over the slower signal line (in red). The highlighted session shows the candlestick above which the long trade would be initiated.

used. One is as an oscillator. Insofar as the two lines — the MACD line and the signal line — both operate above and below a zero line, some traders have used the MACD to indicate oversold market conditions that can be bought (both lines below the zero line) as well as overbought market conditions that can be sold (both lines above the zero line).

Murphy points out that some traders combine the crossover and oscillator aspects of the MACD by looking for bullish crosses (remember, the MACD line crossing above the signal line) below the zero line indicating a buy and bearish crosses (the MACD line crossing below signal line) above the zero line as indicating a sell.

Traders have also used the MACD to spot divergences. In much the same way that traders use oscillators like the RSI (relative strength index) and stochastics, traders look for instances when the MACD makes a lower high while a market is making a higher high (a negative divergence) or when the MACD makes a higher low while a market is making a lower low (a positive divergence).

So where does the histogram fit into all of this? According to Murphy, in a way that makes it even better. He writes:

> As good as the MACD indicator is in the form just described, there's a way to make it even better. That technique is called the *MACD histogram*. The MACD histogram will provide even earlier warnings of potential trend changes and greatly enhances the value of the indicator. Since the histogram shows the MACD crossover signals (in a slightly different way), nothing is lost in its use. What is gained is a way to generate action signals much sooner.

As noted, this ability to create "action signals" ultimately won me over to the cause of the MACDH. The histogram simply represents the difference between the MACD line and the signal line, and plots it as a series of vertical bars. Other indicators such as the commodity channel index (CCI) can also be plotted as histograms. A positive histogram, with vertical bars above the zero line, indicates a market

FIGURE 2: GOLDMAN SACHS, DAILY. An example of an oversold L1 breakout trading using the MACD histogram. Here, the histogram is forming the "P-p-P" pattern, which gives a buy signal with the third bar of the pattern. This particular pattern happens to appear at the end of a brief, largely sideways consolidation.

FIGURE 3: MASTERCARD, DAILY. Another example of the L1 "breakout" MACDH trade. The highlighted histogram bars show a "M-m-M" pattern, which produces a buy signal above the high of the day (or session) that the "M-m-M" pattern is completed. Also called the "trigger," that session is highlighted. Going long the day after the trigger session resulted in solid gains within a few days.

in which the MACD fast line (the MACD line) is above the slow line (the signal line). A negative histogram, by contrast, with vertical bars extending below the zero line, indicates a market in which the MACD line is below the signal line.

When these two lines are close or are converging, the histogram bars will be shallow and small. When these two lines are diverging, moving away from each other, the histogram bars will increase in length — above or below the zero line. Another factor key in creating action signals is what Elder points out as the slope of the MACD histogram. He writes:

> The slope of MACD-Histogram is defined by the relationship between any two neighboring bars. If the last bar is higher (like the height of letters m-M), the slope of the MACD-Histogram is up. If the last bar is lower (like the depth of letters P-p), then the slope of MACD-Histogram is down.

BREAKOUTS AND CONTINUATIONS

Many — though not all — of the signals created by the MACD histogram are related to changes in the slope of the indicator. In fact, the primary signal in my MACDH trading methodology involves just such a change of slope or, more accurately, involves using a temporary change in slope (a histogram pullback or bounce) in order to create a buy signal. I've called these signals "L1" and "S1" (primary long and primary short) and remain my favorite signals using the histogram. Although Elder writes that weekly signals are less frequent and perhaps more reliable than daily ones, I've found that trades using the L1 and S1 methods have been confirmed by buy and sell signals using other methods such as the TRIX as well as often simply proving in hindsight to have marked excellent entry points in trends. (See Figure 2.)

Let's look at how the L1 and S1 breakout entries are created. To use Elder's shorthand, with a primary

I've found that trades using the L1 and S1 methods have been confirmed by buy and sell signals using other methods such as the TRIX.

long or L1 trade, I am looking for a session in which the histogram slopes upward. There are a number of patterns that could produce this slope shift upward — from "M-m-M" to "P-p-P." Numerically, these values could be anywhere between +100 and -100, but for an example, imagine a histogram that reads +3, then +1.7, then +3.4. The session that received the "+3.4" in the second example would be the trigger session above the high of which the trader would be looking to get long.

The key point is that the middle value or histogram bar is either shorter (in the case of a histogram above the zero line) or longer (in the case of a histogram below the zero line) than the pair of histogram bars that surround it on either side.

Conversely, to the short side, a pattern like "m-M-m," "p-P-p," or, again numerically, reading -5, then -3.5, then -6. The session that received the "-6" would be the trigger session. Here, the difference is that the trader would be looking to sell or get short below the low of that "trigger session." See Figure 3.

I began tracking a variation on this for those instances when a market was moving in a trend but the trend was not showing enough of weakness (in a bull trend) or strength (in a bear trend) to get the pattern key to a L1 or S1 buying opportunity. The continuation trade (or L3 and S3 as I dubbed it at the time) simply allowed the trader to go long above the high of any session that showed an increase in slope from the previous session (m-M). To the short side, a decrease in slope (as in "P-p") was all that was needed to signal a continuation trade to the downside.

While this approach has been worthwhile, there are other methods (such as the BOSO method I wrote about a year ago) that do as good a job or better of tracking markets that appear unwilling to provide traders with a pullback (in a rising market) or a bounce (in a falling market) from which to gain a superior entry. Nevertheless, the continuation trade is one worth keeping in mind when a market advance appears well under way, and bargain entries prove themselves hard to come by.

In part II [*found on page 47 of this issue—Editor*], I will look at trading histogram divergences, how to trade crosses of the zero line, specific entry targeting, and exit strategies. ■

This article was originally published on 12/6/2006.

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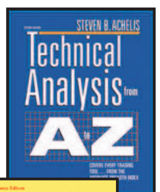
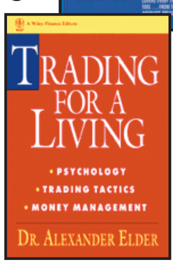

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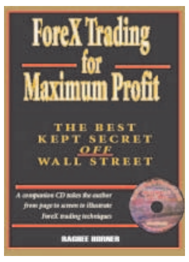

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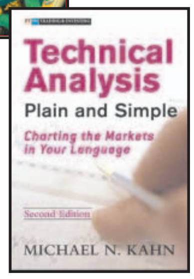

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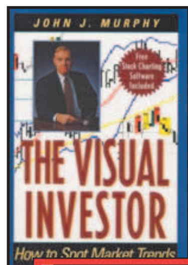
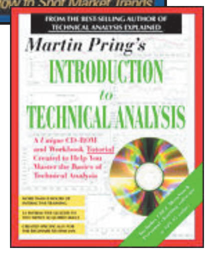

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INDEXES

FLAGS AND PENNANTS

Short-Term Moment Of Truth For The Dow

by Arthur Hill

The Dow Jones Industrial Average has corrected over the last three days, and this correction is nearing its make-or-break point.

Tradable: INDU

The medium-term trend for the Dow Jones Industrial Average (DJIA) is clearly up (Figure 1). The average bottomed in mid-July and moved pretty much straight up for the next three and a half months. It was truly an amazing move, and the pullbacks lasted just a few days. The deepest pullback occurred in August, and each pullback since then has been quite shallow or simply flat. The current pullback lasted three days, with short-shallow pullbacks the norm since mid-August.

I am turning to the 60-minute chart to focus on this pullback and short-term price action (Figure 2). The DJIA hit a new all-time high by moving above 12150 last week and then declined below 12050 this week. The decline looks like a falling flag and the average found support near broken resistance. This is all pretty normal for a minor correction. Broken resistance turns into support and the advance resumes without moving back below the resistance break. Broken resistance at 12030 is the first level to watch for signs of trouble. A break below 12025 would open the door to a deeper pullback that could extend to the August trendline on the daily chart.

The decline looks like a falling flag and the average found support near broken resistance.

As long as broken resistance holds, the decline back below 12050 is viewed as a correction within the ongoing uptrend. A break above the upper flag trendline and Monday's high would signal a continuation of this uptrend and target a move to new highs yet again.

I am also watching the relative strength index (RSI) to confirm a flag breakout. This momentum indicator declined below 50 on Friday and below 40 on Tuesday. Momentum is clearly moving down for the short term, and the RSI needs to break back above Monday's high (52) to turn short-term momentum bullish again. ■

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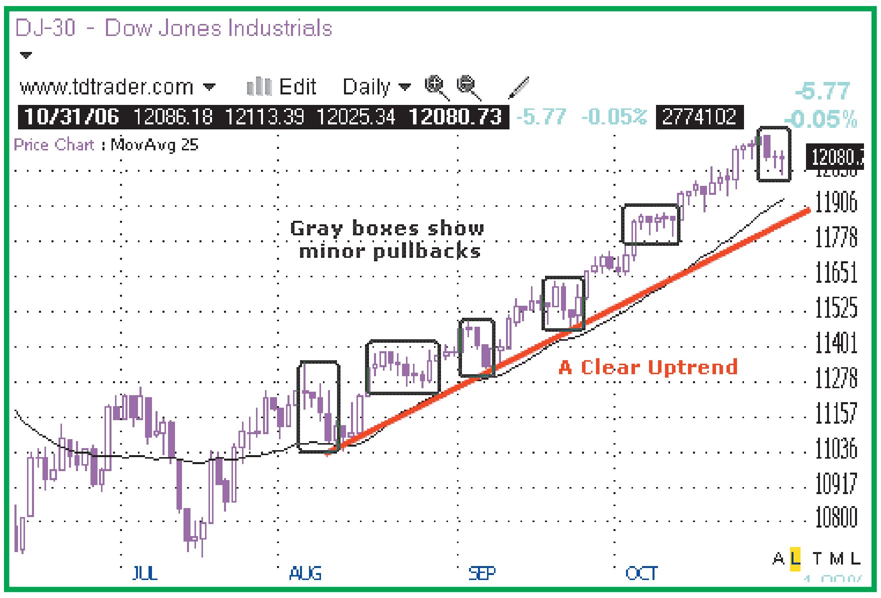

FIGURE 1: DJIA, DAILY. The Dow Jones Industrial Average bottomed in mid-July and since then has for the most part been moving up.

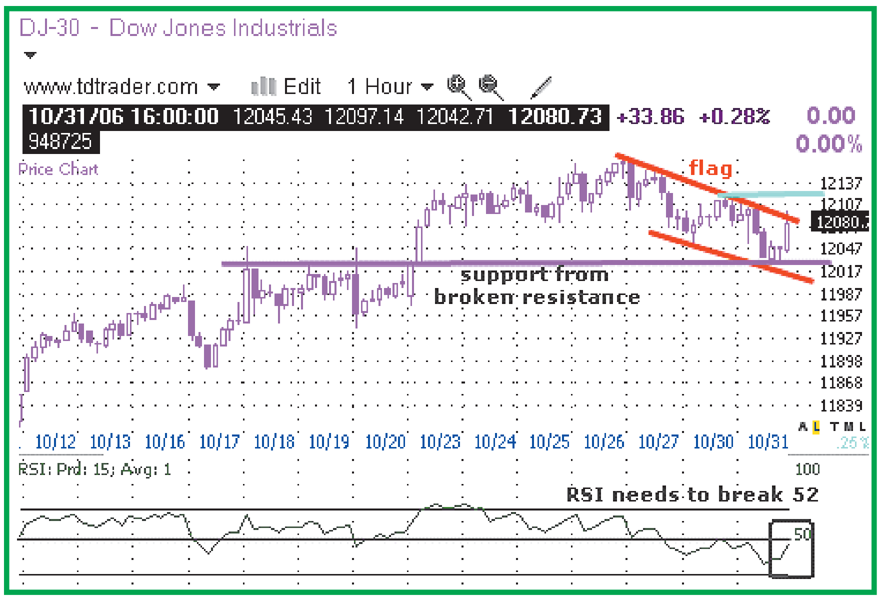

FIGURE 2: DJIA, HOURLY. Broken resistance at 12030 is the first level to watch for signs of trouble.

REVERSAL

Short-Term QQQQ Sell?

by David Penn

What happens when long-term bulls become short-term bears?

Tradable: QQQQ

Few things are more disconcerting than being on the opposite side of someone you respect when it comes to a trading call. Recently, the stalled progress to the upside has apparently encouraged those who think that stock prices are likely to move seriously higher before they move seriously lower that there might be an opportunity to be had — albeit in the short term — from a bet against stocks.

The short-term uptrend the QQQQs have enjoyed came courtesy of a fairly well-telegraphed bottom (see my "Is The End Near?" Traders.com Advantage, November 6, 2006). Positive divergences in the moving average convergence/divergence (MACD) and stochastic, a 2B bottom ... all of these factors came into play to put a bottom in the market in early November. See Figure 1.

So how does talk of a top play now? Looking at the same characteristics that made it possible to call the bottom in early November, I detect some of the same evidence that was so helpful in early November (namely, the positive divergences) coming into play as we move toward midmonth. Assum-

FIGURE 1: NASDAQ 100 TRUST SERIES (QQQQ), HOURLY. The QQQQ have completed the first stage of a potential 1-2-3 trend reversal. The next stage will be an attempt to restore the trend that began on Friday, November 3, including a new high.

ing that a short-term move to the downside should be noticeable on an hourly chart, it seems that the most bearish signs come from the break of the five-day uptrend from the November 3rd bottom. The trendline break was really a one-hour event as the QQQQ topped on Thursday and broke below the trendline later in the day. Almost immediately, however, the QQQQ rebounded — albeit on weak volume — and began moving higher, reaching the breakdown level by the close on Friday. This action sets up a potential 1-2-3 trend reversal, particularly if the QQQQ fails to set a new high and, instead, reverses and falls below the breakdown low at about 42.65 - 42.7.

In addition to the 1-2-3 trend reversal setup, the hourly QQQQ reveals negative divergences on two levels: the MACD histogram and the stochastic (Figure 2). While these negative divergences are, in and of themselves, at least as apparent as the ones noted from the first three days of November, there is some reason to view the bearishness of these indicators with some degree of caution. With regard to the MACD histogram, for example, the size of the histogram peak on November 6 and 7 is strongly suggestive of a market that will take out the price highs that were concurrent with the peak. While those price highs were exceeded a few days later, the subsequent highs seem a little modest given the size of the early November histogram.

With regard to the stochastic, the late session rally on November 10 helped push the stochastic up, almost to the level of the previous stochastic peak. In fact, it wouldn't take very much buying at all on Monday to push the stochastic higher, making the only relevant negative divergence in the stochastic the one between the stochastic peak of November 1 - 3 and the one likely to develop the week beginning November 13. This would create a particularly odd sort of negative divergence — odd, but one I've written about before (see my WorkingMoney.com article, "Dial 'D' For Divergences," March 8, 2006). This kind of divergence could be called the "diamond" divergence because of the way the peaks and troughs in the indicator mirror those in the market in question. In a negative diamond divergence we have three peaks with the higher peak in the center (like a head & shoulders pattern). At the same time, the indicator will form three peaks, with the center peak being the lowest of the three.

FIGURE 2: NASDAQ 100 TRUST SERIES (QQQQ), HOURLY. Negative divergences appear in both the MACD histogram and stochastic. Divergences brought the market higher at the beginning of the month. Will divergences now bring the market down?

That negative diamond divergence will be in effect as long as the third price peak does not take out the high set by the second price peak. Failing that, the bear case — for the time being — will be that much less potent. ■

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LINEAR REGRESSION CHANNEL

NASDAQ Channels Higher

by Arthur Hill

Despite a warning shot from the stochastic oscillator, the NASDAQ remains in a rising channel and trend has yet to bend.

Tradable: $COMPQ

The price chart shows the NASDAQ Composite with a linear regression channel (Figure 1). This linear regression channel is made up of three lines. The middle line is the linear regression itself. Based on the closing prices from July 21 to November 15, the linear regression is the line of best fit. Some closes are above the line and some closes are below. The upper and lower trendlines are parallel and equidistant to the linear regression line, which makes the channel symmetrical.

The trend is clearly up as long as the lower channel trendline holds. The upper trendline acts as resistance and a move above this trendline would signal an overextended situation. The lower trendline acts as support and a move below would break the channel. As it now stands, a move below 2350 would break the lower channel trendline and we could then entertain thoughts of a downtrend. As long as the channel holds, the NASDAQ is rising and a move toward the upper trendline is expected (2570!).

FIGURE 1: NASDAQ. The index remains on an uptrend and has yet to show signs of faltering.

Despite a clear uptrend, the stochastic oscillator fired a warning shot in early November. The stochastic oscillator moved above 80 in August and held above 78 from August 17 to November 2. This is quite extraordinary and reflects the strength of the current uptrend. The stochastic oscillator dipped below 65 on November 7, and this is the first sign of weakness in months. I do not consider this dip bearish, but it does point to vulnerability as the NASDAQ becomes overextended. I would consider momentum to be bullish as long as the stochastic oscillator holds above 50. For a medium-term trend reversal, I would look for the NASDAQ to break 2350 and the stochastic oscillator to break 50. ■

ELLIOTT WAVE

Meeting Parameters On The S&P 500

by Jacob Singer, PhC

Every morning I look for certain stocks to buy, but they have to meet certain parameters. What does it mean if for the past three days, not a single stock has come up that meets those parameters?

Tradable: SPX

Every morning I run an exploration on the New York, AMEX, NASDAQ, and Toronto markets to look for stocks to buy. These stocks must meet certain parameters. For the past three days, not one stock has come up. This is unusual, and I ask, what is this telling me? Figure 1 shows my final exploration result.

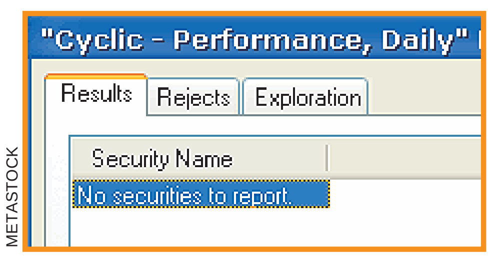

FIGURE 1: PERFORMANCE EXPLORATION REPORT. Not one stock has popped up with the parameters I was searching for—what's that mean?

This suggests that the correction we have been anticipating could be under way. Figure 2, the S&P 500 monthly chart, shows that the index could be topping out in a B-wave.

FIGURE 2: ELLIOTT WAVE AND GANN FANN OF THE S&P 500, MONTHLY. Could the index be topping out in a B-wave?

I first introduced this chart on September 22, 2005. At that time the chart suggested that 2006 would truly be a year of misfortune for the market. It is now November 2006, and the chart shows that the index is still rising.

The first rule in Elliott wave analysis is *the chart must look right.* In this case, the chart looks *very* right. The fifth wave top was the bubble of 2000. The index then fell in an A-wave, and has now recovered in a B-wave.

B-waves are not impulse waves, usually rising in an abc formation (not shown). B-wave tops are also difficult to predict. I have seen instances where B-waves have exceeded fifth wave tops. This usually suggests that the C-wave correction will not be that severe. The Gann cycle, which correctly forecast previous corrections (blue arrows), suggested a turning point on October 20. This as we know has not happened, although we should allow a two-month error on either side of the cyclical projection.

The B-wave has also broken above the suggested target of 1337.40, one of Gann's rule of 8's lines. This suggests that the index could rise to the green 1x4 Gann line. ■

1. Annual Percentage Yield is effective 1/24/07 and is subject to change. A $1 minimum deposit is required to open a new account. Withdrawal limits apply. Online statements required.
2. The Annual Percentage Yield (APY) of the Complete Savings Account as of 1/24/07 is more than 6 times the national average APY for savings accounts with balances of $25,000. Source: Informa Research Services, Inc., Calabasas, CA. www.informars.com. Although the information has been obtained from the various institutions themselves, the accuracy cannot be guaranteed.
3. **For details and important information about Quick Transfer, please visit etrade.com/quicktransferdetails** for a listing of the limitations, restrictions and time deadlines associated with this service.

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WEDGE FORMATIONS

Nikkei Breaking Down

by Arthur Hill

The Nikkei 225 is breaking down on a number of fronts, and this points to a continuation of the April–June decline.

Tradable: $NIKK

On the price chart (Figure 1), the current advance in the Nikkei formed a rising wedge and the index broke the lower trendline over the past two weeks. The April–June decline set the bearish tone and the rising wedge is typical for countertrend rallies. Note that the advance met resistance near the May gap and support break. The recent break below the lower wedge signals a continuation of the prior decline and the downside target is below the June low.

The index also broke back below the 50-day moving average and 200-day moving average. The 50-day moving average has a good history with the Nikkei. The index broke the 50-day with a gap down in May and this moving average turned into resistance in early July. The index then broke above the 50-day in late July and this moving average turned into support in late September. The current break is bearish, and I would look for this moving average to offer resistance in the over the next one to two months.

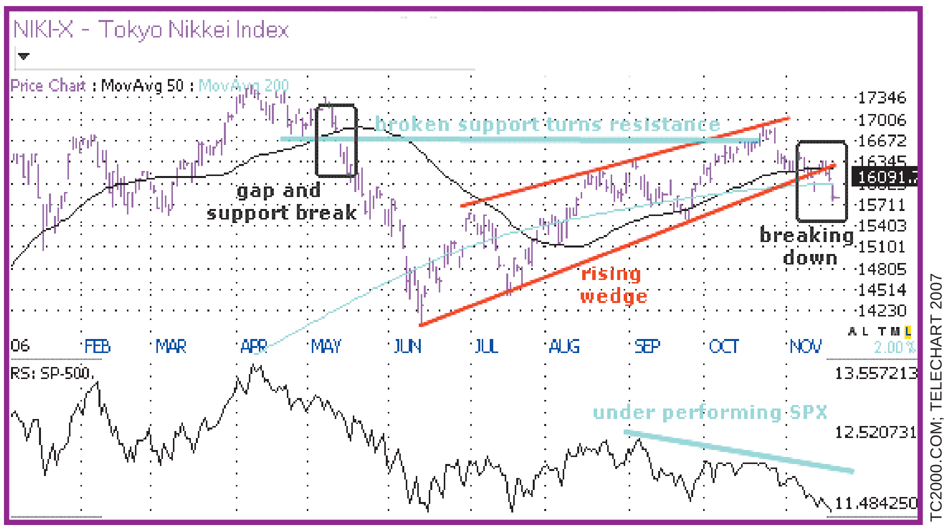

FIGURE 1: NIKKEI. The current advance formed a rising wedge and the index broke the lower trendline over the past two weeks.

In addition to the breakdowns on the price chart, the Nikkei shows relative weakness over the last six months. The price relative compares the Nikkei to the Standard & Poor's 500. The indicator broke to new lows in June and the recovery off the June lows was feeble, to say the least. While the Nikkei moved to new reaction highs in October, the price relative formed a lower high and the Nikkei was not keeping pace with the S&P 500. The price relative recently broke to new lows and the laggard on the way up could become the leader on the way down. ■

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CHART ANALYSIS

NASDAQ Composite Index Shows Pending Downleg

by Gary Grosschadl

Has the Grinch stolen the Christmas rally, or is it already over for the NASDAQ?

Tradable: COMPQ

It's been a good run for the high-tech index since the summer of 2004, as Figure 1 shows. This weekly chart shows a definite uptrend, and a pitchfork view or Andrews line highlights this. The good news is that an uptrend is in place, and the bad news is that a significant downleg may be in store affecting short-term and/or medium-term traders.

Note the history of bearish engulfing candlestick patterns marking sizable downlegs. These are large bearish candles that engulf the previous candlesticks. These can be reliable turning points after a good upleg. After the latest 450-point rise, another such bearish candlestick pattern has struck.

Bearish engulfing candlestick patterns can be reliable turning points after a good upleg.

Several indicators hint at a coming downleg. The average directional movement index (ADX) line at the top of the chart may have peaked, as it is above the positive directional index (+DI) and it has flattened out.

The moving average convergence/divergence (MACD) shows a downturn from peak levels, while its histogram shows a definite downtrend. The relative strength index (RSI) also seems to be coming off its own peak from the 70 level. Meanwhile, the stochastic oscillator hovers in an overbought condition but needs to decline below the 80 level to confirm a negative follow-through.

Two downside targets are possible. The first is a zone between 2300–2350 representing the median line of the pitchfork and a previous support point. The larger downside target is the lower pitchfork median line and the 200-period exponential moving average (EMA) near 2100. Watch these targets for another possible turnaround situation, should a downleg develop from the current position. ■

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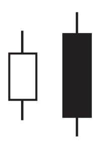


Bearish Engulfing (BEE): The market is trending higher. The white real body is engulfed by a black body. It is the signal for a top reversal.

FIGURE 1: NASDAQ, WEEKLY. There's a definite uptrend, and a pitchfork view highlights that.

The NASDAQ 100 Winds Up For The Pitch

by Arthur Hill

A narrowing consolidation can't last forever, and the NASDAQ 100 looks poised to break the recent trading range. Here's what to look for.

Tradable: $NDX

The NASDAQ 100 has been on a tear since mid-July, with a 25% advance in just over four months (Figure 1). Since moving above 1800, the advance slowed over the last few weeks and a pennant formed. These are continuation patterns that represent a rest in the ongoing trend. The big trend is up and this pattern represents a bullish consolidation.

The November surge added 100 points to the index and it became overbought. There are two ways to work off overbought conditions: correct or consolidate. The NASDAQ 100 chose a little of both. There was a sharp decline on November 27 and then a consolidation over the last two weeks. Taken together, the pennant formed and the next signal is dependent on the direction of the breakout.

A move above the upper trendline and early December high would be bullish. The upside target would be around 1860–1870 (Figure 2). This was found creating a trendline parallel to the lower pennant trendline and extending it up for two weeks. Should the NASDAQ 100 break resistance, the breakout point would turn into support and this would be the first test. The early December low would mark key support.

A move below the lower trendline would be bearish and open the door to further weakness. The downside target would be to around 1720–1730 (Figure 2). This was found by creating a trendline parallel to the upper pennant trendline and extending it down for two weeks. The support break would turn into resistance, and this is the first level to watch for signs of a failed signal. The early December high would mark key resistance. ■

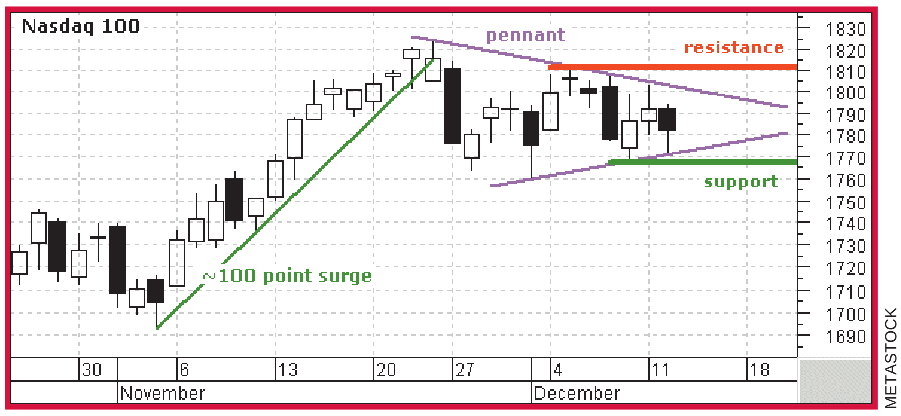


FIGURE 1: NASDAQ 100. The NDX has been on a tear since mid-July, with a 25% advance in just over four months.

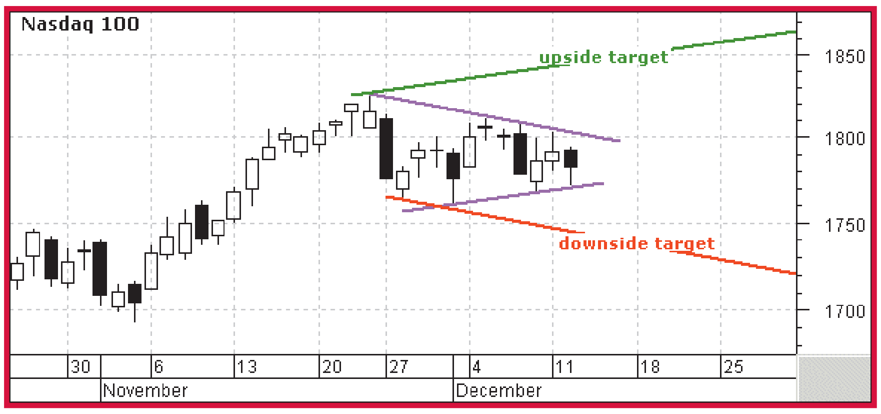
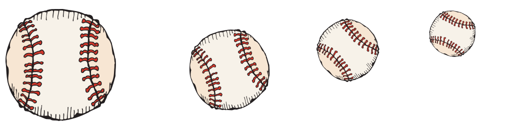


FIGURE 2: NASDAQ 100. A move above the upper trendline and early December high would be bullish, with the upside target about 1860 to 1870.



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METALS & ENERGY

SYMMETRICAL TRIANGLE

Copper Cracks

by David Penn

The much-anticipated breakout from a multimonth symmetrical triangle has arrived.

Tradable: HGZ6

Back in August, I tipped off Traders.com Advantage readers to developments in copper futures ("The Copper Triangle," August 25, 2006). In particular, I wanted to draw attention to the sizable, symmetrical triangle that copper had formed starting in May 2006. This triangle began to take form after a truly amazing rally in the metal, a rally that saw copper move from $2.20 in mid-March to approximately $3.90 by May.

Generally speaking, consolidations in trends tend to lead to more trend. So the most likely resolution of the symmetrical triangle that took shape in the middle of 2006 was to the upside, as the trend that led into the consolidation was restored upon leaving it.

I offered no prediction with my August 2006 article on copper. I simply pointed out that an upside breakout would likely take copper futures to the $4.40 area, while a downside breakdown would probably see copper slipping toward the $2.40 mark. See Figure 1.

It appears as if the break that traders had been waiting for has finally arrived. In the first full week of November, December copper futures fell more than 20 cents on overwhelming volume to break down below the lower boundary of the symmetrical triangle that had contained virtually all price action in the contract since late spring. There is the possibility that the contract will find support at the lowest point of the triangle, a weekly hammer candlestick with lows at about 2.85. Such an event would invalidate the triangle, making the consolidation more of a garden-variety rectangular consolidation. On balance, however, the breakdown from the triangle looks clear cut and, arriving on large volume as it has, very much worth watching.

How might traders have fared acting on this breakdown? The directional movement index/average directional movement index (DMI/ADX) in Figure 2 shows how some traders might have followed one path to profit. The DMI gave a sell signal on October 23 that would have been filled on October 24 using J. Welles Wilder's extreme point rule at approximately 3.40 (see my Working-Money.com article, "Trading DI+/-" from October 12, 2006, for more on the extreme point rule). An intraday high on October 26 of approximately 3.43 notwithstanding (the market closed that day at 3.40), this trade would have worked splendidly. In fact, by the time the ADX confirmed the DMI sell signal on November 2, December copper was trading near 3.29, some 11 cents and $2,750 in profit lower (each cent in copper futures is worth $250).

If the downside objective remains $2.40, then there should still be plenty of downside for traders to exploit. With the optimal DMI/ADX signal already passed, I find short entry targets using other screens such as the BOSO screen ("BOSO," Working-Money.com, October 5, 2005) and the histochastic screen, which uses shifts in the MACD histogram to trigger entries. Based on those two screens, there are short entries at 3.075 (BOSO) and 3.017 (histochastic) that might be levels to look for going forward. ■

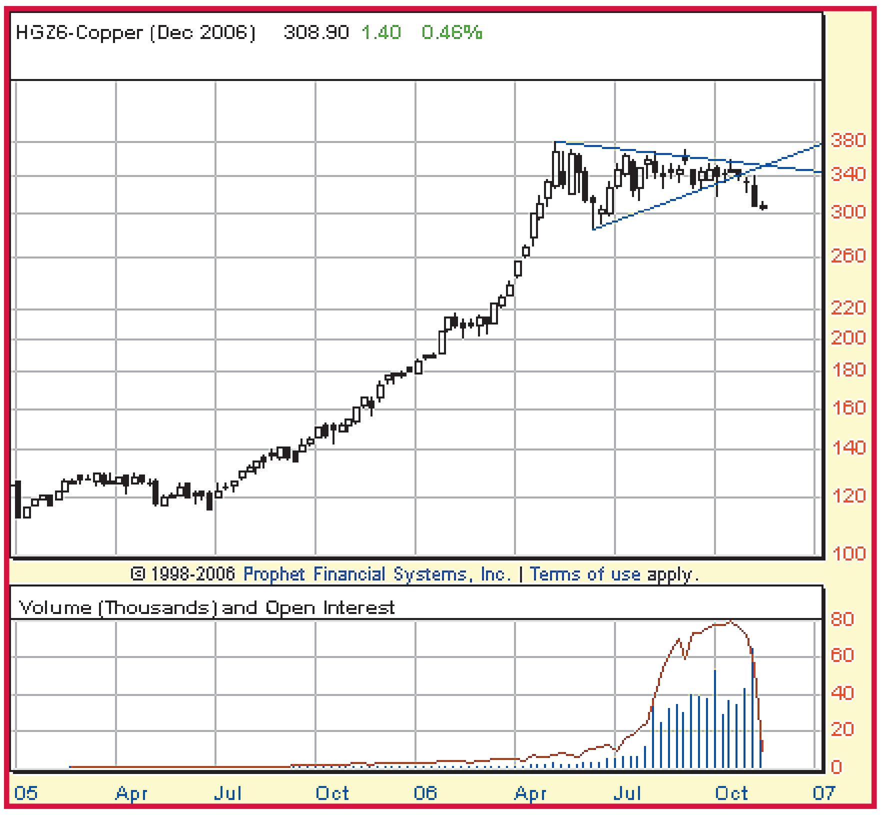

FIGURE 1: DECEMBER COPPER, WEEKLY. The breakdown from this symmetrical triangle comes after an extended sideways correction. Nearest support is at the 2.20 level, from a consolidation earlier in the year.

FIGURE 2: DECEMBER COPPER, DAILY. The DMI provides a sell signal in late October, copper follows through to the downside after the DI- line (in red) crossed up over the DI+ line (in green). This sell signal was confirmed by the crossing of the ADX line (in black) up and over the green DI+ liine in early November.

SUGGESTED READING

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

_____ [2005]. "BOSO," Working-Money.com, October 5.

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Flag Breakout For XAU

by Arthur Hill

Despite the potential for a massive head & shoulders reversal pattern, the Philadelphia Gold & Silver Index recently broke flag resistance, pointing to higher prices.

Tradable: $XAU

Let's start out with the long-term picture for the Philadelphia Gold & Silver Index ($XAU) and look at the weekly chart first (Figure 1). $XAU surged above 130 in January and then embarked on a big consolidation that lasted the next 11 months.

The pattern at work looks like a big head & shoulders reversal: the January high forms the left shoulder, the May high forms the head, and the right shoulder met resistance around 150. The neckline slopes down and a break below this support level would project further weakness below 100. The head & shoulders pattern is only potential as long as the index remains above the October low (117).

The neckline slopes down and a break below this support level would project further weakness below 100.

As long as the head & shoulders pattern is just a potential problem, it is befitting to look for an alternative pattern at work. Figure 2 shows the same time frame and a triangle consolidation over the last nine months. A move above 143 would break the upper trendline and signal a continuation of the prior advance. This would be enormously bullish and the upside target would be well north of 170. However, this pattern is as yet unconfirmed as well. The index simply remains in a one big consolidation and we are waiting on the subsequent breakout (up or down) for a long-term signal.

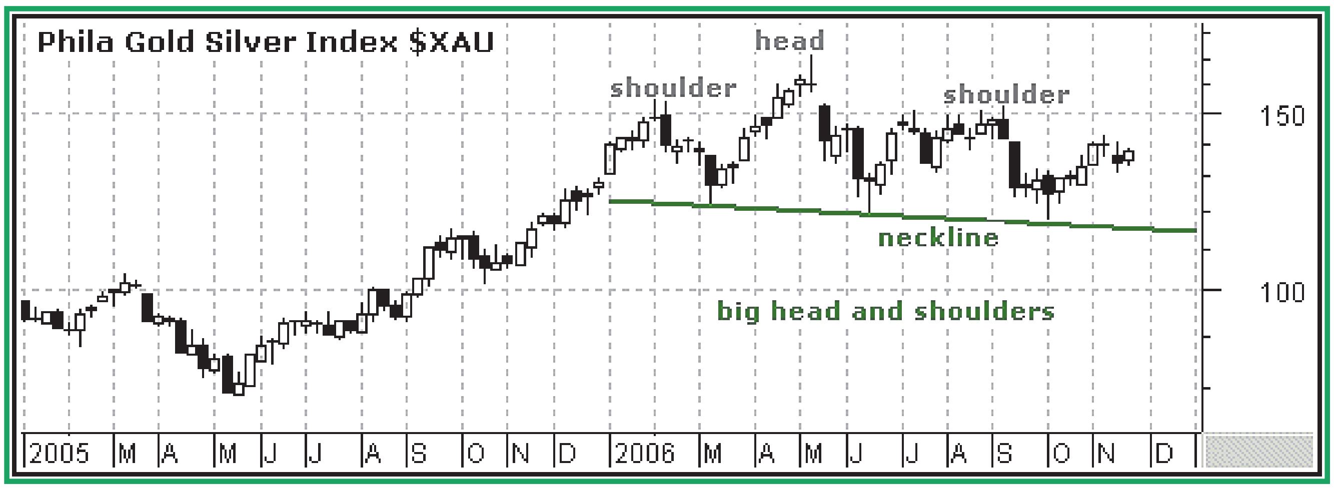

FIGURE 1: $XAU, WEEKLY. Gold surged above 130 in January and then embarked on a consolidation that lasted the following 11 months.

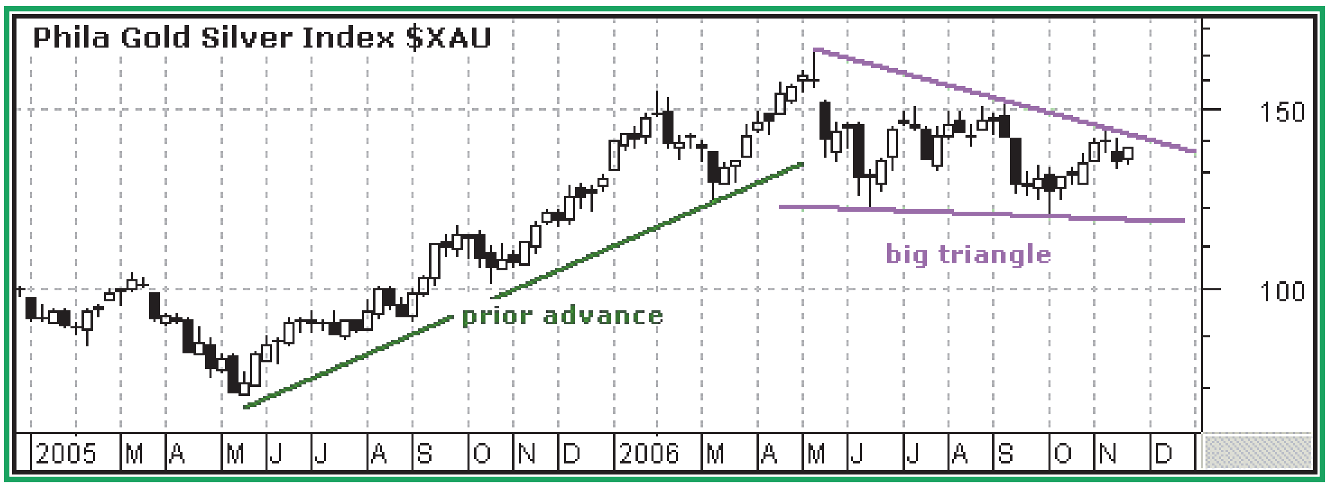

FIGURE 2: $XAU, MONTHLY. Note the triangle consolidation over a nine-month period.

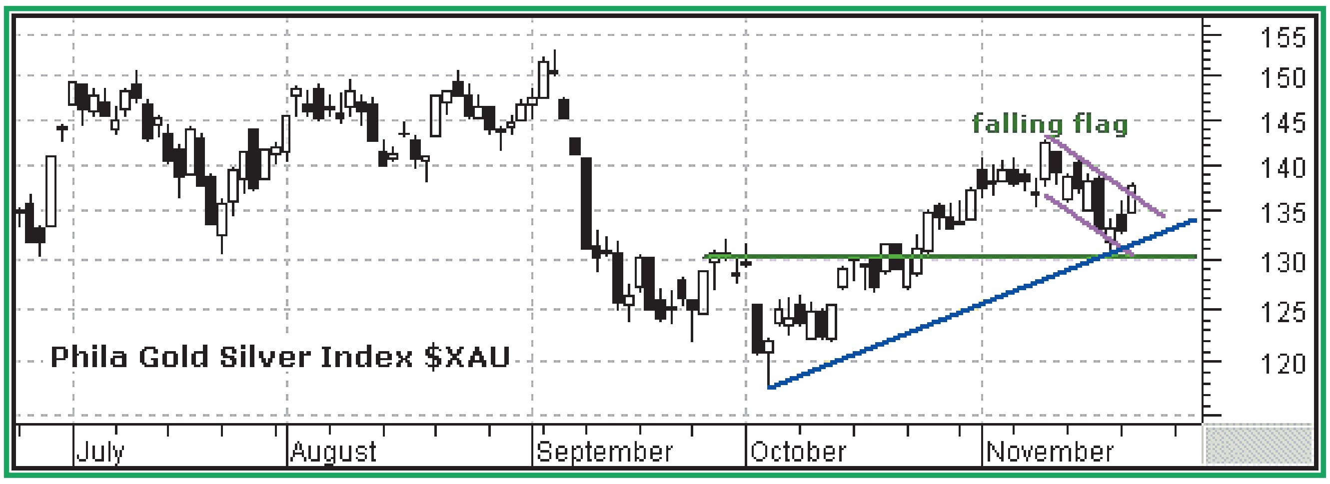

FIGURE 3: $XAU, DAILY. $XAU broke resistance around 130 with a surge in October and then pulled back to a resistance break in November.

Until there is a long-term signal, traders and investors should focus on a shorter time frame for signals. On the daily chart (Figure 3), $XAU broke resistance around 130 with a surge in October and then pulled back to this resistance break in November. The decline formed a falling flag and broken resistance turned into support. $XAU bounced over the last three days and broke flag resistance. This signals a continuation of the October advance and reinforces support at 130. The upside target is around 150 and $XAU would have to move below 130 to negate this signal. ■

FLAGS AND PENNANTS

Halliburton Takes A Rest

by Arthur Hill

After a big surge on high volume, Halliburton took a breather over the last two weeks. Traders should look for a breakout to signal a continuation higher.

Tradable: HAL

Let's start with the weekly chart for some perspective (Figure 1). The Halliburton stock (HAL) formed a double top earlier this year and broke support in July. The support break confirmed the double top and projected a move to around 24 (42 - 33 = 9; 33 - 9 = 24). HAL reached 26.33 in early October and bounced back above 30 with a strong move in the last few weeks. Broken support from the double top (~33) became resistance and the stock stalled over the last three weeks. In addition, the 25-week moving average marked support in 2005 and early in 2006. This moving average marked resistance around 32.

The stock is clearly at its moment of truth on the weekly chart, and a consolidation formed on the daily chart (Figure 2). The pattern over the last eight weeks looks like a sharp advance and a flat flag. Volume surged on the advance and the flag represents a rest or consolidation within the ongoing trend. A break above the flag highs would signal a continuation higher and target a challenge to the April high (~42).

As noted on Figure 2, HAL has lots of resistance around 33. In addition, there is resistance in this area from the August consolidation and flag highs. With so much resistance, HAL could fail near current levels and break flag support. A move below 31 would negate the flag and call for at least a pullback or retracement of the October advance. At worst, a lower high would form around 33 and a move below the October low would be expected. ■

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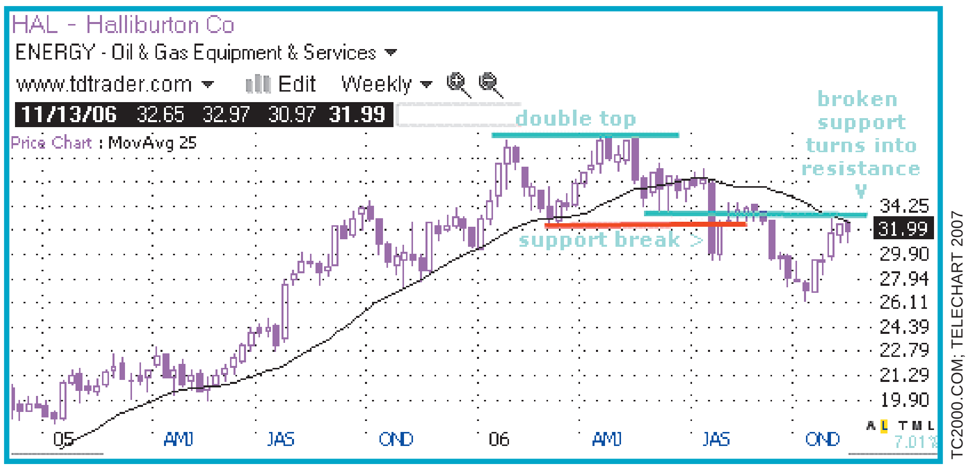

FIGURE 1: HALLIBURTON, WEEKLY. HAL formed a double top earlier in 2006 and broke support in July.

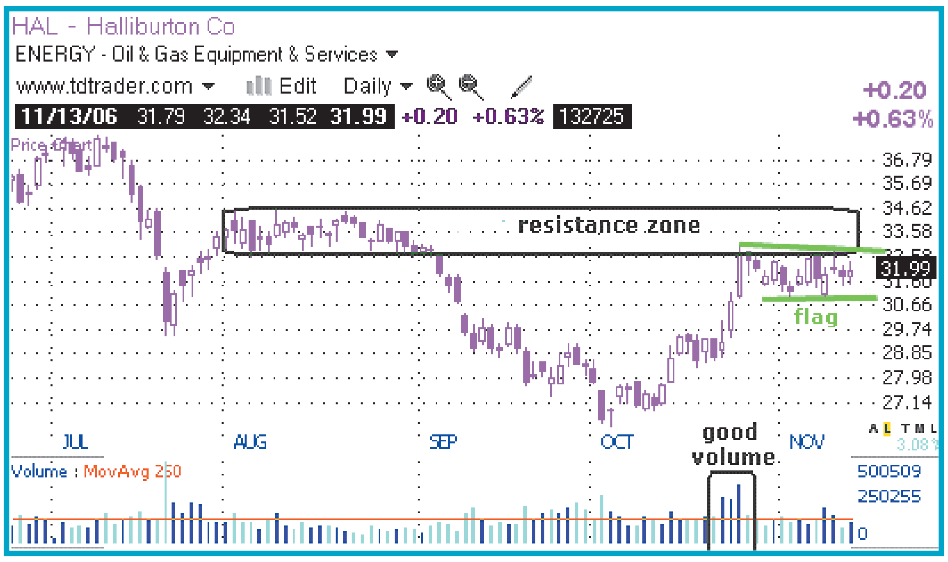

FIGURE 2: HALLIBURTON, DAILY. HAL has notable resistance around 33. In addition, there is resistance in this area from the August consolidation and flag highs.

SECTOR INVESTING

Black Gold Is Back

by David Penn

Breakouts in oil stocks appear as the group moves toward a seasonal sweet spot.

Tradable: OIH, VLO

One of the more interesting sector seasonals noted by stock market historians Yale and Jeffrey Hirsch in their 2006 *Stock Trader's Almanac* is the six months' worth of outperformance that comes from the oil sector between mid-December and mid-June. Using the Amex Oil Index ($XOI) as their proxy and looking at average returns over both a 10- and five-year period, the Hirsches found that the $XOI had a 16.2% average return over the December–June period during the past 10 years and a 19% average return during that same time frame for the most recent five years.

At a time when many markets are overbought and traders and investors are anxiously awaiting any pullback in order to start buying, the prospect of a sector still coming off of a bottom and equipped with a compelling, bullish secular story is likely to be a welcome one.

Then again, it depends on your measuring tool. Compared to the $XOI, which is closing in on its 2006 highs, the oil service HOLDRS — along with many oil service stocks — are still just climbing above the 50% retracement level (Figure 1). In fact, as I review my watchlist of oil stocks, it seems that for every Conoco Phillips and Exxon that are at or above their 2006 highs, there are the Baker Hughes, the Halliburtons, and the TransOceans that are lagging.

If there is to be a sustained move higher in these stocks over the next six months, then it is possible (if not likely) that those stocks that are nearing, at, or have recently notched 52-week highs will do some consolidating — as will those approaching the 50% retracement level — before moving higher. Insofar as oil stocks have yet to gain the atten-

FIGURE 1: OIL SERVICE HOLDRS, WEEKLY. After falling more than 26% from May to late September, oil service stocks rebounded strongly in the autumn, retracing fully 50% of the previous decline by late November.

tion of the investing public, any coming consolidation might be an ideal time for those interested in buying (or "renting") oil stocks to do so.

A stock like Valero is a good example of such stocks that have just started to get going. Looking at the weekly chart in Figure 2, it appears as if a sort of ascending triangle bottom has been developing since early October. In fact, there's an argument that the triangle is even larger and begins in late September (as the trendline in Figure 2 almost suggests). In either event (and taking the more modest case as our example), the triangle projects a move to the 58 area (formation size of 4 plus the breakout level at approximately 54). This 58 level would coincide with a full 50% retracement as well as with potential resistance left over from the lows of early summer. ■

SUGGESTED READING

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

FIGURE 2: VALERO ENERGY CORP., WEEKLY. Although oil stocks like Exxon are making 52-week highs, others such as Valero have yet to truly get moving to the upside. The stock's recent move toward the 38.2% retracement level will be one test of whether stocks like Valero will be a part of the group's overall move higher.

MACD

The Gold Bugs Index Hits Support

by Arthur Hill

The December decline in the Amex Gold Bugs Index hit support and recent firmness could foreshadow a break higher.

Tradable: $HUI

On the daily chart of the Amex Gold Bugs Index ($HUI), the medium-term trend is clearly up (Figure 1). The index bottomed in early October and moved sharply higher over the next two months. HUI forged a higher low in mid-November and a higher high in early December. It is a clear and present uptrend.

Despite this uptrend, HUI experienced some weakness in December. However, the decline looks relatively minor and support is close at hand. Broken resistance and the October trendline confirms this support level.

Even though the big trend is up and the current decline looks like a correction, the current decline has yet to reverse and the moving average convergence/divergence (MACD) 5/35 is still moving lower (red line). I am using different moving averages to increase the sensitivity of MACD (five-day EMA less 35-day EMA). The white line is the five-day EMA of the MACD 5/35 and this acts as the signal line. A move above this signal line would reflect an upturn in the MACD and in HUI. I would take this as positive and call for an end to the correction.

Turning to an intraday chart (Figure 2), we can also focus on the December decline and pick a trend reversal point. A downtrend is made up of lower lows and lower highs. At the very last, a higher high is required to reverse this downtrend and start an uptrend. The last lower high formed around 351 on Monday. A break above this level would forge a higher high and signal an end to the December decline. ■

I am using different moving averages to increase the sensitivity of MACD (five-day EMA less 35-day EMA).

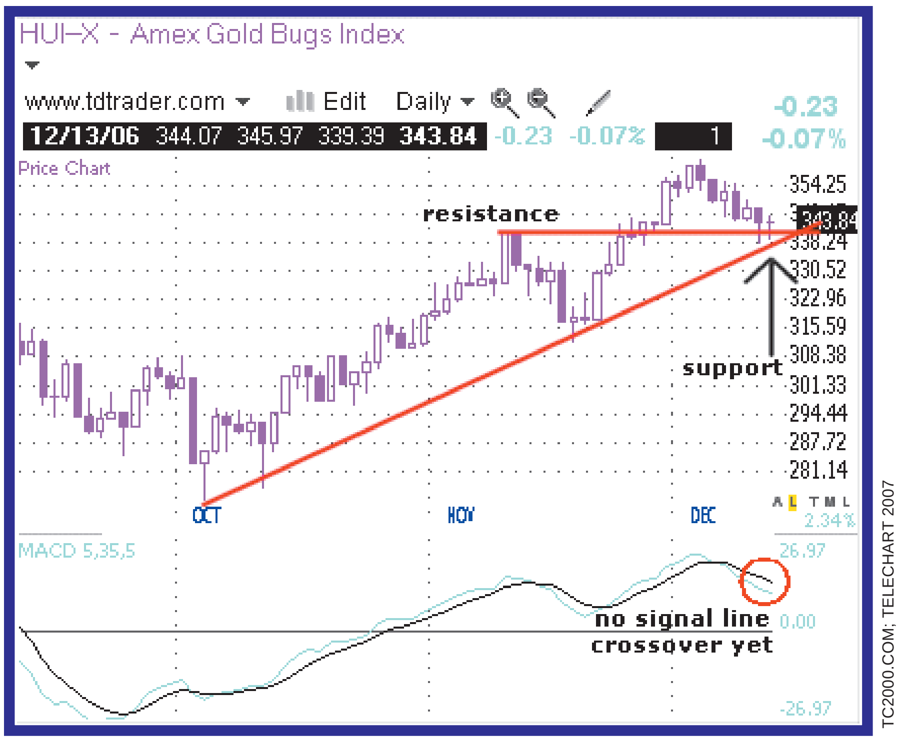

FIGURE 1: GOLD BUGS INDEX, DAILY. Here, the medium-term trend is clearly up.

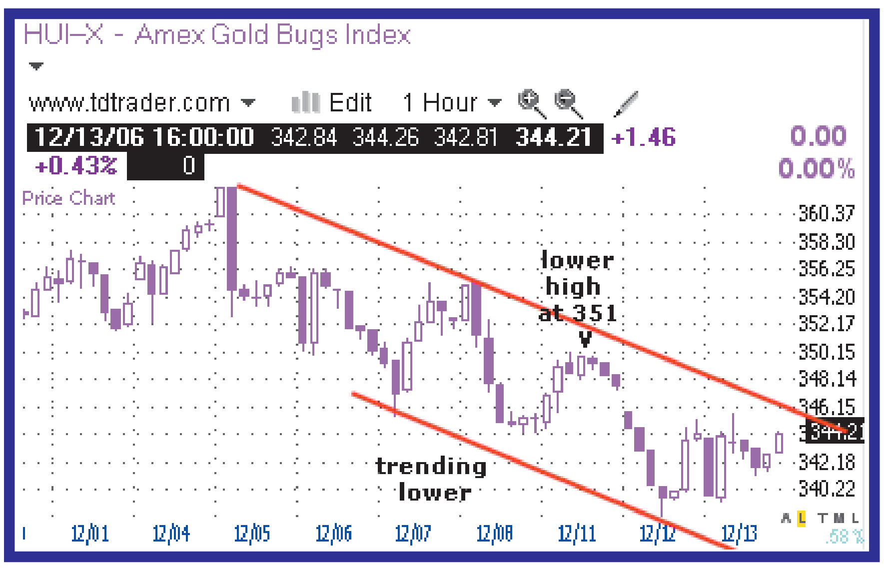

FIGURE 2: GOLD BUGS INDEX, INTRADAY. The last lower high formed around 351. A break above this level would signal an end to the December decline.

GOLD & METALS

Gold's Three Trends

by David Penn

Bullish long-term, bearish intermediate term ... what does a near-term breakout mean for gold going forward?

Tradable: GC

Writing in their classic stock trading primer, *Technical Analysis Of Stock Trends*, authors Robert D. Edwards and John Magee note that "the market, meaning the price of stocks in general," moves in three degrees of trend. As Dow theorists, Edwards and Magee refer to these three degrees as *major* or *primary*, *secondary*, and *minor*. Major or primary trends, per their classification, last at least one year and "may run for several years." Secondary trends run counter to the major or primary trend and tend to last "from three weeks to as many months, and rarely longer." Minor trends, which the authors suggest reflect the "day-to-day fluctuations which are unimportant," are of even shorter duration, "rarely as long as three weeks — usually less than six days."

Whether or not you subscribe to all aspects of these definitions, it is true that there are often multiple forces at work in a market and that these forces can often be classified as long, intermediate, and short term in duration. Looking at a three-year weekly chart of gold futures (Figure 1), for example, it is clear that what Edwards and Magee describe as the "tide, wave, and ripple" aspect of markets is very much in effect here. There is the primary, long-term tide in the form of a bull market in gold that began at least as early as August 2005. From May 2006 until October 2006, gold experienced a secondary or intermediate correction (a "wave," if you will) that retraced approximately 50% of the previous primary advance just mentioned.

The question for most gold watchers right now is what the advance from the October 2006 lows represents. Does it mark the end of the May–October correction and the resumption of the bull market that began in August 2005? Or is the rally simply a minor trend, a short-term movement within the intermediate correction, a short-term move that will end without setting a new high of any consequence and lead to an even deeper correction?

The weekly directional movement indicator acknowledges the likelihood of a significant low in October 2006 (Figure 2). We can tell this by the way the bullish DI+ line has crossed above the bearish DI- line at the beginning of November. The way that gold (basis continuous futures) found support at the 575 level — a level that was penetrated on an intraweek basis in June and again in October — also seems significant. The fact that gold has not yet closed beneath this area makes the 575 level a source of support to be monitored. It is also worth mentioning that the May–October correction at its lowest point retraced fully 50% of the previous advance. While a renewed correction could retrace even more, those long gold can at a minimum be assured that the correction was a significant one and that most of the "weak hands" had been shaken out.

FIGURE 1: GOLD, CONTINUOUS FUTURES, WEEKLY. Gold's primary or long-term uptrend was interrupted by a secondary or intermediate correction in the second half of 2006. That correction has retraced fully 50% of gold's advance from the lows of the summer of 2005.

FIGURE 2: GOLD, CONTINUOUS FUTURES, WEEKLY. Weekly directional movement suggests that gold is likely to head higher over the next few months, at least. Note how the crossover of the bullish DI+ line (in green) above the bearish DI- line (in red) coincides with prices breaking out above the downtrend line that extends down from the spring 2006 peak.

There is a bearish case to be made. While directional movement on the weekly scale is bullish, there is not yet the sort of separation between DI+ and DI- that assures higher prices in the near term. In addition, the past few weeks have seen gold futures break down below a shorter-term, six-week trendline that extends from the late October lows. If higher gold prices are to arrive in the coming months, gold futures will have to rally above the most recent minor high just north of 650. Beyond that, the early July high of 669 lies ahead as another potential source of resistance. ■

There are often multiple forces at work in a market and these forces can often be classified as long, intermediate, and short term in duration.

SUGGESTED READING

Edwards, Robert D., and John Magee [2001]. *Technical Analysis Of Stock Trends*, 8th ed., W.H.C. Bassetti, ed. Saint Lucie Press.

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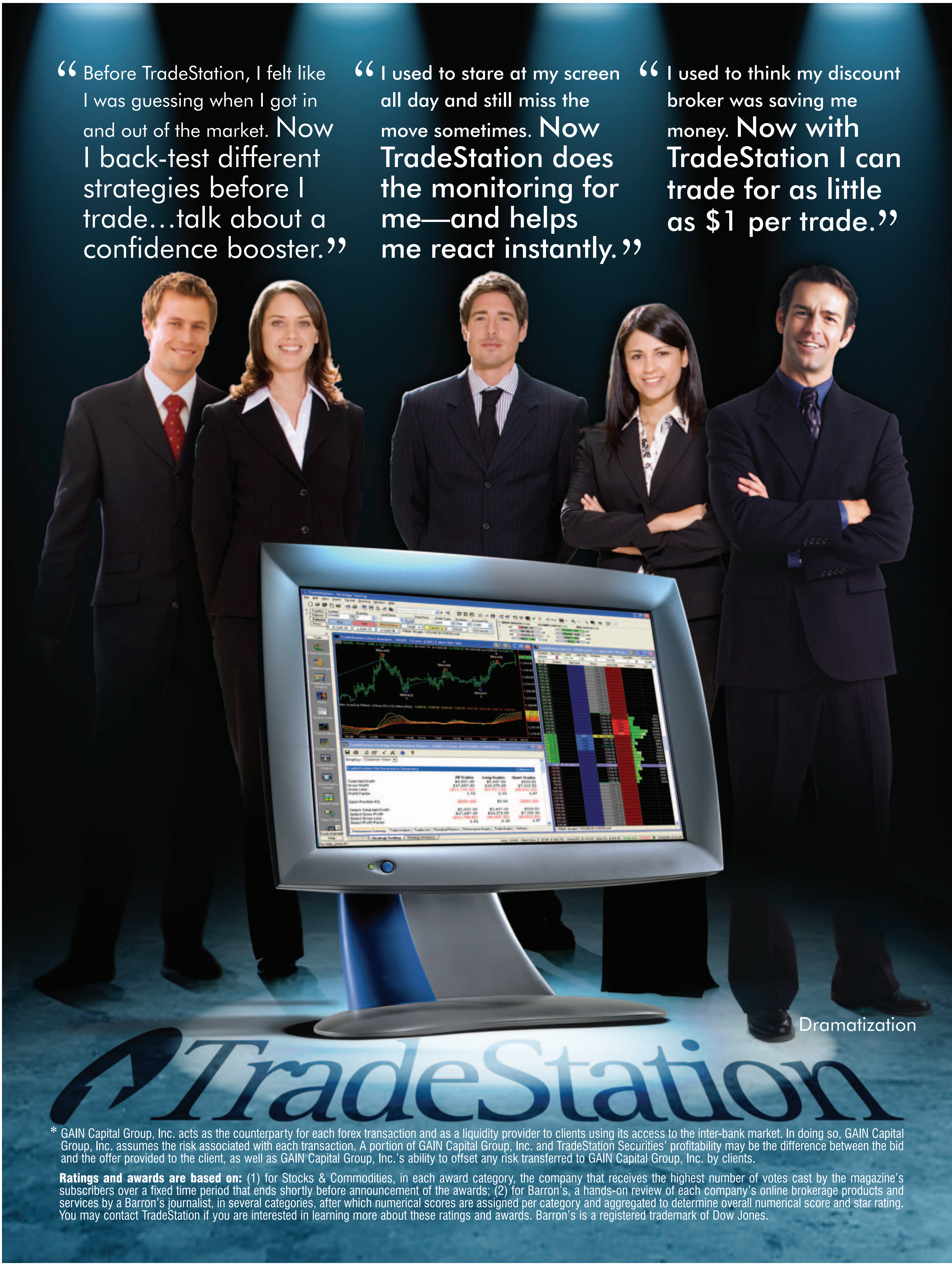
This article was first published on 12/21/2006. See www.Traders.com for more.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REVERSAL

Crackin' Crude

by David Penn

Negative divergences in the MACD histogram and stochastic anticipated the reversal in oil stocks.

Tradable: CL, OIH

Back in the summer of 2006, I wrote an article for *Traders.com Advantage* that suggested that lower crude oil prices were increasingly likely (see my "Cracks In The Crude" from July 25). At the time, crude oil was trading in the mid- to low 70s. But I warned that both weekly and daily charts of crude oil futures were hinting at weakness that anyone betting on higher oil prices needed to be aware of.

PROPHET FINANCIAL

FIGURE 1: CRUDE OIL, CONTINUOUS FUTURES, DAILY. After trading in the high 70s in the summer of 2006, the price of crude oil futures collapsed over August and September before bottoming in October.

Three months later, crude oil futures (basis continuous futures) were struggling to remain above $58. (See Figure 1.)

Crude oil bottomed in October, and oil stocks in particular took the cue and began moving up sharply. Oil futures (basis continuous futures) were relatively modest in their October–December advance, rallying some 10%. But as measured by the oil service HOLDRS — which signaled the bottom with very clear-cut positive divergences in the stochastic and MACD histogram — oil stocks rallied some 25% from their October low to their peak in December.

As often is the case, however, the divergences that announce the beginning of a market move are often mirrored by divergences that anticipate the end of a market move. With oil service stocks (again, as measured by the OIH), negative divergences appeared by mid-December. It was December 18 when both the moving average convergence/divergence (MACD) histogram and stochastic completed lower highs, just as the OIH was coming down from a higher high. As far as oil bulls were concerned, December 18 might as well have been "Black (Gold) Monday," for the deluge had just begun.

FIGURE 2: OIL SERVICE HOLDRS, DAILY. Negative divergences in the MACD histogram and lower highs in the stochastic anticipated this correction in oil service stocks. The depth of the histogram suggests that the 132 level, at a minimum, will be broken before the correction has run its course.

As often is the case, the divergences that announce the beginning of a market move are often mirrored by divergences that anticipate the end of a move.

The divergences provided for a short entry in the OIH near 141. If you look carefully, you can see that the decline stalled in this area for roughly three or four trading sessions before the big breakdown on January 3. And while there is likely to be some profit-taking given the speed and depth of the break, the size of the MACD histogram clearly points to further downside. For this reason, it may be wise to wait for a bounce — ideally up to the 138 level — before putting on a new short position vis-a-vis the OIH.

Where might the correction find support? The 132 area represents roughly a 61.8% retracement of the advance from the October closing low, so it would not be surprising if the bounce — in the guise of the forementioned profit-taking — comes sooner than later (see Figure 2). But if the OIH does not hold up at this level, traders should be prepared for a steeper decline to, perhaps, the 126 level. This level is potentially significant insofar as it matches up with both a swing rule projection downward from the December topping pattern (150 to 138 in height), as well as being near the 78.6% retracement level. ■

The S&P 500's Cup With Handle

by David Penn

A classic chart pattern suggests more upside for the S&P 500 as the holiday season begins.

Tradable: $SPX

For those looking for the great autumn stock market correction, I've got good news and bad news. The bad news: You probably missed it. The good news: The same as the bad news.

The Standard & Poor's 500 has carved out a classic cup with handle pattern in the autumn of 2006. The pattern is short term, consisting of about 14 trading days. But it was well-timed enough to help tip the balance of Congress. And it may be powerful enough to send the S&P 500 even higher as the end of the year approaches.

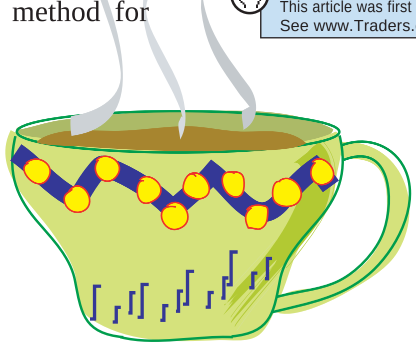
The cup with handle pattern is one of the key patterns recognized by legendary stock trader and investor William O'Neil of *How To Make Money In Stocks.* This pattern was treated more extensively in the world of chart pattern expert Thomas Bulkowski, who wrote in his book *Encyclopedia Of Chart Patterns* about a number of conditions that traders should look for when trying to gauge the most profitable opportunities from among different cup with handle patterns (conditions such as "cups in a bull market" and "pick tall cups").

Bulkowski's quantification of cup with handle patterns is pretty amazing work. Here, I take a much simpler tack, considering the late October–early November as a consolidation first, with a general cup with handle shape second. Essentially, most chart patterns are consolidations at root, and the method for projecting price moves once the market breaks free from the consolidation is often quite straightforward and similar, regardless of the specific type of consolidaton. In most cases, taking the width of the pattern/consolidation at its widest part and adding (for upside breakouts) or subtracting (for downside breakdowns) that amount from the top or bottom of the pattern/consolidation, respectively, provides traders and investors with a good sense of likely near-term price targets.

How could traders have exploited this cup with handle? Figure 2 shows the histochastic screen (the moving average convergence/divergence [MACD] histogram and 7,10 stochastic) with the two blue arrows indicating days when buy signals were issued. Buy signals in the histochastic screen come in part from pullbacks in the MACD histogram. So when the histogram is, for example, at -2.99, then moves to -3.79, then to -3.00, a buy signal is created as of the close of the "-3.00" session — assuming all other bullish conditions are intact (such as the close being above a significant trendline or moving average).

Those buy signals are November 6 and 10 would have been filled on November 14 (long entry target = range of signal day divided by two and added to the high of the signal day).

It will be worth watching to see how the market comes in during the short week of Thanksgiving. My suspicion is that this is an optimal time for some light profit-taking and jockeying for position for the bull run that is likely to take place between late November and the first half of December. ■



Suggested Reading

O'Neil, William J. [1988]. *How to Make Money in Stocks,* McGraw-Hill.

FIGURE 1: STANDARD & POOR'S 500, DAILY. The cup with handle pattern in the S&P 500 projects to an upside of at least 1420, given a formation size of nearly 30 points and a breakout level of 1390.

FIGURE 2: S&P 500, DAILY. Two buy signals were generated during the cup with handle formation's development — one late in the formation of the cup and the other during the market's breakout from the handle.

The Falling Three Method

by Paolo Pezzutti

This candlestick pattern, which is quite rare and usually reliable, has provided some wrong signals lately.

Tradable: MNST, WAT, FII

The "falling three method" is a bearish continuation candle stick pattern. The "rising three method" pattern is basically the opposite (Figure 1). Let's look at the rules. The market has been in a downtrend. At that point, you observe:

- A long black candle
- A series of small candles, preferably with a white body. There should be three, but there can be also two or more than three. Their high is not above the open of the big black candle. The countertrend candles remain within the first session's range.
- The last candle of the pattern opens within the body of the last countertrend bar and the close lower than the first big black candle's close. After this last black candle, the market should continue lower.

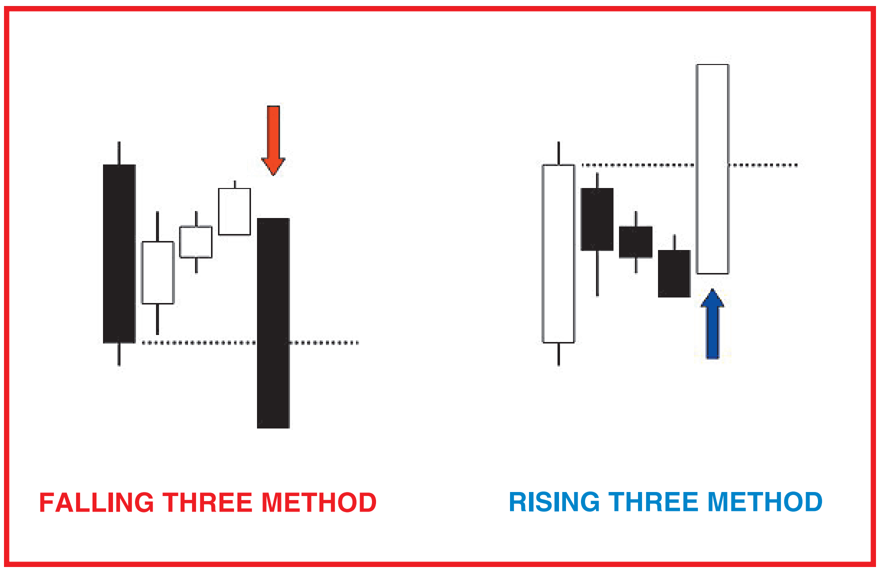


FIGURE 1: FALLING VS. RISING. This five-candles pattern (here compared with its counterpart, the rising three) represents a typical continuation pattern.

The volume of the first and last black candles should be higher than the small countertrend candles. This pattern is similar to a bearish flag or a short pennant.

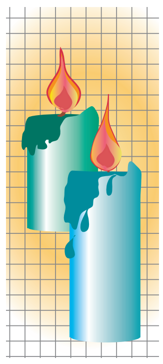
The concept is that prices, after an expansion to the downside, print a pause in the downtrend. Bulls, however, are unable to bring prices higher than the impulse candle. After a few days of low range and volume where prices do not progress significantly to the upside, the bulls give up and the downtrend resumes. The last day of the pattern represents the capitulation of the bulls and the confirmation of the ongoing downtrend.

The pattern is usually deemed as reliable, but last week most of the stocks that developed the pattern experienced a failure of the formation.

In Figure 2, you can see that Monster Worldwide (MNST) at point 1 printed a long black candle followed by three countertrend small candles (points 2, 3, and 4). Note that the three candles did not manage to retrace much of the first down candle.

FIGURE 2: MNST, DAILY. Here, the stock printed a nice pattern that, however, was negated by the impressive wide ranging day at point 6.

Friday's session (point 5) displays a long black candle that resumes the downtrend. At point 6, however, an impressive wide ranging day to the upside negated the formation.



In Figure 3, Waters Corp. (WAT) last week printed the falling three method pattern. Note, however, that the last candle of the pattern at point 5 did not manage to close significantly lower than the previous bars of the formation. In addition, the open was not within the previous candle's body. In any case, the pattern was a good candidate to be traded as the stock had displayed ease of movement to the downside. The next day at point 6, prices reacted to the upside, negating the pattern and producing a loss.

In Figure 4, Federated Investors B (FII) printed a pattern in which points 3 and 4 displayed a black body. The impulse to the downside of the first candle indicated clearly that prices would move to the downside. In addition, the last candle of the pattern confirmed the downtrend. The next candle at point 6, also in this case, negated the pattern.

Risk control must be one of the top priorities. Although this candlestick pattern is usually reliable, failure and the possibility of a loss must be taken into account by traders. ■

FIGURE 3: WAT, DAILY. In addition, this stock printed a failure of the pattern which, however, did not present optimal characteristics.

FIGURE 4: FII, DAILY. Another failure for the pattern. At point 6 a trend day negated the formation.

A Cup With Handle For Treasury Notes

by David Penn

A classic chart pattern suggests bullish times for bonds.

Tradable: TYH7, TY

It has become a popular refrain in financial circles that stocks are be having as if the best is yet to come, while bonds are, to put it mildly, less than enthusiastic. This divergence of sorts has contributed to the bull market in stocks, no doubt providing a steady measure of the requisite doubt and disbelief that powers equities markets higher.

We can easily see how stocks are pricing in a positive future by dint of the rally they've experienced since the summer of 2006. But how can we tell there are nervous nellies in the bond market? The evidence, apparently, is in the bullishness of the bond market itself. Bull markets in bonds often reflect a decline in inflationary expectations. But they also suggest a fear that the absence of inflation might be signaling flagging economic growth. As such, investors move toward the relative security of the coupon (that is, the interest rate) that bonds provide.

The current vehicle of the 10-year's ascent appears to be an ascending triangle (Figure 1). The 10-year Treasury note bottomed in the summer of 2006, the low point of a largely sideways bear market in bonds that began back in the summer of 2003 that saw the 10-year slip from 120 to 104 (basis continuous futures, Figure 2). Since that 2006 bottom, the 10-year has been moving steadily higher, making higher monthly lows up to and including November. It is in the immediate context of these higher lows that we need to consider the ascending triangle that has contained the March 10-year note's price action over the past two months. This is because, generally speaking, consolidations in trends tend to lead to more of a trend rather than a reversal.

Most of my daily screens have already given buy signals in the March 2007 T-note. The earliest buy signal came from the directional movement/ADX (average directional movement index) screen that produced a buy signal on October 26 just as the TYH7 closed above the 20-day exponential moving average (EMA) that was filled the following day. The histochastic screen (which relies on the moving average convergence/divergence [MACD] histogram) produced a buy signal on November 17 at 108.74 that wasn't filled until November 24. Two later signals, from TRIX on November 20 and the BOSO screen on November 21, both at an entry point of 108.50, were filled the day after the respective signals (November 21 for the TRIX, November 22 for BOSO). As of this writing, all are profitable trades.

And there may be more profit to come. The ascending triangle shown in Figure 1 projects to the 110.5 area as an initial upside target. This would force a test of that long-term downtrend line, one that reflects the 2003–06 bear market in the 10-year. Successful penetration of this trendline, with the support of the increasingly upward 10- and 50-week EMA, could be the beginning of a significant reversal of fortunes for the bond market. ■

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FIGURE 1: MARCH 2007 10-YEAR TREASURY NOTE FUTURES, DAILY. Over the course of October and November, the March 10-year has traced out an ascending triangle that anticipates an initial move to as high as 110.5 should the breakout hold.

FIGURE 2: CONTINUOUS 10-YEAR TREASURY NOTE FUTURES, WEEKLY. Taking a longer-term view, it is clear that the current rally in bonds is the market's latest attempt to buck a three-year bear market.

Long-Term Rates Trending Lower

by Arthur Hill

The 10-year Treasury note yield found support over the last two months but remains short of a reversal, and the odds favor a move lower for interest rates.

Tradable: $TNX

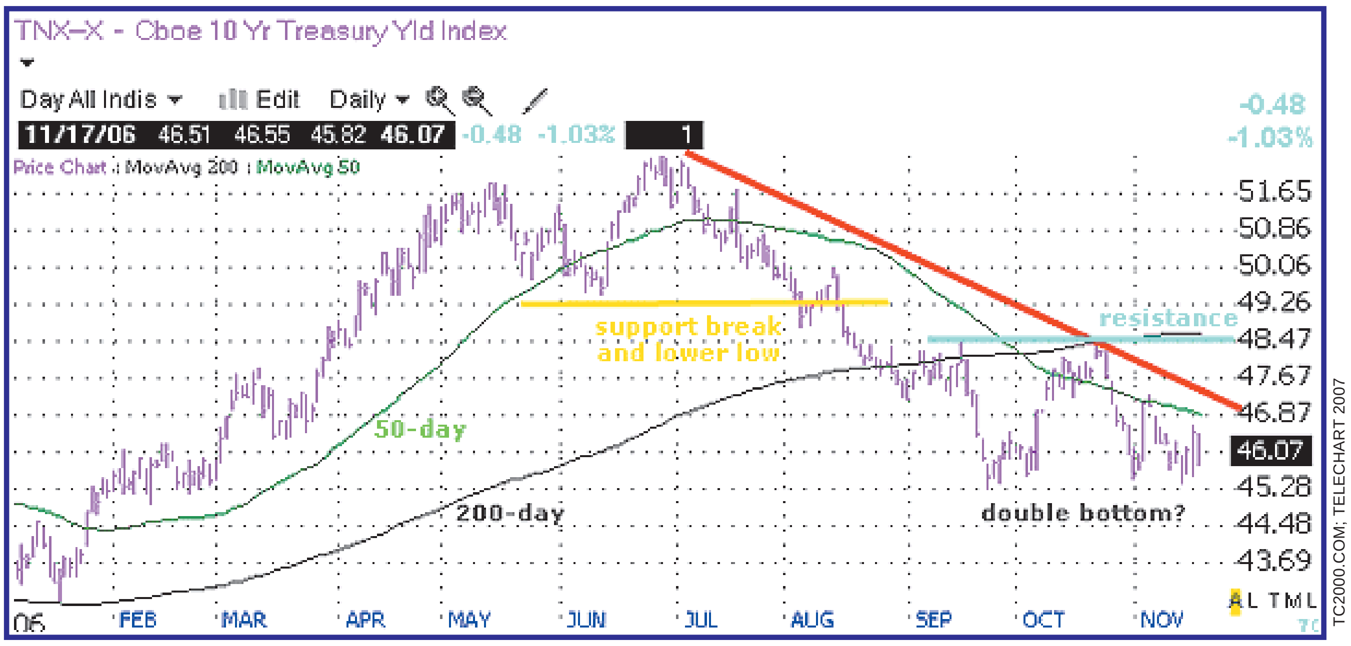

FIGURE 1: 10-YEAR TREASURY NOTE. The 10-year T-note broke below the June low, the 50-day moving average, and the 200-day moving average to establish a downtrend.

The trend for the 10-year Treasury note yield ($TNX) is in place until proven otherwise. My goal is to establish the direction of the current trend and bet on a continuation until proven otherwise. First, I will show that the bulk of the evidence shows an existing downtrend. Second, I will show a bearish continuation pattern that would confirm this assumption. Third, I will show what it would take to reverse this downtrend.

On the price chart (Figure 1), the 10-year T-note yield broke below the June low, the 50-day moving average, and the 200-day moving average to establish a downtrend. You cannot have a downtrend without a lower low and this support break shows weakness. In addition, the 50-day moved below the 200-day in early October. The last crossover occurred in early October 2005 and the uptrend lasted around 12 months. This cross is less than two months old and could have further to run.

$TNX established support around 45.40 (4.54%) over the last three months, and the pattern at work looks like a small head & shoulders of the continuation variety (Figure 2). The left shoulder formed in late September, the head in October, and the right shoulder in November. A move below 45.40 would signal a continuation lower and project further weakness to around 42.5. A decline in rates implies a rise in bonds and such a move would be bullish for bonds.

What would it take to prove this scenario otherwise and expect rates to rise? $TNX established resistance around 48.5 from the October high and the 200-day moving average. The 10-year T-note yield would have to hold support and break above 48.5 to reverse the current downtrend. The pattern at work would be a double bottom and the upside target would be to around 51.5 or a test of the May-July highs. ■

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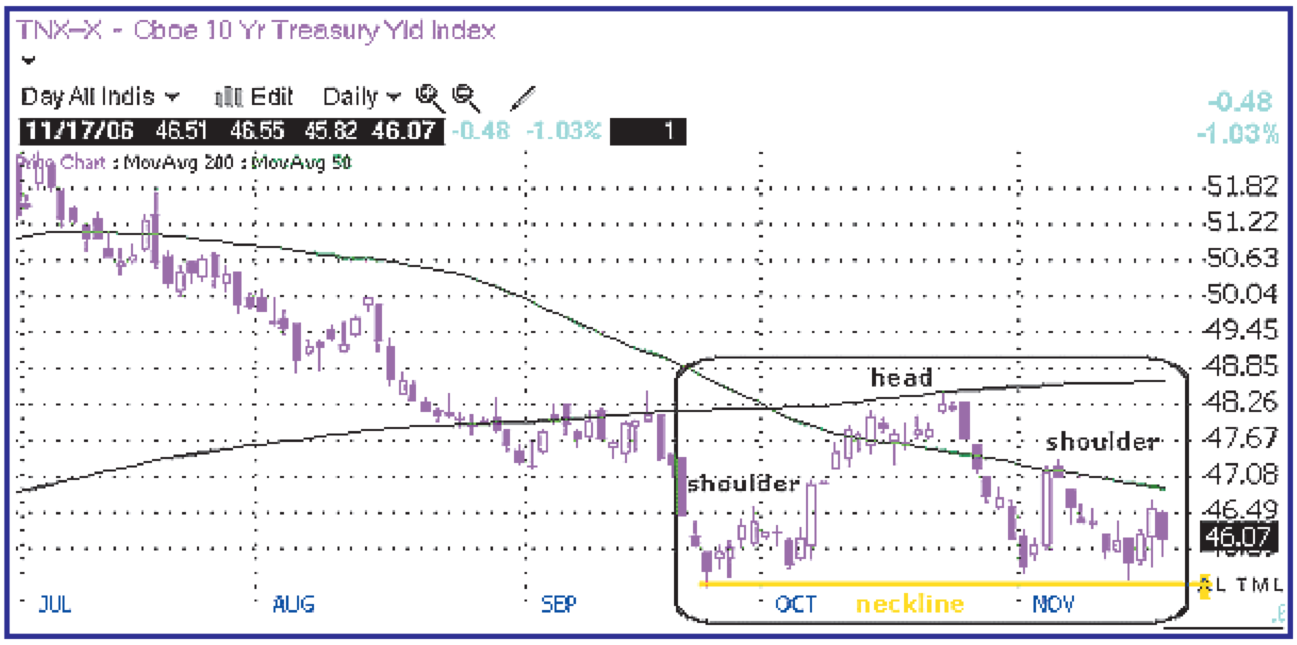

FIGURE 2: 10-YEAR TREASURY NOTE. The 10-year T-note appears to have formed a small head & shoulders pattern.

HEAD & SHOULDERS

A Head & Shoulders Top In Retail?

by David Penn

An autumn consolidation in the retail HOLDRS hints at the possibility of a move lower for retail stocks.

Tradable: RTH

Over at "The Big Picture," one of my favorite "general purpose" weblogs, blogger (and money manager) Barry Ritholz made an interesting point about retail in the 2006 holiday season:

> One of the issues we have been discussing has been how widely and deeply Retailers will be discounting, and what it means to the overall economy.
>
> The most recent review of price cutting is that they are both deep and broad. Our quick survey of both brick and mortar coupons and online savings codes shows that discounting is ramping up dramatically. This will likely be pressure for Q4 profit margins.

With that backdrop, the behavior of retail stocks — as a group — is increasingly understandable. While price cutting — particularly "panic" price cutting — is a wonderful thing to the holiday shopper, it tends to mean something less fabulous to the companies who feel as if sizable price cuts are the only way to bring shoppers to their stores. The market's interpretation of this price cutting — as represented by the sideways movement in retail stocks — seems to support that idea.

Specifically, the market's interpretation seems to have included the formation of a head & shoulders top in the retail HOLDRS (Figure 1). At this point (December 1), the pattern is almost perfectly formed, with multiple touches of the neckline at 96, two well-developed shoulders (the last three weeks of September making up the left shoulder and virtually all of November comprising the right), and a "head" that extends above both of them (October). The size of the pattern (approximately five points) is such that a successful breakdown could see the RTH fall to as low as 91 in an initial downside move.

FIGURE 1: RETAIL HOLDRS, DAILY. After bottoming in July and moving strongly higher in August and early September, the retail HOLDRS (RTH) slipped into a consolidation pattern that resembles a head & shoulders top.

There are a number of other, complimentary ways to look at what is happening in the retail HOLDRS. Consider, for example, using a trendline that extends from the low in late August, the RTH has moved into a 1-2-3 trend reversal setup in November. This setup has helped establish key support and resistance levels at 96 and 100, respectively. A break, then, below the neckline would also be a violation of that support level in the 1-2-3 trend reversal setup. If we cast a trendline from the very bottom of the retail HOLDRS bull market in mid-July, then we get a different trendline — one that intersects the support line at 96 in the final day or two of November. If the RTH does not find support on this longer trendline, then the bears will have validation on at least three different levels that retail stocks are headed for an end-of-the-year correction. ■

SUGGESTED READING

- The Big Picture, http://bigpicture.typepad.com/

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An Oversold Bounce For The Greenback

by Arthur Hill

The US Dollar Index shows signs of firming and looks ripe for an oversold bounce. However, the bigger trend is down—will resistance be around?

Tradable: $DXY

The weekly chart (Figure 1) depicts the big trend and the recent breakdown affirms the current downtrend. The US Dollar Index declined from 92.63 to 83.60 and then bounced back above 87 in October. The advance traced out a slight wedge and the index broke wedge support with a sharp decline over the last few months. This support break signals a continuation of the prior decline and the downside target is long-term support, around 80-81.

Even though the long-term trend is down, there are likely to be countertrend rallies and oversold bounces along the way. The October-December decline created oversold conditions as the 15-day relative strength index (RSI) moved below 30 for the first time since May (Figure 2). This oscillator is considered oversold when it is below 30, and traders should expect some firmness or even a bounce when conditions are oversold. However, with the bigger trend down, oversold bounces are against the bigger trend and then are expected to fail. But where?

Using the price chart and the RSI, we can identify price resistance and momentum resistance to predict where DXY is expected to fail. On the price chart, broken support at 84.50 turns into resistance. This resistance level is further confirmed by the October trendline and I would expect the index to stall or reverse around 84.50. In a downtrend, the RSI often meets resistance around 50. Therefore, I would wait for the RSI to alleviate its oversold conditions with a bounce back to around 50. Taken together, I would expect an oversold bounce to fail around 84.50 in the index and 50 in the RSI. ■

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This article was first published on 12/12/2006. See www.Traders.com for more.

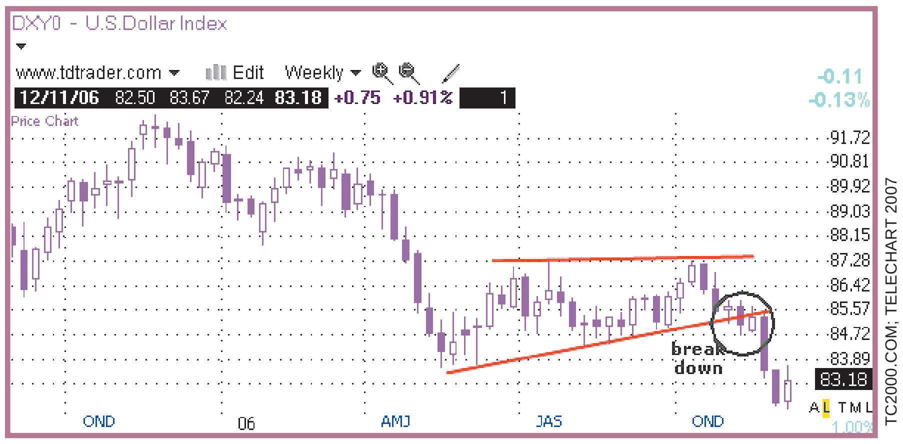


FIGURE 1: US DOLLAR INDEX, WEEKLY. The recent breakdown affirms the current downtrend.

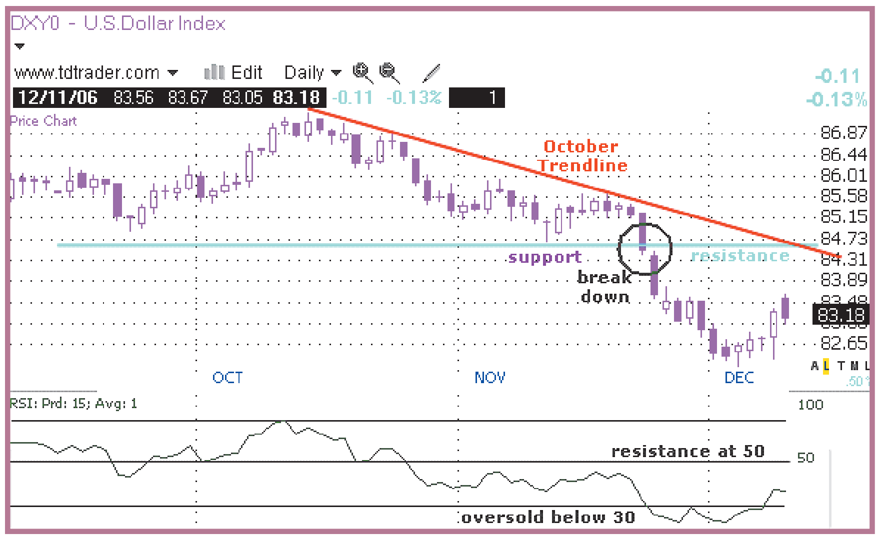


FIGURE 2: US DOLLAR INDEX, DAILY. The October-December decline created oversold conditions in the RSI (considered to be so when it dips below 30).

SECTORS

REVERSAL

Sideways Semiconductors

by David Penn

Waiting for signs of directionality as the semiconductor HOLDRS works its way through a potential 1-2-3 trend reversal setup.

Tradable: SMH

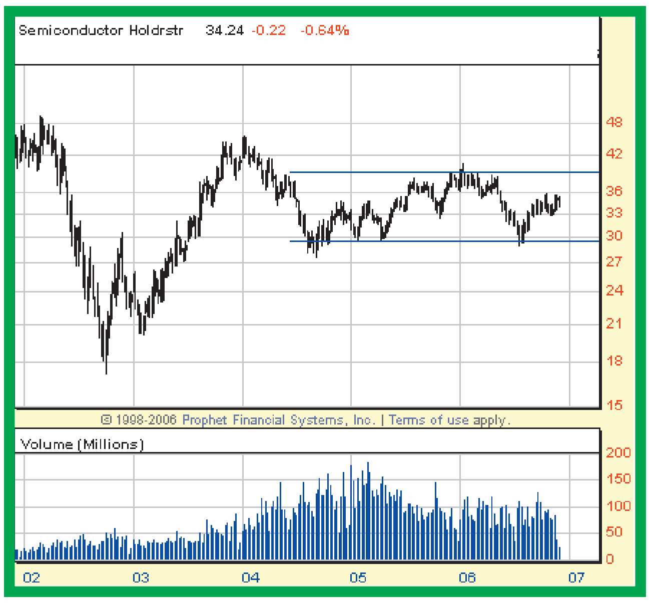


FIGURE 1: SEMICONDUCTOR HOLDRS, WEEKLY. The largely sideways movement in SMH has provided precious few intermediate-term trading opportunities in semiconductor stocks.

FIGURE 2: SEMICONDUCTOR HOLDRS, DAILY. Two steps through a 1-2-3 trend reversal, a close below the November lows will mark the completion of the third stage of the 1-2-3 trend reversal and, potentially, a test of the year-to-date lows.

From a certain, long-term perspective, semiconductor stocks have been in a bear market since the first weeks of 2004. See Figure 1.

To be sure, it has been one of those sideways bear markets that have provided enough strong rallies and clear declines to keep traders and investors interested in semiconductor stocks. After peaking at 45 in earliest 2004, the semiconductor HOLDRS (SMH) fell to a low of about 27 by September 2004. Slowly and fitfully, the SMH rallied to a little more than 39 in the first weeks of 2006. Since then, semiconductors have moved downward, slipping back below 30 in the summer of 2006 before bouncing back up to the 36 level by autumn.

Traders and investors looking at semiconductor stocks in late 2006 can see the immediate context as an uptrend from a bottom just south of 30. From the point of view of the last few months, it appears as if a nascent bull market in semiconductor stocks has run into its first significant correction but managed to find support near the 32.50 level. At the same time, however, we can see through the lens of the 1-2-3 trend reversal that semiconductor stocks are in every bit of a precarious position as their longer-term bear market (the one that began in 2004) might suggest. The SMH has broken down below the main July–October trendline (the "1" in the 1-2-3 trend reversal) and failed to restore the previous trend with a new high in November (the "2" in the 1-2-3 trend reversal). All that remains is to see if, following that failure, the SMH will take out the post-trendline break low near 32.5. This would represent the "3" of the 1-2-3 trend reversal and set the stage for a larger correction than has been the case so far.

Failure to find support near the 32.50 level could have serious repercussions for semiconductor stocks. The SMH chart in Figure 2 shows a consolidation pattern that began in September, one that measures approximately three points at its widest point in October. Should the SMH break down below 32.50, then those same three points would most likely be subtracted from the consolidation low of 32.50 in order to produce a downside target of about 29.5. Such a decline, clearly, would find the SMH retracing the entirety of its July–October advance and seriously test the 2006 lows.

The same consolidation, of course, could be used to project an upside to the 37.5–38 area should the SMH break out rather than break down. A rally to that area would find itself meeting stiff resistance insofar as that level marks the spring 2006 highs in SMH (the 2006 high extends to about 40.5). Certainly any breakout beyond that level would be exceptionally bullish for semiconductors, just as the violation of the 2006 lows would be exceptionally bearish. ■

Internet HOLDRS Reaches Resistance

by Arthur Hill

The Internet HOLDRS rebounded sharply over the last four months, but the rally is running into resistance and the exchange traded fund is still lagging the NASDAQ.

Tradable: HHH

Figure 1 shows the Internet HOLDRS (HHH) from November 2005 to the present (about one year). The stock declined from January to July and then rallied from August to November. The exchange traded fund (ETF) gained more than 20% in the last four months and the rally looks impressive. However, the price relative, which compares the performance of HHH to the NASDAQ, failed to exceed its September high and the advance is not all that impressive on a relative basis.

In addition to less than impressive relative strength, the HHH is running into stiff resistance around 55–57. This resistance zone stems from broken support and a 50% retracement of the January–July decline. The stock established support at 55 in March and broke this level in mid-May. There was a strong bounce in late May, but broken support turned into resistance and the stock was turned back. Prices remembered this resistance level and the stock was once again turned back at 55 in late November.

Despite resistance and lagging performance, the four-month trend on the daily chart is still up. Figure 2 shows HHH and the rally from early August. The stock broke resistance at 50 and this is the current signal. Broken resistance turns into support and this level is key to the current uptrend. In addition, the early August trendline marks support around 50–51. HHH is quite volatile and entitled to a pullback. However, 50 is about as far as I would let this pullback extend. A break below 50 would reverse the four-month uptrend and call for a continuation of the January–July decline. Ouch. ■

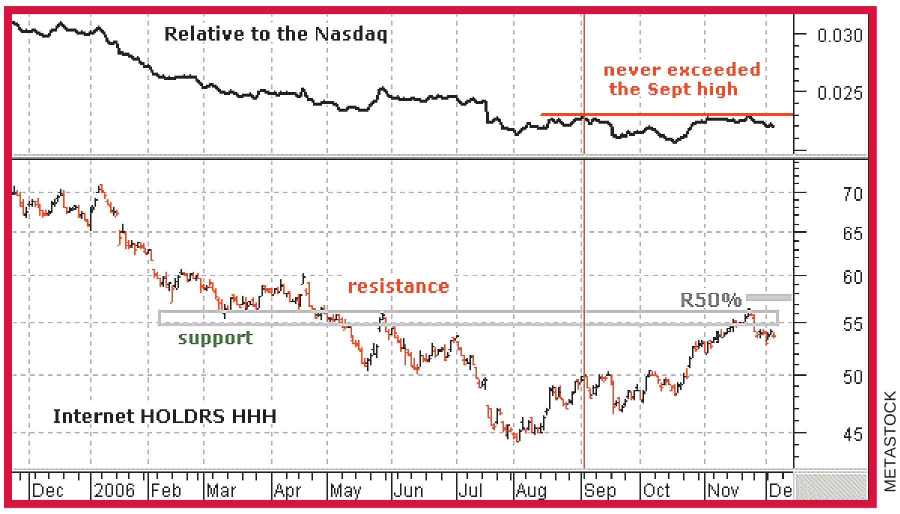


FIGURE 1: HHH, MONTHLY. The Internet HOLDRS declined from January to July and then rallied from August to November.

FIGURE 2: HHH, DAILY. Despite resistance and lagging performance, the four-month trend is still up.

A Banking Breakout

by Arthur Hill

The Banking Index broke to new highs this week to affirm the current uptrend and project further strength.

Tradable: $BKX

The Banking Index ($BKX) is part of the finance sector, which is the biggest sector in the Standard & Poor's 500. As banking goes, so goes the finance sector. As the finance sector goes, so goes the S&P 500. Needless to say, the Banking Index is an important market gauge.

The BKX gapped up and broke resistance in December. The index surged in July, corrected in August, surged again in September, then corrected in October–November. The first correction formed a falling wedge and the breakout at 112 extended to 115. The second correction formed a falling price channel and the breakout at 114.5 signals a continuation of the September advance. See Figure 1.

Broken resistance turned into support and this was the first test. BKX broke resistance at 112 in September and this level turned into support. There were two successful tests in November (green arrows, Figure 1). By extension, broken resistance around 114.5 turns into support and this is the first test for the bulls. There was a dip to 113.6 on December 8 and I am marking support here. A break below 113.6 would call for a reassessment of this bullish signal.

As long as the breakout and support at 113.6 holds, the upside target is to around 120 early next year. To find this target, I first drew a linear regression (magenta trendlines) and then drew parallel upper and lower trendlines (Figure 2). I tried to fit the channel to the reaction highs and lows. There were overshoots in May, June, and July. I elected to draw through these overshoots and keep the trendline slope reasonable. The index has been channeling higher the last 12 months and the upper channel trendline extends to around 120 in early February. ■

FIGURE 1: BANKING INDEX. BKX gapped up and broke resistance in December.

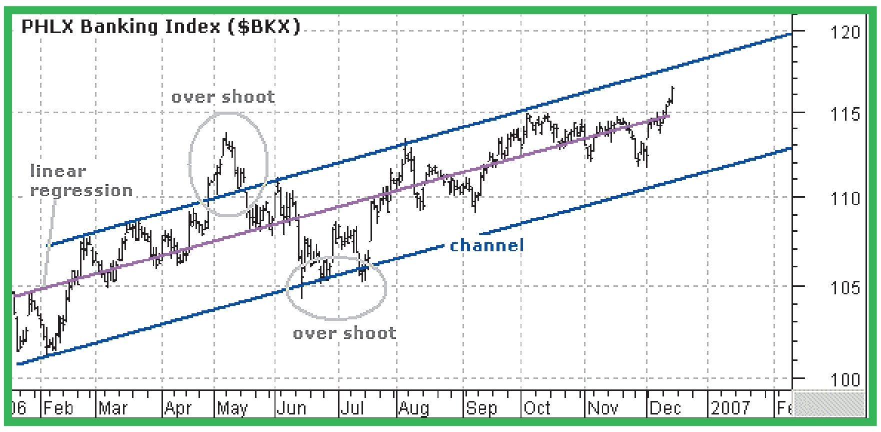


FIGURE 2: BANKING INDEX. As long as the breakout and support holds, the upside target is to around 120 early next year.

REVERSAL

Transports Take A Hike

by David Penn

Negative MACD histogram divergences and a breakdown from a consolidation suggest lower prices ahead.

Tradable: $TRAN

While the Dow Jones Industrial Average (DJIA) wades into all-time high territory, the Dow Jones Transportation Average (DJTA) has been decidedly less adventuresome in recent days and weeks.

To be sure, the transports have already done their part for posterity, reaching new all-time highs back in late 2004 and breaking out above those levels "for good" almost one year later. But with a new all-time high in the transports set in June 2006, the index has arguably set the bar higher than even the highest-flying airline in the group can take it. (Incidentally, that "highest-flying airline" would most likely be Continental, which began 2006 in the low 20s and is currently trading in the low 40s.)

The transports, as shown in Figure 1, broke down below their main, intermediate-term trendline near the end of November. After a very short, post-break bounce, the transports resumed their movement lower, only recently closing below the low created by the trendline break. While it would have been clearer had the transports made more of an effort to set a new high for the intermediate-term advance after breaking the trendline, the new low that has been established suggests that the anemic bounce in early December anticipated the likely breakdown that would come a few trading days later.

Several days before the trendline break, however, the transports had begun showing signs of potential weakness. These signs came in the form of negative divergences in both the stochastic and the moving average convergence/divergence histogram. Negative divergences can be tantalizing, and traders need to be wary of believing that every negative divergence that appears is an unequivocal sell signal (Figure 2). One of the things I like about the Boso approach I wrote about in Working-Money.com ("Boso," October 5, 2005) is that it teaches me never to bet against an overbought stock. This little lesson is helpful in keeping me from chasing tops just because price has diverged from the indicator. As the saying goes, markets can remain irrational for longer than most investors and traders can remain solvent. Something similar is true about divergences. A correction or bounce of some sort almost always follows a divergence. But acting as if that correction or bounce is there before it really is there is a recipe for financial ruin.

In other words, as long as you are on time, there is no reason to worry about trying to be early — the eternal temptation of the divergence trader.

In this instance, note the second peak in November, the peak that represents a higher high in price, but a lower high in both the stochastic and the MACD histogram. The negative divergence is clear as of November 20, when the lower highs in the indicators are formed. However, it isn't until November 28 when two things happen: (1) price breaks down below the trendline and (2) the transports slip from being "overbought." It is only

FIGURE 1: DOW JONES TRANSPORTATION AVERAGE, DAILY. A failure of the 1-2-3 trend reversal test seems likely as the transports close below the post-trendline break low from December 1. The transports also appear to have been tracing out a head & shoulders top since late October. The potential downside from such a pattern would take the transports to as low as 4,380.

FIGURE 2: DOW JONES TRANSPORTATION AVERAGE, DAILY. Negative divergences in both the stochastic and the MACD histogram suggested that the mid-November peak in the transports would likely lead to a correction of some significance.

after the market trades under the November 28 low — ideally on a closing basis — that I would feel comfortable betting against an advancing market that, as far as the 50-day exponential moving average (EMA) is concerned, is still advancing.

Such a wager would have found a trader short transportation stocks on December 12. ■

Suggested Reading

Penn, David [2005]. "Boso," Traders.com Advantage, October 5.

DOUBLE TOPS

A Double Top In Telecom?

by Arthur Hill

The North American Telecom Index is challenging its prior high, but a big negative divergence in the moving average convergence/divergence means traders should also be on guard for a double top.

Tradable: $XTC

The double top is a bearish reversal pattern with two roughly equal tops and an intermittent low in between. It takes a move below the intermittent low to confirm the pattern and project further weakness. The North American Telecom Index (XTC) formed a reaction high around 935 in late October and is again challenging this high. In between the two highs, XTC forged a reaction low around 895 and it would take a close below this level to confirm a double top. After confirmation, the length of the pattern would be subtracted from the breakout point and the downside target would be to around 855 (935 - 895 = 40, 895 - 40 = 855). The 200-day moving average is currently around 845 and there is support from broken resistance at 837. Taken together, I would expect support somewhere between 835 and 855. See Figure 1.

I am entertaining thoughts of a double top because the moving average convergence/divergence (MACD) has a large negative divergence working over the last few months. The MACD surged from late May to early August and then traded at a relatively high level until the end of October. This shows sustained strength. This key momentum indicator then declined to the zero line in late November, and the December bounce remains well below the prior highs. The lower high shows less upside momentum on the current advance and the rally could fail.

For early signs of weakness, I am going to home in on shorter time frame and use the 60-minute chart, which covers the December advance (Figure 2). The MACD moved into positive territory in early December and stayed positive the entire time. I am looking for two things to identify a trend reversal. First, MACD should move into negative territory and this would turn momentum bearish. Second, XTC should break the early December trendline and its mid-December low

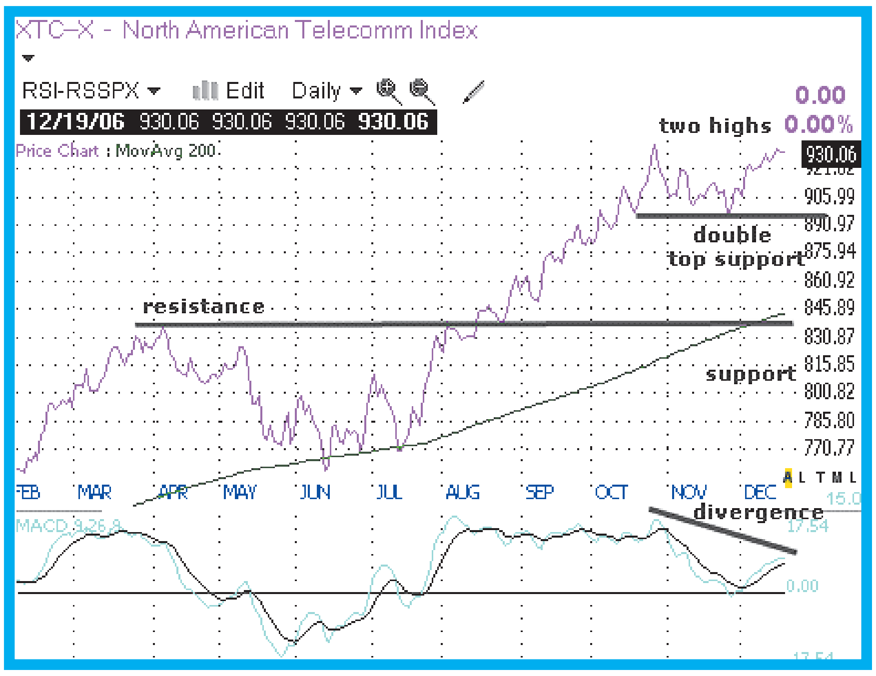


FIGURE 1: XTC, DAILY. XTC formed a reaction high around 935 in late October and is again challenging this high.

TC2000.COM; TELECHART 2007

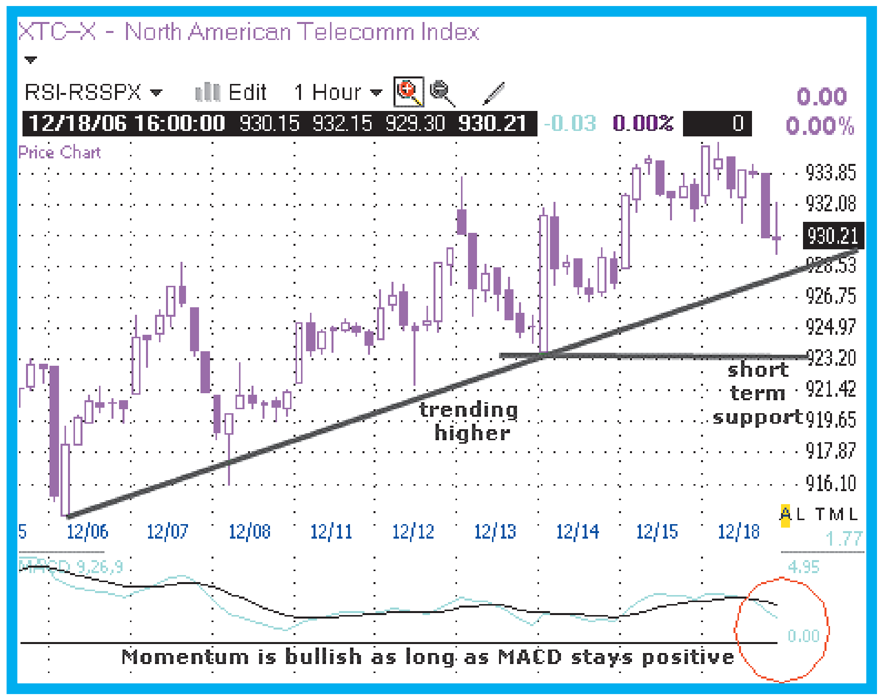


FIGURE 2: XTC, HOURLY. A break below 895 would confirm the double top and call for a medium-term trend change.

(923.6). This would reverse the short-term uptrend and call for a support test around 895. A break below 895 would confirm the double top and call for a medium-term trend change. ■

CANDLESTICK CHARTING

Small Caps Show Relative Weakness

by Arthur Hill

The S&P Small-Cap iShares has been underperforming the S&P 500 this month, and a bearish candlestick reversal points to more weakness.

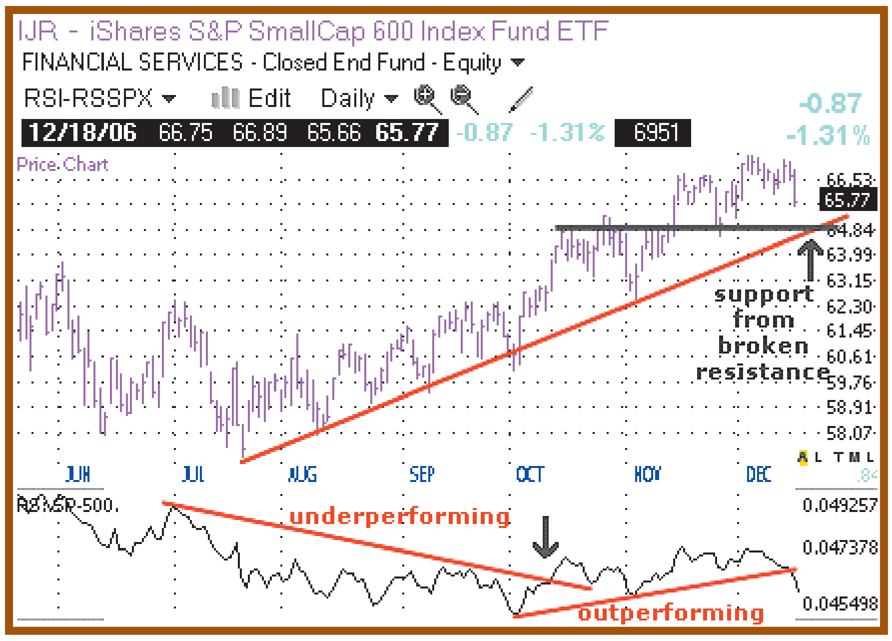
Tradable: IJR

The S&P Small-Cap iShares (IJR) remains in a medium-term uptrend, but relative weakness over the last few weeks could foreshadow a trend reversal. IJR remains with a series of higher highs and higher lower over the last few months. This is the definition of an uptrend, and the exchange traded fund (ETF) has yet to break the July trendline. This trendline converges with broken resistance to mark support around 65. A move below the November low (64.62) would forge a lower low, and this would mark the beginnings of a medium-term trend change. See Figure 1.

The ETF formed a higher high in early December, but the price relative formed a lower high and this shows relative weakness. The price relative compares the performance of IJR (small-caps) to the Standard & Poor's 500 (large-caps). The line rises when IJR outperforms and falls when IJR underperforms. The price relative broke trendline resistance in October to start a period of outperformance (gray arrow). The price relative formed lower high in December and then broke below its late November low this week. Small-caps are now showing relative weakness, and that is not a good sign.

A recent bearish candlestick reversal pattern points to further weakness, and I do not think support at 65 will hold. The ETF formed a dark cloud pattern on Thursday and Friday, December 14 and 15 (Figure 2). This occurs when the open is above the prior close and the close is below the midpoint of the prior candlesticks body. IJR opened strong on Friday but closed weak and this is a reversal day. A long black candlestick followed and this confirms the pattern. A confirmed candlestick reversal points to further weakness ahead and I would expect a support test around 63. This support level is marked by the late October and early November lows. ■

A dark cloud pattern occurs when the open is above the prior close and the close is below the midpoint of the prior candlesticks body.



TC2000.COM; TELECHART 2007

FIGURE 1: IJR, DAILY. This ETF remains in a medium-term uptrend, but relative weakness could foreshadow a trend reversal.

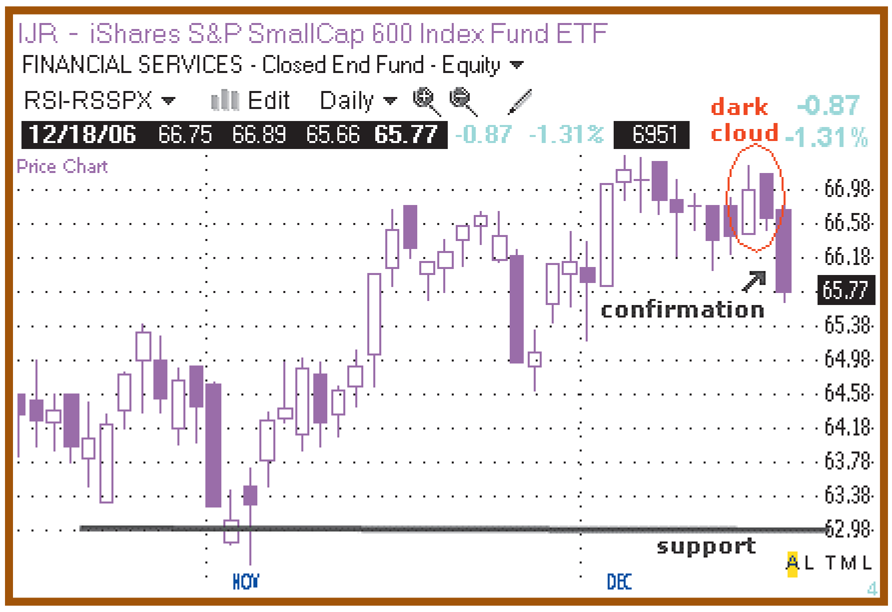


FIGURE 2: IJR, DAILY. A confirmed candlestick reversal points to further weakness ahead.

INDICATORS

TECHNICAL INDICATORS

A Tick Indicator Overview

by Paolo Pezzutti

The tick is a valuable tool, especially when utilized in a very short time frame, as it is quite effective at measuring market breadth. It is popular among daytraders and scalpers, as it can help assess the strength of market moves.

Tradable: $SPX

The tick indicator measures the difference between the stocks listed on the New York Stock Exchange (NYSE) that print upticks versus the stocks that print downticks. You have the same type of indicator also for the Dow Jones Industrial Average stocks (TIKI) and the NASDAQ stocks (TIKQ). The tick is a breadth indicator that provides traders with an assessment of market strength or weakness, providing a comparison of the number of stocks advancing to stocks declining. It is a useful measure of very short-term sentiment because it captures the degree to which the broad market reflects the strength of bulls versus bears. Breadth is typically derived from some calculation that takes into account advancing/declining stocks and their volume. In addition to the tick, other similar indicators are the advance-decline line and the TRIN (also known as the Arms index).

Typically, tick can be used to look for high/low readings to identify overbought/oversold points — difficult to say which values of reading represent oversold or overbought conditions. Authors present different numbers according to their studies or experience. During the past years characterized by an uptrend, the indicator has displayed a positive bias, so you will often see higher values indicated for overbought conditions (+1000 - +1200) than for oversold conditions (-800 - -1000). Should general market conditions change, obviously, you would note a negative bias. The tick can also be smoothed with a moving average to reduce noise. See Figure 1.

Another way to use the tick is to spot divergences between the price and the indicator. A divergence occurs when price makes a new high (or low) but the tick makes a lower high (or higher low). The concept of nonconfirmation, which is valid for any indicator, here finds several good applications in short-term trading.

Linda Bradford Raschke and Laurence Connors in their book *Street Smarts*, refer to it as a smart money indicator. They propose an interesting use of the tick indicator exploiting divergences between price and the indicator on the S&P Index futures. In particular, you have a buy signal when the S&P prints a low in the morning with a tick reading <350. The S&P then has to make a second lower or equal low at least 90 minutes later, which is not confirmed by the tick indicator. If the tick then improves by 100, that is the time to enter your long trade and apply a trailing stop to exit your trade.

TRADESTATION

FIGURE 1: SPX, DAILY. The tick indicator displays a positive bias during the past three years' uptrend. As an example, you can see that the tick's 10-day moving average has always remained into positive territories during the past months.

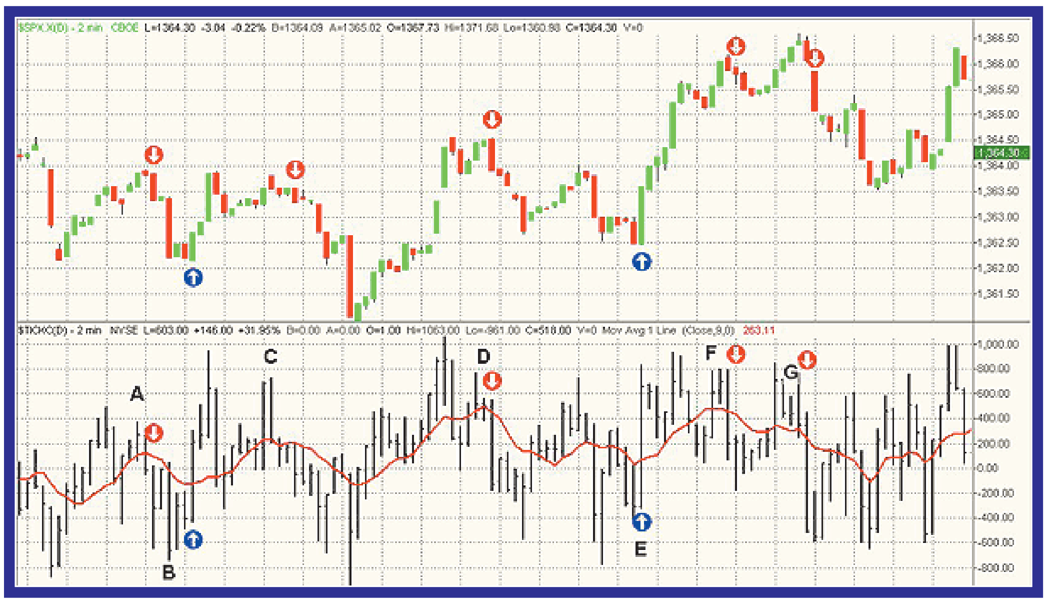


FIGURE 2: SPX, TWO-MINUTE. The tick indicator can help traders spot very short-term reversal points.

There are many variations in the use of the tick indicator. Traders often use it associating its overbought and oversold conditions to bearish or bullish candlestick patterns, respectively, to spot short-term market reversal points. In the following examples, I will display how effective the indicator can be when used to spot short-term turning points associated to divergences.

In Figure 2, you can see how the tick indicator displayed some divergences efficiently, during last Friday's trading session of the S&P index. The chart shows a two-minute time frame.

At point A, the tick indicator prints a negative divergence in coincidence with a relative high. A down candle associated with an expansion to the downside of the indicator provides a sell signal.

A few bars later, at point B the index prints a double low and the tick indicator does not confirm price lows. An up candle associated to an expansion of the tick indicator provides a buy signal. At point C you can see another negative divergence of the indicator. The same occurs at point D, when a double top of prices is associated to a negative divergence of the tick indicator. A long down candle is associated to a long bar to the downside of tick. At point E you have a long up candle after a double low of price. A positive divergence and a breakout to the upside of the tick indicator provides a nice buy signal. At point F you can see an early sell signal that likely would end with a loss and at point G a good sell signal. The negative divergence is confirmed by a long down bar and an expansion of the tick indicator to the downside, indicating that in the very short term, prices would continue lower. ■

The tick is a breadth indicator that provides traders with an assessment of market strength or weakness, providing a comparison of the number of stocks advancing to stocks declining.

SUGGESTED READING

Raschke, Linda Bradford, and Laurence Connors [2004]. *Street Smarts*, M. Gordon Publishing Group.

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VOLATILITY

Remember The Volatility Index?

by Arthur Hill

The NASDAQ 100 Volatility Index has been slowly building a base, and traders should watch for a resistance breakout to solidify a trend change.

Tradable: VXN

In 2006 the NASDAQ 100 Volatility Index ($VXN) surged the first half of the year and fell the second half. Despite two big moves, the ultimate change from January to December was relatively small. Currently, the VXN is trading back near support around 15, and this area marked support from February to May 2006. The indicator is firming once again and traders should be on guard for a breakout. This indicator is important because the NASDAQ is negatively correlated (the NASDAQ usually moves up when VXN moves down and moves down when VXN moves up). See Figure 1.

On the daily chart (Figure 2), VXN remains in a downtrend and needs to break 18.2 for a reversal. The indicator remains below the June trendline and prior highs. An uptrend is impossible as long as both hold.

There are three ingredients to an uptrend: trendline break, higher high, and higher low. VXN is zero for three right now. A break above 18.2 would forge a higher high and trendline break. This would quickly change the count (two out of three), and the odds of a trend reversal would greatly increase.

The moving average convergence/divergence (MACD) shows improving momentum and recently turned positive. Even though the NASDAQ 100 Volatility Index is an indicator, it is a price series and we can apply momentum indicators. The MACD moved into negative territory in mid-August and remained in negative territory until December 8. The early December crossover was brief and the indicator moved back into positive territory at the end of the month. The MACD turned positive for the first time in months and this could be the start of a trend reversal for VXN. The start of an uptrend in VXN would be negative to the NASDAQ. ■

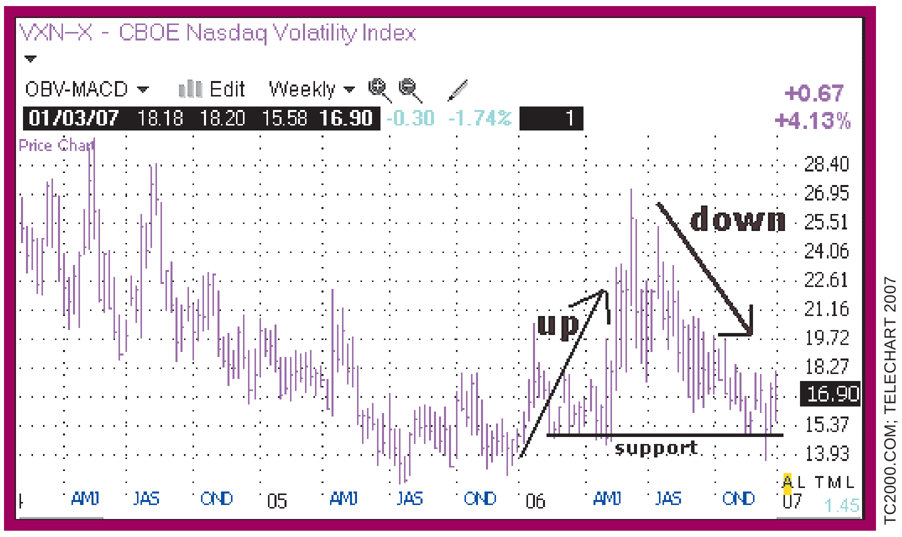

FIGURE 1: NASDAQ 100 VOLATILITY INDEX, WEEKLY. VXN surged the first half of the year and fell the second.

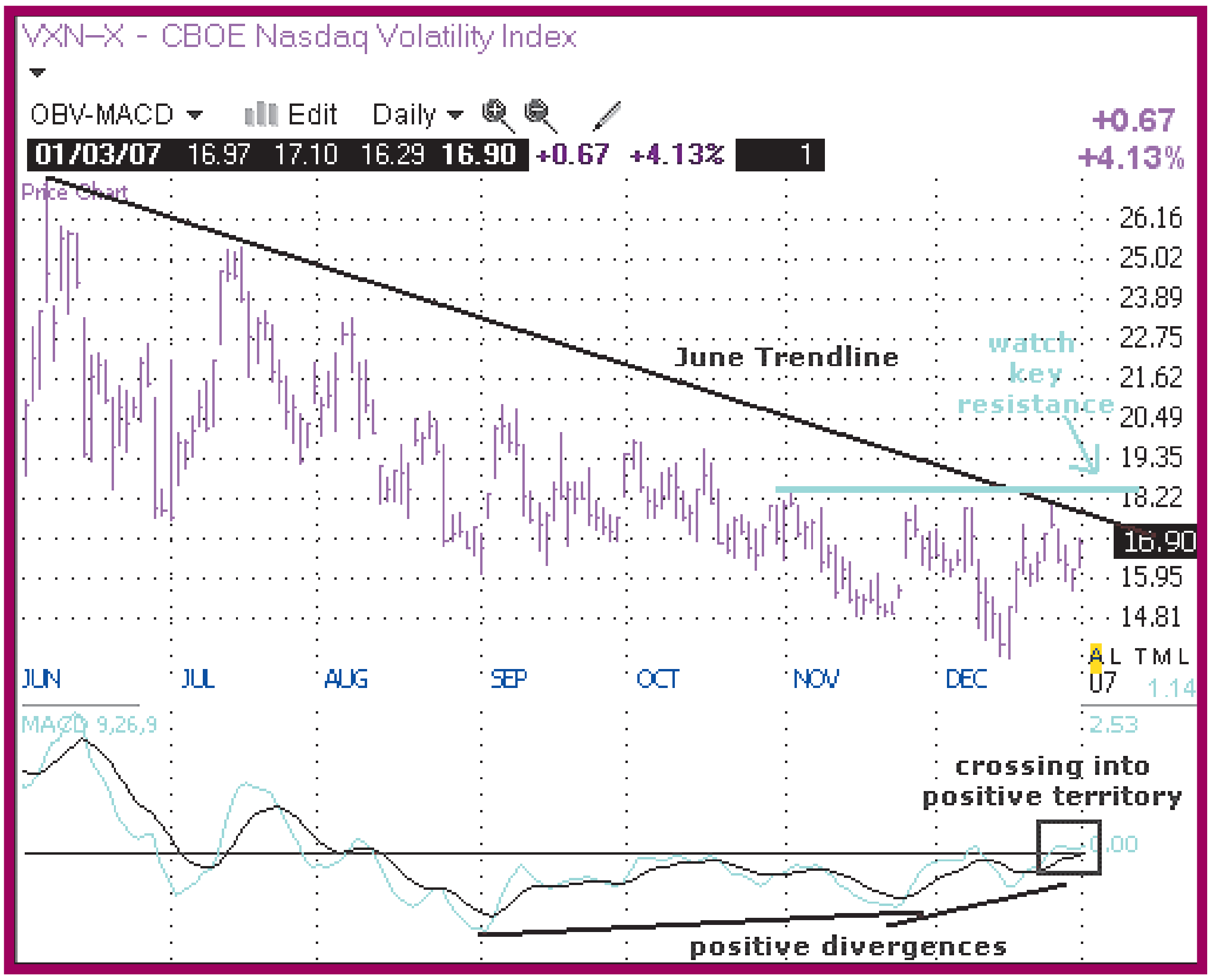

FIGURE 2: NASDAQ 100 VOLATILITY INDEX, DAILY. VXN remains in a downtrend in the daily chart and needs to break 18.2 for a reversal.

REVERSAL

Dollar Divergences: Up And Down

by David Penn

Negative divergences took the dollar down in October. Will positive divergences bring the dollar back up a year later?

Tradable: DX

A few months ago I suggested that the US dollar was nearing a low ("The Greenback Lows," September 8, 2006). At the time, I was focusing on the spring 2006 lows, which seemed to be a place of support near the 84 level (basis continuous US dollar index futures). That wasn't a bad bet, at least for a little while, as the greenback managed to consolidate between 84 and about 87 from early May to late November.

However, in late November, the greenback broke down again, taking out support at 84 and threatening to take out the October 2005 lows near 81. Dollar panic soared, perhaps culminating with a recent speech by Alan Greenspan in which the former Federal Reserve Board chief announced that "the dollar would probably keep falling" because, among other things, international fund managers were "unlikely" to increase their "allocations to the US currency."

We should remember that Alan Greenspan was also the man who encouraged Americans to load up on adjustable-rate mortgage loans in the spring of 2004, shortly after the 10-year note rebounded from all-time lows. As columnist Terry Savage of the *Chicago Sun-Times* noted at the time, "Greenspan has a track record of forecasting mistakes." Thus, I'll admit that

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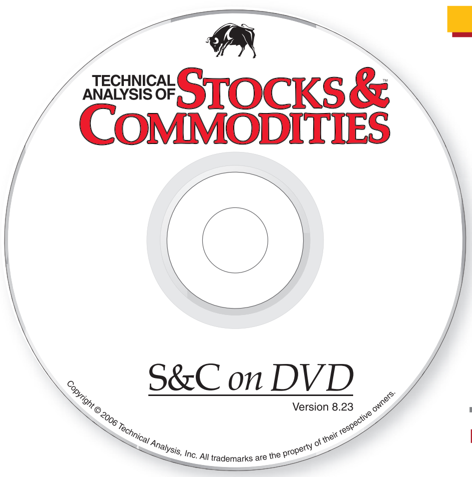

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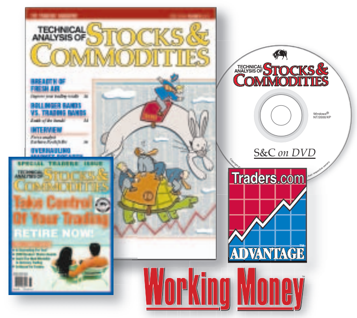

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FIGURE 1: US DOLLAR INDEX, CONTINUOUS FUTURES, WEEKLY. Divergences on weekly charts are often best spotted with the MACD histogram, as the negative divergences in the second half of 2005 and positive divergence in 2006 attest. These divergences are confirmed by divergences in the stochastic (lines not shown because of space limitations).

as soon as I heard of Greenspan's bearishness on the dollar, I started looking for positive divergences on the chart of the greenback.

And positive divergences were exactly what I found. Divergences have done an excellent job in anticipating the major moves of the dollar since it bottomed in late 2004. When the dollar topped out in November 2005, it established negative divergences in both the moving average convergence/divergence (MACD) histogram and the stochastic on the weekly chart (Figure 1). With weekly charts, I tend to give more weight to MACD histogram divergences than stochastic ones, but with both indicators confirming each other, the top seemed particularly well-indicated. And from a level just north of 92 in November 2005, the greenback would find itself balancing on 82 approximately a year later.

Divergences again appear to be coming into play in late 2006. As the dollar moves closer and closer to what is largely believed to be a final goal line stand at 81, we can see that both the MACD histogram and stochastic have refused to confirm the most recent lower low in the greenback. If that pattern holds up, there is a strong likelihood that the greenback's worst days are behind it, with days of perhaps surprising strength all that lie ahead. ■

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RESISTANCE LINE

eBay Tests Overhead Resistance

by Gary Grosschadl

eBay has come off a summer bottom for a nice gain, but what's it got in store now?

Tradable: EBAY

Figure 1, a weekly chart of eBay (EBAY), shows a doji bottom from late July. Dojis often mark important turning points after a significant rise or fall. In this case, the intrepid bottom-picker who took a chance on this potential turnaround signal would be sitting on a 30% gain over four months.

Now another potential entry point draws near in the form of an overhead resistance test at the 200-period exponential moving average (EMA). Note how the stock price is caught between the 200-period EMA resistance and the 20-period EMA support. The outcome here will likely be a tradable move. Current action seems to hint at the successful support off the often-telling 20-period EMA. If so, the next close above the 200-period EMA could signal the next upleg.

On the other hand, a sudden reversal to close below the 20-period EMA would be bearish, possibly leading to a double bottom test.

Several indicators should be examined at this point. At the top of Figure 1, the directional movement indicator with its three parameters shows a bullish cross of its positive and negative directional indicators (DIs). This points to a shift to bullish power.

The earliest buy signal confirming the bullish doji candlestick came with the moving average convergence/divergence (MACD) crossover. The next buy signal was the relative strength index (RSI) moving above the key 50 area, which coincides with the close above the 20-period EMA. Finally, the aforementioned DI crossover kicks in, lagging the other indicators.

The cautionary indicator is the stochastic oscillator showing a downturn from overbought levels. However, if support from the 20-period EMA holds, it will manifest as a "high stochastic turn." With enough bullishness, the stochastic oscillator can "stick high," indicating the presence of a strong uptrend in place.

The upside targets for another bullish upthrust are shown as a former resistance zone of $40–42 and then the previous high of $47. But first, the 200-period EMA must be beaten. ■

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Doji (DJ): *This pattern occurs when the open and the close are the same. It is a significant reversal indicator, depicting traders' indecision.*

FIGURE 1: EBAY, WEEKLY. This chart shows the stock caught between two moving average lines. Watch for a coming resolution.

RELATIVE STRENGTH COMPARATIVE

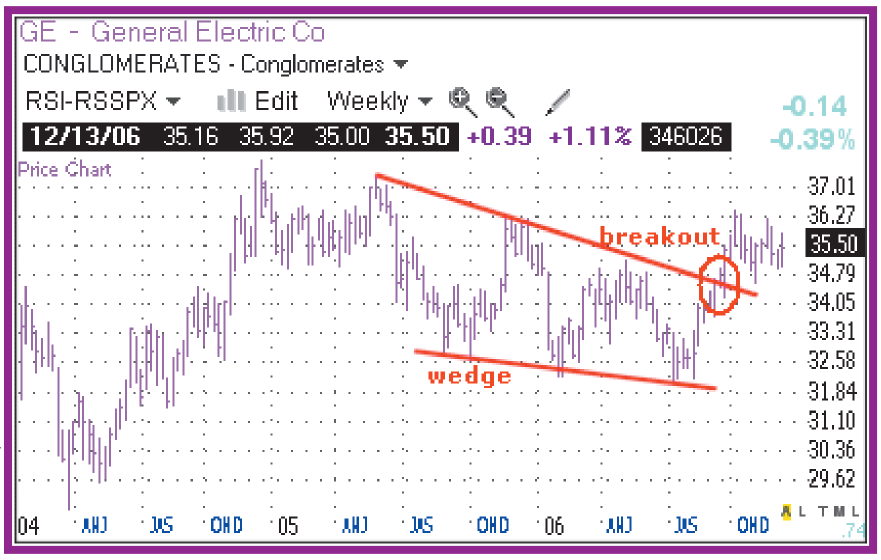

FIGURE 1: GE, WEEKLY. This stock surged in 2004 and peaked at the end of that year before embarking on a long correction that extended until July 2005.

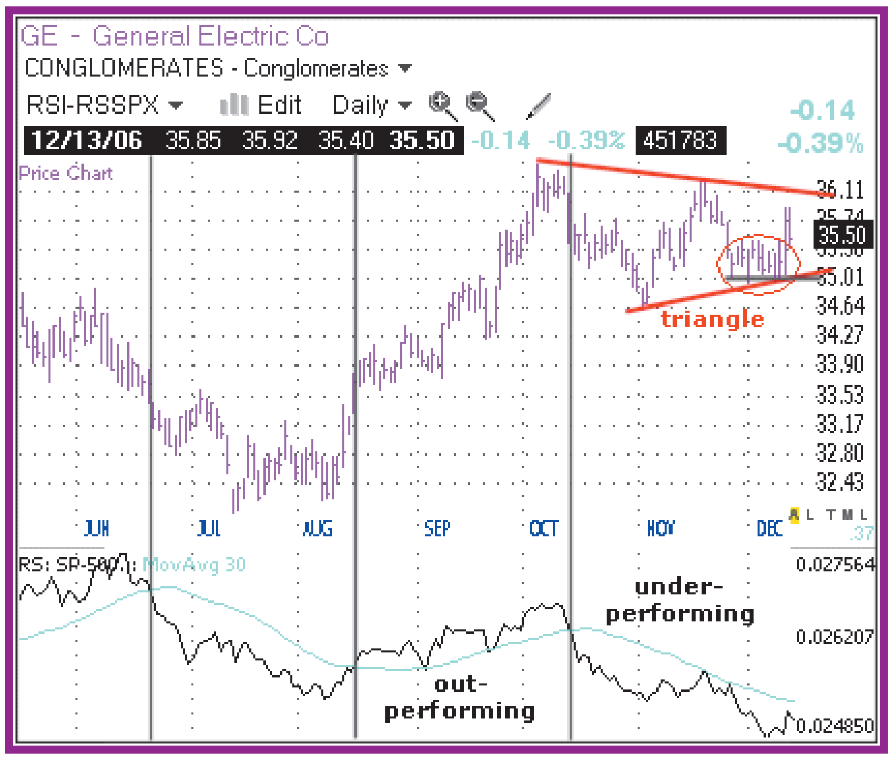

FIGURE 2: GE, DAILY. Even though the long-term trend is up, this stock is stalling on the daily level, and this could spell trouble.

GE Starts To Falter

by Arthur Hill

GE has underperformed the S&P 500 since mid-October, and relative weakness increases the chances of a support break.

Tradable: GE

The weekly chart (Figure 1) shows that the big trend is up. The stock surged in 2004 and peaked at the end of the year (December 2004). GE then embarked on a long correction that extended until July 2005 (18 months). The decline formed a falling wedge and the wedge breakout in September signaled a continuation of the 2004 advance. The breakout targets a move above the prior highs.

Even though the long-term trend is up, the stock is stalling on the daily chart (Figure 2), which could spell trouble. GE surged from July to early October and then formed a triangle over the last few months. There is a lower high in mid-November and a higher low in early December. This triangle represents a consolidation and the direction of the breakout will provide the next signal. A move above the upper trendline would be bullish and a move below the lower trendline would be bearish. The stock consolidated around 35–35.5 at the end of November and the beginning of December. This established support at 35, and I would view a break below 35 as bearish.

GE led the Standard & Poor's 500 higher from July to early October but has shown relative weakness over the last two months, and this is negative. The price relative peaked in mid-October and moved to a new low over the last few months. In fact, the price relative moved below its July low and this shows excessive relative weakness. I added a 30-day moving average to the price relative (**red line**). It is clear that GE performs best when the price relative rises and worst when the price relative declines (gray vertical lines). As long as the price relative remains below the 30-day moving average, GE remains relatively weak and this increases the odds of a support break at 35. Look for an upturn in the price relative and moving average break to confirm a triangle breakout in the stock. ■

Even though the long-term trend is up, the stock is stalling on the daily chart, which could spell trouble.

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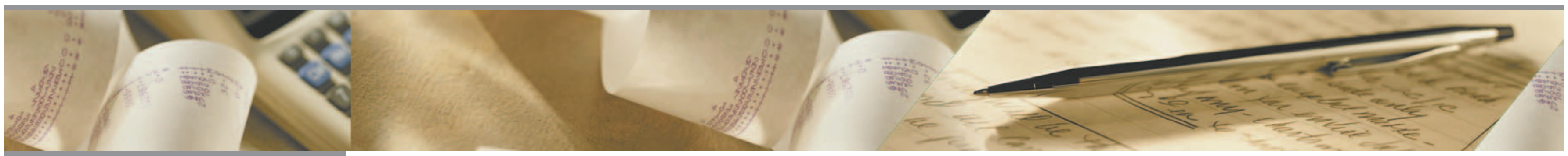

THE OPTIMIZED TRADER

Trading The MACD Histogram

Part II

by David Penn

Here's a look at trading histogram divergences and crosses of the zero line, targeting specific entries, and examining exit strategies.

Any trader who likes the idea of getting into a move early probably has a cherished spot in his or her heart for divergences. While some other methods work well for spotting tops and bottoms of trends (for instance, Victor Sperandeo's 2B method, also known as the "Turtle Soup setup," as introduced by trader Larry Connor), most traders rely on divergences between markets and oscillators like the stochastic, the relative strength index (RSI), and the moving average convergence/divergence (MACD) to catch the imbalance that occurs when markets make new extremes and oscillators refuse to confirm them.

DIVERGENCES AND ZERO LINES

To this group we can add the MACD histogram (MACDH). Although I rely more heavily on divergences as revealed by the stochastic (mostly as a matter of habit), the fact remains that the MACD histogram is capable of revealing clear-cut, often powerfully realized positive and negative divergences. Those eager to buy trends just as they appear capable of reversing would do well to consider the MACDH along with whatever other tool they use to spot such divergences between the market and the indicator.

The divergences using the histogram can be even easier to spot than in those indicators and oscillators that use single lines to indicate values. Spotting peaks and troughs among a set of vertical bars (as in the case with histograms) tends to reduce the sizing-up that can occur with the stochastic or the RSI, as well as eliminate that annoyance of trying to determine if a peak in an indicator was actually made. While numerical indicator values definitely makes it easier for a trader to be decisive with regard to the different levels, the clarity of the histogram bars makes the indicator that much easier and quicker to consult on a regular basis. See Figure 1.

A divergence in the MACD histogram looks just like one with any other indicator or oscillator: the market makes a high (or low) and then goes on to make a further extreme, while the indicator registers either a lower high in the case of a negative divergence or a higher low in the case of a positive divergence. In order to set up the trigger session, I rely on a change in slope on the second peak or trough in the histogram.

In the case of a positive divergence following a downtrend, the pattern representing the change in slope would resemble "P-p-P" on the second, shorter peak, with the second "P" representing the trigger session above which to go long. With regard to a negative divergence following an uptrend, a pattern resembling "m-M-m" would produce a trigger session with the second "m" — below which to go short.

Although it was not something I traded with much frequency, histogram crosses above and below the zero line (that is, when the histogram switches from positive to negative or vice versa) can also provide powerful signals for traders. While histograms above the zero line are more likely to be overbought (and thus sold) and those under the zero line are more likely to be oversold (and thus bought), there is plenty of room between the time the zero line is crossed and a market becomes so overbought or oversold that a change in trend — or at least a correction — becomes necessary. And it is in this area that traders looking to buy a histogram that is moving from negative to positive or sell a histogram that is moving from positive to negative that this particular zero line method operates.

THE HAPPY HISTOGRAM

Essentially, these are all ways of getting into the market. Some of the specifics — like choosing a specific entry level or price — will vary from trader to trader. I take half the range of the "trigger day" — the day or session on which the buy or sell/short signal is issued — and either add that amount to the high of the trigger day (for longs) or subtract that amount from the low of the trigger day (for shorts). Not only does this give me a specific price to enter,

FIGURE 1: NASDAQ 100 TRUST SERIES. The positive divergence in the MACD histogram from May to July was an excellent sign to the watchful that the bear market in the NASDAQ 100 that began that spring was coming to an end.

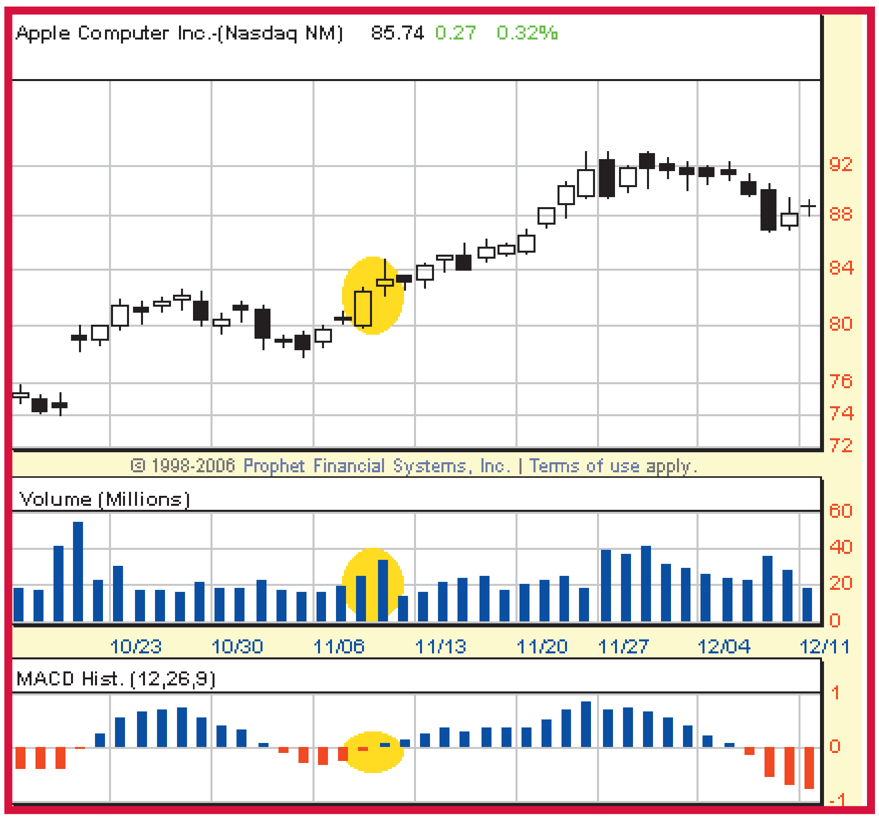

FIGURE 2: APPLE COMPUTERS. When the MACD histogram crosses from negative to positive as a market is moving up from a pullback in a bullish advance, it often provides an excellent signal for traders to climb on board the renewed trend.

but it also provides a little wiggle room based on the kind of trigger I get. A buy signal on a wide-ranging bar will force me to enter the market at a higher level than a buy signal on a relatively short-ranged bar or candlestick. Others may choose to use a fixed-point amount (15 cents above or below the trigger session's high or low), multiples of the average true range (ATR), or even J. Welles Wilder's "extreme point rule," which states that as soon as the price extreme (the high or the low) of the trigger session is violated, the trade should be initiated.

Another small feature that I use with the MACDH trading method is the 50-day exponential moving average (EMA). Every trader has his or her preferred moving average duration and type, and I feel comfortable using the 50-day EMA as a bull/bear line in the sand. By that I mean a histogram buy signal is only valid if it occurs above the 50-day EMA on a closing basis. The session can open below the 50-day EMA, but by the close it must be above that level. Otherwise, the buy signal is ignored. At the same time, I only act on histogram short signals that occur below the 50-day EMA. As you might imagine, the exception to this rule is when dealing with divergences which, almost by definition, will have traders buying below the 50-day EMA and selling above the 50-day EMA.

One last note: The sort of exits most appropriate with MACD histogram trading depend more on the sort of trading, particularly in terms of duration. Although the MACD histogram is a good, all-around entry signal creator, I initially liked the approach as a swing trading tool. This meant relying on shorter-term exit strategies like trailing stops or specific "two up or three down" money management (that is, look to gain two points or lose no more than three).

Oliver Velez of Pristine.com has a trade management approach that I've also found helpful. In his book *Tools And Tactics For The Master Day Trader*, Velez encourages traders to move stops to breakeven once the trade has gained $1, and then employ trailing and time stops. For divergence trades where a little more leeway is a good thing, chandelier stops may be a good option. ■

This article was originally published on 12/29/2006.

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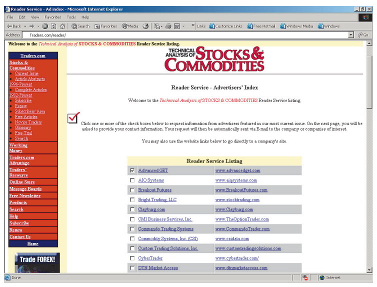

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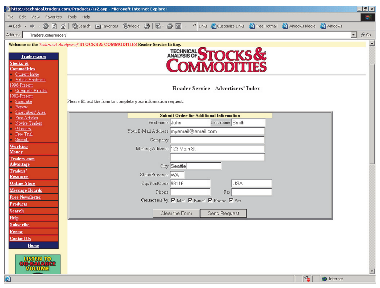

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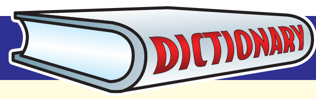

ABC — Elliott wave terminology for a three-wave countertrend price movement. Wave A is the first price wave against the trend of the market. Wave B is a corrective wave to Wave A. Wave C is the final price move to complete the countertrend price move. Elliott wave followers study A and C waves for price ratios based on numbers from the Fibonacci series.

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.

Commodity Channel Index — Developed by Donald Lambert, this price momentum indicator measures the price "excursions" from the mean.

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

Cubes (QQQQ) — Traded on the NASDAQ, cubes are ETFs that track the NASDAQ 100, which is made up of the 100 largest, most active NASDAQ nonfinancial stocks (offers broad tech-sector exposure).

Diamonds (DIA) — Traded on the AMEX, diamonds are designed to closely approximate the performance of the DJIA blue-chip stocks. Like stocks, they can be traded any time during the trading day.

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

Doji — A session in which the open and close are the same (or almost the same). Different varieties of doji lines (such as a gravestone or long-legged doji) depend on where the opening and close are in relation to the entire range. Doji lines are among the most important individual candlestick lines, and are also components of important candlestick patterns.

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.

Gann's Square of 9 — A trading tool that relates numbers, such as a stock price, to degrees on a circle.

Histograms — Measures the difference between moving averages, shorter and longer, and its amplitude is greater when market activity is enthusiastic. When it drops below the zero line a sell signal is generated, while a buy signal is generated when it moves above zero.

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

HOLDRS (Holding Company Depositary Receipts) — Created by Merrill Lynch, they represent ownership in stocks of a sector, group, or industry.

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/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.

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

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.

SPDRs — The symbol for Standard & Poor's Depositary Receipts trust series, which trade like regular stocks or exchange-traded funds (ETFs) and represent ownership in the S&P 500 index. Also known as *spiders*

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.

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.

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.

Whipsaw — Losing money on both sides of a price swing.

Zigzag — In a bull market, an Elliott three-wave pattern that subdivides into a 5-3-5 pattern with the top of wave B noticeably lower than the start of wave A. In a bear market, this pattern will be inverted.

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