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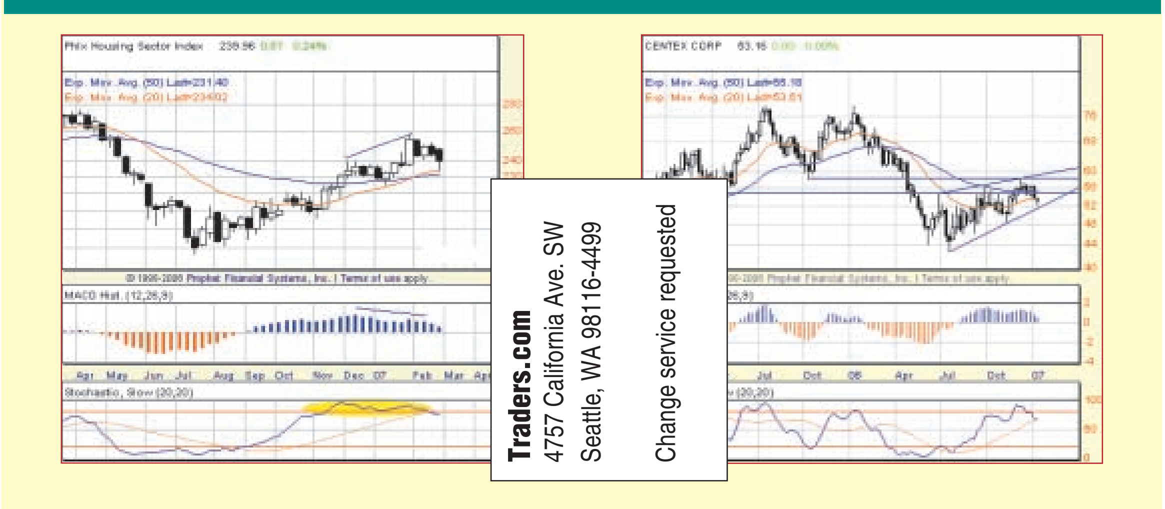

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TABLE OF CONTENTS

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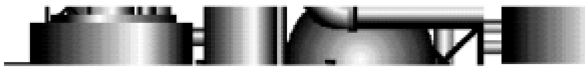

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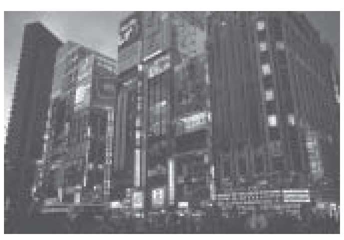

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TABLE OF CONTENTS

May/June 2007 • Volume 5, Number 3

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TRADING NOW

Could the subprime mortgage market be poised to have a similar fate as the dotcoms? The recent turmoil in the US subprime mortgage market has made it abundantly clear that the financial markets are sensitive to changes in any sector, whether it is in the credit markets or in company earnings. In fact, if the subprime mortgage market crisis does not stabilize, it could hurt the US economy and eventually affect the global economy itself.

But when will the subprime market get on an even keel again? The consensus is that it will stabilize toward the end of 2007 — but it would also depend on other economic fundamentals such as interest rates and overall housing trends. This is why, as a trader, you know it is important to keep an eye on the economic fundamentals just so you know what the big picture looks like and what you must be on the lookout for.

To aid in this endeavor, in this issue of **Traders.com** we have included articles on the housing sector, with "Are Housing Stocks Rolling Over" and "Heavy Is The Heart Of The Homebuilders," both by David Penn, as well as articles that focus on indexes over the world — "The Russell 200 Breakout" and"A Big Test Looms For The Naz," both by Arthur Hill, not to mention "Tokyo Nikkei Warning" by Gary Grosschadl and "Negative Divergences And The USD/JPY Breakdown" by David Penn.

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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Chaos theory posits that one action on one side of the world will have an effect on something that is seemingly unrelated elsewhere. Will this concept hold true in the financial markets? We can only wait and see, and keep a wary eye out.

Jayathi Gopalakrishnan

Jayanthi Gopalakrishnan,
Editor

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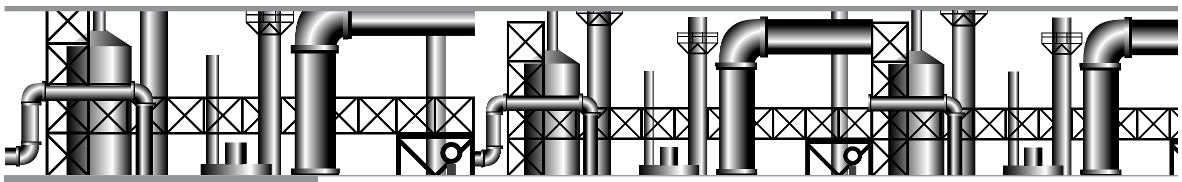

SECTOR SPOTTING

Jumpin' Nat(ural) Gas

by David Penn

Few sectors are as seasonally favored at this time of the year as are natural gas stocks. How are they shaping up technically?

A new year is often a time to start fresh, a time for new plans and resolutions. In the investment world, starting anew at the beginning of a new year is a little trickier. While there are trading notions like the January effect that traders can pay attention to, as well as the annual reconfiguring of the Dogs with the Dow portfolio, there are precious few sectors that speculators and investors can get excited about in the first few months of the year. That is—

Save for natural gas stocks, that is. A great number of sectors tend to begin their most favorable seasonality in the autumn, particularly September and October. But at the beginning of the year, according to the work of Yale and Jeffrey Hirsch in their *Stock Trader's Almanac*, only natural gas presents itself as an opportunity for traders to get in on a potential sector rotation early.

According to the Hirsches, natural gas — as measured by the natural gas index, $XNG — has favorable seasonality between the beginning of February through the beginning of June. The returns during this seasonal period are impressive, with an average 10-year return of more than 19% and a five-year return of more than 10%. At a time when a great many investors are pondering the fortunes of tech stocks, or waiting impatiently for homebuilders to bounce, those who turn their attention to the natural gas stocks may find themselves pleasantly surprised at what kinds of opportunities the first few months of the new year may bring.

GAS AU NATURALE

The last time I wrote about natural gas in any context was an article for Traders.com Advantage in October 2005 ("About That Gas," October 6, 2005). In that article, I pointed out a battle between the bulls and bears in the wake of a year-long advance in natural gas that had seen the commodity move from under five (basis continuous futures) to over 14. At the time, I concluded:

> What is different about the most recent late September peak is that there is also a negative divergence in the MACDH. While I tend to put more weight on stochastic divergences than MACDH divergences — at least on daily charts — the fact that the MACDH is decreasingly bullish (smaller positive values) is another warning that the bull run in natural gas might be closer to its conclusion than many energy traders think.

An apt conclusion, as a picture-perfect 2B top in the fourth quarter of 2005 led to a bear market that completely retraced the October 2004-December 2005 bull market. In fact, by late September 2006, natural gas was trading lower than it was in September 2004 (again, basis continuous futures).

It is this bear market that appears to be the beginning of a renewed move higher in natural gas. Note the chart of weekly continuous natural gas futures in Figure 1. Throughout the entire course of 2006, natural gas futures were making lower lows in price, while making higher lows in the moving average convergence/divergence (MACD) histogram. MACD histogram divergences in weekly charts are some of the best, most powerful divergences speculators can follow, which bodes well for the late September-early October bottom in 2006.

The March 2007 contract for natural gas is where speculators should look for a closer sense of where the commodity is right now. That contract also

FIGURE 1: NATURAL GAS, CONTINUOUS FUTURES, WEEKLY. A 2B top in the fourth quarter of 2005 led to a major bear market that completely retraced the previous advance. Note also the positive divergences throughout 2006, which suggest that the autumn bottom in 2006 will be a lasting one.

shows positive divergences — between the October 2006 and January 2007 lows — that similarly suggest that natural gas will be headed higher before it is headed lower.

The bounce in March natural gas futures that was produced by the positive divergence in the MACD histogram is a sharp one, so sharp it is likely to run into some measure of resistance as prices try to break through the 8 to 9 level. Actually, it wouldn't be surprising at all to see the March contract move similarly to the way the continuous futures contract did after it broke through resistance in November 2006 — breakthrough, pull back sharply, then advance again. The presence of downwardly sloping moving averages (the 20-week and the 50-week in red and blue, respectively) suggests there will be plenty for natural gas bulls to fight through between 8 and 9 before this market will be able to move higher — though "move higher" is exactly what the market seems poised to do, technically as well as seasonally.

STOCKS LEADING FUTURES

One of the lessons of intermarket analysis is that the stocks of certain commodities tend to lead those commodities in both uptrends and downtrends. While some like to posit that stocks "always" lead the underlying commodity, John Murphy, the leading authority on intermarket technical analysis, noted in *Intermarket Technical Analysis* that there are instances in which stocks lead, but also instances during which the commodity leads. Much more important, Murphy reminded us, is to know that "as a rule, they both trend in the same direction. When they begin to diverge from one another, an early warning sign is being given that the trend may be changing."

Bringing Murphy's observations on the relationship between commodities and commodity stocks to bear on the behavior of natural gas and natural gas stocks in 2006, we can see that while the commodity was breaking down significantly (the March 2007 contract was nearly halved), the stocks were holding their own. In fact, it could be argued that while the stocks were in a sort of consolidation pattern for all of 2006 (and the last quarter of 2005 as well), that consolidation had a bullish bias.

I suggest that because of the pattern of higher highs and higher lows that became increasingly apparent in the consolidation range of the natural gas stocks. This trend became especially pronounced after the late spring low in 2006 — which itself was a higher low vis-a-vis the fourth-quarter 2005 low. The resilience of the stocks suggested strongly that when the correction in natural gas as a commodity was over, the consolidation in natural gas stocks would be over also. And what would be a bounce from severely oversold conditions in the former would be a breakout to new highs in the latter.

Looking more technically at the consolidation range in the natural gas stocks, the index of which goes under the symbol $XNG, we note a breakout in the fourth quarter of 2006, then a pullback to just

MACD histogram divergences in weekly charts are some of the best, most powerful divergences that speculators can follow.

FIGURE 2: MARCH NATURAL GAS FUTURES, WEEKLY. Breaking down from a major consolidation between October 2005 and the late summer of 2006, March 2007 futures fell from a consolidation high above 12 to almost six by early 2007. A positive divergence in the MACD histogram strongly suggests that a bottom was made just as the new year was beginning.

FIGURE 3: NATURAL GAS INDEX, WEEKLY. While natural gas futures were moving sharply lower in 2006, natural gas stocks slipped into a horizontal consolidation — and one with an upward bias as the higher lows beginning in the second quarter of 2006 attest.

FIGURE 4: DEVON ENERGY, WEEKLY. Bouncing off of support at the 50-week EMA, shares of Devon Energy look set to test the 2006 highs near the 75 level.

inside the top of the consolidation range. There is trendline support nearby, which should make it difficult for the pullback to fall too much deeper into the consolidation range, At any rate, it appears as if a pivot low has been established at 420 from the very first trading week in January 2007. This, too, should provide comfort for the bulls trying to move natural gas stocks out of their consolidation.

The size of the consolidation range suggests that should the $XNG regain momentum to the upside, a move to the 500 level should be expected (that is, a basic swing rule projection: take the width of the consolidation and add that amount to the value at the top of the consolidation to get an upside target. In order to get downside targets, simply subtract that same amount from the value at the low of the consolidation).

If a breakout is in the cards for natural gas stocks, then which stocks seem best poised to exploit that breakout? Of the 15 $XNG stocks I track, fully eight have produced buy signals based on the weekly MACD histogram (see my pair of Working-Money.com articles "Trading The MACD Histogram, Part I" and "Trading The MACD Histogram, Part II" for more on histogram-based buy and sell signals). And five out of that eight have been trading above their intermediate- and long-term moving averages (20- and 50-week exponential moving averages), and thus may be the cream of the natural gas stock crop for those looking to gain exposure to the group. These five include Devon Energy (DVN), Noble Energy (NBL), Natural Fuel Gas Company (NFG), Southwestern Energy (SWN), and XTO Energy (XTO).

I purposely have used weekly charts in order to cater to speculators and position traders who prefer to operate on a somewhat longer, less hectic time frame compared to the sort of signals and reads usually generated from daily charts. I also suspect that, as was the case with my timely calls on consumer stocks back in the spring of 2006 ("Counting On Consumers," Working-Money.com) and biotechnology stocks a month or so later ("Betting On Biotech," Working-Money.com), weekly charts are an excellent way to read and analyze longer-term seasonal trends. Longer time frames do mean that speculators and investors have to tolerate greater price swings than swing traders, for example, who might play for only a point or two worth of gain. But it is also true that longer time frames can allow the sort of time stocks often require in order to make their biggest moves. And with both seasonal and technical winds at their back, stocks likely to make these sort of moves are often best left to their own devices until the end of seasonality or a change in the technicals tells traders otherwise. ■

This article was originally published on 2/20/2007.

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INDEXES

DOW THEORY

Dow Transports Make A Statement

by Arthur Hill

Surging over the last few weeks, the Dow Jones Transportation Average is knocking on neckline resistance, and a breakout would be Dow theory bullish.

Tradable: $DJT

On the weekly chart (Figure 1), the pattern at work for the Dow Jones Transportation Average (DJTA) looks like a big inverse head & shoulders. What's more, this pattern looks similar to the inverse head & shoulders pattern in 2005. Back then, the shoulders established support around 3500 and neckline resistance was 3800–3900. The distance from the neckline to the head measured about 500 points. The neckline breakout led to a massive advance that exceeded 5000 in May 2006. The rally from 3900 to 5000 was much more than the 500 points projected by the head & shoulders formation.

The current head & shoulders is equally big and a breakout would be most bullish. The shoulders established support around 4400–4500 and there is neckline resistance around 4900–5000. The distance from the neckline to the head is about 800 points. A break above neckline resistance would project further strength to around 5800, and this would be most bullish for the rest of the market. Such a breakout would also confirm the new highs in the Dow Industrials and be bullish for Dow theory.

The December low holds the key (Figure 2). It looked as if the DJTA was breaking down with a big support break in July. However, the average firmed around 4200 and surged back above 4400 to keep the bulls alive. The December pullback held above this breakout and the pattern looks like a falling flag (magenta trendlines). The breakout over the last few days reinforces support from the December low and points to higher prices. Failure to hold this breakout and a move below 4500 would be bearish for the Dow transports and Dow theory. ■

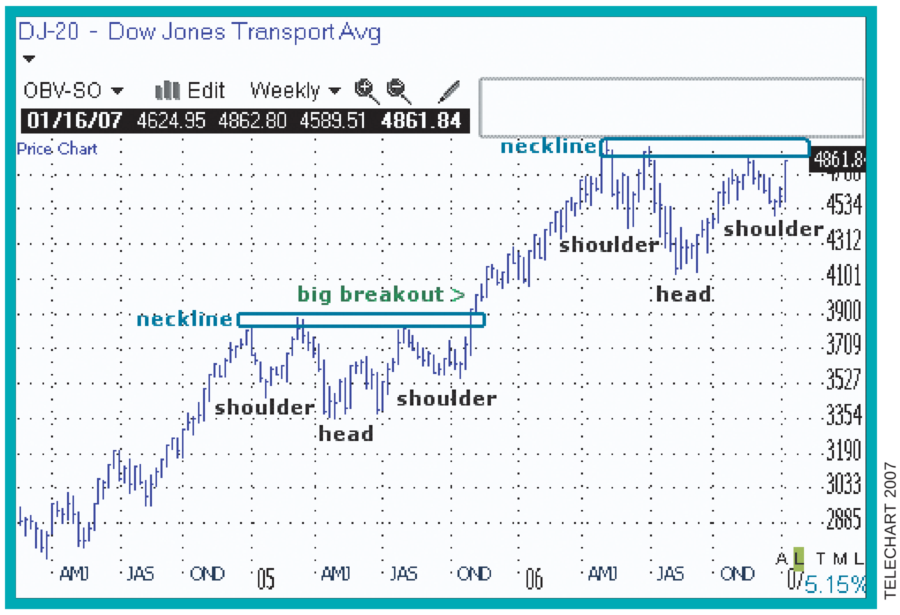


FIGURE 1: DJTA, WEEKLY. The inverse head & shoulders pattern currently forming looks remarkably like the H&S pattern that formed back in 2005.

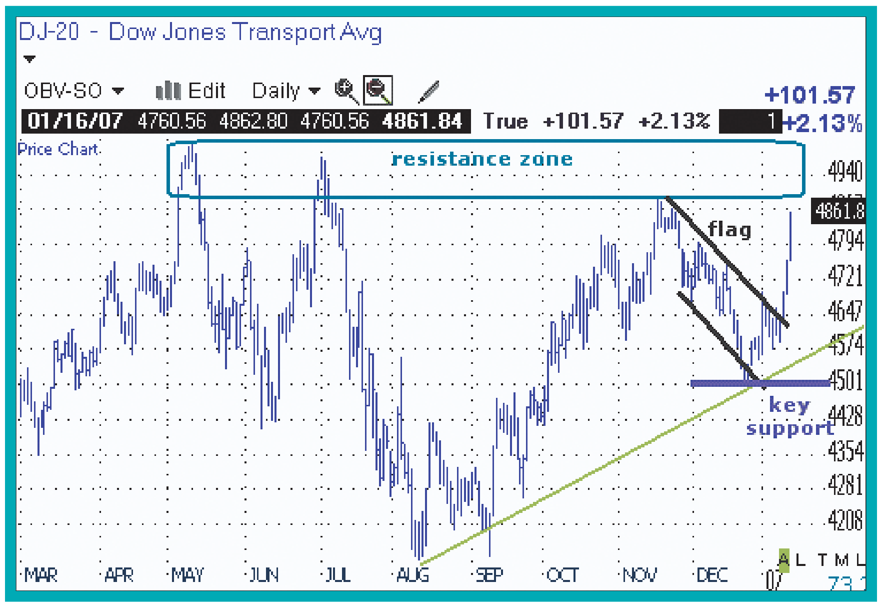
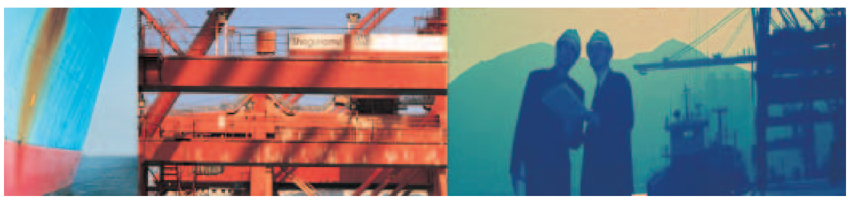


FIGURE 2: DJTA, DAILY. The breakout over the last few days reinforces support from the December low and points to higher prices.



CONSOLIDATION FORMATION

The Russell 2000 Breakout

by Arthur Hill

The Russell 2000 broke consolidation resistance this month and the breakout signals a continuation of the ongoing uptrend.

Tradable: $RUT

The Russell 2000 advanced from August to November and then started a 10-week consolidation (Figure 1). The index found support around 770 and resistance around 800 to mark the range. There were at least five attempts to break above 800 and all failed — until now. The index gained traction in late January and early February to forge a consolidation breakout. This move signals a continuation of the August–November advance, and further upside should be expected

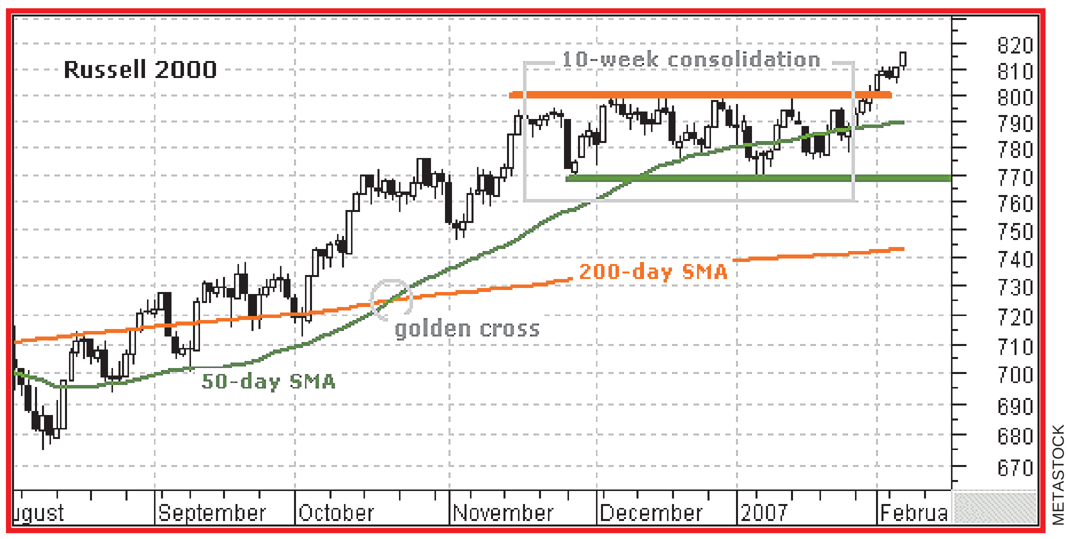
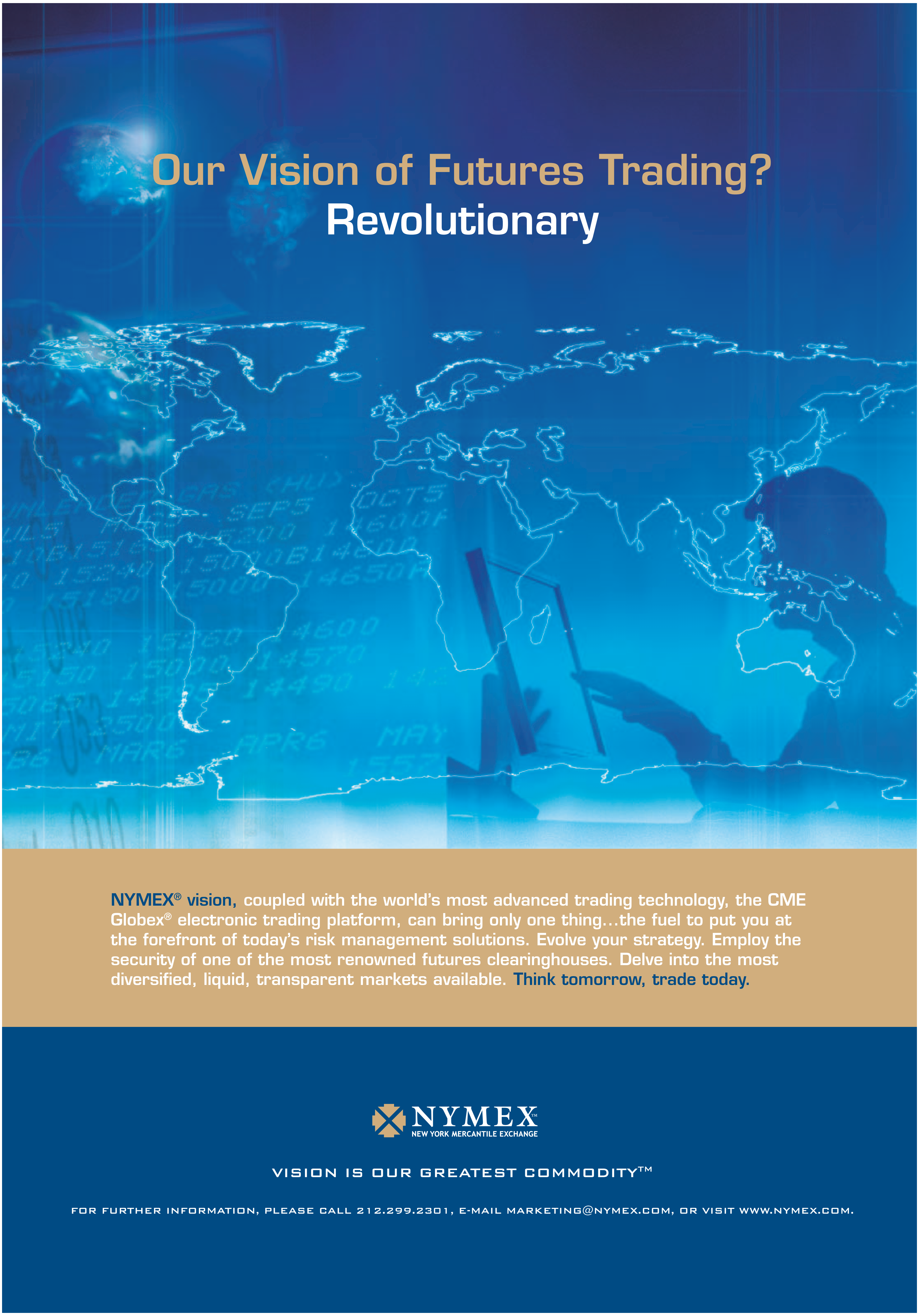


FIGURE 1: RUSSELL 2000. The Russell 2000 advanced from August to November 2006 and then began a 10-week consolidation.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in the coming weeks. Think of the consolidation as a rest after the August–November advance. The trading range gave the index time to reload its batteries, and the breakout has revived the bulls.

The consolidation marks a resistance zone from late November 2006 to late January 2007, and this resistance zone now turns into a support zone. The breakout at 800 marks the top of the new support zone and the first place to expect support. A strong index should hold its breakout, and a move back below 800 would be negative. The bottom of the support zone marks key support and this holds the key to the overall uptrend. Even though failure to hold at 800 would be negative, it would take a break below 770 to turn outright bearish.

Turning to the weekly chart (Figure 2), I can make an upside forecast with a linear regression channel. The red line is the linear regression of closing prices from August 13, 2006, to February 7, 2007. The blue lines are parallel and these mark support and resistance. They also establish the rate of ascent for the current advance. The upper trendline extends up to around 910 by June 30 and this is the midyear target for the Russell 2000 — provided, of course, that the breakout and key support at 770 hold. ■

FIGURE 2: RUSSELL 2000, WEEKLY. The upper trendline extends up to around 910 by June 30, and this is the midyear target for the index — provided the breakout and key support at 770 hold.

Think of the consolidation as a rest after the August–November advance.

REVERSALS

The S&P 500's Fibonacci Foraging For A Bottom

by David Penn

Will a key Fibonacci retracement level provide support for the falling S&P 500?

Tradable: $SPX

The past few days have seen the Standard & Poor's 500 move lower in a nauseatingly choppy fashion. After shooting up like a rocket in mid-month, the S&P 500 got toppy in the second half of February and began to move lower as the month drew toward a close.

FIGURE 1: S&P 500, HOURLY. The correction in the S&P 500, which began in the last full week of February, has retraced approximately 50% of its recent rally.

FIGURE 2: S&P 500, HOURLY. Whether or not the positive divergences in the moving average convergence/divergence (MACD) histogram and stochastic are marking a bottom at current levels (roughly the 50% retracement level), they do indicate a loss of momentum to the downside that will be part of the process of establishing a bottom sooner than later.

It has been a far from comfortable decline in the S&P 500. As Figure 1 shows, the market has moved lower in the sort of jagged, sawtooth pattern reminiscent of the sort of "double 3" corrections that Elliotticians often write about. While this conversation about the correction in the S&P 500 owes little to EW analysis, the similarity of the current correction to the EW "double 3" does underscore my sense that the move lower is just that: a correction to a market that is likely to move higher in the near term.

How near? Having already retraced 50% of the previous advance, the S&P 500 is moving into territory where potential support from a number of sources is likely to stem further significant declines from these levels. That potential support comes in the form of the 50% retracement level most immediately. But as the price action in Figure 1 shows, even failing support at 50% leaves the possibility of support at 1443, the 61.8% retracement level. This level also coincides — roughly — with the gap from the opening hour of trading on Valentine's Day, February 14, as well as the support left behind from various previous attempts to move lower on February 6 and 8. Still another way of seeing potential support at 1443 comes from subtracting the width of the February 14–22 correction (approximately 9 points, excluding an intrahour spike to the downside in the first hour of trading on February 20) from the value at the low of the correction, or 1452, a level that was not breached on an hourly closing basis until the breakdown during the first hour of trading on February 23.

The more I look at the pattern of selling in the second half of February, the more convinced I am that the sellers appear suspiciously eager to unload stocks. The last four days of the correction have featured either immediate, wide-range selling right at the open or, on the other hand, first-hour "fool's rallies" that result in shooting star candlestick patterns and almost instantaneous reversals to the downside. Even earlier in the consolidation this tendency could be readily observed. While anybody can sell at the opening bell for any reason, I suspect this is less the behavior of short-sellers staking out positions and more the behavior of profitable traders taking a few chips off the table to lock in gains in a market that, while advancing since the summer of 2006, has been less than profligate in distributing gains.

I'm not sure if the current divergences, shown and marked in Figure 2, have heralded the bottom in the S&P 500's correction. My suspicion is that one more move down toward the 61.8% retracement level at 1443 will be required before the correction runs its course. In any event, given the rally that preceded the correction, any true move back to the upside and resumption of the uptrend is likely to be a robust one, indeed. ■

FLAGS AND PENNANTS

The Amex Computer Index Looks Toppy

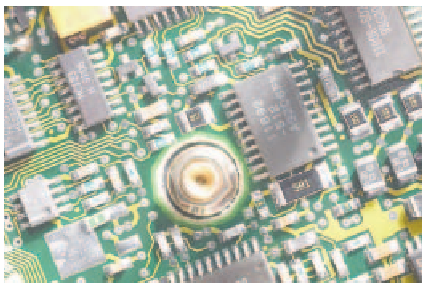
by Arthur Hill

The Amex Computer Index formed a head & shoulders reversal pattern over the last three months, and a neckline break at this point would be bearish.

Tradable: $XCI

The Amex Computer Index ($XCI) reads like a who's who of the technology sector. It features Apple, Adobe, Applied Materials, Cisco, Dell, Google, Hewlett Packard, IBM, Oracle, Texas Instruments, and Yahoo!. It would actually make a pretty good exchange traded fund (ETF). With its array of top tech stocks, I find this index a good bellwether for technology overall and the NASDAQ.

The Amex Computer Index ($XCI)



has been showing relative weakness in February, and this is the first concern (Figure 1). The Standard & Poor's 500, NASDAQ, and Russell 2000 all moved above their January highs this month, but XCI remains well below this high. XCI stalled around 815 in late January and consolidated over the last four weeks. This consolidation looks like a flat flag, and a break below the February low would signal a continuation of the mid-January decline.

In addition to the flag, the index has had a bearish head & shoulders pattern working over the last three months (Figure 2). The left shoulder formed in December, the head in January, the right shoulder in February, and neckline support resides at 790. A break below neckline support would confirm this pattern and target a move to around 735. The length of the pattern (835–790) is subtracted from the breakpoint for a downside target (45 – 790 = 745). Needless to say, this would weigh on the NASDAQ and technology sector.

It ain't broken until it's broken. The flag and head & shoulders are potentially bearish patterns that require some confirmation. With neckline support so close, I would pass on the flag break and wait for a neckline break for a signal. Should XCI hold support around 790–795, look for a break above the shoulder/flag high (815) to revive the bulls. ■

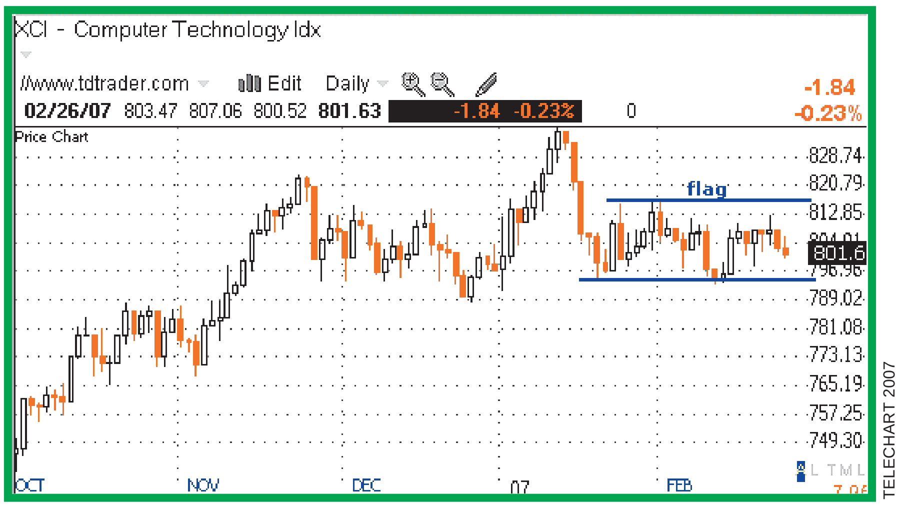


FIGURE 1: XCI, DAILY. The S&P 500, NASDAQ, and Russell 2000 all moved above their January highs this month, but XCI remains well below the high.

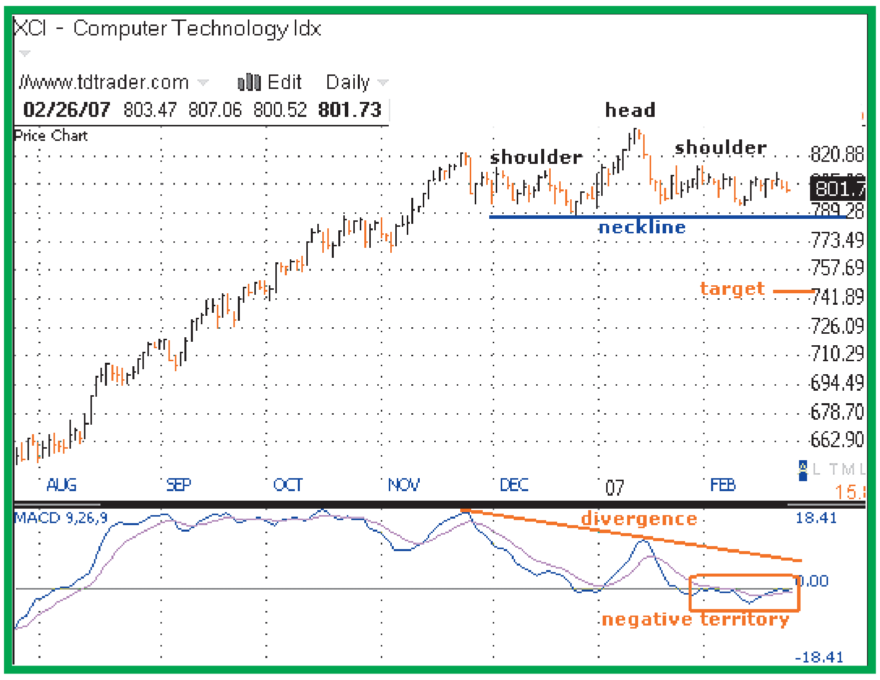


FIGURE 2: XCI, DAILY. The index has a bearish head & shoulders pattern working over the last three months.

MACD

A Big Test Looms For The Naz

by Arthur Hill

The NASDAQ came crashing down on Tuesday, February 27, but support is at hand and the November–December 2006 lows hold the key to a medium-term reversal.

Tradable: $COMPQ

The NASDAQ surged from July to late November 2006 and then worked its way higher from late November to late February 2007. As the moving average convergence/divergence (MACD) confirms, upside momentum was strong in the first half of the advance (July–November) and weaker in the second half (December 2006–February 2007). Even though momentum was not its old self, the MACD remained positive over the last two months and momentum never actually turned negative. The big negative divergence is definitely cause for concern, but the MACD needs to move below zero to turn momentum fully bearish and this would likely coincide with an acceleration lower in the index.

On the price chart (Figure 1), the index gapped down and formed a long black candlestick on high volume. This is the highest volume since late June and shows a pronounced increase in selling pressure. Moreover, the gap looks like a breakaway gap and this should be considered short-term bearish unless it is

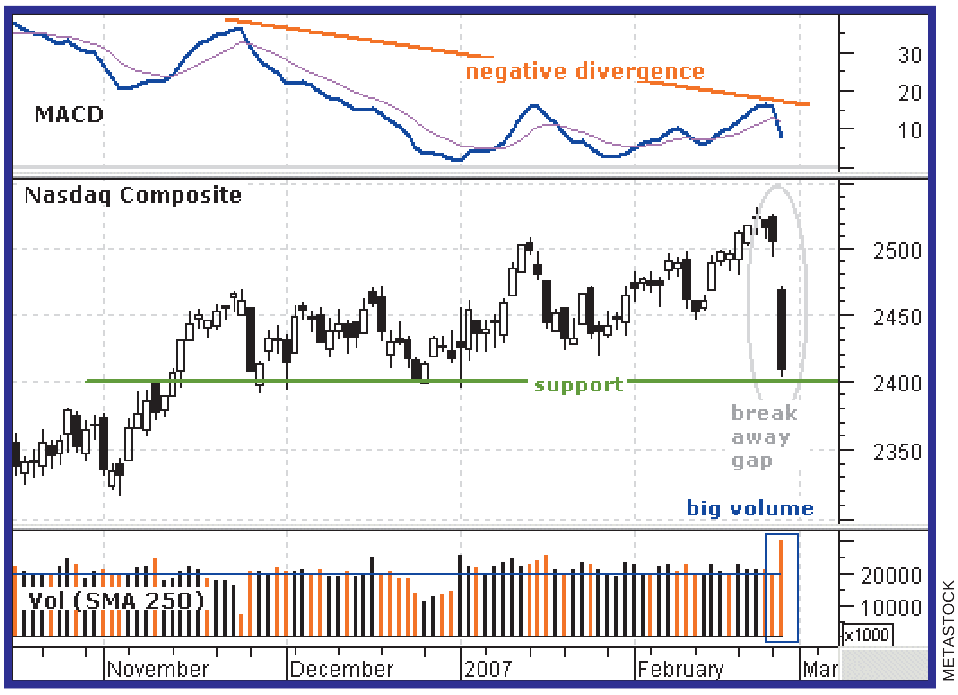


FIGURE 1: NASDAQ. The index gapped down and formed a long black candlestick on high volume.

Breakaway gaps often start trends, and this could mark the start of a medium-term downtrend.

filled. Breakaway gaps often start trends, and this could mark the start of a medium-term downtrend.

Not so fast, cowboy! There is a lot of support around 2400 and the NASDAQ held support on Tuesday. Support at 2390 stems from the November–December 2006 lows. In addition, the index forged higher highs in January and February 2007. A definitive lower low has yet to come in and the uptrend is still in place, technically speaking. A break below the November–December 2006 lows would forge a lower low and argue for a trend reversal. I would then expect at least a retracement of the July–November advance. Normal retracements run 50–62% and this would target a decline to the 2211–2273 region. ■

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FIGURE 2: NASDAQ. There is a lot of support around 2400 and the Naz held support on February 27. In addition, the index forged higher highs in January and February.

CANDLESTICK CHARTING

Tokyo Nikkei Warning

by Gary Grosschadl

Yesterday's Shanghai Composite Index meltdown caused major short-term dives on many major indexes around the world.

Tradable: $NIKK

Market pundits say the Shanghai Composite Index fall, and the resultant drop on the part of many major indexes, was an overreaction and praised the Tokyo Nikkei index ($NIKK) for not taking a similar hit, while the Dow Jones industrials, for example, suffered its biggest one-day drop since 9/11. Taking a closer look at the "saved" Tokyo index, however, I draw little comfort. See Figure 1.

A doji top (with its telltale small cross) often marks major reversal points after large uplegs or downlegs. I never take these lightly, as they tend to be one of the more reliable candlestick patterns. After a doji top or bottom, the next day's candlestick is taken to be confirmation. A close below yesterday's low confirms the bearish warning, while a move above the doji negates it. For the sake of some prudence, let's wait for additional nearby confirmation. A close below 18,000 would be stronger confirmation.

Two major support levels are possible should a sizable downturn develop. The 50-day exponential moving average (EMA) closely mirrors trendline support and currently resides at 17,394. Much stronger support would be at the 200-day EMA at 16,424. Note how the 200-day EMA held support in December 2006.

Several indicators can be considered. The moving average convergence/divergence (MACD) and the relative strength index (RSI) both show their own warnings via a negative divergence to price action. As the index rose to the recent peak, these indicators refused to do likewise, offering a caution or warning of a possible coming downturn. The stochastic oscillator is in overbought territory, above the 80 level. A dip below 80 usually confirms a downleg developing, so this could act as another bearish confirmation.

Dangerous doji or a head fake? Stay tuned to this index as a harbinger of the market puzzle that traders so often try to piece together. ■

FIGURE 1: NIKKEI, DAILY. Could this be a classic candlestick top?

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REVERSAL

Will The QQQQ Come Around?

by David Penn

After a bruising, week-long correction, positive divergences look to bring the quadruple Qs back.

Tradable: QQQQ

As Jack Steiman of The InformedTrader.com likes to say, it is amazing how quickly sentiment can shift to negative in a bull market.

There should be no doubt that the NASDAQ 100, or its exchange-traded fund the QQQQ, is in a bull market. Since bottoming in July 2006 and breaking out above the 50-day exponential moving average (EMA) in August, the QQQQ has not closed

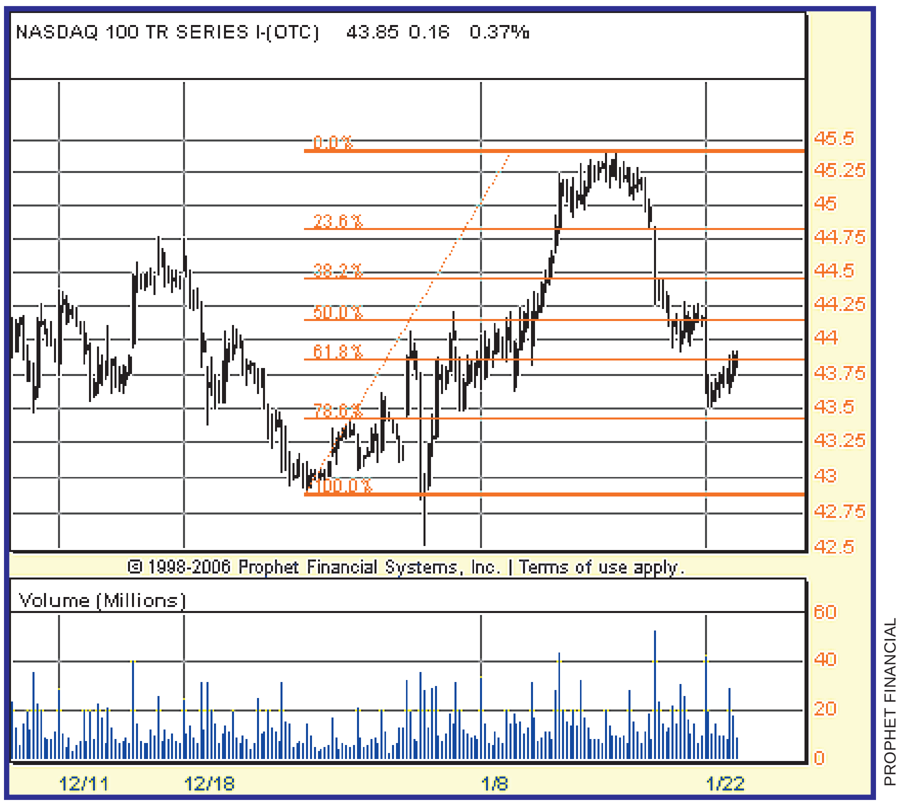

FIGURE 1: NASDAQ 100 TRUST SERIES (QQQQ), HOURLY. The sharp correction in mid-January took the QQQQ down to almost the 78.6% retracement level. Bears need be wary of pressing their bets.

FIGURE 2: NASDAQ 100 TRUST SERIES (QQQQ), HOURLY. Positive divergences in both the moving average convergence/divergence (MACD) histogram and the stochastic suggest that a bottom of some degree has been established at 43.5. Near-term resistance waits at 44 and 44.25.

below that intermediate-term moving average since (save for one day, December 22).

However, the failure of technology stocks to lead the market thus far in 2007 and the subsequent sharp collapse in the NASDAQ that began in mid-January have clouded this idea. Good news in stocks like Bank of America, Apple, and Johnson & Johnson has been met with, at best, a shrug and at worst, strong selling. So it is hard to begrudge the bears their time in the sun.

But could begrudging time be just around the corner? Figure 1 shows a market that has corrected a great deal of its advance from the mid-December 2006 lows below 43 — almost 78.6%. While it is certainly possible that the correction has not run its course and that a total and complete retracement of the advance is what is to come, traders should realize that there are those who successfully bet on this correction and that the only way for those savvy punters to profit on their well-made wager is to start buying — covering — their shorts. The fact that the market stalled at the 61.8% retracement level and started to bounce before plunging lower once again suggests to me that the market might have been looking for a bottom even sooner.

I had been studying the 15-minute charts of the QQQQ and thought there was a good chance for a bounce on January expiration based on positive divergences in that time frame. The bounce was minimal at best, as the QQQQ rallied about 25 cents before rolling over and moving significantly lower. But perhaps the second time will be the charm as a new set of positive divergences — as shown in Figure 2 on the hourly chart — have appeared and look more than capable of encouraging the bears that the "trade has been made" and that it is time for profit-taking and short-covering.

The big hurdle for the QQQQ to clear is at 44.25. This is the level that repelled the bounce that I anticipated from the 15-minute chart. I suspect the QQQQ will fare better in its next attempt to break through the 44.25 level, given in part the larger positive divergence that will be backing it up. Should the QQQQ reach this level, there is a swing rule projection that suggests a move as high as 45. In order to get the swing rule projection, subtract the value at the low from the value at the breakout point to get the size of the swing, then add that amount to the value at the breakout point. Interestingly enough, 45 also represents the next area of potential resistance beyond 44.25. ■

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RELATIVE STRENGTH COMPARATIVE

Rails Taking The Early Lead

by Arthur Hill

One of the top performers thus far in 2007, the Dow Jones Railroad Index caught fire over the last two weeks.

Tradable: $DJUSRR

The Dow Jones Railroad Index ($DJUSRR) shows good relative strength and good absolute strength. After a decline from late October 2006 to early January 2007, the index shot higher and broke its October high this week. The pattern from October to January looks like a falling price channel and the breakout signals a continuation of the prior advance (September–October). This advance was around 70 points and a similar advance from the January low would extend to around 460. See Figure 1.

The price relative confirms strength with a breakout of its down. This price relative shows the performance of the DJ Railroad Index relative to the Standard & Poor's 500. The price relative rises when the DJUSRR outperforms and falls when the DJUSRR underperforms. The price relative declined from late October until early January, and this showed a period of relative weakness. That abruptly changed over the last two weeks as the price relative shot higher and broke out. Railroads are now showing relative strength and the breakout in the price relative is bullish.

The breakout on the price chart is bullish until proven otherwise. A strong index should hold its breakout and continue higher. The DJUSRR broke above resistance at 407, consolidated a

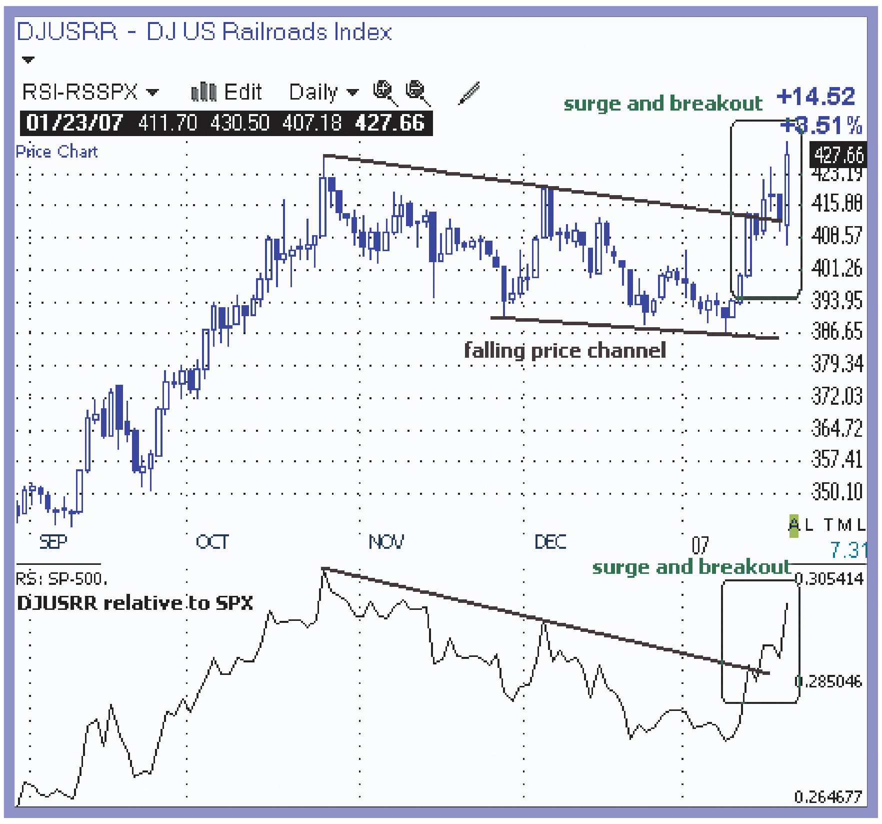

FIGURE 1: DJUSRR, DAILY. After a decline from late October to early January, the index shot higher and broke its October high.

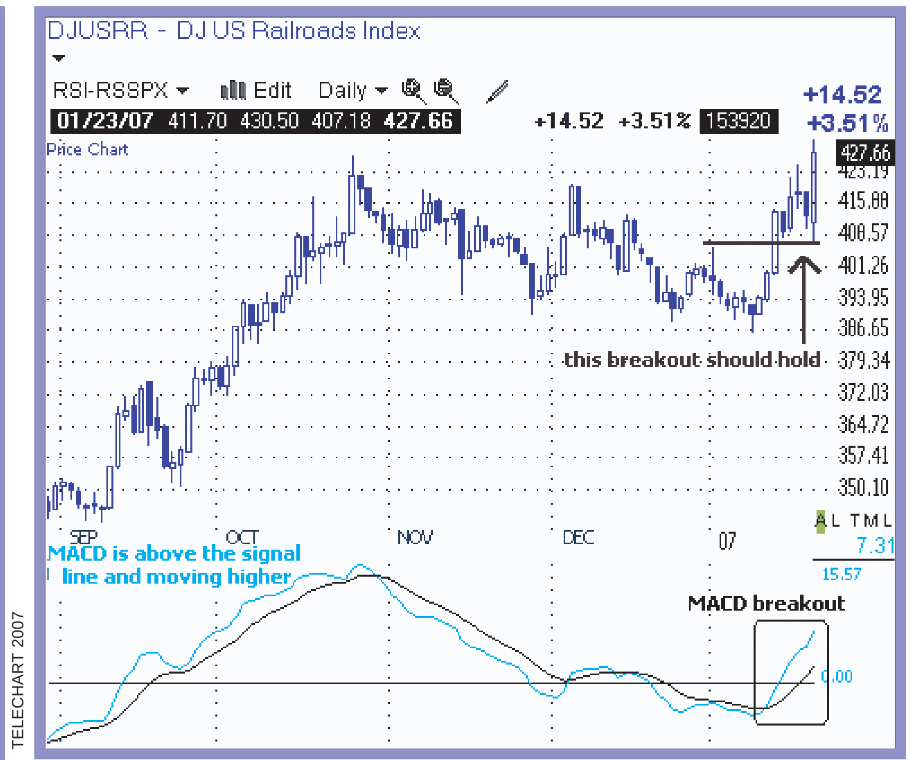

FIGURE 2: DJUSRR, DAILY. The breakout is bullish until proven otherwise.

bit and surged higher on January 23. This surge reinforces the breakout at 407 and a move back below 407 would be negative. I am also watching the moving average convergence/divergence (MACD) to gauge momentum. The MACD moved above its signal line and into positive territory with the surge (Figure 2). The advance is strong as long as MACD holds its signal line (red line). Note that the MACD held its signal line from late August to late October. While I would not turn bearish if MACD moves below its signal line, such a move would warrant a reassessment and closer scrutiny. ■

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SECTORS

AROON

The Moment Of Truth For Small-Caps

by Arthur Hill

The Russell 2000 declined sharply over the past five days, and this key index is now trading at an important make-or-break level.

Tradable: $RUT

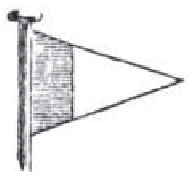
First, let's review the price chart and the patterns at work (Figure 1). The index advanced from mid-July to early December 2006 and then consolidated over the last seven weeks. The advance gained over 20% from low to high and the consolidation represents a rest in the ongoing uptrend.

The consolidation narrowed in December, and the pattern since December 1 looks like a pennant. These are continuation patterns that are dependent on an upside breakout for confirmation. A move above 800 would break resistance and call for a continuation of the uptrend. Failure to break 800 and a break below pennant support at 775 would argue for a correction period. The index is already challenging the lower pennant trendline, and further weakness would be negative.

Pennants are continuation patterns that are dependent on an upside breakout for confirmation.

Now let's look at two indicators to try and predict the direction of the breakout. The Bollinger Bands are overlaid on this price chart and these narrowed over the last few weeks (Figure 2). In fact, the bands are their narrowest in years and volatility contractions often precede breakouts. Bollinger Bands do not give us directional clues, but RUT broke below the lower band and this is negative. It is the first move below the lower band since June.

The Aroon indicators are shown in the top window. These cover 20 periods (one month) with red for Aroon down and green for Aroon up. Notice that Aroon down (**red**) remained below 70 from late July to early January. This pretty much covers the entire advance. In addition, Aroon up (**green**) held above 30 during this time period. The decline over the last few days changed all that as Aroon up moved below 30 on December 26 and Aroon down moved above 70. This shows weakness and favors a support break at 775. ■



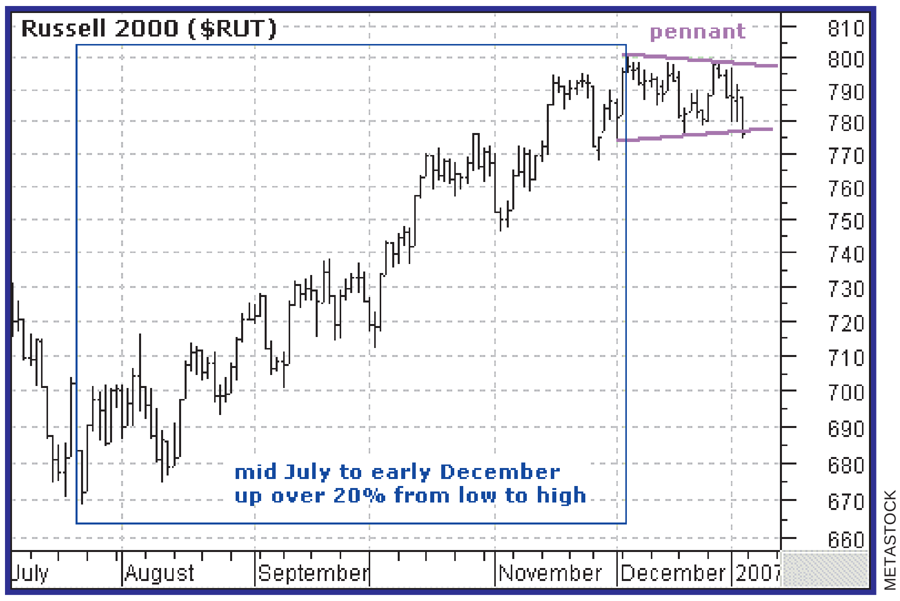


FIGURE 1: RUSSELL 2000. The index advanced from mid-July to early December and then consolidated over the last seven weeks.

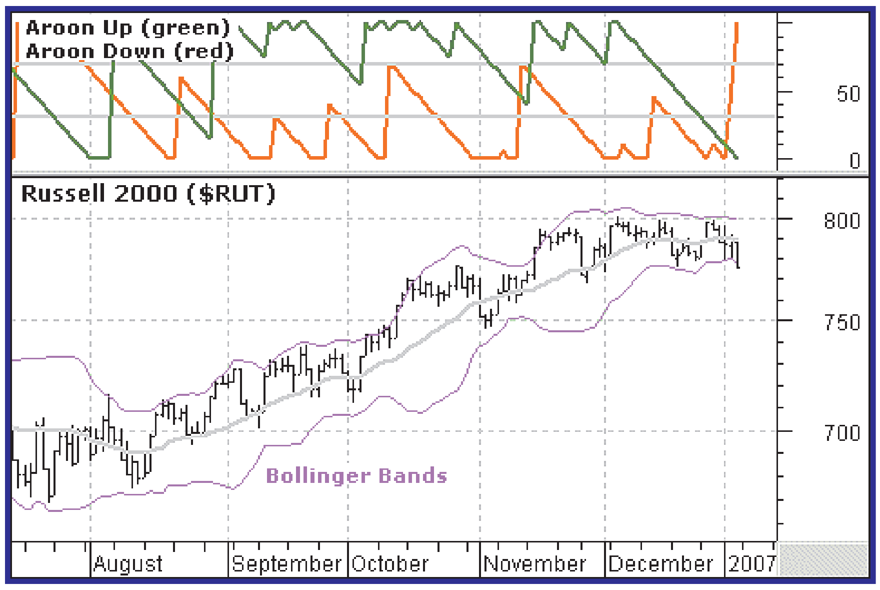


FIGURE 2: RUSSELL 2000. Predicting the direction of the breakout takes some doing. The Bollinger Bands are overlaid on the price chart and these narrowed over the last few weeks.

SECTOR INVESTING

The Biotech Bet Is Back

by David Penn

Does the current test of support mean that biotech stocks are finally ready to move?

Tradable: BBH

Back in mid-June 2006, I wrote an article for Working-Money.com discussing the upside potential for biotechnology stocks ("Betting On Biotech," June 13, 2006). What drew my attention to biotech was a suggestion in Yale and Jeffrey Hirsch's *Stock Trader's Almanac* that the seasonality for biotech was especially favorable between July and March.

Mid-June might have been an excellent time to be reminding traders and investors of biotechnology stocks. After all, the correction in these stocks — as measured by BBH — that began in November 2005 ended the week of June 19. But speculators in these stocks are, in some instances, still waiting for the payoff. Although the BBH has risen from the 170 level in the summer of 2006 to test the 190 level as recently as last week, a number of biotech stocks did not move higher appreciably in the second half of 2006.

There are signs that another move higher for biotechnology stocks may be in the making and with that move, potentially, some much-needed wind in the sails of many individual biotech issues. These signs come in the form of a weekly moving average convergence/divergence (MACD) histogram that, as of this writing, has bottomed and reversed back to the upside (Figure 1). That this histogram did so without recording a strongly negative MACD histogram reading during the pullback in late December and earliest January is an additional bullish sign. That the pullback itself appears to have found support at the 20- and 50-week exponential moving averages (EMAs) is all

FIGURE 1: BIOTECH HOLDRS, WEEKLY. A consolidation range from late spring to mid-summer 2006 so far has acted as an accumulation zone as BBH moved cautiously higher over the balance of the year. The reversal in the MACD histogram in this weekly chart was one hint that the resolution of the summer consolidation was likely to be a bullish one.

FIGURE 2: BIOTECH HOLDRS, WEEKLY. A shallow dip into negative territory and a bounce back into the positive for the weekly MACD histogram suggests strongly the possibility of further gains if BBH is able to close above the high of the week of the histogram's reversal to the upside.

the more noteworthy.

Not only has there been a pullback in BBH, it also appears as if the advance that haltingly began back in June 2006 may be about to resume in the wake of that pullback. Figure 2 shows where the pullback appears to have found support at the 20- and 50-week EMAs. It also shows how the MACD histogram developed a bullish "P-p-P" pattern from the week of December 18 through the week beginning January 1 (for more on histogram patterns, see my Working-Money.com article, "Trading The MACD Histogram, Part I" and "Trading The MACD Histogram, Part II" from December 6 and December 29, respectively).

Note how on the final "P" of that "P-p-P" pattern volume and range, both increase as BBH bounces off of moving average support.

For a full-fledged buy signal to develop using this weekly chart, the BBH will have to make a weekly close above the high of the week beginning January 1. While this may mean an entry price that is "uncomfortably" higher than a speculator might prefer, there are three things worth remembering. The first thing is that being able to buy a bounce off of support — such as that provided by the two moving averages mentioned — is not an opportunity to be casually ignored. The second thing is that weekly buy signals from the MACD histogram often have significant staying power, and whatever points are lost by not buying closer to the week of January 1 high at 190.70 could easily be made up by a BBH that takes out the October 2006 high at 193 or tests the March 2006 high near 199. The third and last thing is that focusing on opportunities unveiled by the weekly chart does not preclude shorter-term traders from looking to trade around BBH. ■

SUGGESTED READING

Penn, David [2006]. "Betting On Biotech," Working-Money.com, June 13.

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This article was first published on 1/9/2007.
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CONSOLIDATION FORMATION

Can Retail Be Trusted To Break Out?

by David Penn

The retail stock HOLDRS wedged higher, but negative divergences frustrated progress.

Tradable: RTH

Retail stocks began the second leg of their bull market advance from the spring 2003 bottom during the summer of 2004. As measured by the retail stock HOLDRS (RTH), retail stocks advanced some 50% from the spring of 2003 to early 2004 in the first leg of their bull market and then rallied more than 37% from the low in the summer of 2004 to their high in the autumn of 2005.

Since making an intraweek high just shy of 103 in August 2005, RTH has slipped into a relatively wide-ranging consolidation pattern (Figure 1). During the back-and-forth trading that has characterized the RTH over the past year, the HOLDRS have slipped to as low as 88 and rallied to as high as 102. What the RTH has failed to do — a failure that was especially notable in the final months of 2006 — was to close above the 100 level on a weekly basis, hold that close, and then follow through with a higher weekly close.

RTH provided traders and investors with a fairly clear-cut buying opportunity back in the late summer of 2006. At the time, RTH was testing lows established back in September 2005. On a weekly basis, RTH closed below those September 2005 lows briefly in the summer of 2006 but did not show any significant follow-through to the downside. This was a clue, a 2B bottom type of clue, that the correction in retail stocks (a relatively minor one, which began in the spring of 2006) had likely run its course. Within 10 weeks, the RTH was back trading near the top of its 14-point range.

Will this most recent trip to the top of the range — the third since the RTH topped out in the summer of 2005 — be the charm? The stakes, it would appear, are great insofar as a 14-point range implies a 14-point move — to the upside or the downside — once the consolidation has been breached successfully. Currently, it appears as if the RTH will struggle to move higher. This is due to the short-term negative divergences in the MACD histogram and stochastic that have been building since October (Figure 2). These are not the most decisive negative divergences to ever appear on a price chart — and I would not be surprised if all they end up heralding is the continuation of slightly lower to sideways price action until the overbought nature of both indicators wears off somewhat and investors become disinterested in retail stocks altogether.

FIGURE 1: RETAIL HOLDRS TRUST, WEEKLY. Retail stocks settled into a wide-ranging consolidation zone shortly after topping out in the late summer of 2005. The highlighted area shows a 2B test of bottom that resulted in a powerful rally in retail stocks during the second half of 2006.

FIGURE 2: RETAIL HOLDRS TRUST, WEEKLY. Although not as decisive as some negative divergences, the negative divergences in the MACD histogram and the stochastic should provide enough of a cautionary tale for would-be retail stock traders and investors.

In fact, if the indicators can unwind without the RTH suffering in the way of price depreciation, then the stage could be set for powerfully higher moves in retail stocks once current resistance between 100 and 102 is surpassed on a weekly closing basis. ■

TRIANGLES

A Broker–Dealer Breakout

by Arthur Hill

The Amex Broker–Dealer Index broke triangle resistance and is leading the market. The breakout is clearly bullish, but will it hold?

Tradable: $XBD

On the price chart (Figure 1), the AMEX Broker–Dealer Index ($XBD) led the market higher with surges in September and again in November. In between, there was a consolidation period from October 11 to November 10. The index again consolidated from late November to late December and again broke consolidation resistance. This breakout signals a continuation of the current uptrend and targets a move to new highs.

Brokers are the backbone of Wall Street, and a breakout in this group bodes well for the overall market.

A breakout is only good as long as it holds. Until there is proof to the contrary, we should treat this breakout as bullish and expect higher prices. What would it take to prove otherwise? The index established support at 238 in late December and a break below this level would totally negate the breakout. The 50-day moving average, the lower triangle trendline, and the late December low all confirm support in this area. A move below 238 would break all three and spell trouble. In addition, the surge over the last two weeks should hold, and failure to hold these gains would be most negative.

Waning momentum is a concern, but the moving average convergence/divergence (MACD) still favors the bulls right now. While the index moved to a new high in late November, the MACD formed a lower high and this shows that upside momentum was not as strong. The index is once again on the verge of a new high and the MACD remains below its November high.

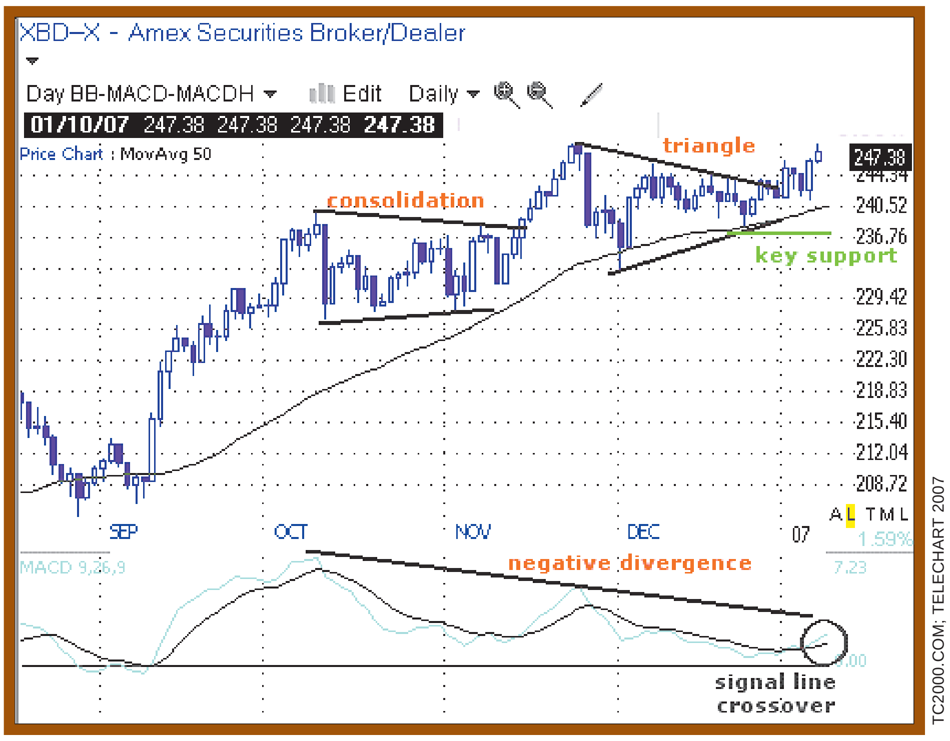
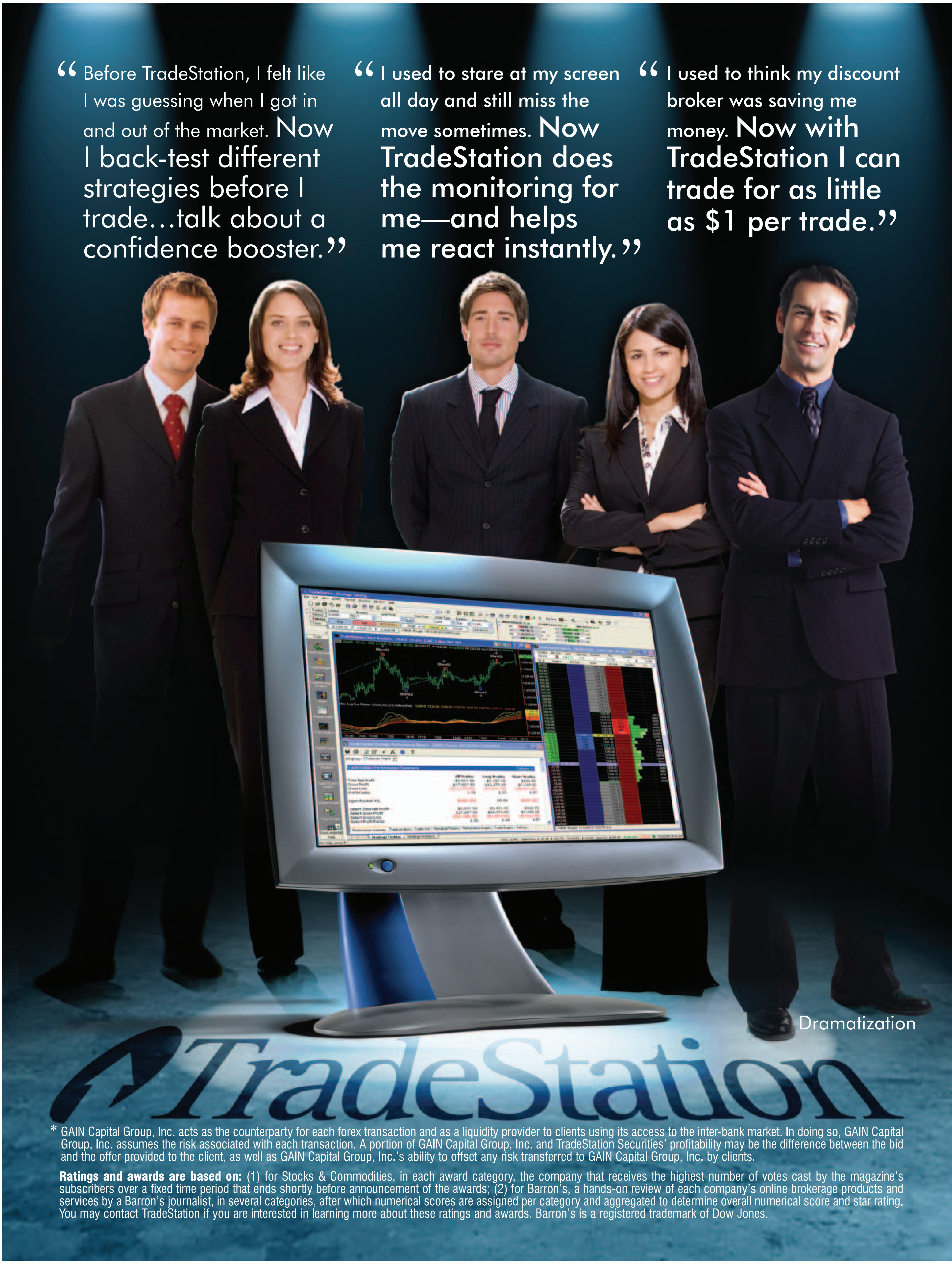


FIGURE 1: AMEX BROKER-DEALER INDEX, DAILY. The XBD led the market higher with surges in September and again in November.

Again, momentum ain't what it used to be. Even so, the MACD is holding in positive territory and the MACD moved above its signal line the first week of January. Negative divergences are a concern, but these cannot be considered bearish unless the MACD moves back below its signal line. To negate this breakout and turn bearish, look for a move below the signal line in the MACD and a move below 238 in XBD. ■

Brokers are the backbone of Wall Street, and a breakout in this group bodes well for the overall market.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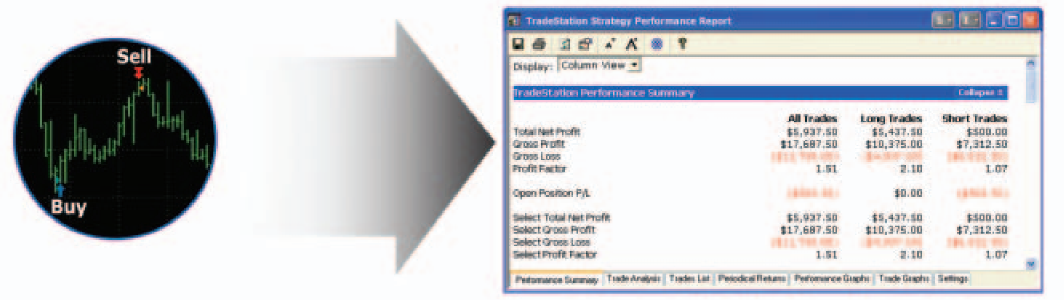

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REVERSAL

Are Housing Stocks Rolling Over?

by David Penn

Giddy talk of a bottom has shifted to anxiety about a market rallying into resistance.

Tradable: $HGX

One of the distinguishing features of the bottom in the market back in the late summer of 2006 was the number of housing stock speculators declaring the end of the bear market in the homebuilding sector. See Figure 1.

This feature was heralded by a declaration from no less than *Barron's* that it was now "Time to Buy Housing Stocks." Published in late August 2006, just as the bounce in the Philadelphia Homebuilding Index began moving higher in earnest, *Barron's* latched on to the growing bearishness in an effort to leverage a contrarian bet in favor of the group. "[With] the investment community firmly entrenched in their bearish outlook," *Barron's* observed, "the time to consider catching some bargain-basement prices in housing stocks may be rapidly approaching."

At least for a trade, *Barron's* timing was excellent. Those who took *Barron's* urging in late August to bid on housing stocks were likely rewarded in short order, as the housing index ($HGX) rallied from a low of 187 in mid-July to an intraweek high of 240 by mid-December (a 28% advance in five months). The question now, as sectors across the board seem to be setting up for a move higher in the first few months of 2007, is whether housing stocks will head still higher, or whether the move up from the second half of 2006 was merely a bounce in a bear market that has not yet run its course.

The downside to the advance in the housing stocks is hinted at in Figure 2 of Centex. Like housing stocks in general, CTX bottomed in the summer of 2006 and rallied over the second half of the year. And also like housing stocks in general, CTX has found resistance at levels that had functioned as support in the past: the October and April 2005 lows. The combination of CTX's rising wedge pattern and the increasing relevance of those support-turned-resistance levels should keep housing bulls from getting too far ahead of themselves — at least until that (roughly) 58 level in CTX is taken out.

A break of the lower of the two converging trendlines in Centex's wedge pattern would be the first true sign that the bounce that began in July 2006 had run its course and that a reversal — potentially a serious one — could be around the corner. If in fact CTX has developed a bearish rising wedge, then the downside implications could be severe. The measuring rule for bearish rising wedges suggests subtracting the formation's size from the value at the breakdown. With a formation size of approximately 14 points (58 to 44) subtracted from a likely breakdown level of about 52, a minimum downside target of 38 — below the summer of 2006 lows — is produced. ■

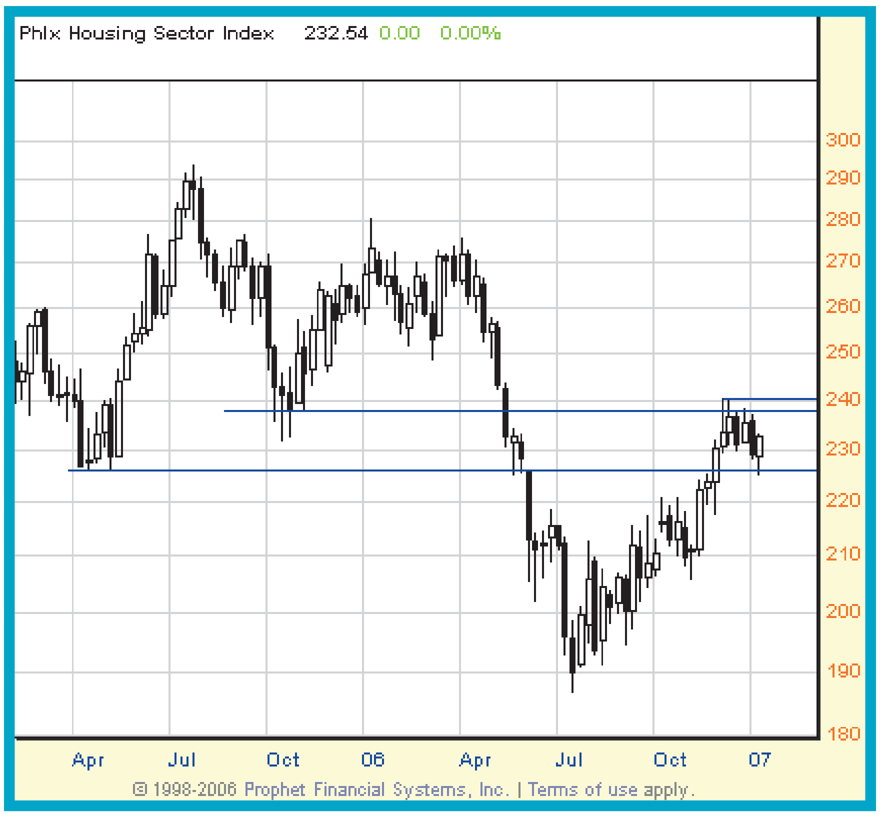

FIGURE 1: PHILADELPHIA HOUSING SECTOR INDEX, WEEKLY. After plummeting by more than 100 points from its July 2005 peak to its July 2006 bottom, $HGX sprung up for a 28% gain over the balance of 2006. Resistance between the October 2005 and April 2005 lows has so far stymied the $HGX going into 2007.

FIGURE 2: CENTEX CORP., WEEKLY. Since rallying from a summer bottom, CTX has moved up in a wedge-shaped pattern. The negative divergence in the MACD histogram suggests that a bearish rising wedge may be the resolution of this advance, sending CTX back toward a test of the mid-2006 lows.

SECTOR INVESTING

The Trouble With Tech

by David Penn

Disfavored seasonally, tech stocks struggle to make progress to the upside.

Tradable: QQQQ, SMH

Recently, Jim Cramer of CNBC's *Mad Money* fame shared an anecdote about how he would summarily dismiss his research director every time the poor guy walked into his office with tech picks at this time of the year. Cramer's distaste for tech stocks at the beginning of the year is backed up by the research conducted by Yale and Jeffrey Hirsch. The Hirsches note two seasonal opportunities for what they label "high tech" and "computer tech" stocks: one period begins in early October and ends between mid-January and early February. The other period, interestingly, begins shortly thereafter, lasting from April to July. See Figure 1.

These two time frames — mid-autumn through the end of the year and mid-spring into mid-summer — are often (though not always) good times seasonally for most stock market sectors. So it is no surprise that technology stocks, which often lead the market, do best during these stretches. Unfortunately, many traders and investors who profit from these end-of-the-year moves often stick around too long into the new year, hoping for more of the same advances. Too often, the market does not deliver, as investors and traders in semiconductor stocks have learned of late.

This predicament is especially interesting right now, as sector rotation currently favors technology stocks — particularly the high-multiple varieties such as those with significant Internet exposure (YHOO, GOOG, EBAY). Although not specifically "high tech" or "computer tech," these kinds of high-multiple stocks often have a sympathetic relationship with the rest of the tech cohort. And some of the relative sluggishness in these stocks at present is likely related to sluggishness across the field of technology broadly defined (the Hirsches suggest that seasonality for Internet stocks is virtually identical to that of "high tech" stocks).

FIGURE 1: NASDAQ 100 TRUST SERIES (QQQQ), DAILY. A seasonal sweet spot for technology stocks is a seasonal sweet spot for the QQQQ as well. From early October to mid-January, the tech-heavy QQQQ appreciated by more than 12%.

FIGURE 2: SEMICONDUCTOR HOLDRS, DAILY. Favorable seasonality did semiconductors few favors between October and the end of the year. A correction going into the spring looks increasingly likely as the SMH tests support at 33.

If it is true that we are in an interregnum between the last seasonally favorable period and the next one when it comes to tech stocks, then traders and investors are probably best off looking for potential breakdowns, corrections, and pullbacks in many of these stocks. The semiconductor HOLDRS chart in Figure 2 shows a market that rallied from a July bottom topped in mid-October (very counterseasonal) and then stalled and moved sideways from the next few months into the new year.

The range of the consolidation is approximately three points from its highest point at 36 to its lowest at 33. This suggests an upside to 39 should the SMH find support again at 33 and then move up, breaking through resistance at 36 and continuing to move higher. From a bearish perspective, a breakdown below 33 invites a move to 30 and a test of the July 2006 lows. As uncomfortable as that may be for those holding semiconductor stocks into that downturn, a successful test of bottom would likely set up the semiconductor group for a strong rally, perhaps over the (historically) seasonally favorable April to July period. ■

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This article was first published on 1/19/2007.
See www.Traders.com for more.

REVERSAL

Heavy Is The Heart Of The Homebuilders

by David Penn

Negative divergences augur lower prices ahead for homebuilding stocks.

Tradable: $HGX

I last wrote about homebuilding stocks in mid-January 2007 for Traders.com Advantage ("Are Housing Stocks Rolling Over?" January 18). Although my indictment of these stocks was relatively broad, the most specific charge was leveled at Centex Corp. (CTX), which was advancing in a bearish rising wedge pattern that I thought — given the proximity of likely resistance — would result in the stock reversing to the downside. I wrote:

> A break of the lower of the two converging trendlines in Centex's wedge pattern would be the first true sign that the bounce that began in July 2006 had run its course and that a reversal — potentially a serious one — could be around the corner.

That break did come, as shares of CTX slipped below the lower trendline a week later. Priced at the time of the article at just north of 53, Centex was most recently trading a few points above 47.

How representative are Centex's troubles? The housing sector, as measured by the Philadelphia Housing Sector Index ($HGX), has yet to break down to the same degree as Centex has. $HGX remains in an uptrend and, in addition, remains above its 20- and 50-week exponential moving averages (EMAs). At the end of January, just as Centex was slipping, the $HGX surged more than 7% higher in a single week.

For better or worse, however, the rally in the $HGX is starting to show the weariness that often leads to corrections, if not wholesale reversals in trend. Specifically, I'm referring to the development of negative divergences in both the moving average convergence/divergence (MACD) histogram and the stochastic between the December 2006 highs and the highs of early February 2007.

While the weekly chart shows a market tap-dancing on moving average support (Figure 1), the daily chart shows the same market having slipped beneath its moving averages — although most recently the $HGX has bounced back to test the resistance of the 50-day exponential moving average (in blue, above). If this bounce fails and the negative divergences shown in the MACD histogram and the stochastic prove true, then the next source of support for a falling $HGX is most likely the January correction low just south of 230. Failing that, there appears to be significant support at the 220 level, based largely on the highs of the consolidation that extends from the early autumn into late November.

As a group, the homebuilding stocks have enjoyed a solid advance off the summer 2006 lows, rising some 30% as measured by the $HGX. And the $HGX remains in an uptrend on a weekly basis. In the daily chart, however, a pattern of lower highs and lower lows marked February, and the most recent correction low (the last low before the most recent high) was taken out in $HGX's most recent move lower (Figure 2). If a bounce fails to materialize — and the size of the MACD trough should keep speculators skeptical of that possibility — then that pattern of lower highs and lower lows will resume, with some of the support levels mentioned soon to be challenged. ■

FIGURE 1: PHILADELPHIA HOUSING SECTOR INDEX, WEEKLY. Negative divergences in the MACD histogram and the stochastic in this chart of the $HGX suggest that a top may be soon in coming for the rally that began in July 2006.

FIGURE 2: PHILADELPHIA HOUSING SECTOR INDEX, DAILY. The same negative divergences in the MACD histogram and stochastic that appear in the weekly chart are shown here in the daily.

SUGGESTED READING

Penn, David [2007]. "Are Housing Stocks Rolling Over?", Traders.com Advantage, January 18.

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This article was first published on 3/2/2007.
See www.Traders.com for more.

METALS & ENERGY

ELLIOTT WAVE

So Where Is Oil Going?

by Jacob Singer, PhC

The price of oil should be rising, not falling.

Tradable: USO

That is the normal winter pattern, but this winter so far, the pattern has been abnormal. Pundits have blamed the abnormal temperatures on global warming, and those who speculate in a rise of oil prices as winter sets in have to date not been that successful. So when is the time to buy oil shares? Figure 1 is a chart that so far has been pretty accurate in forecasting where oil is going. Let us see how accurate it is from now on.

The United States Oil Fund, LP (USO), is a new way for investors and hedgers to manage their exposure to energy. The investment objective of USOF is for changes in percentage terms of the units' net asset value to reflect the changes in percentage terms of the spot price of West Texas Intermediate (WTI) light, sweet crude oil delivered to Cushing, OK (WTI light, sweet crude oil), less USOF's expenses. It is designed to give investors a flexible combination of exposure to a leading global commodity with the ease and convenience of an AMEX-listed security.

The earliest data I have of the fund is from April 12, 2006, when the price was $68.08. The price rose to $74.31 by July 14 in a sideways pattern, and then... from that date it started falling. Why? Did someone know that the winter would be a mild one? Did they suspect that OPEC would not increase oil prices substantially? Did they suspect that those countries that are substantial users would stockpile oil over the summer months? Whatever the reason, the fund suggested that the trend for oil was down, not up, a trend that is contrary to chart patterns of previous years.

The fund price dropped into October 2006 in what looks like a wave iii of a wave III, but as winter settled into a far warmer pattern than previous years, the oil price started falling once again and that in spite of the blizzard that occurred in Denver.

So what for the future? A wave count suggests that the oil fund and hence the oil price could continue falling into wave V, a further 10%, approximately. ($42 – $38 = $4.) The relative strength index (RSI), on the other hand, is suggesting that the price could move up, or should the price of USO follow the previous pattern when the RSI gave a buy signal, at least move sideways.

Can the fund be used as an indicator for the movement of future oil prices? So far it has proved itself, contrary to everyone's expectations. Definitely a way to determine which way oil will go. ■

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FIGURE 1: US OIL FUND, DAILY. A daily chart of the United States Oil Fund, suggesting that a bottom may be in sight, and that oil should by all accounts start strengthening in the not-too-distant future.

REVERSAL

A Crude Bounce

by David Penn

Positive divergences in the MACD histogram anticipated the late January bounce in crude oil prices.

Tradable: OIH, CLH7

A few weeks ago in Traders.com Advantage, I pointed out how negative divergences in the OIH (the Oil Service HOLDRS) that developed during December 2006 resulted in the collapse in oil shares in January ("Crackin' Crude," January 4, 2007).

At the time, the OIH was trading at a little over 133 after suffering a 4.5% single-session drop. The OIH would move lower still, finally putting in a bottom on January 11 at a price only pennies above 126 (another 5% lower). Back in "Crackin' Crude," I wrote that:

> But if the OIH does not hold up at this level (132), 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 (150–138 in height), as well as being near the 78.6% retracement level.

Other than taking my word for it, what clues might traders and speculators have used in order to game the bottom in the OIH — and by extension, crude oil — correction? Some of the best clues to the bottoms that developed in both the OIH and crude oil could be found in the hourly charts of both. In both the OIH and crude oil, positive divergences in the moving average convergence/divergence histogram (MACDH) could be seen developing by January 11 in the OIH and only a few days later in crude oil futures.

Let's look first at the OIH insofar as it was both the subject of my earlier article as well the current leader in the intermarket push-me/pull-you relationship between commodities and commodity stocks. The OIH was plunging through the second half of December 2006. In early January, OIH made an extremely deep MACD histogram trough (Figure 1). This trough alerted traders to two things: First, that the OIH had further to fall, and second, that there was an increasing possibility that the next lower low in price would be the final low for the correction.

The first alert proved true enough. The early January MACDH trough made its lowest point on January 3 with the OIH at 133. And while the OIH would move lower, the MACDH would make no lower trough. The second alert was not perfect insofar as the next low in price (January 9) did not represent the true bottom, which would not come until January 11. But that trough put traders on notice that the time for being short was running out and that the risks were shifting in favor of the bulls. As it turned out, the true bottom on January 11 was barely a point lower than the low from January 9.

I want to point out one thing not shown in Figure 1. There was an even deeper MACDH trough back on December 18–19. While this trough, taken in context with the trough from early January, does contribute to the positive divergence thesis, I don't include it because it arrives far too early in the OIH's correction to be considered part of the bottoming process (the "positive divergence" bottoming process). I refer to such extremely deep MACD histogram troughs that occur early in a correction as "breakdown troughs." These troughs are best used to warn traders that lower prices are likely (see more on this use of MACD histogram troughs in my Working-Money.com article, "Post-Breakdown MACDH Extremes," from May 19, 2004).

Turning to the bounce in crude oil that came only days after the bounce in the OIH, we see much of the same setup. A prolonged downturn forms initially a very deep MACDH trough. But as prices continue to move lower, the MACDH troughs become more and more shallow. This suggests a loss of momentum to the downside, the first prerequisite for the end of a bear turn in the market. What is especially interesting about the March crude chart in Figure 2 is that it clearly shows the MACD histogram spike that accompanied the initial move off the bottom. Such spikes are often excellent tells that the market has indeed bottomed for the time being, and that the market in question is ready to move higher.

Whether the current rally in crude oil and oil shares represents the beginning of a new move higher or merely an oversold bounce, these divergences did traders and speculators a big favor by alerting them to the possibility that profits on the short side were best taken swiftly. ■

SUGGESTED READING

Penn, David [2007]. "Crackin' Crude," Traders.com Advantage, January 4.

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This article was first published on 1/31/2007.
See www.Traders.com for more.

FIGURE 1: OIL SERVICE HOLDRS, HOURLY. The deep MACDH trough on January 3 and 4 was the signal for traders to begin anticipating the possibility of a positive divergence if prices made a lower low while the next histogram trough created a higher low. Note also the relatively smaller positive divergence late in the month as the OIH pulls back to the breakout level.

FIGURE 2: CRUDE OIL, MARCH FUTURES, HOURLY. Positive MACDH divergences helped anticipate the mid-January bounce in March crude oil futures. Note the MACD histogram spike that occurred during March crude's initial advance off the lows. This was further confirmation that a bottom was in and that higher prices — particularly vis-à-vis the price highs that accompanied the MACDH spike — were to come.

SWING CHART

Playing The Gold Bug Swings

by Arthur Hill

The Amex Gold Bugs Index has been range-bound the last 12 months, but the swings within this range offer a way to play and anticipate a bigger breakout.

Tradable: $HUI

Before looking at the swings, let's start with the weekly chart for an overall perspective (Figure 1). The Amex Gold Bugs Index ($HUI) surged from May 2005 to May 2006 and more than doubled in the process. It was a huge move and some sort of consolidation was in order. As a result, the index traded flat from January 2006 to the present and a triangle has taken shape over the last nine months. A break above the upper trendline and December high (362.53) would signal a continuation higher. A break below the lower trendline and October low would forge a reversal lower.

Turning to the daily chart (Figure 2), we can see the swings within this triangle. The red lines show the downswings and the green lines show the upswings. The dotted magenta lines correspond to trendline breaks. The breaks provided pretty good signals, with one bad signal in mid-August. The last downswing occurred in December 2006–January 2007 and the late January breakout started the latest upswing. This signal remains in effect and I expect higher prices as long as the breakout holds. The first target is resistance around 360–370.

The December–January downswing was shorter than the prior four swings, and this tells me that the range is narrowing. The higher lows and lower highs fit with the formation of a triangle on the weekly chart as well. Because of the narrowing triangle, I would also be alert for a short upswing here. It is too early to draw a trendline extending up from the January low, so I have opted for a trendline extending up from the October low (blue). This now defines the current upswing. A break move below 315 would break this trendline and call for a downswing. ■

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This article was first published on 2/8/2007.
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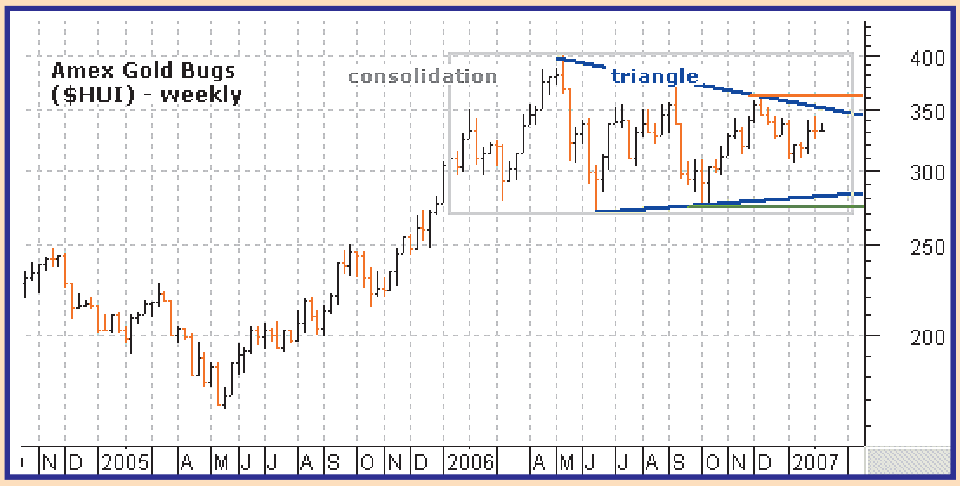

FIGURE 1: $HUI, WEEKLY. The index surged from May 2005 to May 2006 and more than doubled in the process.

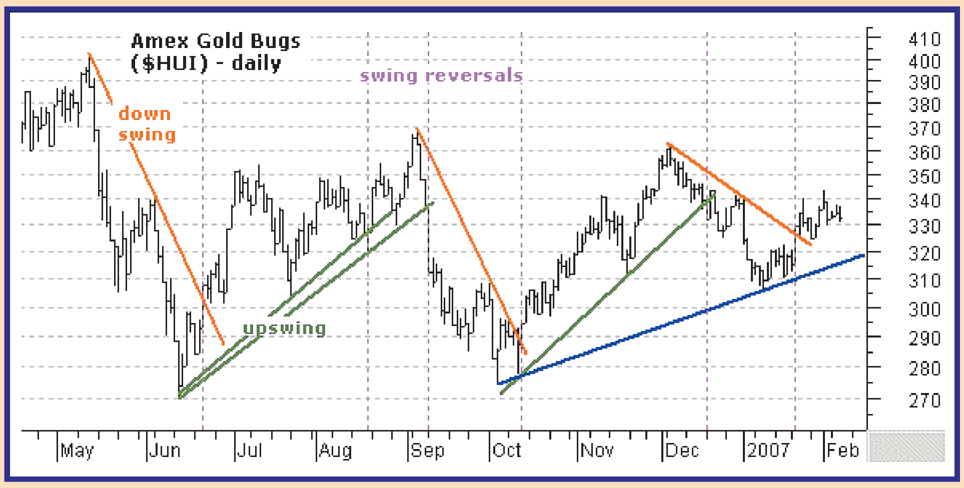

FIGURE 2: $HUI, DAILY. The red lines show the downswings and the green lines show the upswings.

CONSOLIDATION FORMATION

Lower Before Higher For Gold

by David Penn

Does a long-term sideways correction in gold need more downside?

Tradable: GC

Back in late December 2006, I opined on the various short-, intermediate-, and longer-term trends in gold for Traders.com Advantage ("Gold's Three Trends," December 21, 2006).

The takeaway from that article was that gold's bearish intermediate trend, a trend that began in spring 2006, appeared to have ended with a breakout in late October. I suggested that gold was likely to continue moving higher in the short term, a call that was confirmed when the gold market put in a higher low in early January 2007 and moved to challenge the post-breakout high from November.

That high was exceeded on a daily basis in earliest February on both the continuous and April futures gold charts. The question for gold traders was whether gold would finally break through above the $660 level (basis continuous futures). There are some signs that this fourth attempt will, at least initially, fail as well. But in that failure could lay an opportunity for those who have been looking to take a position in gold, but were waiting for a more buyer-friendly level.

The weekly chart of gold futures in Figure 1 shows a market that is working its way fitfully through a 1-2-3 trend reversal setup. I say "fitfully" because while the downside and upside limits of the reversal, at roughly 550 and 650, respectively, have been tested, neither has been breached. It would take a breach of either level on a closing basis and, more important, follow-through, to indicate that a significant break from the consolidation had occurred.

The challenge for gold will be to show follow-through to the upside after making a higher high in January 2007 vis-a-vis November 2006. Although the candlesticks in the past two weeks suggest a market that is running a little short of steam on the upside, it still takes a negative session for a reversal to occur. In particular, traders focusing on the downside should look to see whether gold moves below, roughly, the 630 level. This level corresponds to the low of the November high. Breaching that level would trigger a sell based on the 2B and Turtle Soup top methodologies (Figure 2).

In that event, traders should expect a trading week's worth of decline at a minimum, given the size of the 2B top (see my Working-Money article, "Breakouts, Pullbacks, And Gaming The 2B" from January 24, 2007, for more recent thoughts on 2B/Turtle Soup tops). How far might a correction run? It seems to me as if a test of the 600 level would be a minimum requirement for any correction worth the name. And if any correction that occurs uses that between-peak low from early January as a pivot point, then a swing rule projection lower suggests a gold market could test the correction lows near 560 as well. Such a correction might be ideal for patient bulls insofar as losing the 600 level would likely reflect the requisite pessimism that would be required for the gold correction — now into its 10th month — to end. ■

SUGGESTED READING

Penn, David [2006]. "Gold's Three Trends," Traders.com Advantage, December 21.

FIGURE 1: GOLD, CONTINUOUS FUTURES, WEEKLY. Note gold's breakout in fourth-quarter 2005. Since late in second-quarter 2006, gold has been testing its breakout trendline in a classic 1-2-3 trend reversal setup. Follow-through below about 550 or upside above 650 will be necessary to confirm either resumption or a reversal in trend.

FIGURE 2: GOLD, CONTINUOUS FUTURES, WEEKLY. The most recent, short-term advance in gold has left the traders with a potential 2B/Turtle Soup top. Should the next short-term move take out the low of the November high, then traders should be prepared for a test of the 600 level and, perhaps, of the 580 level as well.

FLAGS AND PENNANTS

Gabriel Resources

by Jacob Singer, PhC

So you believe that the hedge against a falling US dollar is to buy gold shares. Well, so does everyone else. Here is a stock to put on your watchlist.

Tradable: GBU-T

Gabriel Resources Ltd. is a Canadian-based resource company currently engaged in the exploration and development of mineral properties in Romania, with its primary focus on the development of its joint Rosia Montana gold/silver project. Through a joint venture with the Romanian government, Gabriel Resources holds an 80% interest in the Rosia Montana project, which contains reserves of 10.1 million ounces of gold and 47.6 million ounces of silver.

Figure 1 is a weekly chart, showing that the mine first started trading on January 14, 2005, at $1.44. It reached a high of $5.45 on October 20, 2005, and has since been consolidating in what appears to be a flag formation. Weekly volatility in the past few weeks appears to be high, as shown by the candlestick where the bodies on most weeks were a lot shorter

FIGURE 1: GABRIEL RESOURCES, WEEKLY. The mine first started trading in early 2005 before reaching a high in October that year.

ADVANCED GET

FIGURE 2: GABRIEL RESOURCES, DAILY. The flag formation is shown here, where the short-term support line meets the long-term resistance trendline.

OMNITRADER PROFESSIONAL

FIGURE 3: GABRIEL RESOURCES, DAILY. Here are the Omnitrader buy and sell signals.

than the price movement for that week. An Elliott wave count as suggested by the Advanced GET program shows that a fourth wave has still to be completed (a 49% probability of this happening). The program also suggests an immediate target of $4.61 with an outside target of $4.11. The stochastic indicator is negative but is approaching a level, shown by the trendline, where the price has turned positive. Note how at point A the price broke above the main resistance line, which appears to have become a support line.

Figure 2 shows the flag formation more clearly, suggesting a target of $4.41, the confluence where the short-term support line of the flag meets the long-term resistance/now support trendline before a movement up. The stochastic indicator does appear to be bumping along a support trendline and suggests that a turning point could occur in the near future. To obtain a more definite analysis, I turn to an Omnitrader daily chart.

Figure 3 shows that the buy signal was given on the vote line on November 21 when the price was $4.72, and retained that position even though the stochastic relative strength index (RSI) shown on the chart did give short-term buy and sell signals (shown with vertical lines). At the moment the indicator is falling and could soon reach an oversold position, giving a short-term buy. Should you decide that you would like to buy the stock, wait for this signal.

To conclude, Gabriel Resources looks very interesting and could be bought once the indicator suggests. Or the vote line of the Omnitrader program gives a reinforcing buy. ■

REVERSALS

Correction Time For The Dollar

by David Penn

Negative divergences signal a slowdown in the greenback's six-week ascent.

Tradable: DX, DXH7

As I wrote a month ago, positive divergences were signaling that the December lows in the US dollar were not likely to be exceeded to the downside. Dollar pessimism — both the giddy and the fearful versions — was typically resurgent at the time. We even had the requisite, typically ill-timed prediction that the "dollar would keep falling" from former Federal Reserve Board chairman Alan Greenspan.

Since mid-December, the US dollar (basis March) has rallied from 82 to 85, tacking on three cents while most of the speculating community was more focused on the collapsing price of oil — two sides of the same coin this time, however. Which means that those wondering about how low the price of oil may go might find it time well-spent to study the dollar.

The dollar made a major low near the end of 2004 near 81 (basis continuous futures). The dollar rallied from 81 to 92 by late 2005. Since then, the greenback has been in a bear market, sinking as low as 82 late in 2006.

Based on positive divergences at the weekly level in both the moving average convergence/divergence (MACD) histogram and the stochastic, it appears clear that the late 2006 lows were not only the lows for the 2006 bear market, but also likely represented a key higher low vis-a-vis the lower low from late 2004 (Figure 1). The most immediate result of these positive divergences is the rally that began in December 2006, the rally that has taken the March greenback up three cents in a month.

A rally this sharp is begging for a correction, and the charts seem more than ready to deliver one. While breaking out above the 20-week exponential moving average (EMA), the greenback (basis continuous futures) has yet to breach the 50-week EMA. On the daily chart of the March dollar, we can clearly see potential resistance between 84.5 and 85.25 from a November consolidation range. We can also see courtesy of the Fibonacci retracements in the daily chart that the March dollar is testing the 61.8% retracement level of the October–December move lower. That 61.8% retracement level also coincides with the 85 level.

There are no negative divergences of note on the daily chart. But a chart that divides trading activity into 90-minute blocks does show clear negative divergences in both the MACD histogram and the stochastic (Figure 2). This suggests again that there is a slowdown in the near term for the rally in the dollar.

One likely support area is also revealed on the 90-minute chart. There is a gap up between 83.75 and 84 that should provide support in the event that the moving averages, currently at 84.75 and 84.5, do not. ■

FIGURE 2: US DOLLAR INDEX, MARCH 2007 FUTURES, 90-MINUTE. Negative divergences in both the MACD histogram and the stochastic shown in this 90-minute chart of the March greenback suggest that a pullback to recent support is likely in the near term.

FIGURE 1: US DOLLAR INDEX, CONTINUOUS FUTURES, WEEKLY. A sizable positive divergence between the spring and winter lows in the greenback in 2006 suggests both that an intermediate bottom has been established as well as a potentially major higher low vis-a-vis the dollar's late 2004 low.

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This article was first published on 1/18/2007.
See www.Traders.com for more.

REVERSALS

The QQQQ's 2B Top

by David Penn

A classic reversal pattern helped traders anticipate the February 27th market meltdown in the NASDAQ 100.

Tradable: QQQQ

When I say a classic reversal pattern "helped traders anticipate," know that yours truly was not one of those traders so assisted. As I wrote mere days before the selloff on February 27, I was more interested in the possibility of the QQQQ actually breaking out than I was concerned that the NASDAQ 100 might melt down (see my Traders.com Advantage article, "Is The QQQQ Breakout At Hand?" from February 21).

Specifically, I wrote that a weekly close above 44.86 after February 19 would be a bullish development for the QQQQ. That higher weekly close did come as the market ended on Friday, February 23, with a close of 45.26. And although the QQQQ has betrayed bullish traders with a false weekly breakout back in January, it appeared that the second time might be a charm.

So much for all that. While the February 27th reversal back to the downside, from a technical perspective, merely returns the QQQQ to the trading range it has inhabited since mid-November, that is a far cry from the breakout I had anticipated. The good news is that the market — at the daily level — was providing signs that, had I been more attentive, might have helped stem my enthusiasm for the upside that seemed to be indicated by the breakout in the weekly charts.

The flashing danger sign in the daily chart (Figure 1) was the 2B top that developed between the highs of January and the highs of February. I've written extensively about 2B tops, so I won't belabor the point here. Suffice to say that when a market makes a high, pulls back, makes a higher high, then fails to follow through to the upside, the possibility of a correction or reversal back to the downside is great. And that possibility is precisely what became reality on the penultimate day of February 2007.

One of the tricky things about some 2B tops is the exact entry. The rule of thumb is to enter when prices, retreating from the second higher high, move below the low of the initial high. In the case of the QQQQ, that would mean a short entry (or merely an exit if the trader was long at the time and did not want to short) at the low of January 16 at 45.13. Much of the time, the low of the second higher high is above the level of the low of the initial high. But many times that will not be the case, and the trader will have to figure out the best low under which to go short (or, again, to exit). While Victor Sperandeo, from whose work I learned the 2B concept, doesn't provide any specific rule, right now it seems like a good bet is to short or sell below the lower of the two lows. In those instances where the initial high has the lower low, then that low should be the target. And in those instances where the second, higher high has the lower low, then that low should be the target.

Looking at the QQQQ chart (Figure 2), the target for the short/sell would be the low of the second, higher high (February 22) at 45.07. Targeting this low would have gotten a trader short (or out of the position) on February 23.

FIGURE 1: NASDAQ 100 TRUST SERIES (QQQQ), DAILY. When the QQQQ failed to follow through to the upside after taking out the January highs, there was an increased possibility of a reversal by way of a 2B top.

FIGURE 2: NASDAQ 100 TRUST SERIES (QQQQ), DAILY. Negative divergences are often a 2B top's best friend. Such divergences in both the moving average convergence/divergence (MACD) histogram and the stochastic helped underscore the potential for a correction that was indicated by the 2B top.

More cautious traders who prefer a close below the low would have had their trades executed on the following Monday, February 26, at 45.04. ■

The flashing danger sign in the daily chart (Figure 1) was the 2B top that developed between the highs of January and the highs of February.

Suggested Reading

Penn, David [2007]. "Is The QQQQ Breakout At Hand?," Traders.com Advantage, February 21.

Traders.com ADVANTAGE™
This article was first published on 3/2/2007.
See www.Traders.com for more.

Is This The Perfect Market Storm?

by Jacob Singer, PhC

Alan Greenspan is no longer Federal Reserve chairman. China is a Communist country practicing capitalism. Put the two together. Do you get a perfect market storm?

Tradable: SPX

The Standard & Poor's 500 has been suggesting that a major recession is in the offing since testing the first major resistance level, namely the 50% Fibonacci retracement level of 1161.23, as shown in Figure 1, a monthly chart with an Elliott wave count.

The first rule of Elliott wave theory is that it must look right. The chart does look right and is suggesting a B-wave formation is in the process, and may be topping out, as shown by the key reversal in February. A key reversal is where the high is higher than the previous high, and the low lower than the previous low, with the close in the lower 50% of the bar.

This past Monday, Alan Greenspan told a Hong Kong business crowd that he sees growing signs of a US recession. The following day, there was a heady rush of investors to exit the Chinese stock market, a move that caused the worst one-day setback in the Shanghai Composite Index in a decade. Ripples of volatility spread throughout the world as the perfect storm hit every market.

Figure 1, which also shows Gann fans, suggests where the next turning points could be, but the resistance level appears to be the 4x1 line of the Gann fan drawn from the high of March 2000. The chart suggests that the top of the B-wave should happen in January 2008. However, allowing for a margin of error of one year, January 2007 could be the top. I have drawn in the suggested move that could occur as the index falls in a C-wave.

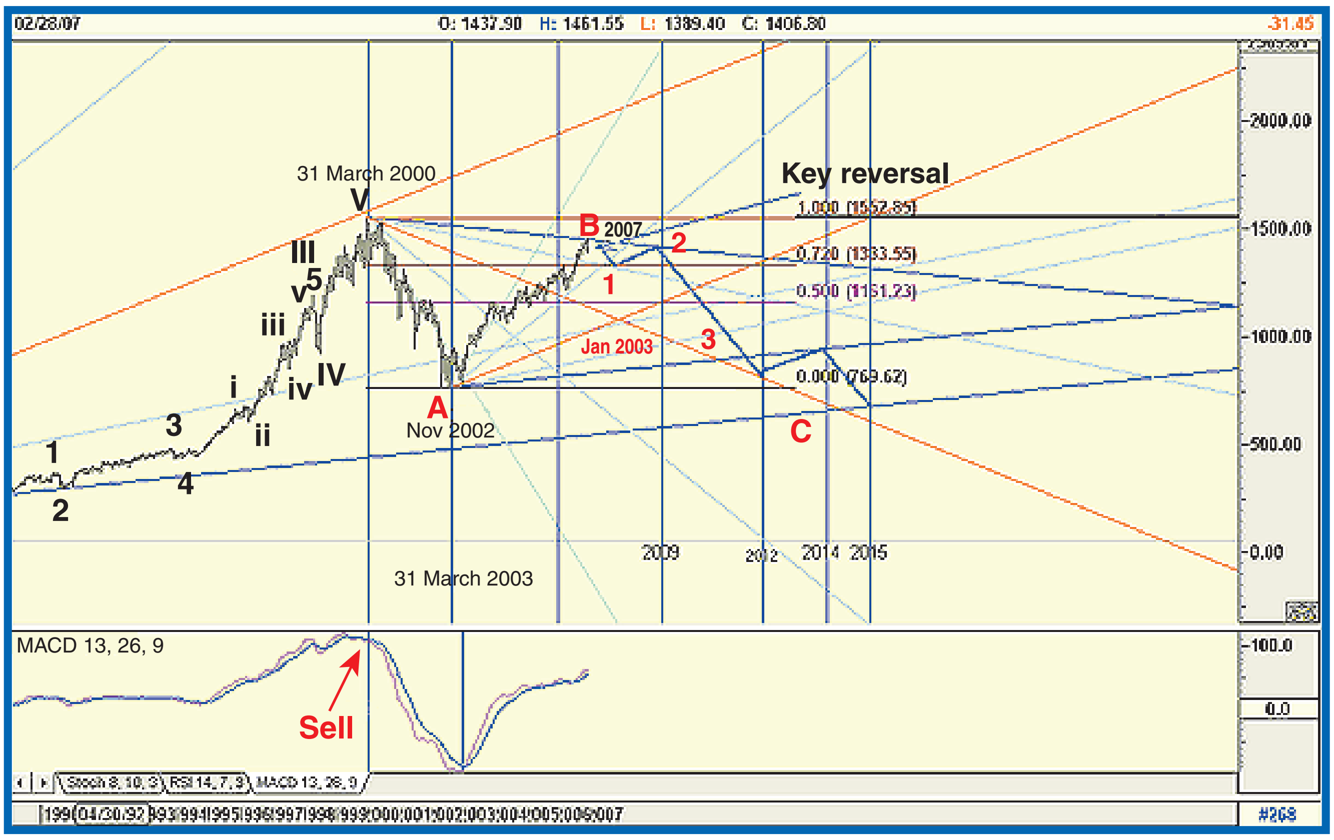

FIGURE 1: S&P 500, MONTHLY. This index shows the possible movement in a C-wave fall. Note the key reversal for February.

FIGURE 2: S&P 500. The index, with Gann fans altered to take in the B-wave top. Note how the suggested dates have changed.

Figure 2 has the Gann fan drawn from the key reversal, assuming it is the high of the B-wave. This fan changes the dates for the low of wave C. I have also drawn in Fibonacci ratios as a suggestion of how the wave could fall, bottoming in 2012, at the 1X4 line of the long-term Gann fann.

Will all this truly happen as forecast? I do not know. I have always believed that an Elliott wave acts only as a signpost, and tells us where we are in the market. It is not a forecaster. The wave format does suggest that if indeed wave B is complete, and the index is truly falling into a C-wave, then the C-wave could be a failure, simply because the B-wave retraced too high. However, my forecast does not take this into account. It is a matter of keeping an open mind, and changing the forecast as time shows its hand.

Finally, note that the indicator, a moving average convergence/divergence (MACD) (13,26,9) has not given a definite sell signal. Will the forecast truly happen? Alan Greenspan seems to think so, and so does the Chinese investor. Be careful out there. ■

> **I have always believed that an Elliott wave acts only as a signpost, and tells us where we are in the market.**

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This article was first published on 3/2/2007.
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REVERSALS

Transportation's Correction Destination

by David Penn

A trend channel's upper boundary provides resistance to a rally transportation sector.

Tradable: $TRAN

Often, in the gnashing of teeth that emerges as a market correction is doing its worst, people tend to forget there are often sound, technical reasons for a market to do what it will. Declines that appear on the surface to stop abruptly, or rallies that appear to terminate inexplicably without warning, often can be understood far more accurately by the market technician and his or her charts than by the conjectures of fundamentally oriented market watchers.

Unlike the Dow industrials, the Dow transports had not just been moving higher since December 2006, but had been doing so with markedly more certainty and conviction (Figure 1). By that, I'm thinking mostly of what I referred to years ago in Working-Money as "don't look back" breakouts. These were breakouts that occurred during trends that did not retrace back into the consolidation whence they came. To picture a "don't look back" breakout, imagine a flight of stairs — or simply take a close look at the way the transports moved post-December. When the market corrected in late January and again in early February, neither of those corrections took out the previous high.

By contrast, the industrials featured an advance that more resembled "rolling hills" than the clear demarcation of rising stairs. While markets can advance in both fashions, a market that does not retrace back into the consolidation from which it broke free tends to reflect a market that is stronger than one that does.

That, of course, does not make a market immune to waning momentum, or the pent-up desires of traders to take profits. Signs of such waning momentum — if not of eager-to-take-profit traders — were growing throughout 2007. The best evidence of this might be in the MACD histogram, which was recording lower highs at the same time that the transportation average was marking higher highs. Interestingly, this was not confirmed by the stochastic, which was recording higher highs along with the transports. Perhaps this underscores the utility, when looking for divergences, of examining more than one indicator (though, unfortunately, neither indicator noted a positive divergence on the daily charts when the transports made their late December bottom).

How much further is the current correction in the Dow transports likely to fall? The sharpness of the correction virtually begs a bounce; from what support is that bounce most likely to come? The transports are hurtling toward a 50% retracement of the rally from the August 2006 bottom, and there are a number of old highs and old lows that are likely to contribute toward supporting the market just above or below the 4,640 level (Figure 2). If the transports do not find support at this common retracement/support level, then there is a good chance that it will find support at the next major Fibonacci retracement level, 61.8%. Here, the price support mostly comes in the form of old lows, though one of those "old lows" — the correction low from late December — is particularly pronounced and should prove especially tough support should the market reach that level. ■

FIGURE 1: DOW JONES TRANSPORTATION AVERAGE, DAILY. A negative divergence develops in the MACD histogram just as the DJTA rallies to test the upper boundary of a trend channel that extends back to the lows of September 2006.

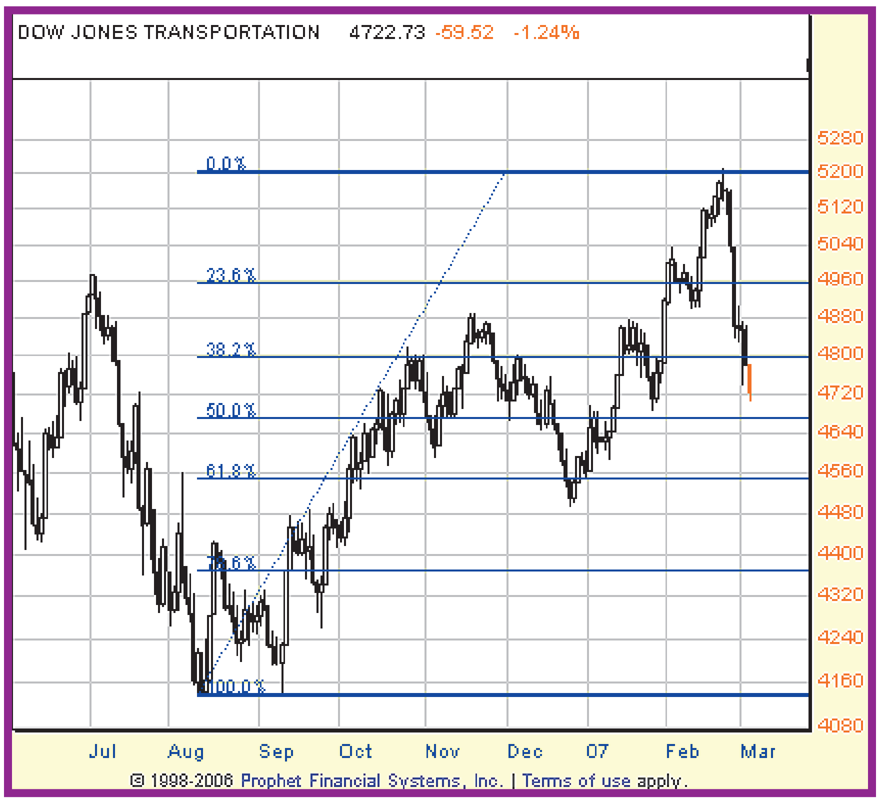

FIGURE 2: DOW JONES TRANSPORTATION AVERAGE, DAILY. The sharp correction in the transports has brought the average close to a 50% retracement of its six-month-plus rally. While there is some price support at the 50% level, there is additional support at the 61.8% retracement level that should provide some measure of support if prices do not stop falling sooner.

BOND & INTEREST RATE

Will Bonds Test A Bottom?

by David Penn

Negative divergences set up the 10-year note for a correction and possible test of the summer 2006 bottom.

Tradable: TY, TYH7

My last Traders.com Advantage article on long bonds (the 10-year Treasury note) was bullish ("A Cup With Handle For Treasury Notes," November 29, 2006). Based on the chart pattern highlighted in that article, I called for a move higher in the notes to at least the 110 level (basis March 2007) futures.

As it turned out, the breakout from the cup with handle pattern fell short of that mark. Breaking out at about 108, the March Treasury note rallied to about 109.50 before pulling back and falling below the breakout level in mid-December. The pullback, so far, has found support at approximately the level of the low of the handle of the failed cup with handle pattern.

Figure 1 shows what the failed breakout looked like in the larger context of the weekly chart. Here, it is clear that the failed breakout helped create a negative divergence with the moving average convergence/divergence (MACD) histogram and the stochastic. Although I pay somewhat less atten-

FIGURE 1: 10-YEAR TREASURY NOTES, CONTINUOUS FUTURES, WEEKLY. Divergences in the weekly MACD histogram are often powerful indications of a market that will be making a change in trend. With a negative divergence in the MACD histogram confirmed by a negative divergence in the stochastic, the odds of a correction in the bond rally that began in the summer of 2006 are increasing.

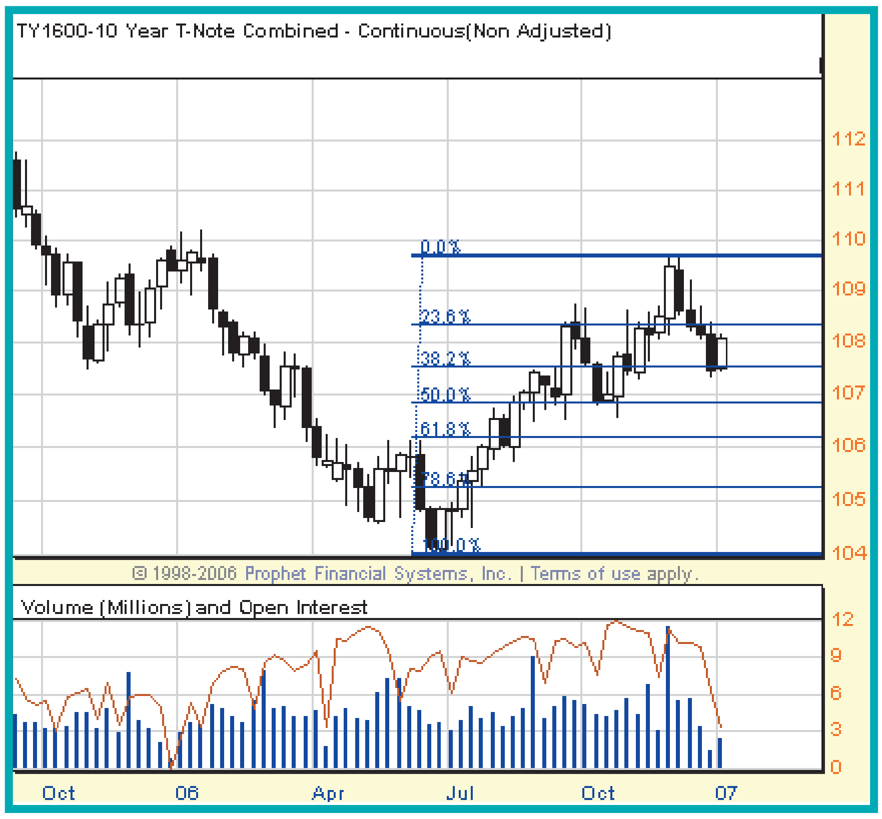

FIGURE 2: 10-YEAR TREASURY NOTES, CONTINUOUS FUTURES, WEEKLY. This Fibonacci projection shows that the correction has found support at the 38.2% retracement level — at least for the time being. Next support lies at the 50% level just south of 107.

tion to the stochastic on weekly charts, seeing that indicator confirm the histogram makes me all the more convinced that the negative divergence will bring lower prices. There is long-term support in the form of 20- and 50-week exponential moving averages (EMAs) at current levels. And it wouldn't be surprising if those moving averages slowed the decline, possibly turning what could have been a sharper correction into perhaps more of a sideways one. But lower bond prices and higher bond yields look like the next step, based on the weekly chart in Figure 2.

Assuming the support at the moving averages does not hold, what can investors expect in the way of downside in the 10-year Treasury note? There is an argument that a topping pattern developed from September through November (the same span as the failed cup with handle), and further that the topping pattern projects downward (in opposition to the upward projection initially based on a successful cup with handle breakout) two and a half points to the 104.5 area (basis continuous futures).

A correction of this magnitude would take the 10-year note tantalizingly close to the summer 2006 lows. From a longer-term perspective, this would be an ideal correction. One of the other points about the "A Cup With Handle For Treasury Notes" article from November was the long-term positive divergence in the MACD histogram — a positive divergence in the weekly chart that extends back to the summer of 2003 and appears to conclude with the lows of the summer of 2006. As such, I suspect that the 2006 low was the true low for the bear market in long bonds that began in 2003 and that a test of those "true lows" will be a key step in beginning any new bull market in bonds that may emerge from a successful test of the lows. ■

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FLAGS AND PENNANTS

Breakout Under Threat For The S&P MidCap Index

by Arthur Hill

The S&P MidCap Index broke flag resistance a week ago but quickly met resistance. This breakout is up for a big test. Will it hold?

Tradable: $MID

The S&P MidCap Index has been trending higher since July and recently broke flag resistance to keep that uptrend alive. The index surged from late September to early December and then declined from mid-December to mid-January. The decline was slight and formed a falling flag, which is typical for a correction within an uptrend. The index broke falling flag resistance with a surge above 820 and this breakout is bullish.

A strong index should hold its breakout. The index pulled back after the breakout surge and broken resistance turns into support around 810. This breakout produced the bullish signal and a move back below would not be a vote of confidence. In addition to support from broken resistance, the

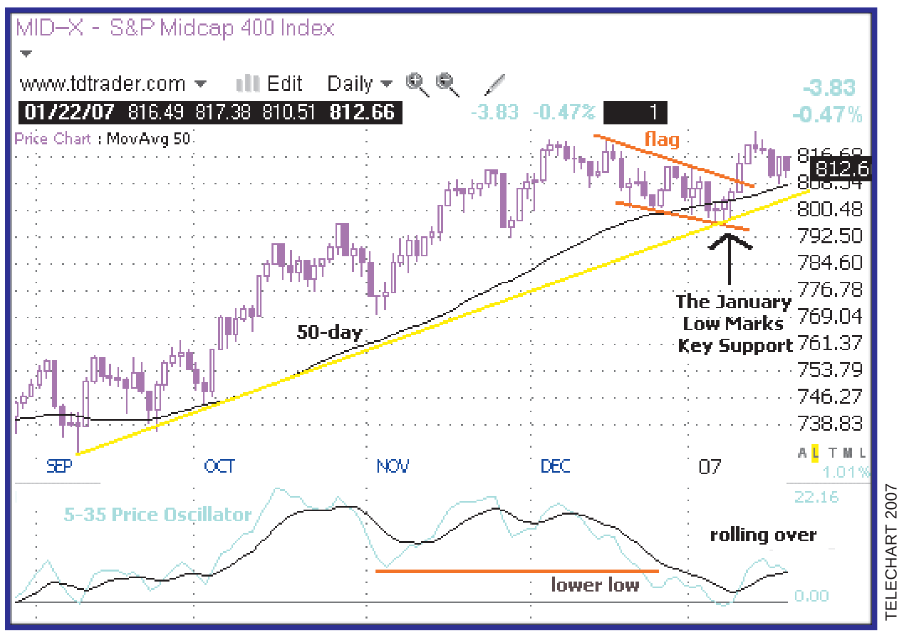

FIGURE 1: S&P MIDCAP 400 INDEX, DAILY. Note the January low marks the key support.

50-day moving average offers support around 808. A move below 808 would break the 50-day and negate the flag breakout.

Even though a failed breakout would be negative, the January low and positive price oscillator held the key to the medium-term uptrend. The index edged above its December high this month and recorded a higher high. The string of higher highs and higher lows since August remains in place, and this is the definition of an uptrend. It would take a move below the January low to break this string and signal an actual trend reversal.

The 5-35 price oscillator has been largely positive since mid-August, and momentum favors the bulls as long as this indicator remains in positive territory. The indicator dipped into negative territory in early January, but rebounded recently. This rebound looks rather feeble and a move back into negative territory would turn momentum bearish. This could be used to confirm a move below the January low in the S&P MidCap Index. ■

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This article was first published on 1/23/2007.
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CURRENCY TRADING

Negative Divergences And The USD/JPY Breakdown

by David Penn

After two months of appreciation against the yen, the USD/JPY took a hard hit in February going into March.

Tradable: USD/JPY

The US dollar has been in a bull market vis-à-vis the Japanese yen since the early summer of 2006. At the time, the greenback was coming off of a sizable correction that had seen the USD/JPY fall from 121.36 in December 2005 to approximately 109 in May 2006. The bull market that brought the dollar to its most recent highs against the yen saw the USD/JPY completely retraced that decline — and then some — topping 122 by January 2007.

There were a number of warning signs that the upside in the USD/JPY was limited. From a fundamental perspective, the concerns were over the yen carry trade. This "carry trade" involved borrowing assets with a low interest rate (such as the yen) in order to buy higher-interest rate assets (such as dollar denominated debt). "Unwinding" the carry trade means, among other things, buying back yen and potentially sending the USD/JPY into a bear market. As Figure 1 shows, this unwinding has resulted in just such a sharp move lower, one that has retraced a large amount of the USD/JPY rally since the December 2006 bottom. From the perspective of the bull market that began in May 2006, the USD/JPY has retraced nearly 50% of that advance.

The biggest technical warning signs, however, were the negative divergences in both the moving average convergence/divergence (MACD) histogram and the stochastic. Both indicators developed lower highs in January vis-à-vis December while USD/JPY was making higher highs. This divergence between the market price and two key technical indicators was a major signal that the rally that began at the end of the December 2006 correction (the main correction in the May 2006 to January 2007 bull market in USD/JPY) was running out of upside momentum.

The result of that loss of upside momentum was the wild and loose trading in most of February and the ultimate collapse in the USD/JPY in late February and into March. Interestingly, as wild and loose as the trading became, the USD/JPY never moved higher than the late January high — the high that was marked as a top by the negative divergences.

The collapse in USD/JPY retraced almost the entire advance from the early December 2006 bottom, and in a remarkably short period of time. As such, the USD/JPY has become particularly oversold and traders who are short USD/JPY or thinking about it should be on the lookout for a bounce. Given the sharpness of the decline — and the likelihood that the majority of traders are expecting the yen to continue to advance against the dollar (that is, continued USD/JPY weakness) — any bounce could be as sharp and sudden as the decline as traders decide to take profits from a spectacularly successful week of shorting USD/JPY. The hourly chart in Figure 2 shows one picture of the market from the perspective of a trader trying to decide whether to press the short bet or cover and move on. ■

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The result of that loss of upside momentum was the wild and loose trading in most of February and the ultimate collapse in the USD/JPY in late February.

FIGURE 1: USD/JPY, DAILY. Negative divergences in the MACD histogram and the stochastic point to a correction in the wake of the late January peak in the USD/JPY. Although it took almost a month for the USD/JPY to finally break down, note that during the movement in February, no new high was made vis-à-vis the high accompanying the negative divergence.

FIGURE 2: USD/JPY, HOURLY. The low point for the MACD histogram came in late February as the price for USD/JPY continued to move lower. From that point, however, the MACD histogram troughs have become increasingly shallow as the USD/JPY has continued to fall. The size of the MACD histogram peak in early March is the first sign that these positive divergences in the MACD histogram have finally slowed USD/JPY's descent. This is the initial precondition for a bottom in the USD/JPY.

Betting On The Bounce

by David Penn

A 50-plus point decline in the S&P 500 leaves traders looking for clues on when to climb back in.

Tradable: $SPX

A little over a month ago, in an article that is now on Working-Money.com ("Fifth Of A Fifth?"), I posted an Elliott wave projection that suggested the possibility of a top at the 1462 level. Specifically, I concluded:

> "But a keen eye on longer-term negative divergences in indicators like the MACD histogram — as well as on price action as the S&P 500 approaches the potential top target of 1,462 — would probably be a smart hobby while pursuing the main work of trading and speculating on a market that, until proven otherwise, continues to move higher."

Again, that was written back in late January. For what it's worth, I was certainly bullish going into the market's smackdown on the penultimate day of February and remain, however improbably, bullish still. As Jim Cramer reminds us, nobody ever made a dime by panicking. And given the magnitude of the move lower, it is imperative that those who were bullish in the intermediate term going into the correction recalibrate their bullishness as the market searches for a way out.

First, was there anything that speculators could have spotted that would have alerted them to the potential for trouble in late February–early March? Truth told, there were — though I of course didn't spot them until after the fact. Both the MACD histogram and the stochastic had developed negative divergences with the Standard & Poor's 500's most recent push toward 1460 in the second half of February (Figure 1). And while there was nothing in those negative divergences to inform traders of the carnage that would soon take place, it can't be disputed that the divergences were telling the important story once again — whether or not anyone was listening.

What now? The talking heads of CNBC, which dedicated large chunks of programming the night of the mini-meltdown to reassuring anxious viewers and investors, generally suggested that (a) the move down was just a correction in a bull market and (b) now was not the time to buy in. I actually suspect the talking heads are right on both counts. Although the move down on February 27 took out a few, previous minor correction lows, it thus far has retraced so little of the advance from the summer of 2006 bottom that it must be treated as a correction within a bull market rather than as a incontrovertible reversal of trend. At least at this point. As Figure 2 shows, the correction has yet to breach the Fibonacci retracement level of 38.2% — often considered the most modest of the Fibonacci retracements.

The support found at the end of the S&P 500's initial plunge lower came from the correction lows of late December 2006 and early January 2007 as well as perhaps the "round number support" at 1400. While there will no doubt be buyers stepping in at these levels — and a good chance that those buyers might reap decent trading gains from, say, a one- to three-session bounce — it would not be surprising in the slightest if the market resumed its correction, particularly with the goal of testing the 38.2% retracement level just discussed (Figure 2). This retracement level lies at approximately 1370, more or less halfway between two correction lows in early and late November 2006. ■

FIGURE 1: STANDARD & POOR'S 500, DAILY. Negative divergences in both the MACD histogram and the stochastic should have alerted observant traders that upside progress would be hard to come by in the end of February and beginning of March time frame.

FIGURE 2: STANDARD & POOR'S 500, DAILY. The first move down in the S&P 500's late winter–early spring correction took the market below the 23.6% retracement level. Next Fibonacci support lies at the 38.2% retracement level near 1360, and the location of a previous correction low.

The divergences were telling the important story once again — whether or not anyone was listening.

SUGGESTED READING

Penn, David [2007]. "Fifth Of A Fifth?," Working-Money.com, February 28.

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This article was first published on 3/1/2007.
See www.Traders.com for more.

Cotton Rising?

by David Penn

It's far from summertime, but May cotton futures appear to be establishing a bottom that could see higher cotton prices over the next several weeks.

Tradable: CT, CTK7

Unfortunately, cotton futures did not make the cut for the latest edition of the *Commodity Trader's Almanac 2007*. Cotton was not alone in being excluded; orange juice, oats, and copper also make no appearance in this otherwise complete guide to commodity seasonality.

In looking at the May cotton futures shown in Figure 1, I had hoped to find some seasonal backing to support the idea that a bottom in cotton was forming over the late autumn–early winter period. In the absence of that seasonal support (or, more accurately, the absence of any knowledge about seasonal support), this call for higher prices in cotton will have to stand on its own technical merits.

For about two years, cotton futures have been trapped in a 10-cent (roughly $5,000 per contract) range between 48 and 58 cents (basis continuous futures). And there is little doubt that cotton traders and speculators have made a fine living out of buying cotton futures toward the bottom of this range and selling them toward the top. The fact that as May cotton futures have slipped to the 52-cent level at the same time that positive divergences have begun to appear does not suggest that any subsequent rally in cotton futures won't simply be part of this range-bound pattern.

Fortunately, it is not likely to matter. Range-bound or range-breaking, speculators who go long on cotton can take from the positive divergences in the moving average convergence/divergence (MACD) histogram and stochastic what they will. At a minimum, these divergences (shown in Figure 1) suggest significant support at the 52 level — the lower low in price that is matched by the higher low in both the MACD histogram and the stochastic. And should the 52 level prove to be at least a temporary floor, then there is a chance that May cotton will be able to rally and test the late December high near 57.50. In fact, a move to the 57–58 level would create a potential double bottom in May cotton — with one trough low in late November and the other in mid-February — that could mean a more significant move higher.

FIGURE 1: COTTON FUTURES, BASIS MAY, WEEKLY. Positive divergences in both the MACD histogram and the stochastic in this weekly chart of cotton futures suggests that spring will feature higher prices for this market.

FIGURE 2: COTTON FUTURES, BASIS MAY, DAILY. The absence of a positive divergence in the MACD histogram or stochastic in this daily chart of May cotton suggests that a move higher might still be a little way off. Significant resistance appears to be in place at the 55 level and the depth of the MACD histogram trough in mid-February suggests that a test of the February lows could come before a rally above the February highs.

Figure 2, a daily chart, is not as promising as the weekly chart for those looking for a move to the upside. The divergences that point to higher prices in the weekly chart are not present in the daily. Instead, both the MACD histogram and the stochastic are making lower lows in tandem with price action in mid-February. In addition, the resistance that May cotton will have to overcome in order to reach the high between the two troughs mentioned previously is clearly visible in the daily chart in the form of the January consolidation, which reaches as low as 54. Indeed, it already appears as if May cotton has made one run at higher prices and failed at precisely that 54 level.

Potential resistance in the form of the downward-sloping 50-day exponential moving average (EMA) also adds a note of caution to any thoughts of an easy ride higher in May cotton. As such, the path of least resistance higher might include either some time spent consolidating at current levels or, failing that, a move lower to test the February lows. ■

Suggested Reading

Hirsch, Jeffrey, and Scott W. Barrie [2006]. *Commodity Trader's Almanac 2007*, John Wiley & Sons.

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This article was first published on 3/1/2007.
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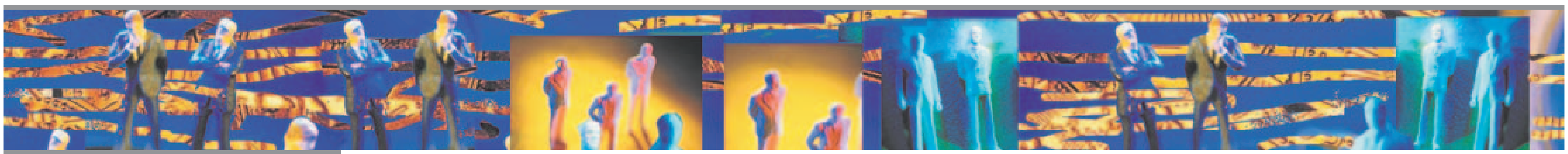

VIEWS FROM THE FIELD

Be Like Buffett

by David Penn

For the past seven years, money manager Doug Davenport and The Wisdom Fund have offered investors a chance at investing in stocks "Warren's way."

Young soccer players long to "bend it like Beckham." A generation of basketballers yearned to "be like Mike." And when it comes to investors, there is perhaps no more inspirational figure than the oracle of Omaha, Warren Buffett of Berkshire Hathaway.

What is it that Warren Buffett has in terms of traits, habits, and investor style that many investors want to emulate? Compared to other famous/legendary investors like Peter Lynch and John Bogle, summing up Warren Buffett's investing style into a few words or a few handy maxims is not as easy as it might appear.

While there are many truisms about investing attributed to Warren Buffett — often excerpts from interviews or copy lifted from the widely read annual reports from his chief investment vehicle, Berkshire Hathaway — there really is no blueprint or guide to investing in stocks "Warren's way."

Even the books that have been published about Warren Buffett and Berkshire Hathaway over the years tend to provide a sense of the man and his work that is more historical or journalistic than the kind of primer an investor aspiring to Berkshire Hathaway success would need to put those aspirations in flight.

We learn What Warren Did and Why Warren Did It. But does knowing how Warren Buffett concluded that Coca Cola was a good investment back in 1988 help us decide what soft-drink company (if any) investors should own right now? How does the average Jane or Joe Investor find the next Geico, or the next American Express, or the next See's Candy Shops?

To make matters more complicated, many of Buffett's signature investments have been and continue to be in private companies with no publicly traded stock. Even if an investor could learn what needed to be known about a private company's fortunes, how in the world could average — or even above-average — investors get a piece of a privately held rock?

Part of the problem in trying to emulate the performance of Berkshire Hathaway is that much of what Warren Buffett does as an investor is not a mystery to most investors. When authors like Robert Hagstrom, author of well-written books on Warren Buffett including *The Essential Buffett: Timeless Principles For The New Economy*, notes Buffett's insistence that he "invests in companies, not stocks," we hear not just the advice of the oracle of Omaha, but the more or less conventional wisdom of every fundamentally oriented investment guru from Benjamin Graham to Jim Cramer.

That, of course, doesn't make the advice incorrect. But if everybody knows that investing in companies is more to the point than investing in stocks, then why isn't everything performing like Berkshire Hathaway (Figure 1)? Something similar could be said of the other main principles Hagstrom accurately derives from his analysis of Warren Buffett's investment style, such as "Demand a margin of safety for each purchase" and "Protect yourself from the speculative and emotional forces of the market."

Sometimes the solution to a problem is so simple you wonder why people hadn't thought of it before. And in the instance of investors wanting to invest "the Warren Buffett way," the solution is not only simple but perhaps as effective and efficient as possible. If you want to invest *like* Warren Buffett, then why not just buy the *stocks* that Warren Buffett buys?

Unlike traders, whose behavior in the market is often so short term that by the time you climb on board to "piggy back" a given trade, the trader has closed out the position and moved on to another one, the trait that makes Warren Buffett's investment style easy to track in some ways is the fact that he is very much an investor in the companies whose stocks he purchases. After all, even the

FIGURE 1: BERKSHIRE HATHAWAY HOLDINGS, CLASS A SHARES. The A shares of Warren Buffett's Berkshire Hathaway Holdings appreciated by more than 80% from the low in spring 2003 to their recent peak in late 2006, even as they suffered a bear market throughout most of 2004 and 2005.

most infrequent Buffett-watcher knows that the oracle of Omaha's favorite holding period for stocks is "forever."

Fortunately, there may be an even surer route to Buffett-hood than chasing the oracle of Omaha's stock purchases, and that's by investing in a fund run by a manager who does that chase for you. Filed under "That makes so much sense why hasn't anyone else thought of it before," The Wisdom Fund, which is run by Douglas Davenport out of Atlanta, GA, has accurately and profitably tracked the investments of Berkshire Hathaway Holdings since its inception in the autumn of 1999. And given that The Wisdom Fund has often bested the Standard & Poor's 500, those looking for a mutual fund that might actually be a true buy & hold fund should consider whether an allocation to a Warren Buffett "tracking fund" might not be a wise move this year.

NOT-SO-COMMON WISDOM

The fact that The Wisdom Fund was launched near the top of the massive bull market of the 1990s—a bull market that, late in its development, became increasingly speculative and hype-driven — is an interesting irony in and of itself, given Buffett's own attitude toward the hot stocks of the day. Recall that Warren Buffett, who had been heralded as a genius for many years, was being ridiculed in some quarters as "behind the times" for his refusal to drink the dotcom Kool-Aid that was being quaffed with much abandon on both Wall Street and Main Street in the late 1990s.

Buffett's — and The Wisdom Fund's — abstinence was well rewarded. As Doug Davenport, portfolio manager of the fund, recalls, "We were going in the opposite direction" when tech stocks and the dotcoms blew up. Davenport notes that The Wisdom Fund bottomed in spring 2000 — mere months after the fund was launched—and it was up 8.5% from that time until October 2002, "while the S&P 500 was down 50%." See Figure 2.

The idea behind launching a fund that would simply but accurately and intelligently track and mimic the purchases of Warren Buffett's Berkshire Hathaway was as simple and straightforward as the fund itself, says Davenport. A unique mutual fund that tracked Warren Buffett's investment purchases would be an easier investment for most people than just buying shares of Berkshire Hathaway (which was selling at a substantial premium in 1999, according to Davenport), and would also be simpler than trying to divine a specific formula out of Buffett's numerous interviews and the annual reports from Berkshire Hathaway. "By reading books [you] don't get any exact formula," Davenport observed. "[We] tried not to reinvent anything. Berkshire Hathaway is my research analyst."

This is not to say that there isn't more to running The Wisdom Fund. In addition to attending Warren Buffett's famous annual conference, Davenport studies what could be called "proxy metrics" and research tools such as the Value Line investment survey (a favorite of Warren Buffett, not coincidentally), as well as free cash flow, net profit margins, and return on equity on the companies that Warren Buffett buys. This is all in addition to some of the intangible research he does, such as evaluating management.

But Davenport's style in running The Wisdom Fund is still essentially to put on the Warren Buffett hat and ensure it has a good fit. That means not only adhering to some of the more mechanical aspects of investing like Warren Buffett, but also in taking to heart much of the spirit that animates Buffett's philosophy of participating in the markets. What does that philosophy entail? As far as Davenport is concerned, much of it can be summed up in an often-repeated remark from Warren Buffett himself, who has said that not only does he have no idea what the stock market is going to do, but also he wishes the market would close for 10 years. Why? Because at the end, as far as he is concerned, investing is about

FIGURE 2: THE WISDOM FUND. Measured from the lows of 2003, The Wisdom Fund (topmost) compares favorably to the performance of the S&P 500.

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If you want to press the issue, it could be argued that the trick to investing is finding improving companies with "broken" stocks. "Home Depot is one recent example," Davenport notes, as were Coca Cola and Wal-Mart. These are companies with increased earnings per share, good dividends but, as Davenport acknowledges, the stock prices haven't gone anywhere. "The market is not focused on the great old companies," he says.

What else has he gleaned from tracking and mimicking the investments of Warren Buffett over the past half-decade or so? Davenport urges investors not to rush, not to "hurry to put their money into the market." He uses the baseball metaphor of a batter in the batter's box to underscore the idea of waiting for the right pitch before taking a swing. In this he recalls the most important edge an investor (or a trader, for that matter) can have: the option to not invest at all.

"Most people are way too impatient," Davenport observes. "They spend more time in trying to decide to buy a car than a stock."

The Wisdom Fund Way

There's a lot to like about how The Wisdom Fund operates. The fund, which has kept pace with the S&P 500, has a relatively low turnover ratio of about 19% and, as such, the expenses are much lower with The Wisdom Fund than they are with many other mutual funds. The other advantage of investing in The Wisdom Fund as opposed to going out and trying to track Warren Buffett's stock purchases on your own is that by investing in a mutual fund, investors are likely to receive far better tax treatment with regard to capital gains — an advantage that also applies when compared to investing in shares of Berkshire Hathaway itself.

One of the questions I had for Doug Davenport was how he and The Wisdom Fund handled private company acquisitions by Berkshire Hathaway. While many of the companies Berkshire Hathaway invests in are publicly traded, a number are not. So how does the fund provide its investors with exposure to these companies?

The short answer is that The Wisdom Fund can't, if the companies involved are indeed private. But what Davenport does with the fund is to search out public companies that are as similar to the ones that Buffett has acquired shares in for Berkshire Hathaway. One example of this was Dairy Queen, the ice cream, sweets, and sandwiches fast-food restaurant acquired by Berkshire Hathaway in 1998. How did Davenport substitute for DQ? After careful research, he concluded that owning shares in companies like McDonalds and Yum! Brands (KFC, Taco Bell, Pizza Hut) would provide investors with the same kind of quality company and strong consistent growth that they would have owned in DQ. Davenport is also not above owning more than one stock in the same group, such as owning at one time shares in both Lowe's and Home Depot, or Coca Cola and Pepsi.

Asked if given the fact that he from time to time has to come up with substitutes for privately held Berkshire Hathaway companies, he is ever tempted to second-guess the oracle of Omaha, Davenport stops and thinks about it for about five seconds before answering with a laugh that there have been times when he wished he owned stock A instead of stock B over a given period of time. But on balance, he and The Wisdom Fund have profited well simply by letting Buffett be Buffett (recall his confession that "Berkshire Hathaway is my research analyst") and letting The Wisdom Fund be The Wisdom Fund. There is plenty of room outside of the fund, in individual investments in stock or with other mutual funds, to experiment and speculate. Investors can get into trouble when they start trying to turn any specific investment strategy into a one-size-fits-all amalgam of every possible investment idea that might seem interesting at first blush. See Figure 3.

FIGURE 3: PROCTER & GAMBLE. One of the largest holdings in The Wisdom Fund, Procter & Gamble represents the sort of "giant of American industry" that has become "historically undervalued," according to Davenport.

That leads us to a fundamental point about investing, one that Davenport thinks is not only at the core of his stewardship of The Wisdom Fund, but also at the center of what makes investors like Warren Buffett so successful — knowing why you are investing in the first place. "Investing," says Davenport, "is a way to preserve capital and obtain a nice return on your money. It is not a way to become extremely wealthy." (Davenport recommends trying to start and operate your own business if "extreme wealth" is your goal.) "Try to preserve capital and get a return that is 3-5% above inflation for at least five years," he adds. It is a path well traveled by famous investors throughout history, to say nothing of the hundreds of thousands of anonymous investors who have taken this tortoise-like approach to growing the money they've already earned.

As The Wisdom Fund states in a brief fund primer included in their third-quarter update: "We invest with a multi-year time horizon rather than focusing on the quarter ahead ... Buffett's style and ours does not limit the types of securities we will buy. *It just limits what we will pay for them.*"

And those are limits, portfolio-saving limits, within which every investor can and should learn to live. ■

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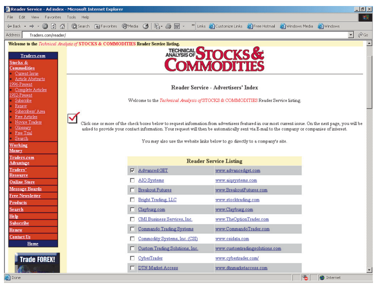

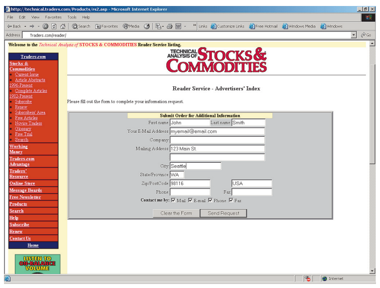

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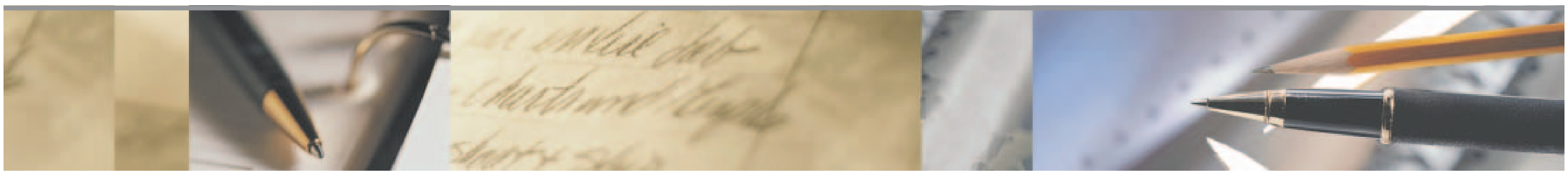

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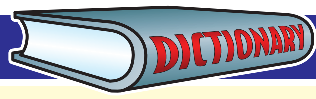

ABC — Elliott wave terminology for a three-wave countertrend price movement. Wave A is the first price wave against the trend of the market. Wave B is a corrective wave to Wave A. Wave C is the final price move to complete the countertrend price move. Elliott wave followers study A and C waves for price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

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

Back-Testing — A strategy is tested or optimized on historical data and then the strategy is applied to new data to see if the results are consistent.

Breakaway Gap — When a tradable exits a trading range by trading at price levels that leave a price area where no trading occurs on a bar chart. Typically, these gaps appear at the completion of important chart formations.

Breakout — The point when the market price moves out of the trend channel.

Chaikin Money Flow — An oscillator that is used to determine if an equity is accumulating or distributing. It is based on the readings of the accumulation/distribution line and on the location of the closing price with respect to the price range.

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. For example, 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.

Money Flow — A number of technical indicators that incorporate volume and price action to measure buying or selling pressure. Calculated by multiplying the day's volume by its average price.

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.

Relative Strength Index (RSI) — An indicator invented by J. Welles Wilder and used to ascertain overbought/oversold and divergent situations.

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.

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