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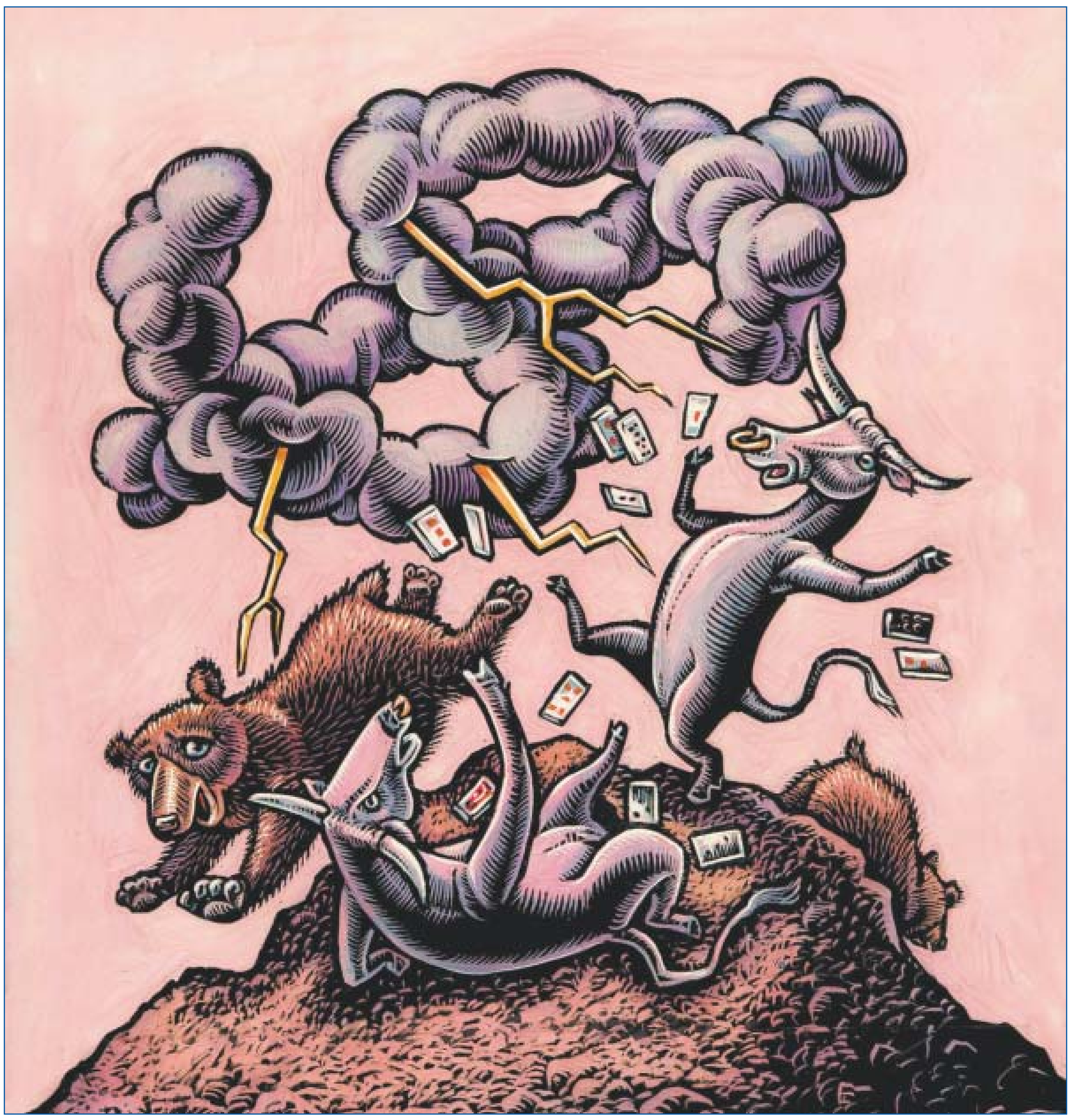

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*By John Wang, Ph.D., CTA, AbleTrend Developer*

AbleTrend is the principle-based decision-making trading software that uses actual price movement to generate recommendations. Our buy and sell signals are calculated by a proprietary, back-tested algorithm that uses real-time or end-of-day price data - providing timely, specific, and objective signals for every trade. Because AbleTrend is principle-based, it offers the following unique benefits.

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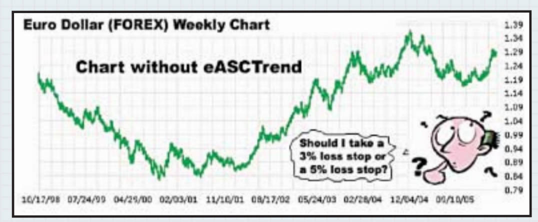


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It's our principle-based formulas that give traders the AbleTrend edge. Sign up for your AbleTrend test drive today, and experience the confidence of using intelligent stops and sweet spots.

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

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# TRADING NOW

There's never a dull moment in the markets. The equity markets seem to have shrugged off the credit squeeze in the US subprime market. The broader indexes show that the losses have been recovered and the markets have entered a party mood. Not only that, if you look outside the US, especially at the emerging markets, you will see that the party is even livelier. The optimism in the markets is going on amid tight money markets and the rising value of gold.

There are a number of reasons for this rally. One of the most obvious is the Fed rate cuts, which have always helped bring back liquidity in the markets in times of crisis. Another is that corporate profits have still been relatively strong. Then there's the weakening dollar, which may not sound like a positive factor but is in actuality an advantage for multinational corporations and makes international investing attractive.

So it may be a good time to join the party if you haven't done so already, but how long will the euphoria last? We can't emphasize enough why it is important to keep an eye on all markets. In this issue of **Traders.com** we have included articles from various sectors, as well as articles on currencies, metals, indexes, the energy sector — all markets to keep an eye on in these volatile times. Gary Grosschadl asks if the NASDAQ is overextended, in "Three Strikes For The NASDAQ"; Arthur Hill points out that there's been a "Breakdown In the Nikkei" and posits what that may mean; Technical Writer David Penn keeps an eye on the US dollar and ponders its next move in "Belt Holds Bolster The Dollar" and "Dollar Dark Cloud Cover." And there's much more.

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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- Visit our Subscribers' Area, where you'll find computer code that has been referenced in S&C articles; and finally,
- Visit our Message-Boards, where you can share your opinions of trading technical analysis, and most everything else you can imagine with other traders.

Are we heading for more good times or times of sorrow? It's hard to say. As I've mentioned in *Technical Analysis of* STOCKS & COMMODITIES, currently our confidence seems to be high and we seem to be buoyant until one small misstep seems to cause us to not just stumble, but tumble to the ground. But then we pick ourselves up again. Wherever we're going in the markets, I can only conclude that we can only get there in small steps — and we have to watch where we're going.

Jayanthi Gopalakrishnan

**Jayanthi Gopalakrishnan,**
**Editor**

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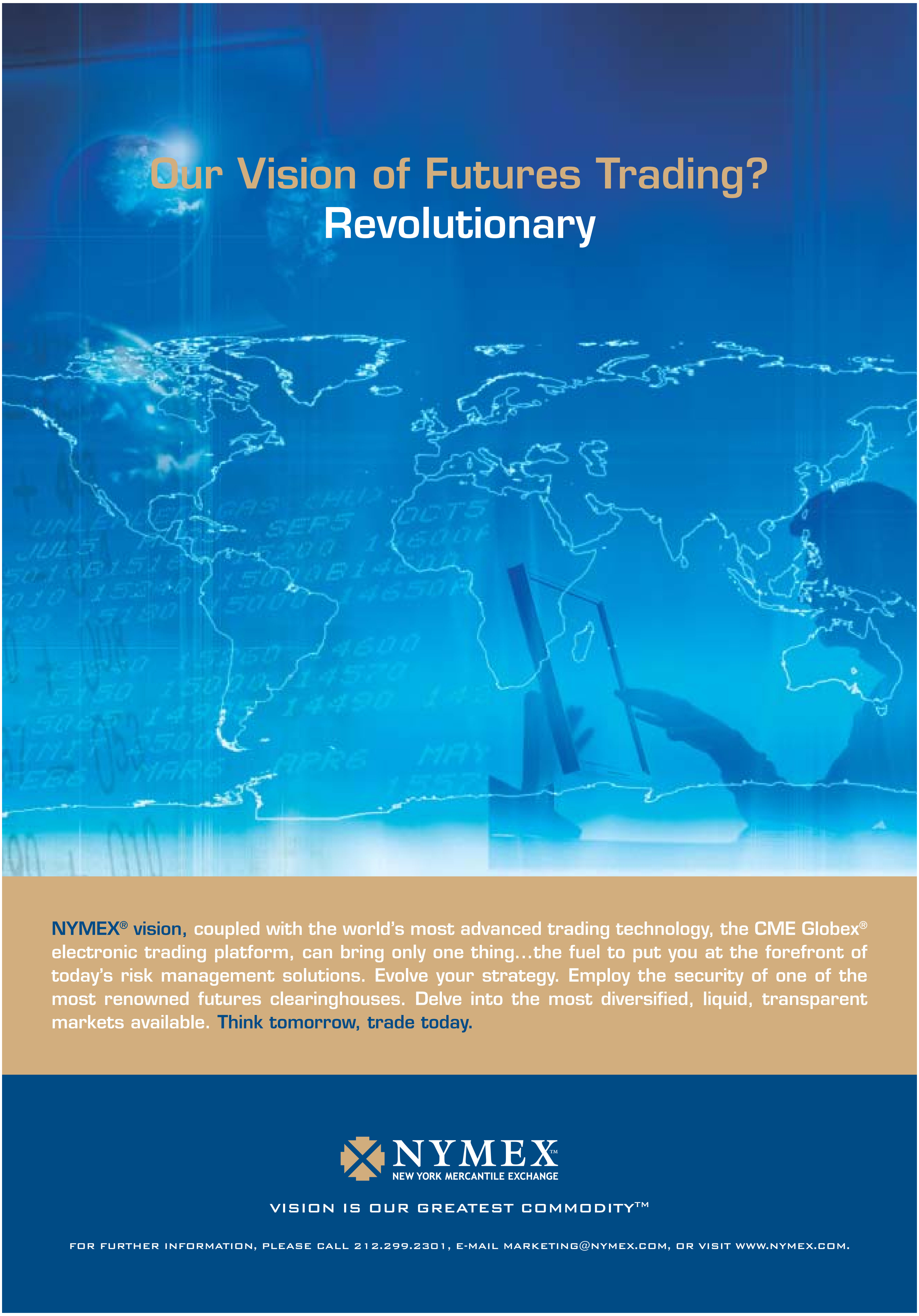
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OPTIMIZED TRADER

# TRIX Two Ways

## *Part I*

**by David Penn**

*There's more than one way to trade this classic momentum indicator.*

It's been almost 25 years since traders were first introduced to the triple exponentially smoothed oscillator (TRIX) in the pages of *Technical Analysis of* STOCKS & COMMODITIES magazine. While there have been a number of ways that technical analysts have modified and tweaked the TRIX for their own purposes since then, many of the original ways that Jack Hutson, the publisher of STOCKS & COMMODITIES and inventor of the TRIX, and others set out for trading the TRIX remain valid and valuable methods for traders.

TRIX is found on most charting software packages, both standalone and web-based. Even so, the computation of TRIX is straightforward compared to a number of other momentum indicators such as the stochastic. Essentially, TRIX is derived by taking an initial exponential moving average, then taking an exponential moving average (EMA) of the first exponential moving average, and then taking an exponential moving average of the second exponential moving average. Finally, take this third exponential moving average and calculate a one-day/one–trading session rate of change to get the TRIX value.

Because the TRIX oscillates above and below a zero line, one of the most common ways of trading using the TRIX is to get long the market when the TRIX crosses above the zero line and to get short the market when the TRIX crosses below the zero line.

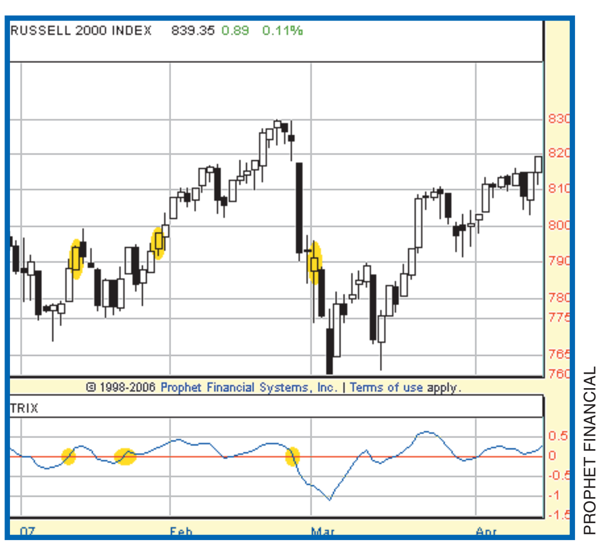


**FIGURE 1: RUSSELL 2000 INDEX, DAILY.** The ovals represent TRIX buy and sell signals in the lower panel. In the upper panel, the ovals represent the confirming closes (higher closes in the case of buy signals; lower closes in the case of sell signals) based on those TRIX trading signals.

Let's take a look at how the TRIX provided buy and sell signals to the Russell 2000 in 2007. We will look to take positions on a confirming close beyond the session when the TRIX buy or sell signal was created. If there is a TRIX buy signal on day 1, we will look to get long on the first session to close above the high of day 1.

For the time being, I will look only at the entries provided by the TRIX. Depending on the market — and the instruments traded — there are any number of ways to exit a trade, and it is worth remembering there is no commandment that the same tools used to get a trader into a trade must be used to get him or her out.

Using the Russell 2000 at our test market, we can see that there were two positive crosses in January. The first led, at best, to a breakeven trade. The second, on the other hand, would have seen a trader long around 798 and well-positioned over the course of February that saw the Russell 2000 advance to the 830 level before stalling and reversing. The sell signal produced by a negative cross, a cross below the zero line, came in late February and would have allowed a trader to get short near 791 in advance of the Russell 2000 falling as low as 760 a mere two days later.

TRIX trading signals in March and April also provided for excellent opportunities. It is important to note that there were instances — for example in late March — where a TRIX signal was given, but the absence of a confirming close kept the trader out of a losing trade. While confirming closes prevent traders from taking positions sooner than they might want to, waiting for confirming closes provides the trader with a measure of confidence that the trade is more likely to be moving in the anticipated direction.

TRIX trading in May and June tended to be less profitable, owing largely to the sideways trading that began in mid-April and continued to characterize the market through the end of June.

### THE HOOKS HAVE IT

While this zero-line crossover technique is a common one with many oscillators, including the TRIX, there is another technique that Hutson revealed in his early TRIX articles that is also worth looking at. In this technique, the focus is not the crossover of the zero line, but simply the "hooking" up or down of the TRIX indicator line. When the TRIX is falling and then develops a small "hook" pointing upward, a TRIX buy signal is created. When the TRIX is rising and then develops a small hook pointing down, a TRIX sell signal is created.

Because Hutson made the point that "the very best results seem to come by using the TRIX subroutine to time your entry in a trending market," I have added a 50-day exponential moving average (EMA) to the price chart in Figure 2. TRIX buy signals will only be taken if they occur in sessions closing above the 50-day EMA. TRIX sell signals will only be taken if they occur in sessions closing below the 50-day EMA. This will help give the signals some trend context and, hopefully, weed out ineffective countertrend signals.

Let's look at the same first four-odd months of 2007 and see what the hook provides by way of entries compared to the zero crossover. The first bull hook comes accompanied by a hammer candlestick in early January and was good for a quick three-day ride higher before pulling back to the breakeven level. A pair of bull hooks developed in late January, both of which would have been solid entries for the rally that began in February.

Interestingly, the hook method would have not provided any short entry during the Russell 2000's collapse in late February. Arguably, the negative divergence in the TRIX would have alerted traders to, at a minimum, the threat of a correction. But leaving aside for now the issue of divergences — which are an excellent strategy for analyzing potential tops and bottoms in the TRIX and will be discussed in greater detail in part 2 — the hooks method provided no short signal during a significant and sharp decline in the market.

At the same time, the hook method did provide a number of profitable trades during May and June, when the zero crossover method of using the TRIX failed to make money. Bull hooks in mid- and late May as well as in mid-June were excellent short-term opportunities.

The hook method is one limited not to TRIX, but can be found in other momentum oscillators such as the stochastic as well. George Lane, writing about the stochastic in an article for STOCKS & COMMODITIES, wrote about how traders could use the "reduction in the velocity of movement" in a momentum oscillator as a trading signal in and of itself. For Lane, there were two types of hook: the "hinge" and the "warning." The hinge appeared in the stochastic in the same way that the hook does in the TRIX: as a bending or curving or angling away from the direction the oscillator is moving. In other words, trading signals are derived from either a hinge/hook up in a downward TRIX or a hinge/hook down in an upward TRIX. While the zero-line crossover approach has its strengths, the hooks approach has much to offer the short-term, momentum-oriented trader. As was the case with the stochastic in the BOSO method (see my Working-Money.com article "BOSO" from October 5, 2005), crossover to the zero line can anticipate enduring trends to the upside or downside. Consider again the chart of the Russell 2000 in Figure 1. The TRIX crossed into positive territory in the second half of January, and did not fall meaningfully back into negative territory until late February. In that time, the Russell 2000 rallied from near 800 to as high as 830 and back to below 800.

The hook method, on the other hand, is especially geared toward highlighting trading opportunities as soon as there is the slightest wiggle of waning momentum in the oscillator. If you compare the entry signal from the zero-line crossover to the entry signal from the hook, you'll see that while the momentum often runs out quickly after a hook buy or sell signal, the hook signals tend to come sessions before the zero-line crossover signals arrive. While both techniques can be effective, the hook approach is especially helpful for short-term, momentum traders with the discipline to take whatever profits the markets provide.

Next time, in the second part of this article, I will look at two other ways of using the TRIX: divergences and with a signal line to reveal golden crosses, dead crosses, and other profitable trading patterns. ■

*This article was originally published on 8/2/2007.*

## SUGGESTED READING


Hutson, Jack [1983]. "Good TRIX," *Technical Analysis of* STOCKS & COMMODITIES, Volume 1: 5.

Lane, George [1984]. "Lane's Stochastics," *Technical Analysis of* STOCKS & COMMODITIES, Volume 2: 3.

Penn, David [2002]. " TRIX Is For Traders," *Technical Analysis of* STOCKS & COMMODITIES, Volume 20: March.

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



**FIGURE 2: RUSSELL 2000 INDEX, DAILY.** Where the zero-line crossover method failed the Russell 2000, the hook approach performed much better, catching swing opportunities as the price action in the Russell 2000 became choppy in May and June.



**The hooks approach has much to offer the short-term, momentum-oriented trader.**

# INDEXES

CANDLESTICK CHARTING

## Three Strikes For The NASDAQ?

**by Gary Grosschadl**

*When a stock or index is overextended, it can suddenly correct at the first candlestick warning or defy gravity a while longer.*

**Tradable:** $COMPQ

This daily chart of the high-tech index shows three bearish candlestick formations (Figure 1). The first bearish engulfing pattern was quickly forgiven — call it strike 1. The second warning (strike 2) came as a doji candlestick; after an extended rise, dojis often mark a pending reversal. This one only precipitated three down days.

Now another bearish engulfing candlestick has appeared, bigger and uglier than the first one. This third warning could be strike 3. Three warnings will not go unnoticed; call me superstitious, but technical analysis is rife with patterns involving threes — triple tops & bottoms, head & shoulders, three white soldiers, three black crows, and so on.

Multiple negative divergences (three of them) often point at a run being overextended and due for a correction. The moving average convergence/divergence (MACD), the relative strength index (), and the Chaikin money flow indicator (MF) all show diverging action. As the index makes new highs, these indicators fail to confirm the bullish price action. This is certainly a bearish indication, but the question will be: When and how much?

Note the previous good support from the 50-day exponential moving average (EMA). A close under this level could be the final nail in this coffin. Moving averages often are likened to natural trendlines. A support trendline drawn would closely match this EMA. Should a sizable correction occur, look to the always important 200-day EMA as a likely downside target or test; note the previous successful test of the 200-day EMA last May.

In summary, this index has warned three times of a possible top. The bulls are starting to waiver, say the indicators. The umpire is watching the 50-day EMA, and failure there could be a run south to stronger support. Time will tell soon enough. ■



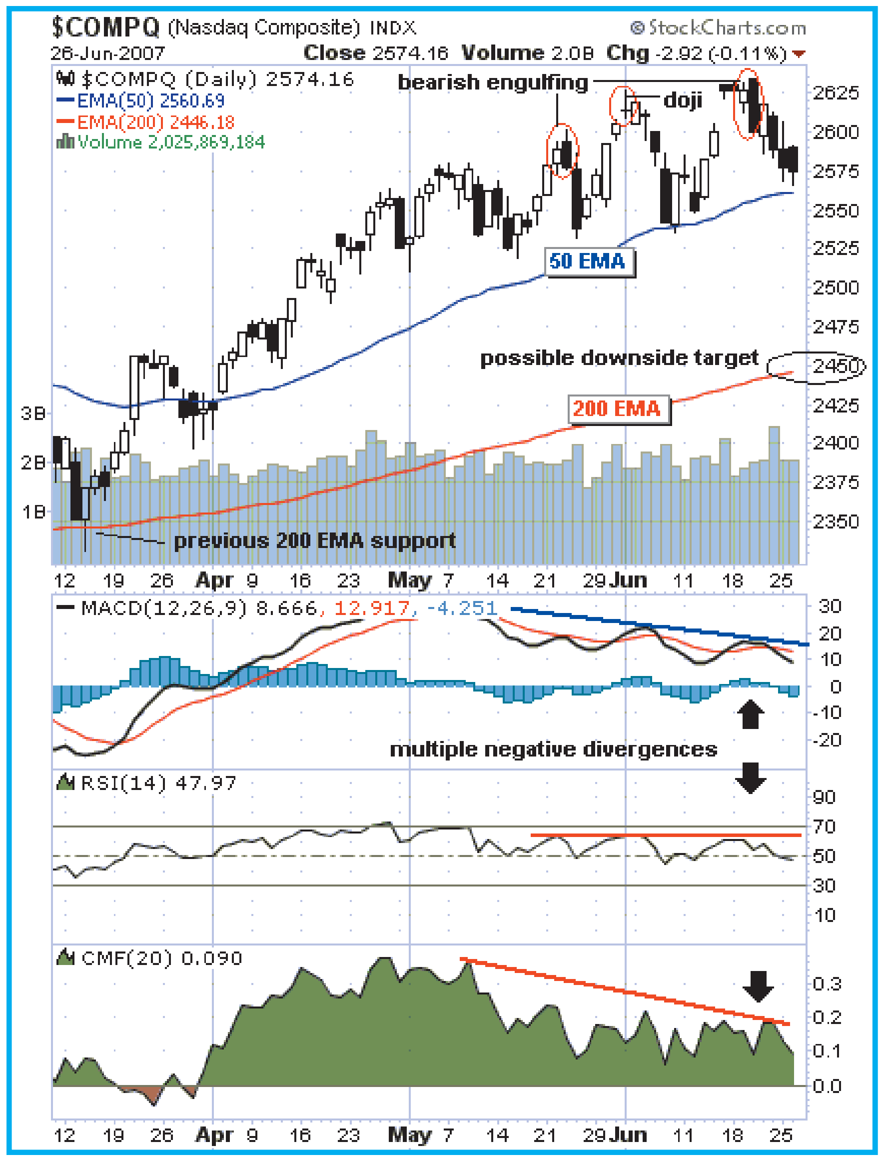


**FIGURE 1: NASDAQ, DAILY.** The chart hints at three strikes via bearish candlestick formations.

FLAGS AND PENNANTS

## The S&P 100 Index Bounces Back

**by Chaitali Mohile**

*$OEX has turned positive, leaving behind some of its resistance.*

**Tradable:** $OEX

The bullish rally on the Standard & Poor's 100 index began at closing on August 16, followed by a strong opening on August 17 as the Federal Reserve came in with discount cut news. The rally strengthened as the entire market surged with the news. The entire advance rally gave almost $35 to traders. Thereafter, throughout the intraday session, the index turned sideways in a 10-point range. This day-and-a-half move formed a flag & pennant pattern on the intraday chart (Figure 1). According to the chart, the index closed at the support of the 50-day moving average (MA). The first and closest intraday hurdle of the 50-day MA was taken off with the upward swing of the US financial markets.

In Figure 2, the 200-day MA resistance turned into support by the bullish weekend closing. The long bullish candle closed above the 200-day MA, with the high made at the $676 level. The smallest note I would like

**FIGURE 1: $OEX, HOURLY.** The flag & pennant breakout will see the minimum level of $710. In between, the resistance — likely at 200-day moving average and the previous intraday high at $700 — may get violated.

to highlight here is that during the downfall, the $OEX had a moderate halt in the range of $675-$680 (the marked circle). And the previous trading session closed under the same resistance levels, so there arises a possibility of a minor sideways move on positive ground. With all the mishaps in past weeks, the smallest possibility cannot be ignored.

The stochastic (14, 3, 3) is likely to open new trading opportunities by moving above the 20 level. The journey from oversold levels (20) can definitely be bought. The MACD (12, 26, 9) is still not in favor of bulls. The MACD (12, 26, 9) needs to confirm a bullish crossover to strengthen the rally. This opposite sign again diverts the mind from the minor sideways move at the $676 level. This minor consolidation may also help the MACD (12,26,9) turn fully positive, but the entire picture shows that bulls are back in form and ready to jump over the hurdles on their way. The 50-day MA is the next resistance of the pullback rally. The previous high of $720 would act as the final target for this move. Above this level, a rally may begin.

Thus, the flag & pennant breakout can be bought with the target of $710 first as per our calculation and then look toward $720 as the highest level to achieve on the rally. ■



**The MACD is still not in favor of bulls. The MACD needs to confirm a bullish crossover to strengthen the rally.**


**FIGURE 2: $OEX, DAILY.** The resistance of the 50-day moving average is crucial for the bullish rally. Above this hurdle, $720 remains the final target in this upside move.

WEDGE FORMATIONS

# The CRB Is Breaking Down

**by Arthur Hill**

*With a sharp decline over the last three weeks, the CRB Index broke the lower trendline of a rising wedge, and a bigger ABC pattern points to further downside in the coming months.*

**Tradable:** $CRB

On the weekly candlestick chart (Figure 1), the CRB Index declined sharply from May 2006 to January 2007 and then bounced back with a rising wedge this year. The wedge retraced 50% of the previous decline and met resistance near broken support. This is a classic setup. The rising wedge is typical for countertrend rallies, and a 50% retracement is normal for such rallies. The index broke the lower trendline with a sharp decline over the last three weeks, and further weakness below the May-June lows would complete the bearish trend reversal.

Turning to a long-term chart (Figure 2), we can get an idea for a downside target. First, you can see that the index broke a long-term trendline in 2006 and is in the midst of at least a correction. The index pretty much doubled with the run from 183 to 265 (October 2001 to May 2006). This advance occurred with relatively small corrections along the way and the current decline is the first significant sign of weakness.

According to Elliott wave theory, corrections often take form as ABC declines. Wave A is the initial decline, wave B represents a bounce after this decline, and wave C is a continuation of wave A. In addition, wave C is often equal to wave A and we can use wave A to calculate a downside target. Wave A declined 21% and a 21% decline from the wave C high would carry down to around 260. This level is between the 50% and 62% retracement marks. The 50% retracement mark is around 275 and this is too close to the low of wave A. Therefore, I would mark my downside target zone around 250-260. ■



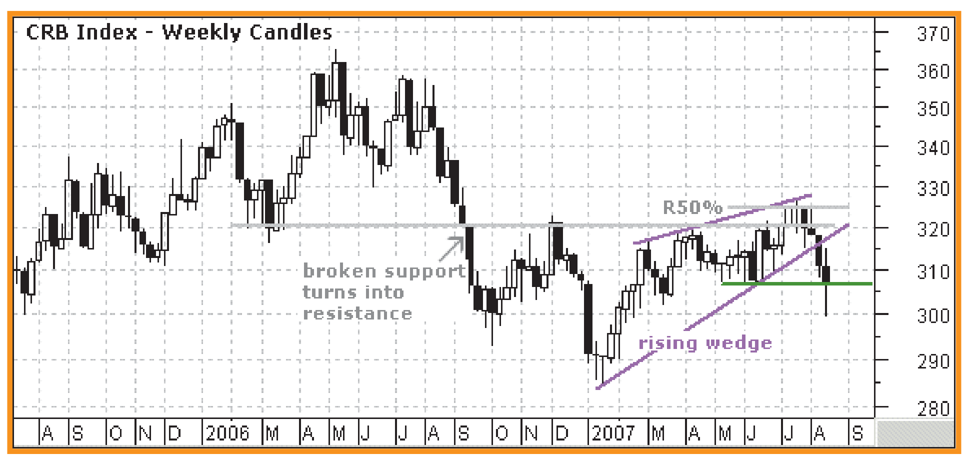


**FIGURE 1: CRB INDEX, WEEKLY.** The CRB index dropped from May 2006 to January 2007 and then bounced back with a rising wedge.


**FIGURE 2: CRB INDEX, LONG-TERM.** Looking long term, we can get at least an idea for a downside target.

**According to Elliott wave theory, corrections often take form as ABC declines.**

CHART ANALYSIS

# The TSX Composite's Monthly View

by Gary Grosschadl

*The Toronto Stock Exchange has outpaced the Dow Jones Industrial Average since the big runup started late in 2002.*

**Tradable:** $TSX

For the first time, this Canadian index surpassed the Dow Jones Industrial Average (DJIA) as it recently hit a peak just over 14,600 vs the DJIA 14,000. The extra juice came from the heavier oil and gas weighting. These indexes will probably stay neck-and-neck for a while unless oil prices plunge.

A stock or an index on a strong run will stay above its 20-period exponential moving average (EMA), and this was aptly illustrated (Figure 1). Note the doji candlestick marking the bottom on this chart. Dojis often mark important turning points. Confirmation of a turnaround came in two flavors. The index finally beat overhead 20-day EMA resistance and the directional movement indicator at the top of the chart flashed a buy signal (directional indicators crossed over). Now a topping formation has appeared on this chart via a small-bodied candlestick with a long upper shadow. Whether you call this a near doji or a shooting star candlestick, the top warning remains the same. Confirmation comes with the completion of the August candlestick and subsequent ability to beat the previous high-water mark.

Two downside targets are considered on this monthly chart (Figure 1). Note how the 20-day EMA and the 50-day EMA currently relate to previous support and resistance levels marked by horizontal lines. If support holds at the 20-day EMA, the strong uptrend is intact. If that support fails, the 50-day EMA may come into play, currently 11,000. Should that also fail, a major decline is likely under way under the 10,000 level.

The indicators under the chart show mixed sentiment. The moving average convergence/divergence (MACD) still shows a strong uptrend, but its histogram does show negative divergence. This sometimes reveals a coming change or reversal ahead.

The relative strength index (RSI) shows an overbought condition not likely to continue much longer. The stochastic oscillator also reflects this overbought condition. When the market is in a strong uptrend, this oscillator will stick high, as it's considered a nontrending indicator.

In summary, an adage comes to mind: What goes up must come down.

It's been a grand run. How far down does she go? Will this be a modest dip down or a bigger correction? Only the market knows for sure, but charts help navigate the waters and hopefully keep some of us off the rocks, should a perfect storm arise. ■



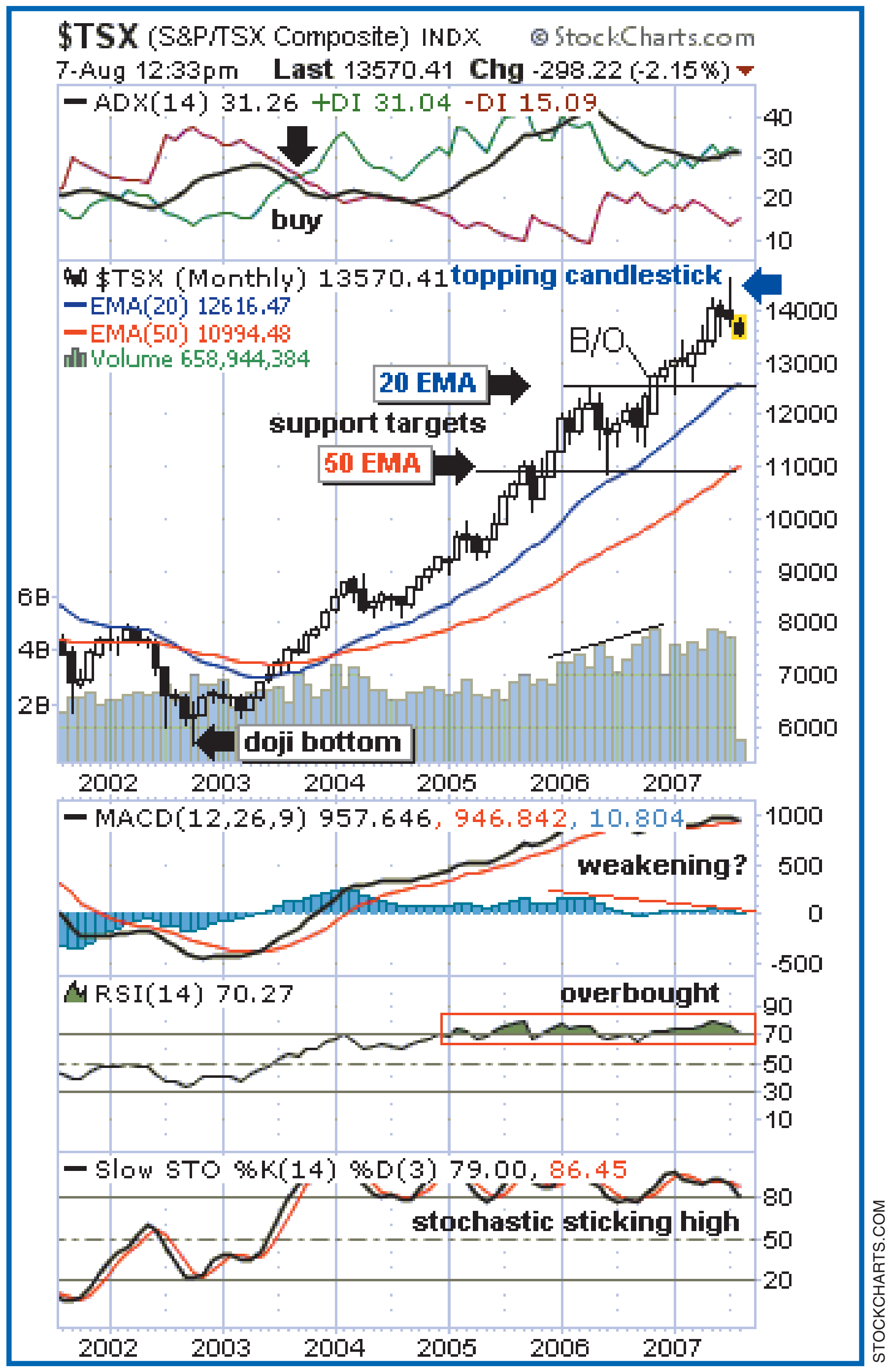


**FIGURE 1: TORONTO STOCK EXCHANGE (S&P/TSX COMPOSITE), MONTHLY.** How far will she go? Will this be a modest dip or a bigger correction?



OVERBOUGHT OVERSOLD

# Russell 2000 Hits Support

by Arthur Hill

*The Russell 2000 bore the brunt of selling pressure over the last two to three weeks, but the index could be ripe for a bounce as it becomes oversold and trades at support.*

**Tradable:** $RUT

On the daily chart (Figure 1), the Russell 2000 ($RUT) declined over 10% in the last 11 days and this is the sharpest decline since July 2002. The decline carried the index past its June lows last month and past its March lows on Friday. Technically, RUT closed below the March lows, and this support break is bearish. However, the break is just one day old and it could still be an overshoot. The Russell 2000 is made up of high-beta small-cap stocks and these are more volatile than large-caps. As such, we can expect some overshoots and I find it best to use support or resistance zones. I am setting a support zone around 760 and the index is still within 5 points of this zone.

In addition to a support zone around 760, the index is oversold by most measures and ripe for a bounce. First, a 10% decline in 11 days is extreme and a simple visual chart inspection shows that this decline is overdone. Second, the relative strength index (RSI)

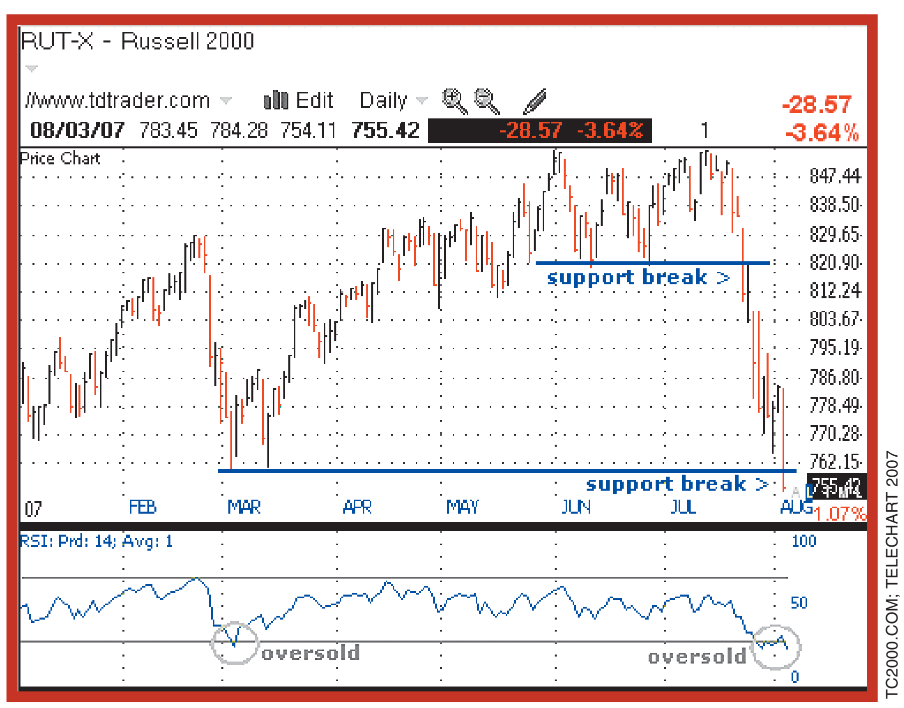


**FIGURE 1: $RUT, DAILY.** The Russell 2000 declined over 10% in the last 11 days and this is the sharpest decline since July 2002.

dipped below 30 for the third time this year. The first time was in March and the second in July. The index tried to bounce last week but failed and the RSI moved back below 30 on Friday. With the RSI oversold, it is too late to consider short positions and traders should be on guard for an oversold bounce. Look for the RSI to break above last week's high to start a bounce in momentum.

How far might an oversold bounce extend? There are two methods to measure upside targets. First, broken support levels turn into resistance. $RUT broke the June lows at 820 and this break turns into resistance. In addition, the May lows can be incorporated as broken support at 810 and there is a broken support zone from 810 to 820. Second, countertrend rallies usually retrace 38-62% of the prior decline (~860 to ~755); 38% and 62% are based on Fibonacci numbers and 50% is based on Dow theory. This range extends from 795 to 820. I would expect a 50-62% retracement and this marks resistance around 807-820. Taken together, I would target an oversold bounce to the 805-820 region (Figure 2). ■



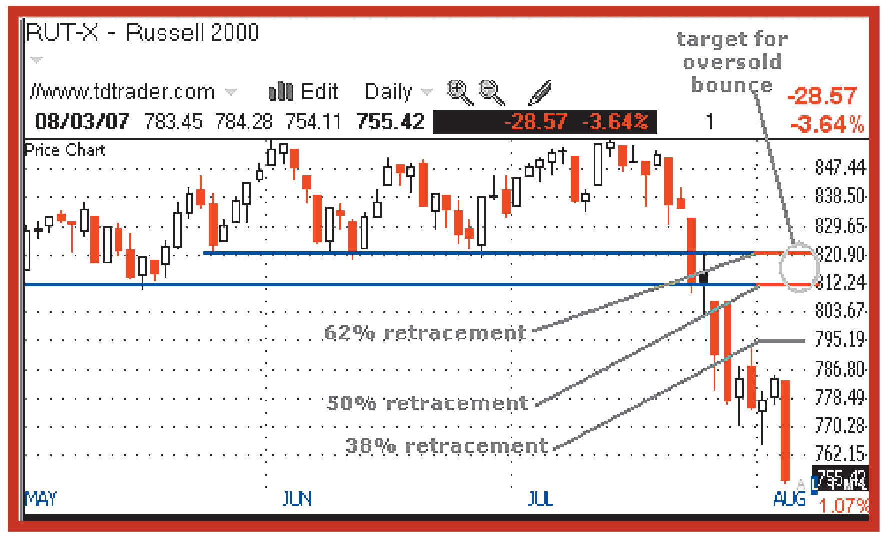


**FIGURE 2: $RUT, DAILY.** How far might an oversold bounce extend?

RELATIVE STRENGTH OSCILLATOR

# A Breakdown In The Nikkei

**by Arthur Hill**

*After meeting stiff resistance from its March high, the Nikkei gapped down and broke support to reverse a 12-month uptrend. At the very least, we can expect a retracement of this big rally.*

**Tradable:** $N225

On the weekly chart (Figure 1), the Nikkei 225 ($N225) met resistance from its March high and gapped down last week. The index first closed above 18000 in mid-June and then stalled with five small candlesticks. These five small candlesticks showed indecision, and the index indicated its mind was made up, coming up with a long black candlestick. The decline featured a gap and broke the trendline extending up from June 2006. This gap should be considered bearish as long as it remains unfilled and the trendline break signals a reversal in momentum. Look for a move above the July highs to reverse this signal.

The momentum reversal is also captured by the relative strength index (RSI) with its break below 50. The indicator moved above 70 in March and formed a lower high in July. Despite a five-month advance back above 18000, the RSI did not reach its prior high and momentum was not as strong. Based on weekly closing prices, a negative divergence formed and the indicator went on to break the June trendline as well. More important, the RSI moved below 50, and this puts the indicator in the bottom half of its range (zero to 100). Momentum now favors the bears and lower prices are expected.


**FIGURE 1: NIKKEI 225, WEEKLY.** The Nikkei met resistance from its March high and gapped down recently.


**FIGURE 2: NIKKEI 225, WEEKLY.** While Figure 1 examined the reversal, Figure 2 looks at downside targets.

Figure 1 dealt with the reversal, and now, Figure 2 looks at downside targets. The first downside target is based on the March low around 16500. It is also possible that a large double is forming with the March and July highs. A break below the March low at 16500 would confirm this top and project even further weakness.

The next support or target is around 15500. This is based on the September–December 2006 lows and a 62% retracement of the entire advance. The index bounced off 15500 twice last year and there is obviously a lot of support here. This is further reinforced by the Fibonacci retracement. Corrections are part of the natural ebb and flow of an uptrend. The advance lasted for a year and a multimonth correction is entirely feasible. The index is up over 25% since last June but a 15% decline would also be quite feasible. ■

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OSCILLATORS

# A Long-Term Analysis Of The DJIA

**by Koos van der Merwe**

*Are the events of the week ended July 27 the start of a major correction in the Dow Jones Industrial Average? A look at the chart presents conflicting evidence.*

**Tradable:** DWIX

Figure 1 is a yearly semilogarithmic chart of the Dow Jones Industrial Average (DJIA) from 1890. The indicators on the chart are as follows:

**a** A Fisher transform calculation of the **moving average convergence/divergence** (MACD) of the highs. This indicator is superimposed on the price chart and clearly shows the high of 1929, the low of 1944 followed by the high of 1965, and the low of 1982 leading to the high of 2006. Note how the bubble of 2000 appears as a small correction compared to the meltdown of the 1930s. This is because a semilogarithmic chart measures price movement relative to the movement at that time. The indicator is suggesting a correction should occur in the near future. On the chart the degree of the future correction could be minor, but the percentage correction as we know could be painful.

**b** The second indicator in an indicator window is the **rapid RSI**. This indicator called the high of 1929 as it broke above the 70 line. It then fell to the 30 line suggesting that the correction could possibly have ended, and that a new long-term bull market was starting. However, in 1951 it crossed above the 70 line once again suggesting caution, but the signal was too early, as the correction only occurred in 1965. The indicator only broke below the 70 line giving a sell signal in 1966, as shown by the two arrows. The start of the 1975 bull market was not suggested at all by the indicator, which only broke and then moved above the 50 line. Using the indicator purely as a sell indicator, we can see that it is currently above the 70 line, and a sell signal has not been given — yet.

**c** My final indicator is a **stochastic RSI** with an 8 parameter. I use this indicator as a buy indicator. Its sell side is far too early, which is why I prefer the rapid RSI as a sell indicator. As you can see, it is suggesting a buy signal at the moment, and with the rapid RSI not giving a sell signal, and the Fisher transform of the MACD highs still in a sideways movement, I would be inclined to believe that there is still some strength in the DJIA before a major correction occurs. The pattern at point A does suggest that although the stochastic RSI has given a buy signal, the other two indicators a and b above have given definite sell signals, and the index then moved sideways before drifting down. This could well occur now, but only when a sell has been given.

To conclude, the DJIA, on a yearly chart, has not given a sell signal ... yet. A buy signal has been given, suggesting that the trend for the year is still up, but indications of an overbought position are present and could turn to a sell at any time. To fine-tune the trend, a weekly and daily chart should be looked at. ■

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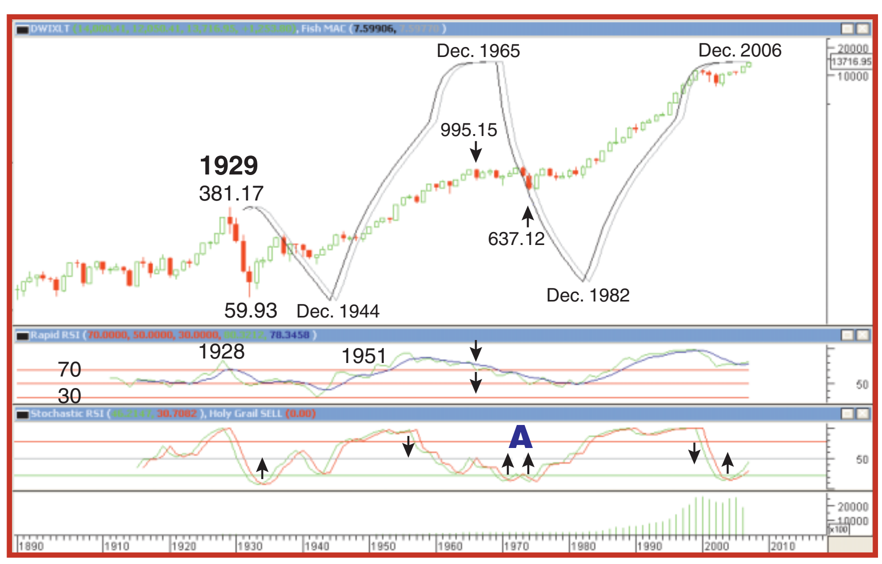


**FIGURE 1: DOW JONES INDUSTRIAL AVERAGE, 1890 TO 2007.** The start of a major correction? Or not?


WILDER'S RSI

# RSI: Platinum's Failure Swing

**by David Penn**

*Using the relative strength index to spot potential turns in the market.*

**Tradable:** PLN7

I have never been a huge fan of the relative strength index (RSI). It's nothing personal; it's just that I always found oscillators like the stochastic and the moving average convergence/divergence histogram (MACDH) and the TRIX to be more helpful for the kind of technical analysis I do.

One of the things I have found interesting about the RSI, though, was the idea of the failure swing. The failure swing in the RSI occurs when the indicator reaches an extreme, either overbought or oversold, and then pulls back out of extreme territory. Traders then look to see if the market makes another move toward the extreme — only this time failing to enter overbought or oversold territory.

If the market moves back below the low between the two peaks (in the example of an uptrend) or back up above the high between the two troughs (in the example of a downtrend), then the market has made what J. Welles Wilder called a "failure swing." As such, the market is increasingly vulnerable to reversal.

The chart of platinum futures in Figure 1 provides an example of a failure swing in action. Note how the market made a high in April, pulled back, and made a higher high in May. At the same time, the relative strength index made a high in April and a lower high in May. This in and of itself created a bearish, negative divergence that should have alerted traders to the vulnerability of the platinum market to correction.

Failure swings can appear with or without being a part of a divergence. Here, the failure swing appears as part of a divergence. Regardless, however, we can see how the failure swing develops. Note how the second, lower high does not penetrate into the overbought zone, and instead, moves down and, by the middle of May, has passed below the low point between the two peaks. The moment the market does so on a closing basis, the trader can consider making a bet against the market.

Using the example in Figure 1, the trader would have gotten the signal on May 17 with a close of 1317.90. Going short the following open, the trader would have a short entry at approximately 1314. Although the market moved higher on the day of entry — rallying as high as 1328 — within days the platinum market was in full retreat. Five days after the short entry, July platinum was trading at 1277.80 and still moving lower. ■


**FIGURE 1: PLATINUM, JULY FUTURES, DAILY.** At the same time that July platinum was developing a negative or bearish divergence in the spring, a failure swing was setting up. The failure swing was confirmed by mid-May, when the RSI fell below the low point between the April and May peaks.

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This article was first published on 6/28/2007. See www.Traders.com for more.

# The DJIA's Double Top Test

by Gary Grosschadl

*The Dow Jones Industrial Average is currently trying to find support from its 50-day moving average. This coincides with a possible double-top formation.*

**Tradable:** $INDU

Figure 1, a daily chart, hints at a possible bounce off the 50-day exponential moving average (EMA), which relates to previous support. This also serves as a double-top test as the symmetry looks good and the trendline is established.

If the bounce is good and the bulls have enough stamina, a triple top via a third peak is a possibility. If instead it falters and closes below the trendline at about 13250, then the double top looks good and the completion target would be at about 12800.

The completion target for this pattern is the distance from the peak to the trendline, as applied to a downside break below the trendline. Note that the ever-important 200-day EMA currently looms 200 points below that target at 12600.

Several indicators reflect quite a bearish tone. At the top of the chart, the average directional movement index (ADX) shows a somewhat rare pattern. It's not often we see a double top of the ADX line. That clearly led to a bearish cross of its DI lines, or directional indicators. In simpler terms, the previous bullish trend is over.

Below the chart the moving average convergence/divergence (MACD) and the relative strength index (RSI) are showing pronounced negative divergences to recent price action. This foretold the ensuing test of the previous support of the double top trendline.

But is it really over? That is the real question. Renewed downside is something to be wary of, especially when considering the Chaikin money flow indicator (CMF). The CMF shows a severe erosion of bullish buying power. If the bulls have left the party, who will drive this index to new heights?

All things considered, I will be surprised if a third peak ensues before further downside is explored. Keep your eye on the trendline; a close below spells trouble. As always, the market has the final say. ■

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**If the bounce is good and the bulls have enough stamina, a triple top via a third peak is a possibility.**

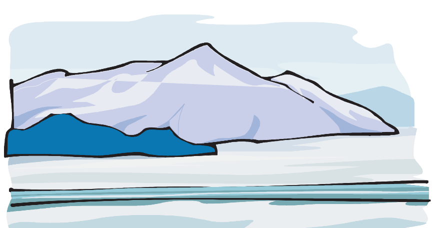



**FIGURE 1: DJIA, DAILY.** There's a possible double top for the Dow Jones Industrial Average if the trendline fails on this chart.

# So What *Is* The True Elliott Wave Count?

by Koos van der Merwe

*We should stick to the rules.*

**Tradable:** SPX and DWIX

The most important rule of Elliott wave analysis is "The wave structure must look right." It is because of this rule — one that I ignored when I believed the Standard & Poor's 500 was in a B-wave upward — that I changed my outlook about the wave count. In Figure 1, I have shown my original wave count in red with a question mark. My new wave count suggests that what I believed was a B-wave could be the beginnings of a wave V.

To recap the basic wave rules:

1. **The wave pattern must look right.** By this I mean that wave 3 should be equal to or greater than wave 1. That waves 1 and 5 should be equal in length, and that wave 4 should fall to the fourth wave of lesser degree and be a complicated wave if wave 2 is simple, and vice versa.
2. **In time, an ABC correction should be 38.2% of the rise of wave 1 to 5.** This rule has been more successful in analyzing gold, but nevertheless it can be used as a guideline in determining when we can see an end to the devastating C wave.
3. **Finally, in a major A-B-C wave retracement — that is, at the end of a long-term bull cycle, the A and C waves should retrace in a five-impulse wave and could retrace further than the fourth wave of lesser degree.** The question arises as to whether the rise from 1974 to July 2000 is a major long-term bull cycle.


**FIGURE 1: S&P 500.** This shows possible cyclical turning points.

ADVANCEDGET


**FIGURE 2: DJIA.** Here's the ultra long-term DJIA semilog chart.

METASTOCK

To answer this question, let us look at a chart of the Dow Jones Industrial Average (DJIA) from 1890.

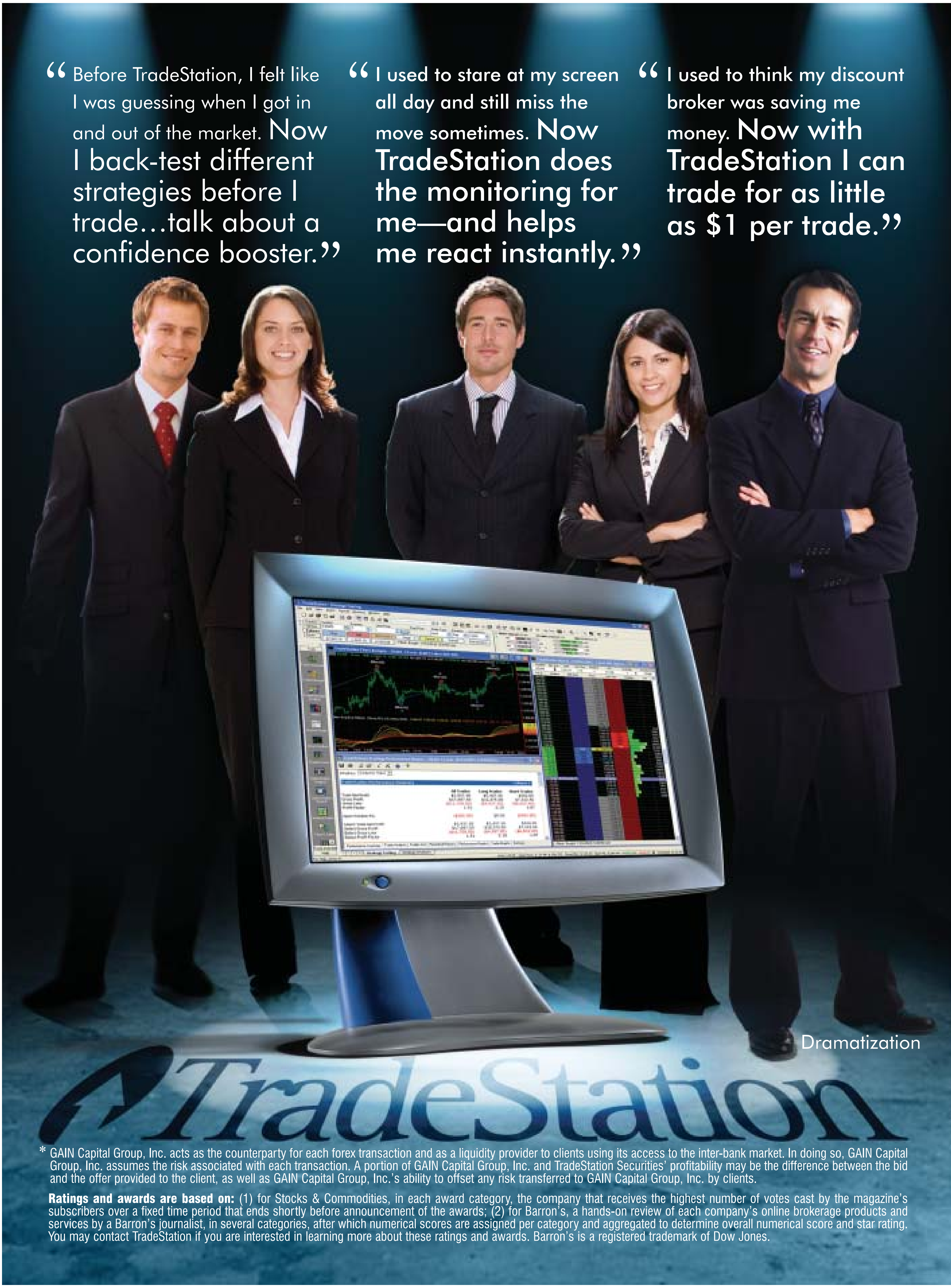
Figure 2 is a semilog chart and clearly shows the wave I and wave II correction of the 1930s. Note how the relative strength index (RSI) became oversold and gave a buy signal. The only other time a buy signal was given was in September 1974. It is because of this that I have labeled the correction of March 2000 to December 2002 as a minor fourth-wave correction, rather than a major one.

Do note the trendline drawn from the low of wave II in 1932 to the low of wave 4. A parallel line (semilog) shows that the DJIA penetrated it in March 1966 but then used the line as support for the wave-iv correction. The trendline also suggests that the wave V top could be in the 18000 region. This will be confirmed if the RSI completes a divergence top.

So although in my first chart I am showing an S&P 500 chart with a wave count, the long-term chart of the DJIA is suggesting that the S&P 500 has still some way up to go, possibly to the level of 1684 as suggested by the MOB line of Advanced GET. Whereas the MOB line is suggesting a date of December 2010 as a top, the Fibonacci time line is suggesting April 2010.

**Whereas the MOB line is suggesting a date of December 2010 as a top, the Fibonacci time line is suggesting April 2010.**

Returning to the chart of the S&P 500, it is now obvious that the 2000 correction is a wave 4 correction, and because of its depth, a 50% correction of the rise from 1974 to 2000, the fifth wave should not be very high. Wave 1, in fact, was only 260 points (321-61=260). Wave V has far exceeded this length. Does the wave count meet the first rule of Elliott — namely, it must look right? Yes, in my opinion it does. The chart also suggests that the major ABC correction, when it occurs, should retrace to somewhere between the high of 1966 and the low of 1974, the dates of the fourth wave of lesser degree shown on the long-term DJIA chart. ■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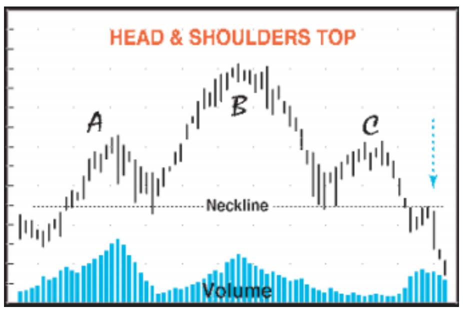
HEAD & SHOULDERS

# The QQQQ's Intraday Head & Shoulders Top

**by David Penn**

*The rally in the NASDAQ 100 lasted almost a month before a head & shoulders pattern signaled a correction.*

**Tradable:** QQQQ




I've had much better luck finding many of the traditional chart patterns such as triangles, diamonds, and head & shoulders in intraday charts compared to daily or weekly charts. It would be one thing if I were simply canvassing all of the intraday price action in all the stocks of the Wilshire 5000 for chart patterns. But many of the patterns I find are in exchange traded funds — even exchange traded index funds — which are a far more restrictive survey sample.

The head & shoulders pattern in the QQQQ was as close to ideal as you are likely to find. Developing over the days between July 13 and 24, the pattern has the requisite shape of two peaks ("shoulders") separated by a higher peak ("head"). The actual breakdown from this pattern occurred early in the afternoon of July 24, with the QQQQ falling nearly 60 cents in an hour. The market bounced — or, rather, moved sideways — for a few days before resuming the decline.

Given the size of the head & shoulders pattern, about $1.00, and a breakdown level at about 49.64, we can project a minimum move to the 48.60–48.50 area. Note that this coincides with potential support at the morning low from July 11 just south of 48.50.

In addition, note how the head & shoulders pattern coincides with the 1-2-3 trend reversal (Figure 1). The QQQQ broke down below the trendline that supported the rally from late June on the morning of July 24 to form the "1" of the 1-2-3 trend reversal, and the bounce hours later represented stage 2. Stage 3 of the reversal followed shortly thereafter as the low from stage 1 of the 1-2-3 trend reversal was taken out to the downside. ■


**FIGURE 1: NASDAQ 100 UNIT TRUST (QQQQ), HOURLY.** This head & shoulders top emerged at the end of a nearly month-long advance in the NASDAQ 100. Note also how the head & shoulders pattern — and its breakdown — also complete a 1-2-3 trend reversal.



CANDLESTICK CHARTING

# Advance Block In QQQQ

**by Chaitali Mohile**

*The bullish rally is blocked with an advance block candlestick pattern in PowerShares QQQ Trust.*

**Tradable:** QQQQ

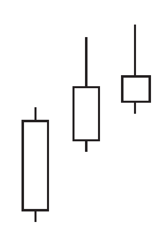
An advance block is a bearish reversal candlestick pattern that appears in an uptrend. This pattern is a derivation of three white soldiers. In Figure 1, QQQQ was attempting a bullish rally from the $47 level, which is below the 50-day exponential moving average (EMA). The first candle in the circle is very bullish with a smaller upper shadow; the second and third candles were bullish as well, but the upper shadows are much longer, showing weakness in the rally. This action makes the pattern different from the three white soldiers. The basic difference in the two patterns is that advance block appears in an uptrend, while the soldiers pattern appears in a downtrend. In addition, in three white soldiers all the three candles end close to their days' highs, whereas here the second and third candles fail to close near a high, indicating nervous participants.

In Figure 1, QQQQ started a downward move at $50.66. This negative momentum came up with the entire market slump; otherwise, the uptrend in the stock was sustained. The loss of $4 on the rally does not turn an uptrend to down, and the QQQQ began its bullish move, violating the 50-day EMA resistance. Overall weaknesses in the entire market followed by global turbulence weakened the first pullback in the stock. QQQQ started a second upward rally from the same support of $46.98 with good bullish strength initially, but the second day and the third witnessed some profit-taking near the extremes of two trading sessions. The profit-taking action shows losing bullish power.

Advance block has already shown its effect. Leaving behind a 50-day EMA support, QQQQ dipped below $46.98. To identify the future direction, refer to the moving average convergence/divergence (MACD) (12, 26, 9) and the stochastic (14, 3, 3). The MACD (12, 26, 9) is highly negative after its bearish crossover at the end of July. Currently, the indicator has also moved below its zero line, pouring weakness into the rally. The histogram has continued below the zero line.

The stochastic (14,3,3) was overbought when the price was hovering near the $50 level. The price nosedived, carrying the stochastic (14, 3, 3) to the oversold area. The advance block pattern stopped this upward trip from the oversold position and the indicator had to turn back. So currently, both indicators have a bearish indication.


**FIGURE 1: QQQQ, DAILY.** Due to the advance block in the uptrend, the bullish retraced back to its low pivot.



With the bearish scenario on the chart, PowerShares QQQ Trust is likely to see more downside. Support levels like $46 and the 200-day EMA should be observed. ■

# Cup With Handle Becomes Diamond

by David Penn

*A failed breakout sets up a diamond consolidation in the Dow transports.*

**Tradable:** $TRAN

Back in late May, I wrote an article for Traders.com Advantage that suggested that a large cup with handle pattern in the Dow transports was a bullish sign for the group — and perhaps for stocks in general ("A Cup With Handle In Transports," May 31, 2007).

The transports indeed broke out of a consolidation range in late May. However, sellers quickly overwhelmed the breakout, sending the market tumbling back into the consolidation range by mid-June. See Figure 1.

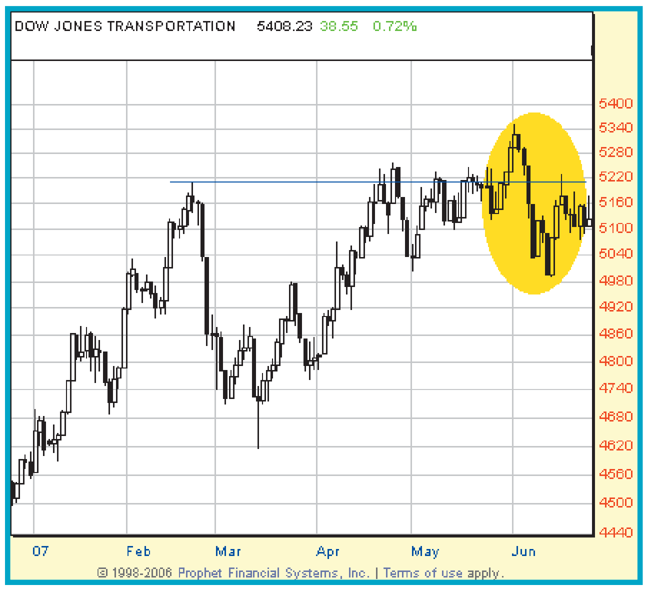



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**FIGURE 1: DOW JONES TRANSPORTATION AVERAGE, DAILY.** The breakout from the cup with handle pattern failed in the first few days of June. A lower low was created in June vis-à-vis May, warning of the potential for further weakness going forward.

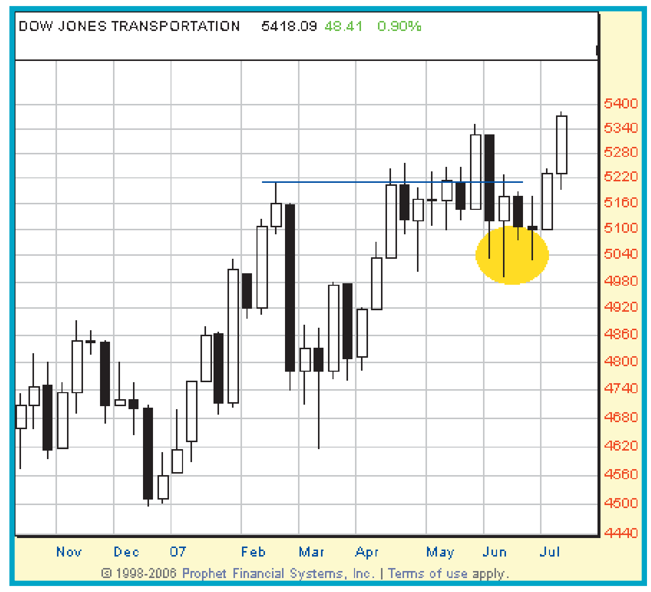


**FIGURE 2: DOW JONES TRANSPORTATION AVERAGE, WEEKLY.** The long lower shadows on the weekly candlestick lines in June suggest weakness on the part of sellers trying to push the market lower in the wake of the failed breakout in late May.

But the weekly chart reflected underlying weakness on the part of the sellers when it came to pushing the market lower, rather than merely stopping the move higher on the first attempt (Figure 2). Weekly candlestick lines in the first half of June featured long lower shadows, suggesting an inability on the part of sellers to close the market at or near the lows given key opportunities. These opportunities revealed themselves in the first, second, and third weeks of June, yet buyers, who had been beaten on the breakout, stepped up to prevent the market from breaking down.

This weakness in the weekly candlestick lines helped suggest that while the transports may not have been ready to break out, they were not yet in any mood to break down, either.

The failed breakout, pullback, and resumption in the Dow transports invalidated the cup with handle pattern, but it also seemed to create another consolidation pattern: a diamond (Figure 3). Diamond patterns, like their cousins the symmetrical triangle, serve as both continuation and reversal patterns. However, in the context of the previous cup with handle pattern (which was bullish) and the failure of the failed breakout to result in a true reversal (also bullish), technicians had reason to hope if not believe that the diamond in the Dow transports would result in a breakout to the upside.

That breakout to the upside did in fact occur. How far might it go? The width of the diamond pattern is approximately 325 points. With a breakout at approximately 5,215, this suggests an upside target near 5,540. ■


**FIGURE 3: DOW JONES TRANSPORTATION AVERAGE, DAILY.** The failed breakout and pullback in the Dow transports contributed toward the development of this diamond pattern. A breakout to the upside in early July led to new all-time highs in the transports by midmonth.

## SUGGESTED READING

Penn, David [2007]. "A Cup With Handle In Transports," Traders.com Advantage, May 31.

Traders.com ADVANTAGE™
This article was first published on 7/16/2007.
See www.Traders.com for more.

# The Dow Jones Pitchfork View

**by Gary Grosschadl**

*The Dow Jones Industrial Average has declined some 800 points from its 14,000 high. What is the next likely move?*

**Tradable:** $DJIA

The daily chart of this most-watched index shows a magnificent run from the low on this chart of 12,000 to a giddy 14,000 high (Figure 1). One less common way of showing possible support and resistance comes from the Andrews line method, also known as the Andrews pitchfork tool. With this method, three turning points are chosen (in this case, turning points 1, 2, 3) and then the chart software automatically plots the median lines representing likely support and resistance levels. One of the "rules" of pitchfork theory maintains that a move off either the upper median line or the lower median line eventually reaches the center median line.

Here we have the perfect example. Remember that this can be plotted in advance—after the turn starts at 14000. Here we see a perfect bounce attempt at this median line.

What are the possibilities going forward from here? Let's ignore the moving average lines for the moment and just consider the pitchfork itself. If this median line holds, then a bullish bias persists as this pitchfork points up. The continued rise will tend to stay between the median line and the upper median line until one of those lines is violated. Should a future test of this center median line fail, then there will be a pull toward the lower median line. The bigger picture says the uptrend is intact as long as the lower median line is not violated. Traders, being traders, will often play the anticipated moves between the three median lines.

Now let's factor in those moving average lines. The 50-day exponential moving average (EMA), the more sensitive sister of the simple moving average, held support during the major part of this rise. With it now being violated to the downside, it should be considered important overhead resistance. If this bounce off the median line is to be sustainable vs. short-lived, then the index must close above the 50-day EMA. Failure at this EMA would result in another median line test but in my mind most likely would bring about a test of the ever-important 200-day EMA currently at 12,800. Under bearish-enough conditions, should the 200-day EMA give way, then the lower median line near 12,200 could be a trading target.

Several indicators are considered. At the top of the chart, the directional movement indicator shows a bearish stance with a rising average directional index (ADX) between bearishly poised DIs (directional movement indicators). Below the chart, the moving average convergence/divergence (MACD) shows a sell signal occurring several trading days ago. The relative strength index (RSI) shows a decline from the 70 level, which fell below the 50 level. Watch this 50 level as a possible key resistance going forward.

Finally, the stochastic oscillator reminds traders that this is an oversold condition with a bounce attempt likely under way.

In summary, a bounce attempt is being made with the immediate upside test being the 50-day EMA. Failure there could bring a swing down to test the 200-day EMA. Should that occur, keep an eye on those median lines for further guidance of support and resistance. ■


**FIGURE 1: $INDU, DAILY.** This Andrews pitchfork shows a perfect bounce (so far) at the median line.

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This article was first published on 8/3/2007. See www.Traders.com for more.

# METALS & ENERGY

TREND CHANNELS

## Oil Service Stocks Test Support Of Trend Channel

**by David Penn**

*As the advance in oil prices stalls, oil service stocks move to the low end of a trend channel that has contained prices for months.*

**Tradable:** OIH, CLU7

My previous look at oil and oil stocks considered the challenge that crude oil would have in making new highs. This was in the wake of the late spring correction that saw crude oil slip from 68 to 61 (basis June).

Interestingly, oil service stocks were breaking out of an old trend channel at precisely the same time that crude oil was in a correction mode (that is, April into early May). Generally, when commodity stocks are moving higher while the commodity is correcting, traders take that for a bullish signal. Traders expect the commodity to catch up with the bullishness of the commodity stocks.

In a way, crude oil futures *did* catch up. By late May it looked increasingly as if a bottom had been formed in crude, and by mid-June, crude oil was back testing year-to-date highs.

But that test remains to be passed insofar as crude oil set new year-to-date highs only to pull back, failing to follow through to the upside. When this happens, it often signals significant weakness on the part of the bulls. Opportunities for reversal often appear in just these situations.


**FIGURE 1: OIL SERVICE HOLDRS TRUST, DAILY.** OIH developed a more aggressive uptrend in the spring of 2007 as it broke free from an initial, three-month trend channel. The new trend channel has contained OIH prices but is being tested for support late in June.


**FIGURE 2: CRUDE OIL, SEPTEMBER FUTURES, DAILY.** Crude oil futures bottomed in May, just as shares of oil service companies were accelerating to the upside. But crude oil's failure to follow through after making new year-to-date highs combines with a pullback in oil service stocks to paint an intermediate-term bearish picture for oil and oil stocks.

With crude oil finding trouble moving higher, it is of little surprise to see oil service stocks moving back down toward the lower end of its more recent trend channel. This trend channel began when oil service stocks broke out in the spring and has contained prices in the OIH ever since. The lower boundary of this trend channel was tested once in early June and now appears to be tested again at the end of the month.

There are two main ways to trade a test of trendline. The first is protrend. Buy the market and either place a stop below the trendline or decide to exit on the first close below the lower boundary of the trend channel. The second approach is to play the potential breakdown. In this scenario, you would short the first close below the lower boundary of the trend channel. With a channel height just shy of 14, a breakdown below the trend channel could take the OIH to as low as 155. ■

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This article was first published on 6/27/2007.
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CHART ANALYSIS

## Gold & Silver Index Move In Narrower Range

**by Chaitali Mohile**

*The symmetrical triangle on the $XAU chart is likely to contract the Index range.*

**Tradable:** $XAU

The Gold & Silver Index ($XAU) has been undergoing a highly volatile session since May 2006 with a high of 170. The downward journey of the index began with the negative divergence on the relative strength index (RSI) (14) against the higher high made on the price chart. The lowermost and strongest support was around 125 level, and this support was tested many times during the volatile rally.

The lower highs and higher lows further narrowed the rally, forming a symmetrical triangle on the weekly chart (Figure 1). As the triangle reaches the maturity level, the upper resistance line and the lower support will move closer, tightening the rally further. In Figure 1, the 145 level is the resistance and 135 is the support level to be observed. Trades may get trapped in this 10-point range. Below 135, the 125 level will be the major support.

The moving average convergence/divergence (MACD) (12, 26, 9) is also showing a volatile run. The indicator has been moving very close to its trigger line, but the fact that it has sustained above the zero line is a positive sign. The RSI (14) is indicating bullish strength with a support level of 50.

In Figure 2, the 134-135 level is seen as major support throughout the rally. The index in its range-bound move of 134-144 established the support level at the 200-day moving average and the 50-day moving av-


**FIGURE 1: $XAU, WEEKLY.** The symmetrical triangle formed can narrow the index movement further.

**The symmetrical triangle on Figure 1 and the trendline resistance on Figure 2 are indicating a narrow range in the Gold & Silver Index.**

erage. Currently, $XAU stands on the 50-day moving average support and is ready to move toward its upper resistance, as indicated by drawing the trendline. On the daily chart (Figure 2), the levels to be watched are 142 (resistance), the 200-day moving average as first support, and 134 as final support. The MACD (12, 26, 9) is showing a positive divergence, so some kind of bullish rally can be expected. The ultimate upper resistance of 145 in the weekly chart can be marked during the bullish rally.

Thus, the symmetrical triangle on Figure 1 and the trendline resistance on Figure 2 are indicating a narrow range in the Gold & Silver Index. The maximum 10-point range is a high-risk trade, though both indicators on the charts are bullish. ■




**FIGURE 2: $XAU, DAILY.** The positive divergence in the MACD (12, 26, 9) may result in a marginal bullish rally.

OSCILLATORS

# Is It Time To Nibble At Gold?

**by Koos van der Merwe**

*The XAU i-Share is close to thinking so.*

**Tradable:** XAU-T

Figure 1 shows the XAU with Donchian channels. (20,0). The blue and red arrows on the chart are suggested buy and sell positions. In all cases I have suggested a buy when the Donchian lower bar has been reached *and* the stochastic oscillator (8,10) is below the 20 horizontal line and has given a buy signal. A sell signal is when the upper Donchian channel is reached and the stochastic (8,10) is oversold and given a sell signal. At the moment, the i-Share does appear to be touching the lower Donchian channel, but the stochastic oscillator is not quite oversold although it does appear to be touching the 20 level. We could wait for a lower level before buying.

Figure 2 suggests that although a buy signal is close, it has not been triggered yet. My indicators used are as follows:

**a.** Superimposed on the index is a Fisher transform of the MACD of the highs. This indicator is still suggesting weakness.

**b.** Rapid RSI modified. Although the indicator is playing with the lower level, it has not yet suggested a buy signal.

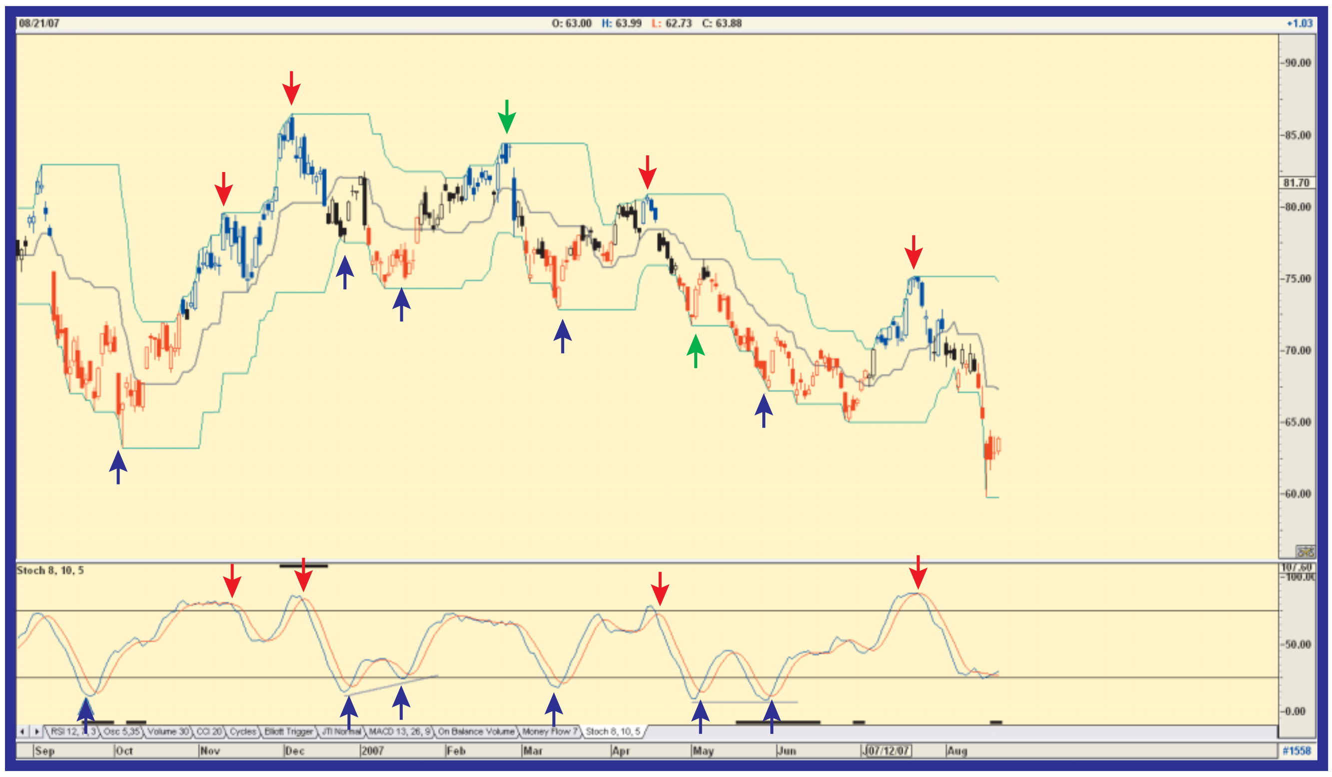
ADVANCEDGET

**FIGURE 1: XAU I-SHARE WITH DONCHIAN CHANNELS.** The blue and red arrows are suggested buy and sell positions.

**c.** The stochastic RSI is still falling.

Although the XAU i-Share looks promising, a buy signal has not been given as of yet, but it is worth watching because a signal could be triggered in the near future. Is it time to nibble at gold? Not yet, but you could taste it. ■



METASTOCK

**FIGURE 2: XAU I-SHARE WITH VARIOUS OSCILLATORS.** A buy signal may be close, but not just yet.



WEDGE FORMATIONS

# Energy Select Sector May Undergo Some More Correction

**by Chaitali Mohile**

*XLE has moved into the overbought area, and the daily price chart has formed a rising wedge. The sector is likely to witness a correction during the uptrend.*

**Tradable:** XLE

Figure 1 shows the energy sector in a strong uptrend beginning its bullish rally from as low as $60 up to $74. The 50-day exponential moving average (EMA) shows the upward path of the sector. This support was tested once at the 67 level. In addition, price retraced more than once at this level, forming a strong support, though a higher high was also made. The rally that began from the 50-day EMA support formed a rising wedge. A rising wedge in an uptrend can bring a temporary fall in the price. Sometimes, this formation can be a continuation pattern as well. In the daily chart in Figure 1, the sector has already begun its down journey, confirming the formation to be a reversal. As a result, the price is likely to retrace to its low pivot. The volume shows a more volatile move than the price throughout the rally.

The stochastic (14, 3, 3) is in an overbought area, which has added pressure on the price correction. This indicator can move flat at the overbought level and carry on the bullish rally. But on the daily chart, the stochastic (14, 3, 3) failed to move flat, thus indicating the weakness in the bullish rally. The moving average convergence/divergence (MACD) (12, 26, 9) has tipped down, so it may retrace to its trigger line support. The average directional movement index (ADX) (14) indicates a developing uptrend with reducing bullish pressure and a weak bearish pressure. As a result, the uptrend could sustain, even though price may witness some correction.

The sector has already moved down $2 from the $74 level. Therefore, the 50-day exponential moving average

(EMA) will be an important support level for this correction. A serious correction is not expected on this formation, but the lowest support of $67 should be observed.

In 2007, the Energy Select Sector SPDR (XLE) bottomed out in the range of 54-60. The 54 level was a support level and the 60 level was a very strong resistance, which pulled the price as low as $50 in 2006. As a result, violating this resistance required heavy volume and strong indicator support. Accordingly, the stochastic (14, 3, 3) offered good buying opportunity at the 20 level. The MACD (12, 26, 9) also had a bullish crossover, and the average directional movement index (ADX) (14) pulled up, with the positive directional index (+DI) gaining the trend strength. Thereafter, the ADX (14) moved steeply upward, indicating a good developing uptrend.

The upward rally from 60 gave a handsome profit of $14 to traders. As a trader, I would be more watchful at this current level, as the extended rally from $68 to $74 is more volatile than the previous one. In addition, the stochastic (14, 3, 3) is highly overbought


**FIGURE 1: XLE, DAILY.** The rising wedge can make price retrace to its low pivot, but the existing uptrend will


**FIGURE 2: XLE, WEEKLY.** The flat stochastic is likely to take a dip for creating space for a bullish rally. As a result, the price may undergo some correction.

at 91 level and has moved flat for a longer period, so the indicator can correct to create some space for the upward rally (Figure 2). The other two indicators are very positive and support the upgoing rally.

To conclude, I expect a smaller correction in the XLE with respect to the rising wedge and indicators on both time frames. ■

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This article was first published on 7/23/2007.
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REVERSAL

# Barrick Gold's 2B Top

**by David Penn**

*Look, Ma, no indicators! How resistance, new highs, and a failure to follow through helped traders trade the top in ABX.*

**Tradable:** ABX

I've said before that one of the most helpful things a trader can do is spend some time looking at price charts without technical indicators. I love my technical indicators as much as the next market technician. But it is often refreshing to be reminded that technical indicators are tools to assist the analysis, not to replace it.

I was listening the other day to Peter Schiff of Euro Pacific Capital make the case for gold, if not gold stocks. In noting that some gold stocks had held up relatively well, Schiff pointed to Barrick Gold (ABX) as an example of a gold stock that was making "new 52-week highs as recently as last week." Not having paid much attention to Barrick Gold, I decided to take a look.

That excursion into 52-week-high territory provided an excellent example of one of my favorite technical trading setups: the 2B. Found here as a market is making a top, the 2B is, as trader Victor Sperandeo wrote, one of the best ways to catch a change in trend — or even a profitable correction — as early in the change as possible.

Note how Barrick Gold (ABX) rallied from late June into early July in a near-vertical path en route to new 52-week highs (Figure 1). The stock pulled back sharply before vaulting higher again in late July going into August. The second advance notched an intraday new high, but by the close, the market had fallen back. This created the opportunity for a 2B top. If the market for Barrick Gold failed to continue moving higher and, instead, reversed and closed below the low of the 2B pattern (which includes the lows of both the initial and the second new high), then a 2B top would be in effect. Traders who had been long going into the 2B would have the warning they need to reduce their exposure. More aggressive traders would now have their signal to get short.

The confirmation came swiftly as the market following the second new high closed below the lows of the previous two new-highs sessions. That close was a confirming close for the shorts, who would have been able to take positions against Barrick Gold as of the end of day on that session (August 13 at 33.59).


**FIGURE 1: BARRICK GOLD, DAILY.** A month-on-month 2B top in ABX signaled a sharp correction in mid-August. The highlighted oval represents the confirming close for those taking short positions.

I like to look at these trades through the lens of an option buyer since I do not trade common stock. As of the close on August 13, the September 32.50 calls were trading at about 1.00, while the September 30 calls were trading at 0.35 (although it is often not recommended, I still tend toward out-of-the-money options). The 32.50 level represented an area I believed ABX had to fall to if the 2B top was legitimate. The 30 level represented an area I believed Barrick Gold could fall to based on the distance from the top near 35 to the mid-July, intrapeak low just south of 32.

Barrick Gold fell apart almost immediately. By the morning of the third day after the confirmed short on August 13, the stock was in free fall. This day turned out to be a selling climax (note the volume), and the long lower shadow on the candlestick line on August 16 shows that the bearish momentum was evaporating as the market moved into the close.

This kind of candlestick pattern is a loud signal for traders on the short side to begin reducing exposure. Sure enough, within days Barrick Gold was moving almost vertically back up as short-side traders who had overstayed their welcome rushed to cover.

How did the options plays turn out? As of the close on August 16, the September 32.50 calls had gone from 1.00 to 3.00, with an intraday print on the 16th as high as 3.80. The September calls had gone from 0.35 to 1.60, with an intraday print on August 16 as high as 2.00. ■

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This article was first published on 8/27/2007.
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SECTORS

BOND & INTEREST RATE

# Negative Divergences And The Bond Bounce

by David Penn

*Lower peaks in the MACD histogram accompany the advance in the September Treasury note.*

**Tradable:** TYU7

The specter of rising long-term interest rates reached an apogee in the first half of June, as the yield on the 10-year Treasury note surged from less than 4.6 to more than 5.25 in a month. That surge is reflected in the hourly chart of the September 10-year Treasury note in Figure 1.

The moving average convergence/divergence (MACD) histogram has already provided some helpful guidance for traders on the hourly chart. The bottom was anticipated by a positive divergence, and the massive size of the histogram that develops after the positive divergence is a strong signal that prices will continue to move higher.

That initial "massive" histogram peak itself featured a very short-term negative divergence from the beginning of the peak to its later stages. The market was sensitive to this divergence as well, as the September T-note dipped below the 20-period exponential moving average (EMA) before moving higher and resuming the rally.

But the negative divergences in the MACD histogram continue to mount, which makes the rally more susceptible to reversal or, at a minimum, sideways correction. The critical support level is at 104.5. A close below this level would create a lower low, signifying if not a new downtrend, then at least the conclusion of the uptrend for the time being. ■

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This article was first published on 6/29/2007. See www.Traders.com for more.


**FIGURE 1: US TREASURY NOTE, SEPTEMBER FUTURES, HOURLY.** The bounce in bonds that began in the first half of June is increasingly characterized by shorter and shorter peaks in the MACD histogram. This suggests that the move higher is losing momentum to the upside and is ripe for correction.

CHANNEL LINES

# Long-Term Rates Run Into Resistance

**by Arthur Hill**

*Long-term rates have been rising for four and a half years, but that may be about to change as major resistance comes into play and a large double top takes shape.*

**Tradable:** $TNX

The long-term chart shows the 10-year Treasury note yield ($TNX) over the last 30 years (Figure 1). Before getting into the analysis, remember that bonds move opposite of interest rates, and the reverse of this analysis can be applied to bonds. The big trend is clearly down for rates with a large falling price channel that extends back to 1981. The advance over the last few years carried rates from the lower trendline to the upper one. In fact, TNX pierced the upper trendline twice over the last 12 months but failed to hold above and complete a breakout. This upper channel line represents resistance and a big downtrend.

In addition to the upper channel trendline, we also have resistance from broken support around 5.25% (52.5 on the chart). TNX hit support here in September 2003 and December 1995. After the breakdown, the 10-year T-note yield hit resistance in this area three times (March 2002, July 2006, and June 2007). Taken together, there is stiff resistance around 5.25-5.50% (52.5-55) and a break above 5.50% is needed to reassert the uptrend.

Turning to a shorter time frame (eight years), we can see a rising wedge evolving over the last four and a half years (Figure 2). The advance retraced 62% of the prior decline and met resistance below 5.5% twice. The decline over the last few weeks carried the 10-year T-note yield to trendline support, and a big test is at hand. A trendline break and move below the December 2006 low (red arrow) would reverse this uptrend and call for a continuation lower.

In addition to the rising wedge, there is also a double top brewing over the last 18 months. Yes, these are big patterns that relate to the big picture. Double-top support is at 4.4% (44) and a break below this level would confirm the pattern. The downside projection would be to around 3.5%. The length of the pattern is subtracted from the break for a target.

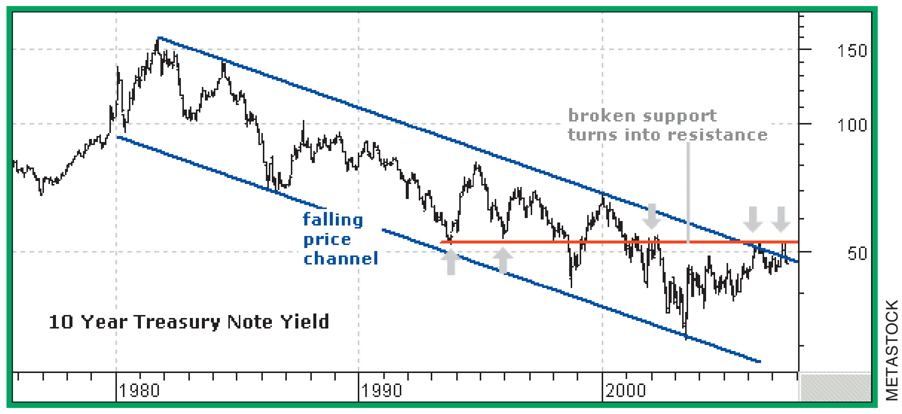


**FIGURE 1: 10-YEAR TREASURY NOTE YIELD, LONG-TERM.** The big trend is clearly down for rates with a large falling price channel that extends back to 1981.

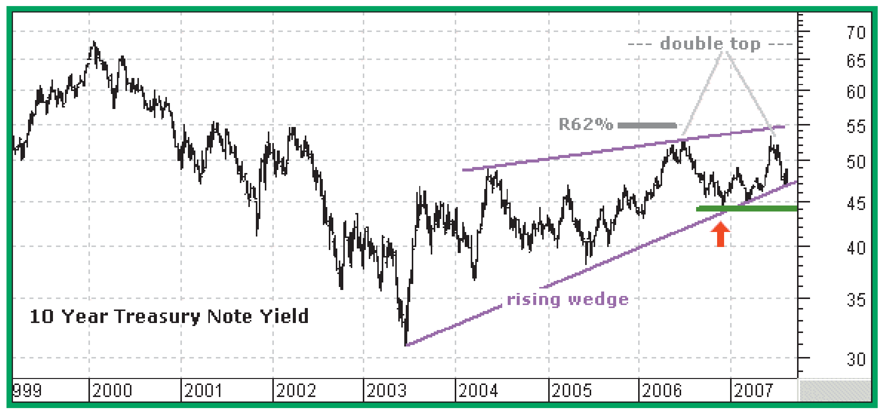


**FIGURE 2: 10-YEAR TREASURY NOTE YIELD, 1999–2007.** Here's a rising wedge evolving over the last four and a half years.



TRIANGLES

# Transports Stall Near Support Break

**by Arthur Hill**

*After breaking support with the sharp decline, the Dow transports stalled over the last seven days, and it looks like a continuation pattern is forming.*

**Tradable:** $DJT

On the daily chart (Figure 1), the Dow transports surged to a new high in mid-July but came down just as fast with a sharp decline at end of the month. The decline broke support from the May-June lows and the average stalled around this support break. There is also support around 4950 from the 200-day moving average.

Despite the ability to firm around support, the technical damage has already been done. The average forged a lower low in August and the 50-day moving average turned down. A rising or flat moving average would indicate a current uptrend. However, a falling moving average suggests that a downtrend has started and this favors further downside.

Turning to the 60-minute chart, we can focus on the current consolidation for the next signal (Figure 2). The average formed a triangle over the last seven days with support at 4870 and resistance at 5050. This

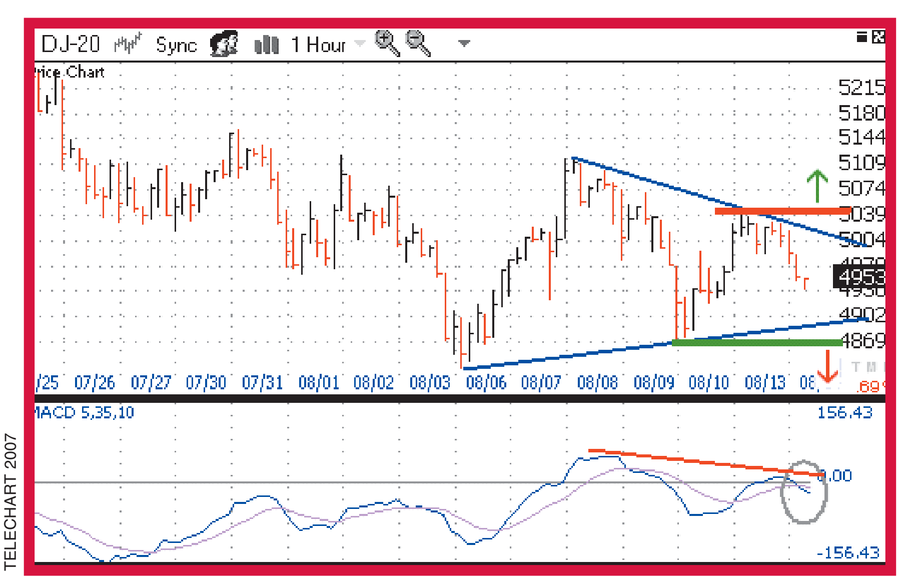


**FIGURE 1: DJTA, DAILY.** The Dow transports surged to a new high in mid-July, but came down just as fast with a sharp decline at the end of the month.

pattern would look like a pennant on the daily chart. Triangles are neutral patterns and pennants are continuation patterns. I am looking for a triangle break for the next signal. A move above 5050 would break triangle resistance and keep the bulls alive. A move below 4870 would break triangle support and argue for a continuation of the July-August decline. The downside target would be support from the March lows.

I am also showing moving average convergence/divergence (MACD) on the 60-minute chart and momentum is turning lower. The indicator formed a lower high this week and moved back into negative territory on Tuesday. Short-term momentum is breaking down again and this also favors a support break at 4870. ■

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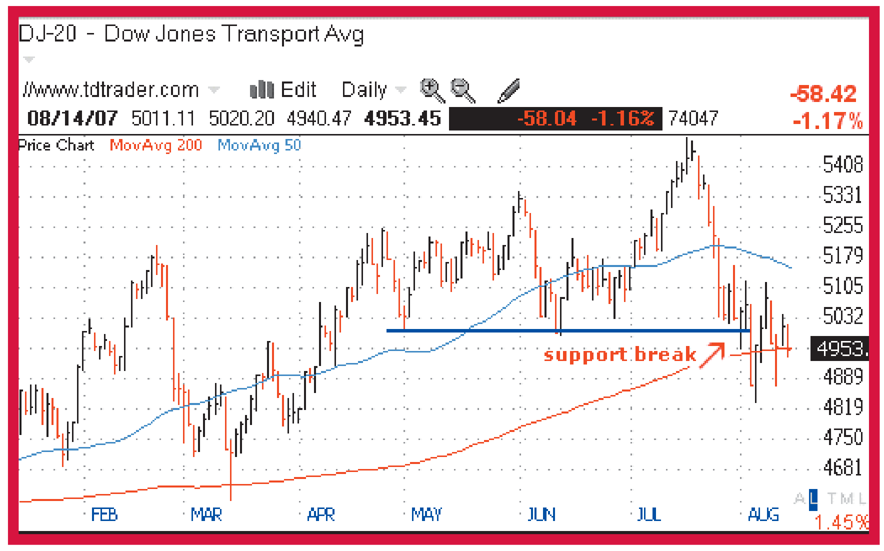


**FIGURE 2: DJTA, HOURLY.** The DJTA formed a triangle over the last seven days with support at 4870 and resistance at 5050.

REVERSAL

# Divergences And The Dow Jones Utilities Index

**by David Penn**

*Positive divergences in the second half of July helped create a bottom in the falling DJUA.*

**Tradable:** DJUA, $UTIL

The Dow Jones Utilities Average (DJUA) topped in the spring of 2007 near 535. From that high in mid-May, the DJUA fell to about 485 by the second half of June before bouncing to a high just north of 520 by mid-July.

Since then, the DJUA has slipped back into correction mode, creating a new low for the decline as it failed to take out the May high and, instead, took out the June lows in ferocious fashion in the second half of July (Figure 1).

The utilities have been in rally mode ever since, moving higher in a nearly vertical advance that as of this writing has retraced just short of 50% of the late July decline. The bottom that made the rally possible was telegraphed fairly clearly by the moving average convergence/divergence histogram (MACDH). But you had to be looking at the hourly charts in order to spot it. See Figure 2.

The MACDH began making a series of higher lows in the hourly charts on July 26 and did so again on July 30 while the DJUA was continuing to move lower. The hourly charts also reveal the key moment when momentum to the downside ran out for the bears and gave bulls an opening to push prices back up. That moment was a morning star candlestick pattern on July 30, which coincided perfectly with the second higher low in the MACDH and a clear positive divergence. Confirmation of the morning star pattern came immediately with an hourly close above the high of the pattern.

Since reversing, the DJUA has retraced nearly 50% of its decline from the highs of mid-July. In doing so, the index has begun creating new divergences at the hourly level. These divergences, in contrast to the earlier ones, are negative or bearish divergences. Note how as the DJUA advances, the peaks in the MACDH grow smaller. While this is often the case in newly advancing markets, the shrinking MACDH is a warning to traders that momentum to the upside is waning and that the chances of a correction to this bounce are increasing. ■

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This article was first published on 8/6/2007.
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**FIGURE 1: DOW JONES UTILITIES INDEX, HOURLY.** Divergences early in the second half of July helped traders anticipate this bottom in the utilities average. Note also the morning star pattern that appears at precisely the moment when the market reverses.


**FIGURE 2: DOW JONES UTILITIES INDEX, HOURLY.** As the utilities average climbs toward a 50% retracement of its late July correction, negative divergences begin to appear in the MACD histogram. While the DJUA is likely to continue moving higher in the near term, momentum to the upside is clearly growing weaker.

STOCHASTIC OSCILLATOR

# Dow Jones Basic Materials Hits Support

**by Arthur Hill**

*The Dow Jones Basic Materials Index led the market lower last week, but traders should be on guard for a bounce as the index is now oversold and at support.*

**Tradable:** $DJUSBM

On the daily chart (Figure 1), the Dow Jones Basic Materials Index ($DJUSBM) declined around 6% in the last six days and has become oversold for the first time since March. My oversold assessment is based on the stochastic oscillator, which moved below 20 for the first time since March. The index also suffered a sharp decline in late February and bottomed in the first half of March. The indicator should be considered both oversold and bearish as long as it remains below its signal line (magenta line). The signal line is called %D and it represents a three-period exponential moving average (EMA) of the stochastic oscillator, which is called %K. A break above %D would signal the first upturn in the indicator.

**In addition to being oversold, the index is trading near a support zone that extends back to early May.**

In addition to being oversold, the index is trading near a support zone that extends back to early May. DJUSBM bounced off support at 270 at least four times in the last three months and the index is once again testing this support level. A break below this support zone would forge a lower low and reverse the medium-term uptrend. For now, the support zone is holding and traders should prepare for an oversold bounce.

While an oversold bounce is possible at support, I am turning to the 60-minute chart for some evidence of strength and a short-term breakout (Figure 2). The index is clearly trending lower on this chart and remains below the trendline extending down from July 24. In addition, the stochastic oscillator is fluctuating between zero and 20, which is oversold territory. I am looking for a breakout in both the stochastic oscillator and the price. A move above 277 would break the trendline, forge a higher high, and reverse the downtrend on the price chart. I would also confirm this with a momentum breakout in the stochastic oscillator. The indicator hit resistance at 45 last week and a move back above 50 would turn short-term momentum bullish.

The initial upside target would be broken support around 285. On the 60-minute chart, the index broke support at 285 last week (red circle). This area now turns into resistance and an upside target zone. On the daily chart, this target area also corresponds with resistance from the June highs. The index was turned back at this level in early and mid-June. ■

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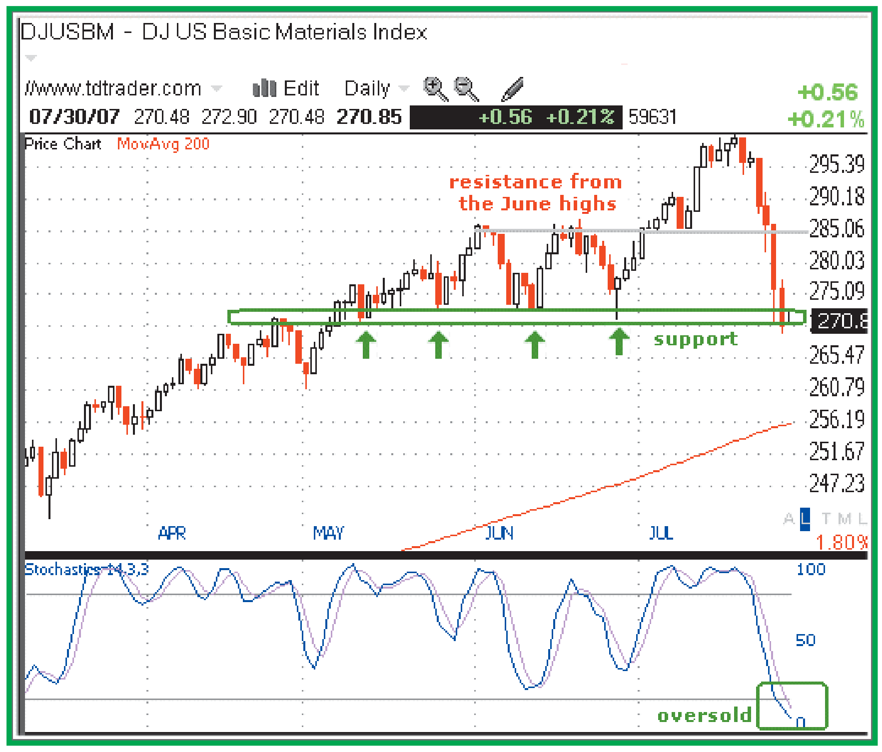



**FIGURE 1: DJ BASIC MATERIALS, DAILY.** The index declined around 6% the last six days and has become oversold for the first time since March.

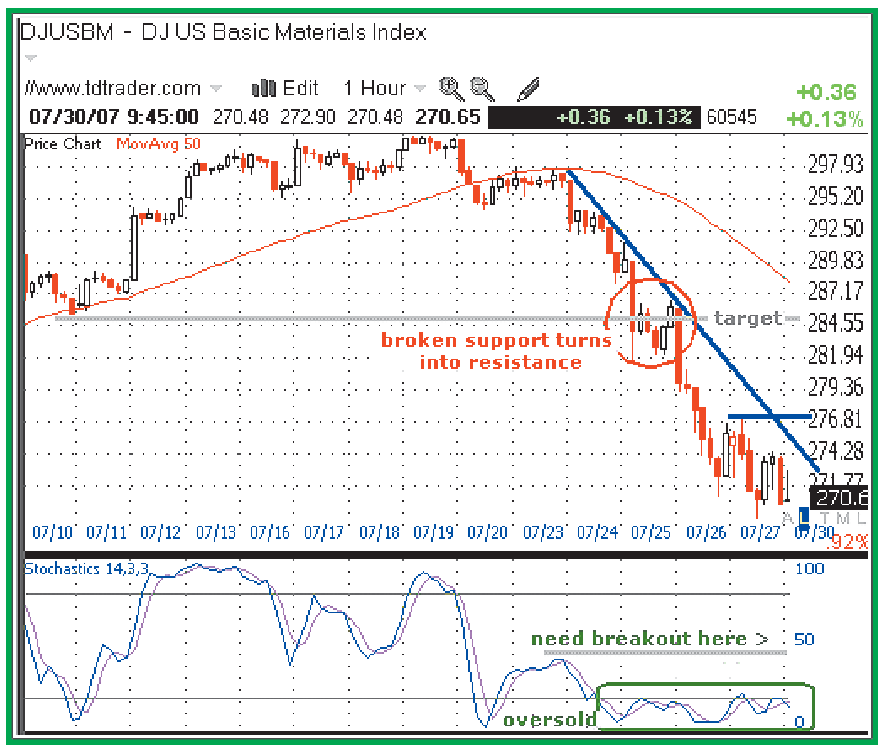



**FIGURE 2: DJ BASIC MATERIALS, 60-MINUTE.** Some evidence of strength and a short-term breakout can be seen.



SUPPORT & RESISTANCE

# December Bonds Drive Into Resistance

**by David Penn**

*Negative divergences develop as the 10-year Treasury nears contract highs.*

**Tradable:** TYZ7

Late in July, I wrote about the reversal patterns — including "dark cloud cover" — that were appearing in the charts of the September 10-year Treasury bond futures contract ("Dark Cloud Cover Caps Bond Rally," July 30, 2007). "Dark cloud cover" is a Japanese candlestick pattern that develops during uptrends and signals waning momentum to the upside (Figure 1). After a series of rising candlestick lines, a market will open up but close down, so far down in fact that it penetrates 50% or more of the real body of the previous candlestick line. That phenomenon is called "dark cloud cover."

At least initially, dark cloud cover is more a warning to bulls than it is an opportunity for the bears. All the dark cloud cover pattern reflects is simply waning bullish momentum. Only when the market actually reverses by closing below the low of both the dark cloud cover session and the session that is being "covered" can traders consider the dark cloud cover pattern confirmed as a reversal pattern and suitable for trading to the short side.

This rule, unfortunately, would not have kept traders out of the clearest, dark cloud cover short trade in September T-note futures, the dark cloud cover of August 6 that was confirmed as shortable on August 8. September futures reacted strongly to the market's test of the 50-day exponential moving average (EMA), with buyers stepping in to bid prices higher and turning a dark cloud cover short into a pivot low at support. The move from that test of support brought September T-note futures from just above 107 to more than 109 in less than 10 days.

The advance in bonds, however, has brought that market right up to what appears to be a significant resistance level at 109. This potential resistance level coincides with the March 2007 highs in T-note futures and, understandably, the market has started showing the sort of fatigue that often accompanies tests of new highs. In particular, while the market for T-note futures remains overbought (basis December), reflecting an abundance of buying interest, the market has begun to develop negative divergences in both the MACD histogram and the stochastic.

As was the case with the candlestick reversal patterns, divergences serve first as a warning to those who were following the trend that the divergence appears to challenge. So again, these divergences are foremost a warning to T-note bulls to reduce their exposure to the market. However, should the market in fact reverse and close lower, particularly below 107.75 or so, then T-note bears may once again have an opportunity to make reasonable bets that bonds will be priced lower in the near term. ■

## SUGGESTED READING

Penn, David [2007]. "Dark Cloud Cover Caps Bond Rally," Traders.com Advantage, July 30.


**FIGURE 1: 10-YEAR TREASURY NOTE, DECEMBER FUTURES, DAILY.** Negative divergences in both the MACD histogram and the stochastic serve as a warning of waning momentum to the upside just as December T-note futures test resistance at the March highs.



BREAKOUTS

# Breakout In Computer Technology Index

by Chaitali Mohile

*The Computer Technology Index surged above resistance, targeting its old highs.*

**Tradable:** $XCI

The Computer Technology Index ($XCI) has been underperforming the last three to four years. Since mid-2006, some slow recovery has been seen, offering some trading opportunities in the short term. The index follows along with the pullback rally in the entire market. $ XCI made a high of 925 before the plummet in financial markets on credit issues. Now, the index has turned positive on a short-term basis. The hourly chart (Figure 1) has already moved ahead of the 200-day exponential moving average (EMA) with the bullish support of indicators. The relative strength index (RSI) (14) is overbought at the 75 level. This indicator can remain overbought for longer periods. Thus, the RSI (14) at the present level indicates a bullish rally ahead.

The average directional movement index (ADX) (14) is at 29, indicating a developed uptrend. The uptrend can continue as the indicator is considered overheated only above 40. The moving average convergence/divergence (MACD) (12,26,9) is positive as well. In addition, the 50-day EMA is ready for an upside journey and the 200-day EMA is tipped downward. The moving averages may have a bullish crossover but this crossover is yet to happen. Hence, traders can just watch this crossover and trade according to the confirmed indication. Thus on an intraday basis, traders can go long with a target of 895, which is the first intraday resistance above the 200-day EMA with a stop-loss of a 200-day EMA support.


**FIGURE 1: $XCI, HOURLY.** The breakout here has first resistance of a previous high at the 895 level. This resistance will be the first intraday target on this breakout.


**FIGURE 2: $XCI, DAILY.** The 50-day EMA has offered strong support to the breakout on the daily chart. The breakout is on its way to previous high resistances.

In Figure 2, the bullish rally began at the 840 level. The candles with long shadows moved below the 200-day EMA support but closed at 840. The upside rally had gained about $42 by closing above the 50-day EMA. Now this moving average will be strong support for this upward move. The rally would have a first target of $900 and then the highest pivot of 925 would be the final target on this level according to Figure 2.

The RSI (14) at 55 shows fresh buying opportunity and indicates bullish strength in the rally. The ADX (14) at 24 indicates a developing uptrend with the possibility of an increase in buying pressure in the coming session while sellers' pressure is diminishing. The MACD (12,26,9) is striving for a bullish crossover (with confirmation necessary) in the negative area, but the histogram is giving an advance bullish indication by moving above its zero line.

Hence, traders can get a good long trade with a breakout above the 50-day EMA with a target of previous highs. ■

# CURRENCIES

REVERSAL

## USD/CHF: Positive Divergences And Hammer Candlestick Lines

**by David Penn**

*"I'm not dead yet!" cried the greenback, as divergences and reversal patterns hint at a bottom.*

**Tradable:** USDCHF

Market technicians like me who have been looking for a bottom in the US dollar have resembled little more than those who, as early as 1998, began looking for a secular top in the stock market.

Perhaps like those seers of the late 1990s, dollar bulls will be proven "late but correct." While some of the smartest people around like Peter Schiff of Euro Pacific Capital (and author of *Crash Proof: How To Profit From The Coming Economic Collapse*) believe the dollar could collapse any day, other no-less-bright minds such as Tim Wood of *Cycles, News and Views* suggest that the support the dollar has found near the 80 level in the US Dollar Index should provide some caution for those who believe the ultimate breakdown in the dollar is imminent.

Most recently, the US dollar/Swiss franc currency pair seems to have sided with Wood. I say this because a number of bullish — or at least "counterbearish" — developments have appeared in the daily charts of the USD/CHF. Whether these developments embolden greenback bulls or merely warn greenback bears remains to be seen. But it does appear that the USD/CHF pair has become worth watching — again.

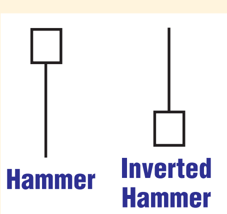
First up is the growing positive divergence, now in evidence in both the moving average convergence/divergence histogram (MACDH) as well as the stochastic (Figure 1). The low point of the MACDH came in early July, at a time when the USD/CHF still had at least another 200 points' worth of downside. The low point in the stochastic arrived a little later, but also in the first half of the month when the currency pair was still making lower lows.

These positive divergences have been helped tremendously by the appearance of a hammer candlestick in early August. While the positive divergence reflects waning downside momentum, the hammer candlestick not only underscores that weakness on the part of bears, but also reveals through the pattern of its real body and shadow of the session when that weakness became clear to all observers. All that is required to confirm the hammer candlestick as a reversal pattern is a close above the high of the pattern. The fact that the MACDH is ticking up in a bullish PpP pattern is further supportive to the bull case. ■


**FIGURE 1: US DOLLAR/SWISS FRANC (USD/CHF), DAILY.** Positive divergences in the MACDH and the stochastic combine with a hammer candlestick line to suggest an opportunity to the upside in the greenback/swissy pair.

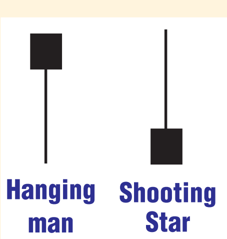


### SIGNIFICANT CANDLESTICK PATTERNS



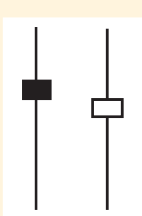

**BULLISH HAMMER & INVERTED HAMMER**

A bottom reversal pattern characterized by a long lower shadow and a small body. The body can be either color, but white bodies are considered more significant.




**BEARISH HANGING MAN & SHOOTING STAR**

These bearish counterparts of the bullish hammer formations occur in uptrends and forecast a reversal. They are the same formation, only appearing near the top of an upward trend.



**SPINNING TOP**

This is considered a neutral pattern that occurs during a consolidation period. The significance is in the small body rather than the length of either shadow. Why even bring it up? Because it confirms the continuation of the trading range and perhaps serves as a summation of the day's trading activities.

*—Sharon Yamanaka*

CANDLESTICK CHARTING

# Belt Holds Bolster The Dollar

by David Penn

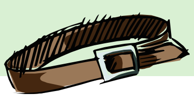
*A pair of bullish belt hold patterns in the greenback suggest near-term strength.*

**Tradable:** DXU7

When I first saw the reversal pattern developing in the September US dollar, I wanted desperately for the pattern to be a morning star.

But the first leg of a morning star pattern needs to be a down candlestick line. The market needs to fall into a morning star, with a bearish session leading to a gap down neutral session, which is then followed by a clearly bullish session. Unfortunately for me, the initial candlestick line of the would-be morning star was bullish, rather than bearish, as the market gapped down but finished significantly higher during that session.

**The bullish belt hold pattern occurs when a market opens at or very near the lows and finishes near the highs of the session.**



So even though the rest of the pattern, the other two-thirds, very much resembled a morning star reversal pattern, I was forced to look elsewhere for the proper descriptor of this obviously significant — and potentially significantly bullish — development.

Fortunately, there aren't too many candlestick patterns that have escaped the analysis of Steve Nison, author of *Japanese Candlestick Charting Techniques* and *Beyond Candlesticks*. On closer observation, and a few minutes of consultation with Nison's first book, I realized that the bottoming pattern in the September dollar actually consisted of a number of patterns. And two of those patterns were the less-often-discussed *bullish belt hold*. (See Figure 1.)

The bullish belt hold pattern occurs when a market opens at or very near the lows and finishes near the highs of the session. In addition, bullish belt hold patterns are long lines and reflect an impressive range as buyers bid prices higher over the course of the session.

As is the case with all Japanese candlestick patterns, context is critical. A bullish belt hold pattern appears as a reversal pattern only when it has something to reverse, such as a mature downtrend or a short-term correction in an overall uptrend.

Here, the bullish belt holds develop at the end of a mature downtrend in the September greenback. The first one is what I had wished would be the initial leg of the morning star. The second, a larger, arguably more convincing bullish belt hold appears two days later and a third, two days later still.

Trading rules allow for positions as soon as there is a confirming close. By a confirming close — and, moreover, a bullish confirming close in this case — I mean a close that is above the high of the highest point in the pattern. In the case of a bullish belt hold, that would mean a close above the high point of that single candlestick line. ■

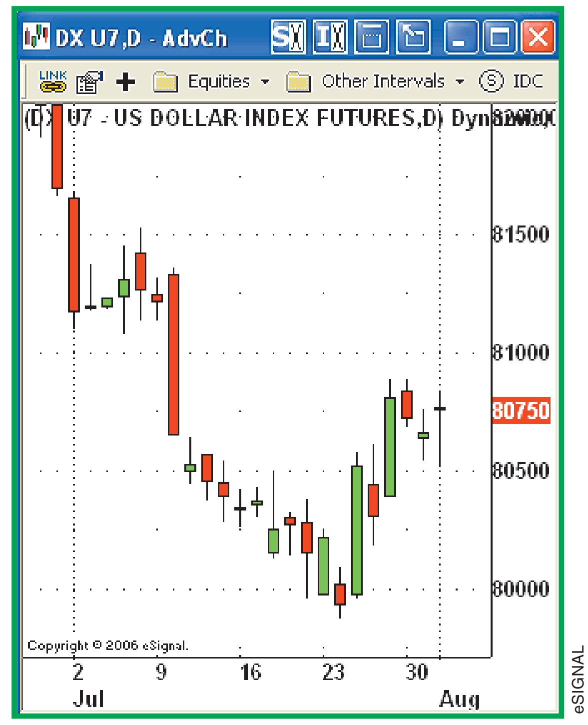



**FIGURE 1: US DOLLAR INDEX, SEPTEMBER FUTURES, DAILY.** Three bullish belt hold patterns appear in the second half of June, stemming the dollar's descent and signaling higher prices in the near term.



CANDLESTICK CHARTING

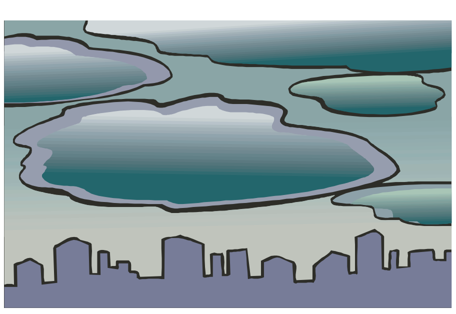
# Dollar Dark Cloud Cover

by David Penn

*A classic bearish reversal pattern in the second half of June put an end to the rally in the September greenback.*

**Tradable:** DXU7

You will find few technicians who have been as desperate for a bottom in the dollar than yours truly. And, if truth be told, I still think there is as much a chance of the dollar making a bear market rally



(especially if interest rates rise) as there is of the dollar collapsing.

But you have to know when to fold 'em, and for dollar bulls — a battered lot, to be sure — folding time came in the second half of June.

The spring rally in the dollar brought the market from 81 to 82.5 (basis September) from the low in late April to the high in mid-June. In doing so, the dollar retraced just over 50% of its decline from the year-to-date highs in January near 84.5.

In mid-June, the dollar was nearing a source of potential resistance just north of 82.5, resistance left over from a short-term bounce in late March.

The market opened up well above the resistance level, suggesting initially that buyers were ready to take the market higher. But sellers immediately overwhelmed the market, driving it lower by the close to the point where the lows of the previous day were almost taken out.

This reaction on the part of sellers created what Japanese candlestick chartists call "dark cloud cover" (Figure 1). When, in a rally, a market opens higher but then closes lower, penetrating the range of the previous day by 50% or more, that market is called "dark cloud cover." It suggests that the momentum to the upside has been exhausted, and that the market is increasingly vulnerable to reversal.

The key is *vulnerable to reversal*. The only guarantee with dark cloud cover is that upside momentum has stalled. Only when the market in fact reverses, closing below the low of the dark cloud cover pattern, is the reversal confirmed and the market safe for selling.


**FIGURE 1: US DOLLAR INDEX, SEPTEMBER FUTURES, WEEKLY.** The follow-through to the downside helps turn this dark cloud cover pattern in the second half of June into a true reversal pattern.

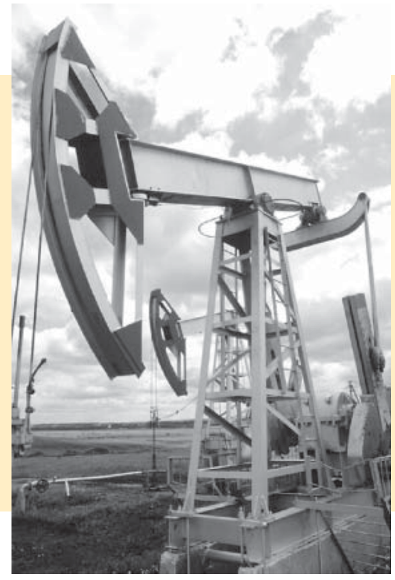
By "dark cloud cover pattern," I mean both the "dark cloud" candlestick and the candlestick that is being "overshadowed." The dark cloud cover developed in the September dollar as of the third week of June. That was the warning to the bulls. The fourth week of June represented confirmation for those looking to sell the dollar that the seven-week bounce from mid-April was over.

Two weeks later, the dollar broke down to new lows on a weekly closing basis. ■

THE OPTIMIZED TRADER

# TRIX Two Ways

## *Part II*



**by David Penn**

*Trading divergences, golden crosses, and falls with the classic momentum indicator. Installment 2 of two.*

My last discussion on the TRIX or triple-smoothed exponential oscillator covered two of its popular applications: bullish and bearish crossovers involving the zero line, and "hooks" when the TRIX curled up or down. Crossovers, generally speaking, provide particularly valuable signals on the intermediate level. Hooks tend to be most effective for catching short-term shifts in market momentum.

There are two other important ways that momentum traders can use the TRIX. The first involves positive and negative divergences, while the second involves using a second line, a signal line that is a derivative of the TRIX, in order to spot key patterns that signal growing or waning momentum.

Divergences are a fairly common topic, so let's begin with TRIX divergences. As with divergences in other momentum indicators like the relative strength index (RSI), stochastics, or the moving average convergence/divergence histogram (MACDH), divergences in the TRIX occur when the indicator fails to track price action when higher highs and lower lows are made. Specifically, when a market makes a higher high and the TRIX makes a lower high, then a divergence, a negative divergence, has occurred. When a market makes a lower low and the TRIX makes a higher low, then a positive divergence has occurred.

There are other divergence patterns, many of which I described in an article for *Working-Money.com* last year ("Dial %91D' For Divergences," *Working-Money.com*, March 8, 2006). But for now, let's stick with the basic, most common, positive and negative divergence scenarios.


**FIGURE 1: CRUDE OIL, SEPTEMBER FUTURES, DAILY.** A month-to-month negative divergence in the TRIX from early July to early August signaled waning upside momentum as crude oil soared higher in midsummer.

Note the chart of September crude oil futures in the summer of 2007 in Figure 1. After sideways trading for much of the spring, crude oil futures broke out in early July, rallying $8 per barrel from the beginning of the month to the end. As an aside, the consolidation pattern in the spring, from April to late June, measured approximately $7 at its widest point. Breaking out at approximately $70, September crude did an excellent job of reaching its price projection based on the width of the consolidation that preceded the breakout.

In any event, as September crude rallied higher in July, the TRIX indicator began to lag, creating lower highs at the same time that crude oil was creating higher highs. This is the pattern of a negative divergence in the TRIX.

I've come to believe that these sort of negative divergences at the tops of markets are more news for bulls than they are for bears. Advancing markets often make a number of negative divergences before they reach their ultimate peak. Negative divergences serve most effectively as warnings that upside momentum is waning. That is not the same thing as a sell signal, though many traders will treat it as such.

That doesn't mean that negative divergences cannot be sold. It simply means that a negative divergence in and of itself is not necessarily the best reason to take a new position against that particular market. It is, however, a good reason for someone who is long a market that develops a negative divergence to consider taking profits or reducing risk exposure in the event that the negative divergence does turn out to mark a larger correction or even outright reversal.

Let's look at an example of a positive TRIX divergence (Figure 2).

Here we have a market in bearish mode, with lower lows going into and through June. However, as August gold was making lower lows in late June, the TRIX was making higher lows. This is a classic positive, or bullish, divergence. Note also how the TRIX crosses above the zero line shortly after the positive divergence, a bullish sign that further supports the case for higher prices in gold. After a brief, post-positive divergence pullback in the first few days of July, August gold is on the move higher, rallying from a late June low near 644 to a late July high of more than 684.

I'll say again that I tend to look at divergences initially as a warning to those with positions in the direction of the trend that has just been challenged by the divergence. For those who trade divergences as reversals, however, there are some helpful rules to make the most out of such trades. First, the low point of a positive divergence or the high point of a negative divergence needs to be the *Amityville Horror* "Get Out!" point. As I mentioned, trending markets will create multiple divergences en route to their ultimate tops or bottoms. One way to avoid getting killed trying to fade these trends by betting on the divergences is to make sure that there is a clear tap-out point.


**FIGURE 2: GOLD, AUGUST FUTURES, DAILY.** The failure of the TRIX to make a lower low in the second half of June when August gold did was a sign that bearish momentum was waning and that an opportunity to the upside existed for August gold.

As such, trading divergences means giving markets a great deal of wiggle room — at least in the beginning. Note how the gold market in Figure 2 bounced immediately after the positive divergence to north of 660, but then pulled back to as low as 648. A stop that was too tight would have prevented a trader from exploiting the true value of the positive divergence, which was the larger move that unfolded over the course of July. Again, when divergences are successful, they are often intermediate-term developments (that is, a month or more on the daily charts). A wider than usual stop, particularly in the beginning, can help a trader take maximum advantage of this.

## CROSSES AND FALLS

The last technique I want to show involving the TRIX includes the use of a signal line. This particular implementation of the TRIX comes courtesy of Tim Knight, founder of Prophet Financial Systems and author of *Chart Your Way To Profits*. The idea of a signal line with the TRIX is the same as signal lines with other momentum indicators such as the stochastic and the moving average convergence/divergence (MACD). Signal lines provide an additional rate of change indication, which can help overcome the lag often associated with moving average-based indicators such as the TRIX.

In the same way that Japanese traders have enhanced our ability to read price charts with the use of Japanese candlestick charting, so have Japanese traders improved upon the notion of indicators and signal lines to spot certain patterns that can help traders anticipate the sort of crosses between indicators and signal lines that often result in significant price moves. The combination of signal lines and the patterns I will discuss is a particularly winning one that traders who use crossover-based trading systems should consider.

With the crossing of the TRIX (or any indicator)


**FIGURE 3: S&P 500 INDEX, SEPTEMBER FUTURES, 15-MINUTE.** The two highlighted ovals on the left side of the chart reveal sell/short signals based on falls where the TRIX (in blue) rolled or hooked downward. The rightmost highlighted oval reflects a golden cross buy signal. The highlighted oval in the center shows a golden cross buy signal following a TRIX positive divergence.

and its signal line, there are four main patterns, two of which trigger trader action. These patterns are called *golden crosses*, *dead crosses*, *bounces*, and *falls*.

*Golden crosses* occur when the TRIX moves through the signal line heading upward in a bullish direction. *Dead crosses*, by contrast, occur when the TRIX moves through the signal line heading downward in a bearish direction. *Bounces* occur when the TRIX hooks upward after at least one downward session. *Falls* occur when the TRIX hooks downward after at least one upward session.

Trading with these patterns, although applicable to intermediate-term trading, is especially geared toward shorter-term, momentum-oriented trading. As such, while traders are encouraged to take positions on golden crosses with the TRIX breaking out above the signal line, traders are also encouraged *not* to wait around for a dead cross in order to exit. Rather, exiting on the fall after a golden cross is recommended instead. Traded in the short term, a position could lose substantial value if a trader kept the position long enough for the TRIX to actually cross below the signal line. The shift in momentum displayed by the fall is sufficient for profit-taking or, at a minimum, reducing exposure.

One of the nice things about Prophet Financial System's implementation of the TRIX with two lines is that it draws green and red arrows to indicate where golden crosses and falls (respectively) appear. This isn't necessary; eyeballing the chart is sufficient. But having the arrows in place not only helps traders learn how to spot these patterns in any crossover situation whether or not the TRIX itself is used, but it also makes it easy to see buy and sell opportunities with a single glance.

The chart of the September emini Standard & Poor's 500 futures contract in Figure 3 gives us a number of things to look at. I have included a 50-period exponential moving average (EMA) to put a bit of a filter on the TRIX trades; no long trades below the 50-period EMA and no short trades above it — unless there is a negative or positive divergence. Generally, when I am using this setup, I require divergence confirmation from the moving average convergence/divergence histogram instead of relying solely on TRIX divergences. But that is just my personal preference.

I have been following this emini S&P 500 daytrading system on and off for the past year or so, and regularly since June. I have been impressed with its results. Because the system involves some strict money management — and because I suspect that money management has been critical to the system's success — I won't spend a lot of time on the system per se, save for using it to show how buying golden crosses and selling falls can be part of a winning technical trading method.

On the left side of the chart we have two sell/short signals. In both instances, a TRIX that was rising, however temporarily, turned or hooked down. Because the market was trading under the 50-period EMA, both instances represented sell/short opportunities. On the far right side of the chart, we see a highlighted oval that represents a golden cross and a buying opportunity. Remember that golden crosses develop when the TRIX rallies and crosses above the signal line.

Finally, I want to point out the highlighted oval in the center. Here we have a buy signal — as shown by the green arrow that indicates a golden cross has occurred — however, the market is trading below the 50-period EMA. No trade? Au contraire, mon frère! Note that just before the TRIX made its golden cross, the indicator developed a positive divergence, making a higher low at the same time that the market was making a lower low. This is one of the few times I

**Certain TRIX techniques, such as zero line crossovers and divergences, seemed to indicate best over the intermediate term. By contrast, TRIX techniques like the hook were good fits for short-term trading.**

would bet in favor of a market that was trading below the 50-period EMA: when a positive divergence signals waning momentum to the downside. The same would be true in the case of selling a market that was trading above the 50-period EMA: no divergence, no trade.

I mentioned that certain TRIX techniques, such as zero line crossovers and divergences, seemed to indicate best over the intermediate term. By contrast, TRIX techniques like the hook were good fits for short-term trading. I would put the golden cross/fall methodology in the short-term trading camp as well. Although the entries provided by this method, as those with the hooks, can be used by longer-term traders and even trend traders to initiate positions, my own experience has found the hooks discussed in part I of this two-part series and the golden cross/fall technique shown here to do as good a job as any other indicator or method in spotting short-term shifts in momentum that may or may not result in larger moves, but certainly, in the short term, are often replete with opportunity for the nimble trader. ■

*This article was originally published on 8/24/2007.*

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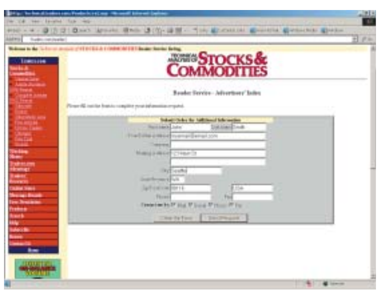
Click the box for each advertiser you'd like to hear from. At the bottom of the list, click "continue" when finished.



**STEP 2:** Simply fill out your name and address and click "Send Request." Your request will then be sent to the advertisers you selected. And that's it!

**OR**

**MAIL OR FAX**

*OR* fill out your information in the box below and check the advertisers you'd like to hear from.
Then fax or mail it back to us!

- ❑ AbleSys Corporation
- ❑ Aspen Research
- ❑ E*Trade Financial
- ❑ eSignal
- ❑ Fidelity Advertising
- ❑ Field Financial Group
- ❑ FXCM
- ❑ Global Futures & Forex Ltd
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■

## TRADERS' GLOSSARY

*Andrews Method or Pitchfork* — Technique whereby a technician will pick an extreme low or high and draw a line from this point that bisects a line drawn through the next corrective phase. Lines parallel to the line are drawn through the high and low points of the corrective phase. The parallel lines define the resistance and support levels for the price channel.

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

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

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

*Buy and Hold* — The acquisition of a tradable for the long term rather than quick turnover.

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

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

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

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

*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.

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

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

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

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

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

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

*Pairs Trading* — Taking a long position and a short position on two stocks in the same sector, creating a hedge.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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