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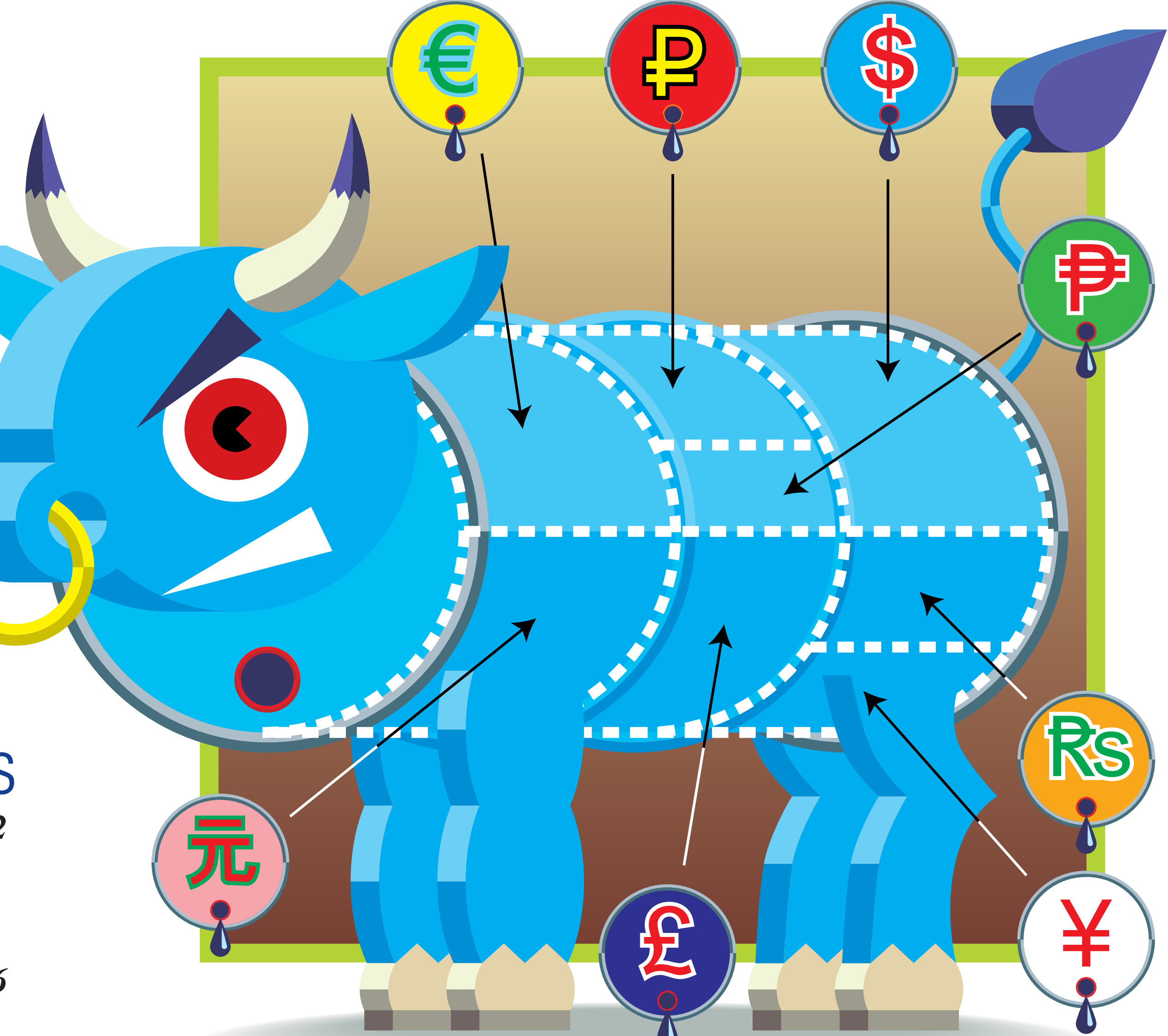

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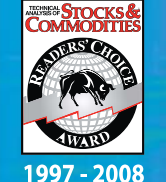

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Two Major Benefits of Principle-Based AbleTrend

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.

Rational risk management with "Intelligent stops"

Traders use a stop loss to help protect gains and limit losses. When the market hits their stop, they liquidate their position. Any trading software can suggest stop-placement, but traders should be aware that the type of stop they use could determine if they win or lose. There are stops, there are arbitrary stops, and there are the AbleTrend principle-based stops -- the new generation of intelligent stops that are defined by the market's own support and resistance levels.

These intelligent stops are dynamic and are automatically adjusted by the software as prices change. A built-in feedback loop retrieves the data for market direction, price range, and momentum. And, because the stops are determined by actual market conditions, they are objective, back-testable, and can be used in real-world trading.

Here's a chart without AbleTrend. It's open to lots of interpretation - and that's where distracting and misleading emotions can come in.

Euro Dollar (FOREX) Weekly Chart
Chart without eASCTrend
Should I take a 3% loss stop or a 5% loss stop?

Now, here's the same chart with AbleTrend, showing stops with small blue dots below the bars for buy positions, and small red dots above the bars for sell positions. What a difference!

With AbleTrend you can see where the trend changes. Where it's recommended to buy or sell. Where to place stops to help you stay in a trade as long as possible without taking on too much risk. And you have the confidence of knowing that the software is based on meticulous formulas that have been back-tested for years.

Seek to cut losses short, let your profits run, and trade the "sweet spots"

The number one reason why traders fail is that they don't know when to get out of a losing trade. The number two reason is that fear makes them abandon winning positions too early - and not let their profits ride.

With AbleTrend, you get clear, precise, easy-to-read "buy" and "sell" signals on every trade. All you have to do is log onto the system and look at your screens. Any time you see a LARGE BLUE CIRCLE on your chart, it's time to buy. Any time you see a LARGE RED CIRCLE on your chart - stop! It's time to call your broker and say, "Sell now."

And if you're in a trade where the market is moving in your favor, you can add to your position at more favorable times as the market progresses. We call these recommended optimum times to get in on a trade "sweet spots." The AbleTrend software signals sweet spots with the first blue bar to appear after a series of green bars.

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

It's our principle-based formulas that give traders the 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: SCT8MA**

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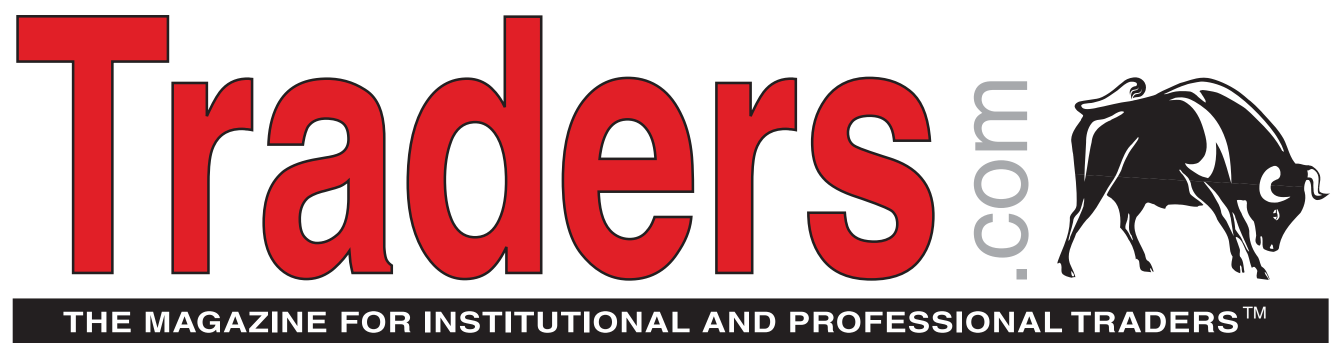

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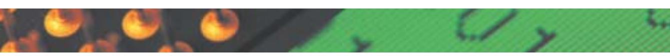

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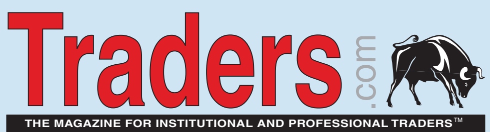

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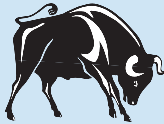

TRADING NOW

If there were any doubt before, we are starting to see the spirit of the recession make its way to other parts of the world. The Japanese government has announced there is a strong chance the Japanese economy will head into a recession. If you need visual confirmation, take a look at a chart of the yen; you can see that it has fallen against the US dollar, reaching a seven-month low as of this writing. Not only that, the euro also fell against the dollar, which could be a sign of some negative news emerging from Europe. We have also seen a fall in oil prices and other commodities, which not surprisingly has lifted the equity markets.

The big question is, "Is this just a correction or the beginning of a road to recovery?" It's easy to become optimistic when there are positive movements in the markets after such a long stream of negative news. But let's not forget that the impact of the financial crisis in the US is still being felt. It has started to spread to other parts of the world, and it won't be too long before we see not just developing nations experience slower growth, but emerging markets as well. There's still a long way to go on the road to recovery, and it's best to just keep monitoring all markets.

In this issue of **Traders.com**, we do just that with a look at all sectors of the markets. Ron Walker posits "Conflicting Signs On The S&P 500," while Alan Northam is of the opinion that "The DJIA Bear Market Continues." Then again, is there "A Breakdown For The Dow?" Arthur Hill asks. Mike Carr asks whether "Interest Rates Heading Higher?" And what about gold? Koos van der Merwe asks if "Is Gold A Buy?" And what about oil? That's the question everybody's asking right now. An answer may be had in Mike Carr's article, when he looks at "A Conservative Bet On Oil By Buying Russia," and van der Merwe's "Where Is The Price Of Oil Going?" Or maybe it's time again to look at another source of heat and energy, Carr suggests, with "Coal: The Forgotten Commodity."

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So what do you think? Are we in the midst of a correction or are we on the road to better times? Whatever you believe is the case, I think we're all in agreement that we have to keep an eye on the markets. A *very* careful eye.

Jayanthi Gopalakrishnan

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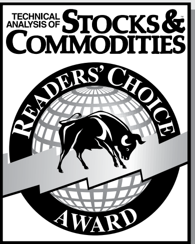

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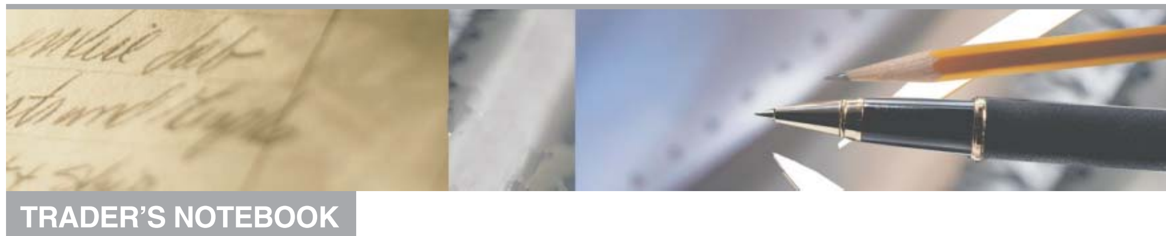

TRADER'S NOTEBOOK

The Dollar Index

by Brian Twomey

The dollar is still hanging in the balance without a clear direction.

Between 2001 and 2002, the dollar index (DX) that trades on the New York Board of Trade peaked into a near-triple top at about 120 (Figure 1). The actual values were 119.53 and 119.73. Since the last top at 120 in 2002, the index has been in a long-term downtrend, currently trading at the last quote of 73.50 with long bullish engulfing candles at its bottom. The euro, which is the dollar opposite, has been in a long-term uptrend since the dollar index peaked in 2002 and almost broke its historic barrier at 6.000 from a starting point of about 1500.

The dollar-bloc currencies, as represented first by the Japanese yen, was trading at its peak at about 128 in 2002 and is now trading in the high 104s. The Canadian dollar and the Swiss franc had been in long-term downtrends since 2002. Since 2002, the dollar opposites have been in a long-term uptrend due in part to the commodity boom we are experiencing in the markets and due to the downtrend of the US dollar. Australia, New Zealand, and the Canadian dollars are considered commodity currencies because they are not only heavily dependent on exports but they export commodities such as Canadian oil, New Zealand dairy products, and Australia metals and bananas, to name just a few.

What can you glean from this information? You can discover a possible dollar bottom and the start of a long-term uptrend, a significant opportunity for traders in all markets. This is because, at present, world economic fundamentals as well as technical chart levels dictate a change.

THE FUNDAMENTALS

To understand the dollar and its ramifications, a historical perspective will be outlined, fundamental analysis explained, technical significance understood, and what it means as an opportunity for traders in stock, bond, currency, options, and futures markets.

In the Bretton Woods conference of 1944, what the world tried to accomplish was a uniform trading system and the first-ever coordination of a monetary system. Forty-five nations agreed to the Bretton Woods agreement. All world currencies were pegged to the dollar with a fixed exchange rate based on the gold standard. Simply, the gold standard meant a fixed $35 per ounce price of gold with a 1% allowable deviation, up or down, in prices. The price of the dollar was fixed at $100. This system broke down over a 25-year period because the United States depleted its $20 million in gold reserves, the price of gold had trouble achieving its $35 base, and the system had

FIGURE 1: THE DOLLAR INDEX. Between 2001 and 2002, the dollar index (DX) peaked into an almost triple top at about 120.

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violators as well as inflation for many nations.

So President Richard Nixon, without warning, took the US off the gold standard. Before this actually occurred, however, the US and its 10 major trading partners adopted the G-10 index. The G-10 index was used to analyze how changes in the foreign exchange value of the dollar influences the US's international trade. These nations traded based on trade shares from the index. The more valuable a trade partner was to the US, the more trade shares a nation would trade. But this system, too, broke down. So a new index was adopted.

The differences between this index and previous ones are the number of nations, and the goal of the index is to better measure and understand trade flows and capital flows in and out of the US.

This new index increased the number of trading partners to 26 nations and changed the trade share formula. The scheme measured competitiveness of US goods in the US and in foreign markets. Weights were changed annually to reflect changes in trade patterns. Because of the adoption of the euro in 1999, this index had to be revised again because of the difference in trade patterns and currency distributions. Today, the Atlanta Federal Reserve Board's dollar index is responsible for its own dollar index to measure trade. They have the domain when it comes to US trade.

The differences between this index and previous ones are the number of nations, and the goal of the index is to better measure and understand trade flows and capital flows in and out of the US. The idea is to measure trade, not in weighted currencies but weight on capital flows and trade. Nations that belong to the index must be a developed nation with a low inflation rate, similar to those rates in the US. Trade rates are calculated each day at 12 noon, signed off by customs and certified by the New York Federal Reserve Board. So transactions are reported each day on the New York Federal Reserve website.

Nixon's surprise announcement to take the US off the gold standard led to the 1971 Smithsonian Accord. In this, a group of 10 nations, our largest trading partners, agreed to appreciate their currencies against the dollar. This agreement lasted almost two years, until 1973. When this agreement failed, this led the world down the path of free-floating currencies. First, however, nations began intervening to appreciate their currencies based on their trade flows to realize profits. It was a basic economic war for a time, costing nations fortunes for intervention. Second, the world agreed to keep their currencies free-floating within a 15% trade band up or down, which again failed.

Now, we have the New York Board of Trade (NYBOT) dollar index, where currencies are allowed to free-float on exchanges. The value of the dollar is now based on a basket of six currencies that happen to represent that of our largest trading partners — euro, yen, British pound, Canadian dollar, Swiss franc, and the Swedish krona. So the value of the US dollar is a weighted geometric mean that trades every trading day on the NYBOT and is allowed to have values as markets dictate based on economic fundamentals.

Now let's move on to economic fundamentals. We must go back to President Franklin Roosevelt's policies of the 1930s to figure out that an economy cannot deflate its way out of an economic problem because prices for our basic goods become too expensive. Roosevelt reinflated his way out of a falling dollar and the economy recovered. A dollar that has fallen as much as the US dollar has can only create the asset bubbles that have further caused us harm as those bubbles burst. And that bubble finally burst in the housing market that led to a worldwide housing problem not just in the US. So they lowered interest rates and weakened the value of the dollar further.

What a weak dollar can do for the US, however, is increase exports and ensure US companies earn a profit by converting expensive dollars to an overpriced euro and British pound. First-quarter exports rose 0.7% in the last reporting period while the factory orders index was up 1.4% from -0.9. If transportation is excluded from this equation, factory orders were actually up 2.2%, a healthy sign.

Another sign of a turnaround is the $220 billion or so inflows from foreign central banks since the start of this year. This is another healthy sign of a turnaround, as this reflects the rising bond prices since the last rate cut and the dollar turnaround. Bond prices are almost at the 4% mark, a milestone in the recovery process if those prices can break and hold.

Ten-year bond prices hit 3.859 from 3.769 at last Friday's nonfarm payroll day while the two-year bonds hit 2.45 from 2.37. Institute for Supply Management (ISM) numbers, which measure two components, service and manufacturing, dipped to 49.5% from 49.6% last month, which means they are still holding steady. Wholesale inventories are -0.5 from 1.1%. Trade balance is still off $61 billion from $62.3 billion, but an improvement. This means the US economy is not in recession but is holding steady. This is positive for the dollar. But how would a trader know?

DOLLAR POSITIVES

Look at the high price of the euro, the British pound, and Australia and New Zealand dollars. All have had a long runup in prices with rising economies, rising wages, rising consumer price numbers, rising consumer and business sentiment, and all have increased interest rates into strengthening economies. New Zealand's interest rate is 8.25% but the economy is showing signs of faltering. That's a positive dollar sign. Australia's interest rate is 7.25% with a steady to faltering economy. England had an interest rate of 5.5%, but they have since cut back to 5.0% and expectations are for a further cut to 4.75% due to poor economic releases over a period of time and another faltering economy.

Not only that, Japan's economy is in a deflationary contraction where prices are so high for all goods that their economy can't handle another piece of bad economic news. With an interest rate of 0.5%, the

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Japanese can't raise rates due to a negative economic situation. They are export-dependent, but the high price of food and energy is worsening the situation.

With a weak dollar comes a high food and energy price, since these two categories trade opposite each other. This also means we are importing inflation into oil-producing nations. More than one OPEC nation has recommended shifting out of US dollars and moving toward a basket of currencies, beginning with the euro.

DOLLAR TURNAROUND?

Currently, economic fundamentals point to a dollar turnaround. Recent Fed rate cuts will either give the economy some needed stimulus, or more deterioration is on the way. The economic numbers point to an economy hanging in the balance. Dollar-opposite currencies are hanging as well without a clear directional change. Short-term dollar opposites are correcting while the dollar is rising. Is this a correction for the euro or a trend change? And is this a correction for the dollar or a trend change?

Charts currently point to a correction unless price action and indicators can give a better signal. From the dollar charts, it appears the dollar bottomed at 71.5 with strong supports from recent candles and closed last at 73.5 on the daily chart with long bullish candles and increased volume. The daily charts (Figure 2) show a positive crossover of the 10- and 20-day simple moving average, while it appears the dollar broke the 10-day average on the weekly (Figure 3) and was about to break on the monthly (Figure 4), but resistance is at about 79 at the descending 20-day simple moving average on the weekly and monthly.

Parabolic stop and reverse (SAR) points down on the weekly and monthly with resistance at about 76. Parabolic SAR is, however, pointing straight up on the daily chart. There is a chance the relative strength index (RSI) will continue moving up. The directional movement index (DMI) and the average directional movement index (ADX) are rising on the daily, weekly, and monthly but are a bit high on the weekly and monthly. Slow stochastics are at 86 on the daily, 32 for the weekly, and 24 on the monthly. At 73.50, the price is trading in the 24% Fibonacci ratio and needs to gain momentum to clear the 38% Fibonacci at 74.14.

What this says from a chart perspective is that the dollar is still hanging in the balance without a clear direction. What the dollar could use is a decent stream of economic news to push it past formidable resistance so we can say without question that the dollar is truly trending. ■

This article was originally published on 6/10/2008.

SUGGESTED READING

Acree, Bryan. "Revising the Atlanta Fed's Dollar Index," *Atlanta Federal Reserve Board Economic Review*.

Leahy, Michael P. [1998]. "New Summary Measures Of The Foreign Exchange Value Of The Dollar," *Federal Reserve Bulletin*, October.

Loretan, Mico [2005]. "Indexes Of The Foreign Exchange Value of the Dollar," *Federal Reserve Bulletin*, Winter.

FIGURE 2: DAILY CHART. Here you see a positive crossover of the 10- and 20-day simple moving average, the parabolic SAR is pointing up, RSI, DMI/ADX, and slow stochastic look like they are pointing up.

FIGURE 3: WEEKLY CHART. Here the dollar broke the 10-day average, parabolic SAR is pointing down, DMI and ADX are pointing up.

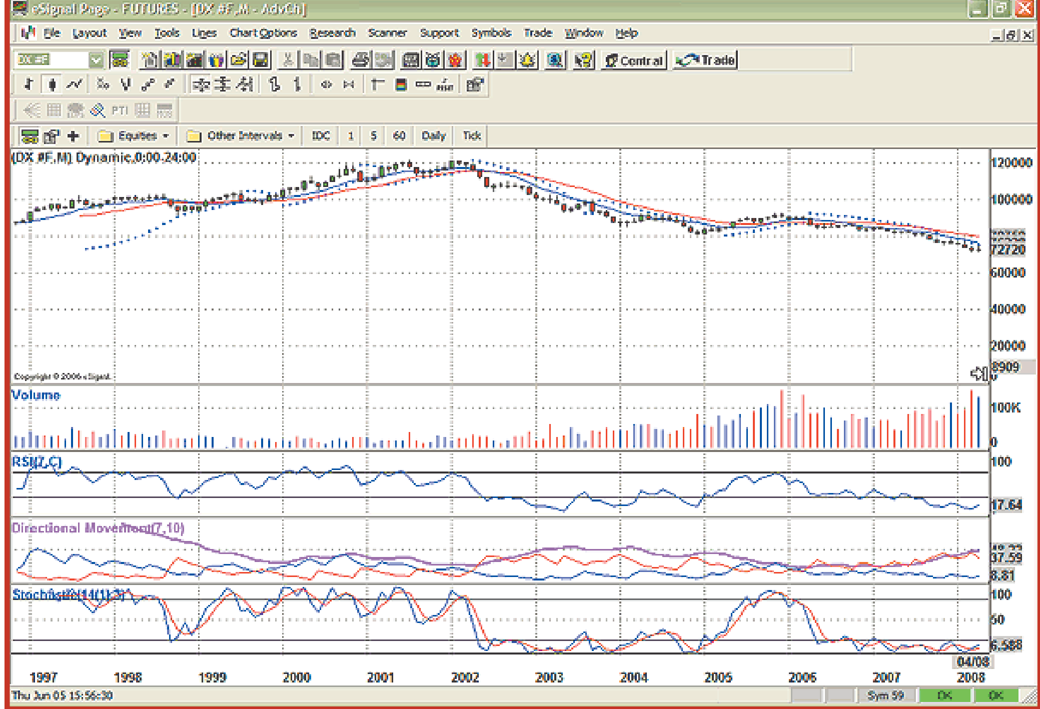

FIGURE 4: MONTHLY CHART. On this chart there is no clear direction as to which way the dollar will go.

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Jones Soda Co.	JSDA	+87%
Potash Corp. Saskatchewan	POT	+82%
Apple, Inc.	AAPL	+81%
E*Trade Financial Corp.	ETFC	+68%
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INDEXES

CHART PATTERNS

Conflicting Signs On The S&P 500

by Ron Walker

The intraday 60-minute chart on the S&P 500 has developed a bullish inverse head & shoulders pattern, while its daily chart has formed a bearish rising wedge. Moreover, the daily chart is in an uphill battle as it approaches the 200-day simple moving average and Fibonacci retracements. Which pattern will prevail? Support and resistance may hold the key.

Tradable: $SPX

The last time I wrote about the Standard & Poor's 500, it was forming the handle on an inverse complex head & shoulders pattern. Since that time, the S&P 500 moved above the handle and broke above its intermediate downtrend (Figure 1). After a very powerful breakout that lifted prices toward the 200-day simple moving average (SMA), the bulls took a breather while the S&P 500 moved back to test the broken trendline. Prices successfully bounced off the trendline, as support was found at the 20-day exponential moving average (EMA). At that time, the relative strength index (RSI) (14) held above the support level of 50, indicating a reduction in bearish sentiment. This is now the third touch of the rising trendline off the March low. If the S&P 500 can produce a definitive break above the last high of 1423 without the trendline being breached, it will be classified as an intermediate trendline.

After prices bounced off the downward trendline, the S&P 500 attempted to test the 200-day SMA once again, but the rally seemed uncertain as a hanging man candlestick appeared on May 16. In addition, a rising wedge has formed from the March lows, which could bring about some bearish ramifications. A hanging man candlestick will be confirmed if prices close below the long tail underneath the real body of the candlestick. The S&P 500 has been stuck in a trading range ever since prices broke the downward trend in late April, with support at 1383 and resistance near 1423 area. On May 16 prices did manage to move above 1423, but only by 2 points with a close of 1425. The hanging man candlestick

FIGURE 1: $SPX, DAILY. With the S&P 500 approaching resistance at the 200-day SMA, a narrow range has developed, with resistance at 1427 and support at the rising trendline near the 1405 area. A rising wedge pattern on the S&P 500 may play out if prices fail to conquer the 200-day SMA.

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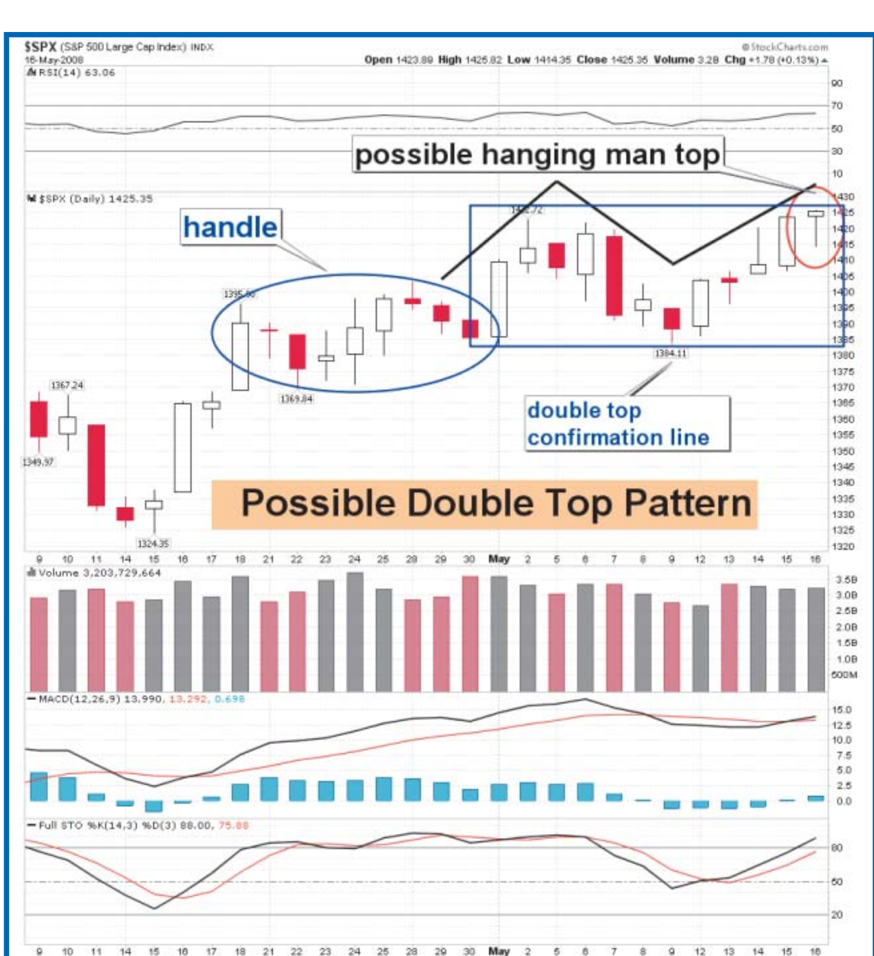

FIGURE 2: $SPX, DAILY. With prices in a trading range, another possible pattern has emerged, a double top. If prices can break above the mid-1420 area, the bulls will continue their reign over the market. But if the 1383 area is violated, it will help the bears regain their footing.

FIGURE 3: $SPX, 60-MINUTE. The 60-minute chart has developed an inverse head & shoulders pattern, but negative divergence is looming over the hourly chart. Currently, a handle is being carved out. If prices break down, watch the rising trendline at 1405.

could be setting up a possible short-term double-top pattern near the mid-1420 area (Figure 2). The confirmation line would be 1383, the pattern measures 42 points with a target of 1341. That is the 50% Fibonacci retracement from the March 17th low. And if you were to draw a parallel line that mirrors rising resistance (the upper boundary), taking from the March low, it points to the 1341 area (Figure 2). So that is a area of interest, should this rally falter. But keep in mind that before the confirmation line can be violated, the rising trendline must break near the 1405 area.

In contrast to the daily chart's bearish overtones, the S&P's 60-minute chart (Figure 3) reveals that there is an inverse head & shoulders pattern that has developed since the beginning of May. Currently, there is a handle forming on that pattern. This pattern measures 40 points, from the high of 1423 to the low of 1383. The target is found by taking the difference and adding it to the tallest point on the pattern. That gives a objective target of 1463. If the pattern is obtained, prices will have successfully risen above the 200-day SMA. Further, the 10-, 20-, and 50-period EMAs remain bullish, while they are pointing upward with no signs of a bearish crossover. But the histogram (12,26, 9) now has negative divergence, which could hinder the bulls.

The S&P 500 is also coming very close to the 61.8% Fibonacci from its October high. Its weekly chart adds to the massive amount of resistance at these levels, as it is approaching overhead resistance near the 1435 area, from the August and November closing lows. The S&P 500 is overdue for a correction, but until the rising trendline on the daily chart is violated, the bulls remain in power. However, should the moving average convergence/divergence (MACD) (12,26, 9) in the daily time frame get a lower peak than its last peak, negative divergence could set in. The same is true for the RSI in that same time frame. That could eventually allow the rising wedge to play out, increasing bearish forces in the form of a contratrend.

If a corrective move did take place at these levels, I think prices would recover, ultimately reaching the daily chart's inverse complex head & shoulders pattern target of 1536. No one has been more bullish than I have been, but now that we are running into some major resistance, a defensive posture should be taken. But until the rising trendline on the daily chart is broken, the bulls remain in power, and we may witness the head & shoulder pattern on the 60-minute obtaining its target of 1463. Nevertheless, the volatility index (VIX) is reaching levels of complacency, with its lowest readings since October. This should be regarded as a short-term negative signal, allowing the rising wedge to break down. ■

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ELLIOTT WAVE

The DJIA Bear Market Continues

by Alan R. Northam

Now that the market rally off the mid-March lows is complete, the DJIA bear market continues.

Tradable: $DJIA

The Dow Jones Industrial Average (DJIA) made a major market top in October 2007. Since then, the DJIA has traded in the downward direction in five waves (1, 2, 3, 4, and 5). These five waves obey the Elliott wave rules for an impulsive wave, which state that waves 1 and 4 cannot overlap and wave 3 cannot be the shortest. In his writings, R.N. Elliott, who studied market waves more than 70 years ago, states that an impulse wave then defines the major direction of the market that in the case of the DJIA is down. These five waves also form wave (1) down of a much larger five-wave impulsive wave.

According to Elliott, after a five-wave move the market will undergo a market correction to correct for this move. Since March 2008, the DJIA has been trading in an upward corrective direction. This upward move is known as a bear market rally. This rally now looks to be complete and completes wave (2) of a five-wave impulse wave down. If wave (2) down is complete, then wave (3) down is now under way. Third waves are typically the longest wave and are normally 1.618 times the length of wave 1. This would then put the completion of wave (3) down somewhere around 9500 for the DJIA.

Looking at the trading action since the beginning of May of this year, I have identified two and possibly three subwaves and labeled them as waves (i), (ii), and (iii). Subwave (iii) looks to be complete but a few more trading sessions will confirm it. If wave (iii) is complete, then wave (iv) should be unfolding but should now carry above the horizontal red line as fourth waves cannot overlap first waves. Once wave (iv) is complete, then wave (v) should unfold and once completed all five subwaves will then make up wave 1 down. Waves 1, 2, 3, 4, and 5 should then make up wave (3) down, which should be complete at or around 9500.

The DJIA has also traded up to its 200-day moving average twice now and both times have bounced off it and moved lower. Thus, the 200-day moving average is acting as strong resistance to the market. Since mid-May, the market has continued to trade lower and has broken through to the downside of its 50-day moving average. I would now expect the market to retest the 50-day moving average, as wave (iv) is completed to see if it is offering a strong line of resistance. If our wave count is correct, then the market should respect the 50-day moving average and bounce off it in the downward direction, as wave (iv) cannot overlap wave (I). Once this test of the 50-day moving average as a strong line of resistance has been proven, the market should then turn much lower.

FIGURE 1: DJIA, DAILY. Daily closing price chart of the DJIA showing the Elliott Wave count, 50-day moving average and the 200-day moving average. The MACD is also shown below the price chart.

The moving average convergence/divergence (MACD) oscillator has provided a sell signal by moving below its zero line. This sell signal confirms that the DJIA is now starting to sell off. However, the red signal line has not yet confirmed the sell signal. I would expect to see the signal line cross below zero once wave (iv) is complete and the market starts to move lower again.

In conclusion, it looks like the bear market rally, consisting of wave (2), is now complete and the DJIA bear market continues. ■

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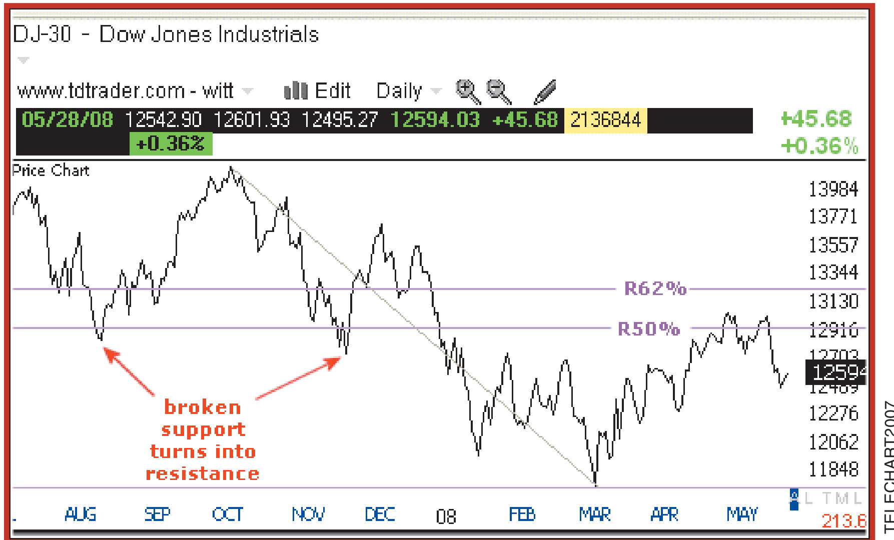

FIGURE 1: DJIA, DAILY. Here are closing prices to filter out some of the noise from the spike lows in January and March.

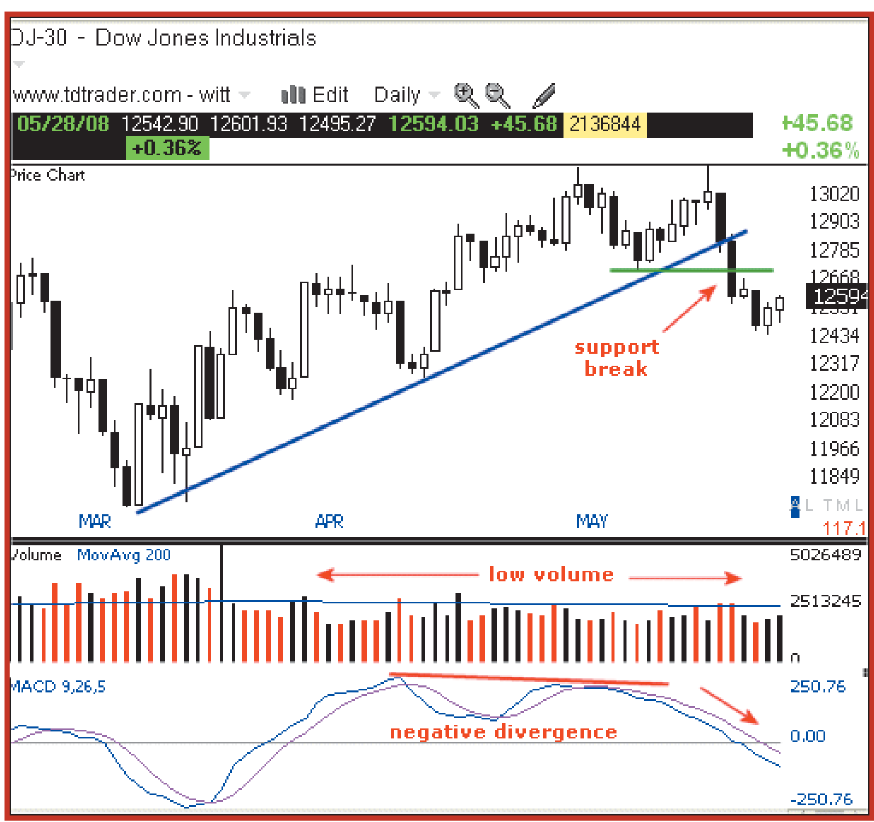

FIGURE 2: DJIA, DAILY. Note the May highs and the recent breakdown.

A Breakdown For The Dow

Tradable: $INDU

by Arthur Hill

After failing at a key resistance point, the Dow Jones Industrial Average broke a key support level to reverse an uptrend that started in mid-March.

Figure 1 shows closing prices to filter out some of the noise from the spike lows in January and March. The Dow Jones Industrial Average (DJIA) declined from October 2007 to March 2008 and then bounced back to broken support in May. Even though the DJIA overshot the August–November lows (~12,800), it met resistance around 13,100 twice in May. Using zones and allowing for a little leeway, we can assume that broken support zones turned into a resistance zone.

Resistance around 13,000 is confirmed by two key retracements. The DJIA became oversold after the October 2007–March 2008 decline and the March–May rally alleviated these oversold conditions. In addition, a corrective advance typically retraces 50–62% of the prior decline (pink lines). The DJIA moved into this zone in early May and met resistance twice.

Figure 2 focuses on the May highs and the recent breakdown. The DJIA established support with the May 9th low around 12,700. With a sharp decline from resistance, the DJIA broke the March trendline and forged a lower low. This break was quite clean and reverses the uptrend that had been in force since March. After all, downtrends start with lower lows.

Momentum confirms weakness as the moving average convergence/divergence (MACD) turns bearish. MACD formed a negative divergence from April to May and moved into negative territory in late May. The signal line crossover in early May provided the first bearish signal. With a move into negative territory, MACD and momentum clearly favor the bears. ■

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$TRAN Sees Huge Selloff

by Chaitali Mohile

Entire gains of the early trading hours vanished by end of the day, and the Dow Jones Transportation Average may move flat further to the lower support.

Tradable: $TRAN

The day began on highly bullish notes after a few days of a consolidated move. The trading session on May 19 showed robust strength in early trading hours, carrying the average approximately 225 points higher from the support level at 5375. According to Figure 1, May 15 and 16 were normal consolidation days with convincing bullish views by relative strength index (RSI) (14) and moving average convergence/divergence (MACD) (12,26,9). Accordingly, the strong breakout was witness on May 19, accumulating the trader's confidence. The RSI (14) moved vertically from 50 to the overbought area as the price moved higher and higher. In addition, the MACD (12,26,9) was positive. So the situation was favorable for the breakout to move ahead.

But the RSI (14) at overbought levels seemed slippery. The price movement signaled the reversal as the evening doji star was formed at the new high of the day. This reversal candlestick pattern put an end to the upward rally and indicated a fresh fall. $TRAN still tried to recover those few lost points, but the RSI (14) failed to show bullish strength. In addition, the MACD (12,26,9) had a bearish crossover weakening the transportation average. The selling pressure turned serious and the gains vanished in the last two hours of the trading session. The stock was back to the previous low at one movement but recovered marginally as the day ended. This showed the power of reversal candlestick pattern.

The evening doji star is a bearish reversal pattern. It always appears in an uptrend and turns an existing trend to a bearish favor. The doji shows indecision amid the traders to continue the bullish rally ahead. The bears get the advantage here and come in with pressure. The highly overbought RSI (14) also declined steeply to oversold areas near 30 levels. Above all, the MACD (12,26,9) plunged to negative territory with no signs of recovery. So the entire gains of the day were taken off as the session closed.

The 10-minute chart was just a glimpse of intraday business, but the real picture of the next trading session was seen on the daily chart. The intraday price movement of this particular trading session formed a second strong bearish reversal pattern, which was more alarming. The shooting star was formed at the top, leaving the traders stunned. Figure 2 shows that the stock was in a strong uptrend since March 2008, and the price thus formed higher highs and higher lows. $TRAN was moving in an upward channel along with strong bullish indicators. At the 5400 level, the rally stalled and some correction poured in. But undergoing a correction or consolidation after the prolonged advance rally can be a healthy sign for bullish traders. On the same note, the $TRAN recovered but by now, 5400 turned out to be a psychological resistance for traders on board. And the intraday selling pressure formed a shooting star, which was a warning to traders.

The average directional movement index (ADX) (14) too moved closer to overheated levels of 40, which again pointed to a trend reversal. Sometimes, the ADX (14) does extend to higher overheated levels like 50, 60, but here the indicators showed possibility of a decline. So there are two bearish signals now, a shooting star and an overheated ADX (14). So the selling off is likely to head to further weakness at least for a few trading sessions. The earlier support level of 5200 may get tested with this move. ■

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FIGURE 1: $TRAN, 10-MINUTE. With an evening doji star and overbought RSI (14), the $TRAN plunged hard and the entire bullish rally was back to an intraday low.

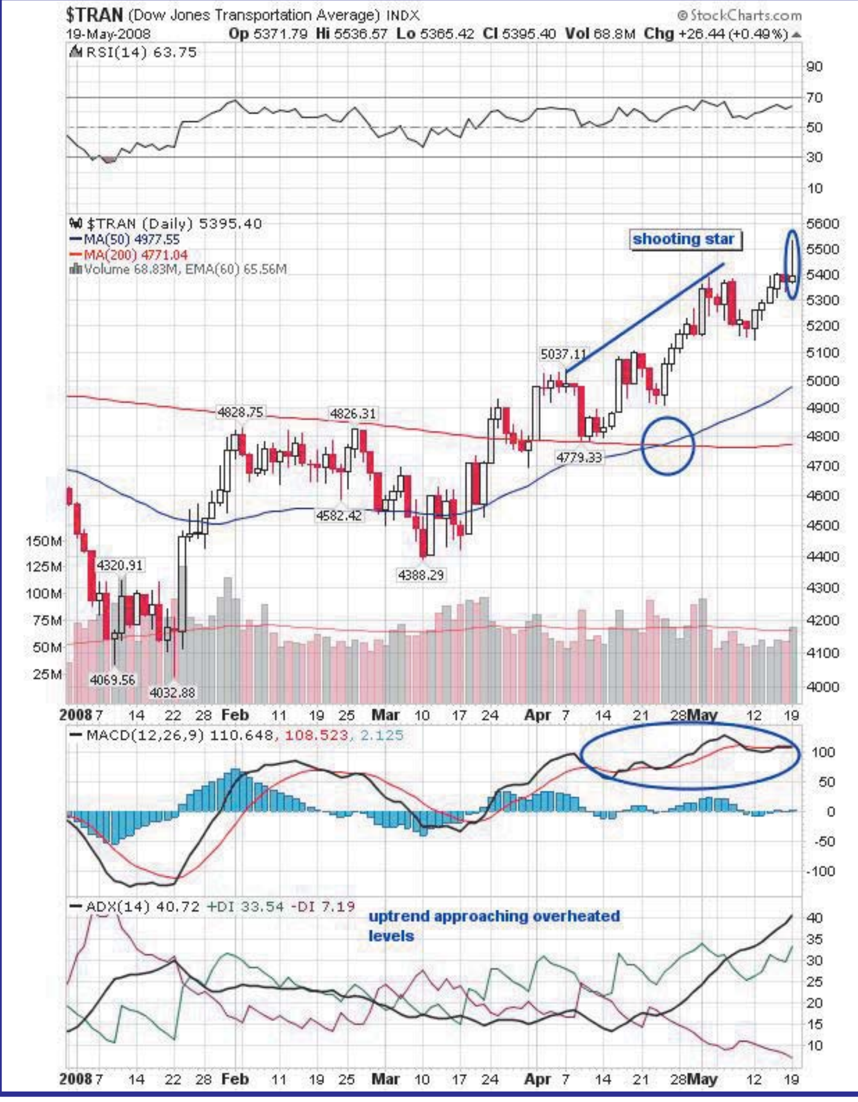

FIGURE 2: $TRAN, DAILY. The uptrend has reached overheated levels and RSI (14) was unable to move above 70 levels. In addition, due to the shooting star, the transportation average was likely to retrace to a prior low of 5200.

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CANDLESTICK CHARTING

An Advance Block For The S&P 500

by Ron Walker

The Standard & Poor's 500 is forming a head & shoulders top near the 200-day simple moving average. An advance block pattern is helping to complete the right shoulder.

Tradable: $SPX

The Standard & Poor's 500 has performed nicely during the runup from the March 17th low to our recent highs in mid-May. It has risen with little corrective moves along the journey higher. Figure 1 reveals that recently the S&P 500 tagged its 200-day simple moving average (SMA), where it found resistance in the form of a gravestone doji candlestick. Price wasn't able to conquer it, having failed to close above the 200-day SMA. The S&P then broke below support at 1383, as it drifted down to rest on the 50-day SMA at 1373. It suffered considerable technical damage. Finally, the 50-day SMA managed to resurrect the index, as the entire market fared well during a short-term tech rally for the next four trading sessions.

As the S&P marched back up to recoup the previous weeks losses, it ran into resistance at the 20-day SMA. The S&P 500 became trapped between support and resistance, trading in a narrow range with the 50-day SMA support level at 1380 and the 20-day SMA resistance near 1400. Although its technical condition improved rising back up to the 20-day SMA, it was not enough to make up for all the damage suffered from the previous week. Further, a bearish candlestick pattern had now formed on the index during the rally, which is displayed in Figure 2. An advance block pattern is a three-day candlestick pattern that is bearish. It looks similar to a three-white soldier pattern, but a three-white soldier pattern occurs in a downtrend and is a bullish reversal pattern while the advance block occurs in an uptrend and is a bearish pattern. The advance block is characterized by the first day being bullish, but the second and third days form long shadows above the real body of their candlesticks. The long shadows above the candlesticks signal that sellers are coming into the market at these levels.

On the next trading session, on June 2, the pattern began to play out as a bearish belt hold candlestick appeared (Figure 2). By this time you can see that a head & shoulders top is forming; the last stages of a right shoulder is almost completed. The neckline is slanting downward, pointing toward 1370. A break below that confirmation line will validate the pattern. The pattern measures approximately 70 points with an objective target near 1300. If prices break below the last minor low of 1373, a downward trend will be established with a lower high and a lower low in place. Moreover, the belt hold candlestick caused the relative strength index (RSI) (14) to form a negative simple divergence, while the stochastic (14, 3, 3) indicator starts hooking down. In Figure 1, the Aroon (25) got a bearish cross, with the Aroon down (red line) crossing above the Aroon up (green line) as it moved above the value of 70. It is signaling that the trend is feeble. The Aroon down needs to move below 30 to constitute a new downtrend. However, the average directional movement index (ADX) (14) with plus (+DI) and minus (-DI) directional indicators is signaling a trendless environment. The ADX is wandering below 20, as the plus and minus DI lines continue to crisscross as they weave together back and forth. Nevertheless, the indicator still implies weakness of the previous advance. This setup looks ripe for short-sellers.

The S&P 500 has had a huge run since the March low, rising a hefty 14.65% from its 1256 intraday low to the 1440 intraday May peak. If we were to just use the closing low of 1273 on March 10, to the closing high of 1429 made on May 19, the S&P 500 still rose a whopping 12% in just over two months. The S&P will likely fall to test the last significant minor low of 1324. The 50% and the 61.8% Fibonacci retracements are likely areas where the S&P will find support. Once the market has a chance to catch its breath, I believe that it will ultimately resume the advance exceeding the May high. The stock market looks forward, and the second half of the year continues to look much better. But for now, it appears that the S&P 500 is developing a contratrend. ■

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An advance block pattern is a three-day candlestick pattern that is bearish. It occurs in an uptrend.

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FIGURE 1: $SPX, DAILY. The S&P 500 looks to be in the last stages of completing a right shoulder in a head & shoulders pattern that has been developing since late April. It is trapped between support at the 50-day SMA at 1380, and resistance at the 20-day SMA near 1400.

FIGURE 2: $SPX, DAILY. A bearish belt hold candlestick confirms suspicion of an advance block pattern, which is setting up a right shoulder. Note how each peak got a bearish candle pattern as the 200-day SMA is lurking above a potential bearish head & shoulders top.

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Dow Transport Index New High Prediction

by Alan R. Northam

The Dow Jones Transportation Average has made a price high in July 2007 and in May 2008. The transports could now be set to make one more run at yet another new high in the very near future.

Tradable: $TRANS

Figure 1 shows the monthly chart for the Dow Jones Transportation Average (DJTA) rally off the 2003 lows. This rally has been impulsive and has completed waves (1), (2), (3), and (4) of the five-wave impulse. I have shown wave (5) in the gray color, representing that wave (5) may not yet be complete.

Impulse waves are made up of five subwaves and define the direction of the major trend which is up for the transports. Once the impulse wave is complete, this market should sell off and could lose from one-third to two-thirds of the price gained for the complete rally from 2003 or from 4250 to about 3250.

Zooming in to the weekly chart for the DJTA in Figure 2, I have shown the rally from the early 2008 low. This rally also looks impulsive and has completed subwaves 1, 2, and 3 of wave (5). Currently, this market is in the process of completing wave 4 down, a corrective wave, that does not yet look complete. Once complete, the final wave, wave 5, should commence, which when completed will complete the five-wave impulse, wave (5) off the 2003 lows. I have also added a support line drawn off the price high of wave 1. Price cannot move below this support line or the analysis will have to be reconsidered and could be an indication that the price high made in March is the final market top. The transports have already started to move lower to correct the complete rally off the 2003 lows.

Zooming in further shows the daily price chart in Figure 3. From the high of wave 3, the transports has been undergoing corrective wave 4. This corrective wave is taking the shape of an A,B,C zigzag with wave C forming an ending diagonal. Ending diagonals are made up of five subwaves, waves a,b,c,d, and wave e of which waves d and e are not yet complete. Therefore, I expect to see the transports work themselves a little lower in the next few days before completing corrective wave 4. Ending diagonals signal that the market correction is near completion and the previous trend is about to resume, which in the case of the transports is up. Once corrective wave 4 is complete, then the final wave 5 of the five-wave impulse off the January 2008 lows will commence. Once wave 5 is complete, this will also complete wave (5) of the five-wave impulse off the 2003 price lows. I have added a price target for the completion of both wave 5 and wave (5) of 5625.

In conclusion, the DJTA could be setting itself up for one more run to new higher highs with a price target of 5625. However, for the transports to move higher, the support line drawn off the price high of wave 1 on the daily price chart must be respected and the market cannot penetrate this support line. However, should the support line be penetrated, then the transports have already made a bull market top and a market selloff is already under way that could result in the transports losing from one-third to two-thirds of the price gains it has made off the price lows of 2003. ■

Impulse waves are made up of five subwaves and define the direction of the major trend, which is up for the transports.

FIGURE 1: $TRAN SHOWING ELLIOTT WAVE COUNT, MONTHLY. Chart shows waves (1) through (4) of a five-wave impulse as being complete, with wave (5) yet to be completed. Impulse waves define the direction of the market trend, which in the case of the transports is up.

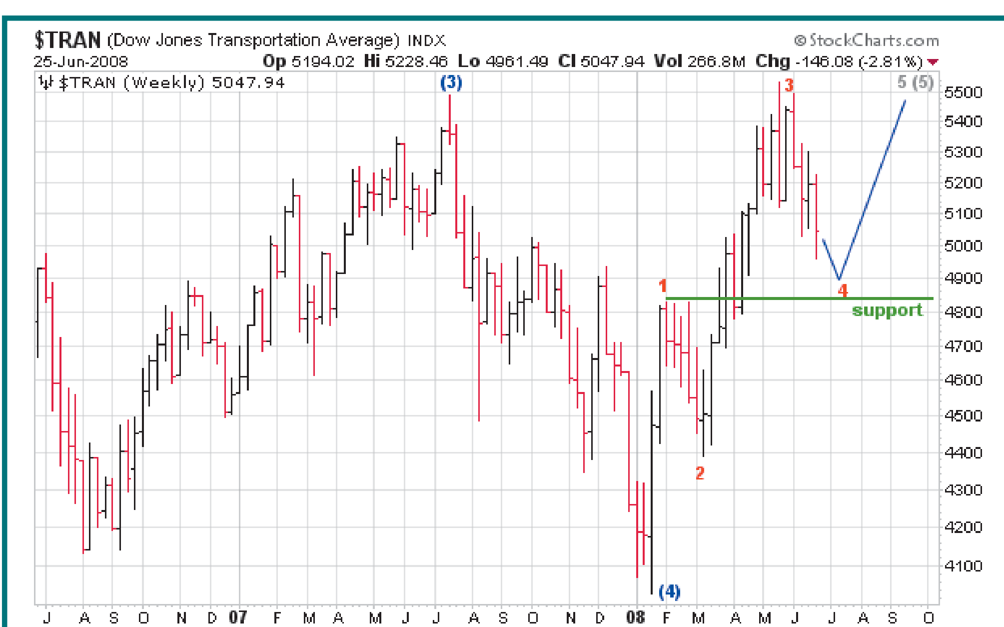

FIGURE 2: $TRAN SHOWING THE ELLIOTT WAVE COUNT, WEEKLY. The Elliott wave count shows that subwaves 1 through 3 of wave (5) to be complete, with subwaves 4 and 5 yet to be completed.

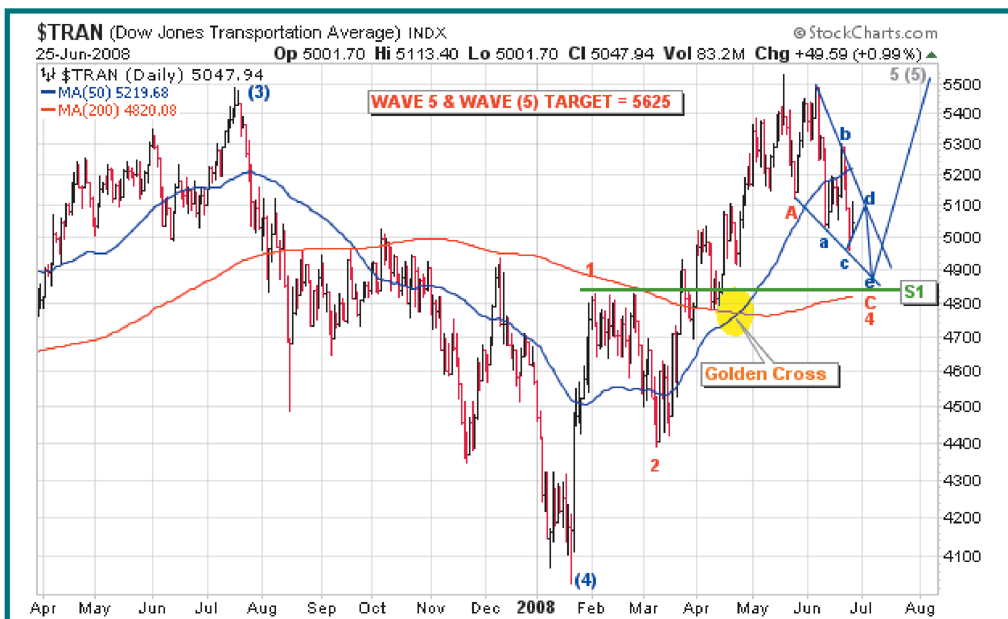

FIGURE 3: $TRAN SHOWING THE ELLIOTT WAVE COUNT, DAILY. The Elliott wave count shows that wave 4 still has one more upwave, wave d, and one more downwave, wave e, before being complete. Once wave 4 is complete, then wave 5 should commence.

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STRATEGIES

FIGURE 1: 30-YEAR TREASURIES, DAILY. The daily chart of the yield on 30-year Treasuries shows that higher interest rates are likely.

FIGURE 2: 30-YEAR TREASURY BONDS, DAILY. Volatility moves in cycles, and low volatility as we have now is followed by high volatility.

Interest Rates Heading Higher?

by Mike Carr, CMT

With the Fed signaling that short-term rate cuts may have ended, the market is signaling that long-term rates are ready to rise.

Tradable: RYILX

In response to a weakening economy and turmoil in the credit markets, the Federal Reserve aggressively lowered interest rates and by many measures has flooded the market with cash. These steps to increase liquidity bring with them the possibility of higher inflation, and the Treasury market seems to be growing concerned about that possibility. If inflation goes up, the interest rate on long-term Treasuries should also go up. In Figure 1, we see that this interest rate is in fact going up.

After peaking in the middle of last year, the yield broke a longstanding down trendline in early May. Since then, the chart shows that an inverse head & shoulder pattern has been completed. The initial target from this formation is a yield of 4.95%, significantly above current levels near 4.71%. Determining chart patterns is more art than science, and many traders would argue that the head & shoulders in this formation are loosely defined. Those traders may see a triangle formation or perhaps a rectangular bottom. The important point is that these formations also are completed and call for higher prices, with the exact same initial target.

In Figure 2, we see that Bollinger bands also argue for higher yields. Bollinger BandWidth is a proxy for volatility. Studies have shown that volatility is cyclical. From current low levels of volatility, we should expect to see larger moves in interest rates. We can also see that when the yield has gone beyond its upper band, it is just as likely to continue higher as lower. This behavior is typical in all tradables except stocks.

Traders looking for an increase in interest rates can buy mutual fund shares such as the Rydex Inverse High Yield Strategy (RYILX), which is inversely correlated to the performance of the high yield bond market. ■

Determining chart patterns is more art than science, and many traders would argue that the head & shoulders in this formation are loosely defined.

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CHART PATTERNS

HEAD & SHOULDERS

CTX Tests Head & Shoulders Support

by Arthur Hill

Centex has formed a bearish head & shoulders pattern over the last few months and looks poised to break support for a bearish signal.

Tradable: CTX

Figure 1 shows weekly prices for Centex (CTX) with a clear downtrend in progress. The stock broke support around 43 last summer and dipped below 20 in late October. After such a sharp decline, the stock was oversold and ripe for a consolidation or oversold bounce. There were a few bounce attempts, but each failed and a consolidation took hold over the last six months.

Although not as clear on the weekly chart, CTX traced out a head & shoulders on the daily chart (Figure 2). These can form as reversal or continuation patterns. After a decline, a head & shoulders would be deemed a continuation pattern and a break below neckline support would signal a continuation lower. This is the case with Centex.

The daily chart expands on the head & shoulders pattern. The left shoulder formed in December, the head in January, and the right shoulder in March. Neckline support resides around 18–19. A break below this support zone would confirm that pattern and signal a continuation of the downtrend. Note that volume expanded with weakness over the last few days and selling pressure is intensifying.

Traditional measurement techniques call for a decline equal to the length of the pattern from the head to the neckline. This would imply a 12-point decline from the neckline break (30 - 18 = 12). With neckline support at 18, this would make the downside target around 6. An alternative would be to measure the percentage decline from the head (peak) to neckline support (30 - 18 = 12, 12/30 = 0.40 or 40%). A 40% decline from the neckline break at 18 would target a move to around 11 (18 x 0.40 = 7.2, 18 - 7.2 = 10.8). Either way you slice it, a neckline support break would be most bearish. ■

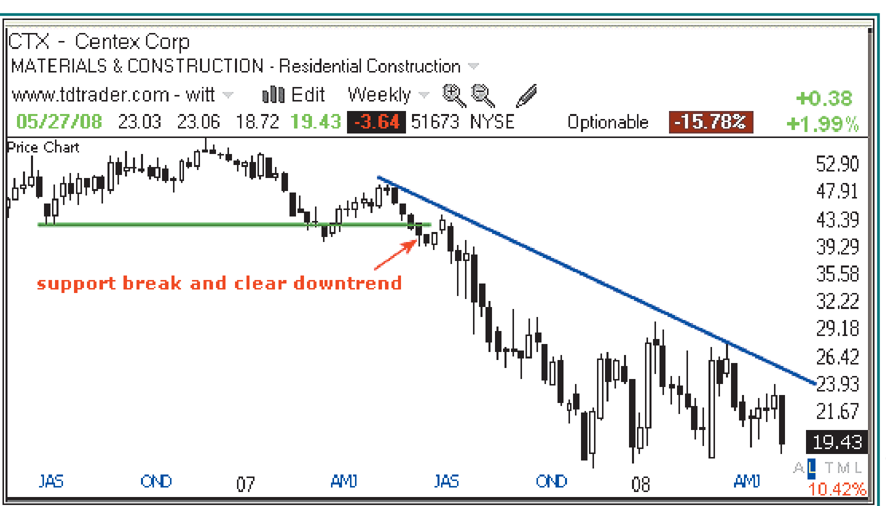

FIGURE 1: CTX, WEEKLY. A clear downtrend is in progress.

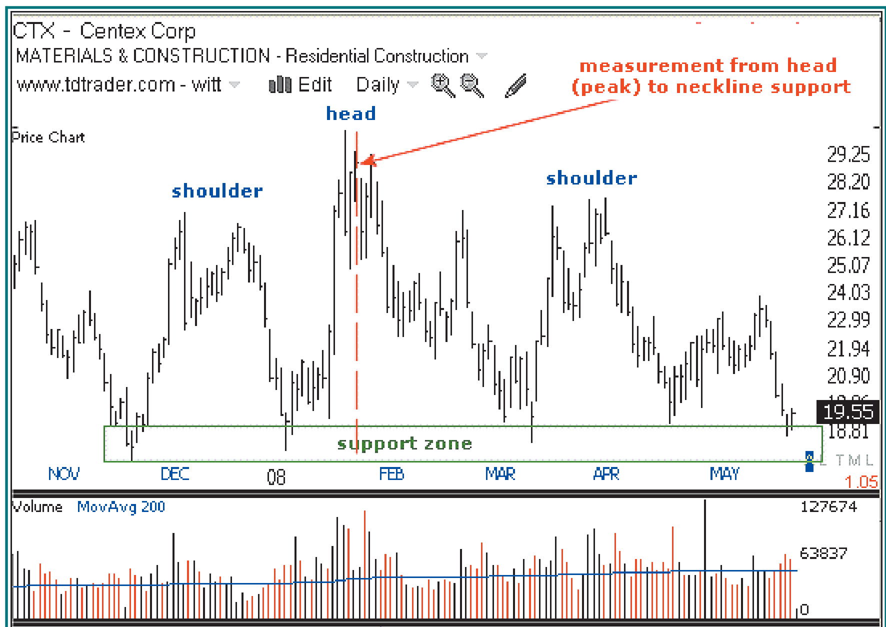

FIGURE 2: CTX, DAILY. A head & shoulder pattern traced out on the daily chart.

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LINEAR REGRESSION CHANNEL

A Fragile Dollar Uptrend

by James Kupfer

The US Dollar Index recently created an upward sloping linear regression channel.

Tradable: $US

Given the recent price action in the US Dollar Index, it is now possible to construct a linear regression channel showing the current price trend. Although the trend is very young and thus prone to potential failure, at this junction the direction is up and therefore represents a potential market bottom for the multiyear decline the dollar has experienced.

As shown in Figure 1, the red line is a linear regression line between the March low and today's prices. A linear regression line is drawn using the method of least squares, thus making it the median line of price action. Above and below the linear regression line are the two channel lines from which are created two standard deviations from the center regression line. In essence, these channel lines act as support (lower line) and resistance (upper line) for a security.

While it can be a somewhat subjective matter to create and use linear regression channels, they can do a great job of representing the current trend. In this case, you can see that the dollar has held support at each of the green circles. The red circles represent where resistance has been touched. When the dollar eventually trades for an extended period of time outside the channel bands, it may signal as a trend change. Until then, expect the dollar to continue to move slowly upward. ■

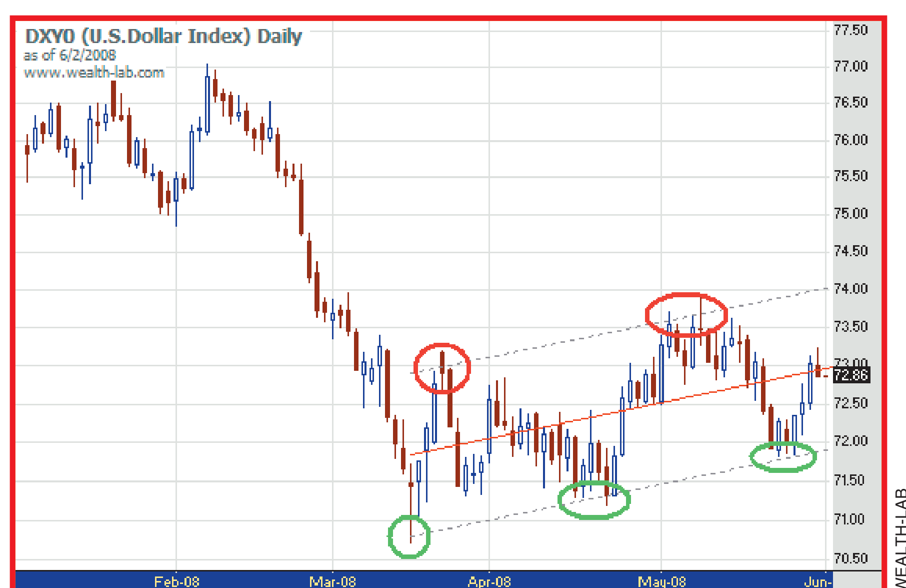

FIGURE 1: US DOLLAR, DAILY. The red line is a linear regression line between the March low and today's prices.

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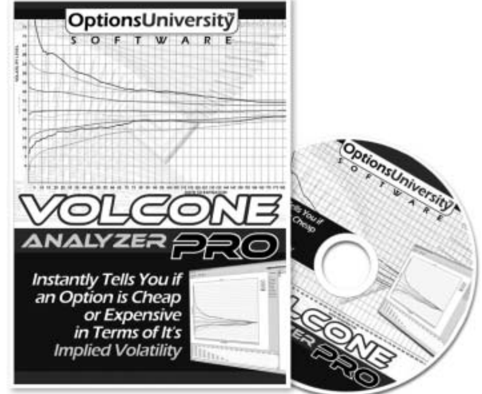

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DBC Fails To Hold Lifetime High

by Chaitali Mohile

The breakout leads the DB Commodities Tracking Index Fund to a lifetime high. The index slipped below the new high and the slide may continue on weak trend notes.

Tradable: DBC

DB Commodities Tracking Index (DBC) went through a strong upward rally after a sluggish move in January and February 2008. Once prices broke out above the range breakout in mid-February there was no slowing down and the volume was also encouraging. The price followed the 50-day moving average direction perfectly and consistently, and reached a new high at 39 in a month and half. The index at this level entered a bullish phase of consolidation after the prolonged upside journey. Sustaining higher levels is more important than losing all the profits earned as the indicators showed shaky moves at their highest levels. From Figure 1, you can see that the entire upward rally was pulled on the overbought stochastic (14,3,3) running in same area for an equally longer period of the rally. So even the consolidation has a wider range of 39-35 that narrowed further, but interestingly, the price rested on the support of 50-day moving average at the lowest consolidation level.

The index rally has a robust bullish strength with the view that the stochastic (14,3,3) declined to an oversold area very fast, while the price held the moving average support — not just stochastic, but the moving average convergence/divergence (MACD) (12,26,9) and the average directional movement index (ADX) (14) also turned out to be very volatile at these higher levels. But as they recovered their strength, the price immediately moved out of a consolidation period and rallied higher. Figure 1 shows a flag & pennant breakout supported by healthy volume. The breakout was surely a buying opportunity, and the traders on board must have enjoyed the rally, as the index was soon at its all-time high of 42.55. Our trading rules say that a stock that makes a new high runs higher in near term, so the trading positions can be carried forward. But here, the picture was different due to weakening oscillators and trends.

The index declined from the all-time high and is more likely to touch the support of upper range at 39 levels. As indicators are weakening, further support testing is more likely to happen. The stochastic (14,3,3) has already left behind its bullish levels and is heading downward. In addition, the MACD (12,26,9) is ready for a bearish crossover in positive territory, adding some more bearish pressure. In addition, the ADX (14) indicate a very weak trend to move the index higher. So the index lacks the strength to pull back, but resting on the upper range resistance converted to support is necessary.

Figure 2, the weekly chart, gives us a clear picture of a flag & pennant formation. Earlier, the index was moving within the range of 24-41 for a considerable period, and as the upper range was violated, the DBC entered a fresh uptrend. The breakout dragged the index to new highs gradually, accumulating strength where necessary. Figure 2 also shows an increase in volume at every rising price level, along with highly bullish stochastic (14,3,3) that never drifted below the 70 level since 2007. The volume was highest at the 39 level and thereafter slowly declined as the stock entered consolidation. The breakout offers fresh buying opportunity. So far the big picture is very positive for the flag & pennant breakout and therefore can carry the index to an all-time high and closer to the target. The target could have been 39 - 32 = 7 + 39 (breakout level) = 46.

The index turned volatile at 42 that is its 52-week high and begun its downside journey. The stochastic (14,3,3) is in an overbought area but is declining. The blue annotated line shows the support for stochastic during the autumn. The MACD (12,26,9) is also in positive territory and ADX (14) also suggests a well-developed uptrend.

Hence, the index has slipped from an all-time high, and the technical indicators are bullish, so traders need not worry. I would recommend booking profits at present levels, and reentering once the support of 39 held and a pullback is confirmed. ■

Figure 2, the weekly chart, gives us a clear picture of a flag & pennant formation.

FIGURE 1: DBC, DAILY. The breakout made its lifetime high and is likely to retest the previous support.

FIGURE 2: DBC, WEEKLY. The indicators are highly bullish, so the price may pull back from the support of the flag & pennant pattern (39).

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BREAKOUTS

Schwab Holds The Breakout

by Arthur Hill

Charles Schwab Corp. is holding its resistance breakout with a consolidation, and traders should watch the consolidation highs for a bullish continuation signal.

Tradable: SCHW

Figure 1 shows daily prices with a high-volume breakout in April. This move carried Schwab above two key moving averages (50-day and 200-day). Volume expanded during the four-day surge to show strong buying pressure. Broken resistance around 20.5 turned into support, and this area held into early June. Note that the two moving averages also turned into support. The breakout was strong and it is holding. This shows strength.

The pattern at work looks like a big advance and falling flag. This is a bullish setup and a break above flag resistance would signal a continuation of the April surge. Failure to continue higher and a break below support at 21 would negate this setup. The bottom indicator window shows the price relative, which compares the performance of SCHW to the Standard & Poor's 500. Schwab is holding up quite well in recent weeks and a price relative breakout would increase the chances of a price breakout.

I am turning to the weekly chart for an upside target and long-term perspective (Figure 2). Based on traditional technical analysis measurements, a flag breakout would project a move to around 26. The length of the first move (23 - 18 = 5) is added to flag support (21 + 5 = 26). This target is confirmed by resistance from the October high.

This weekly chart also shows the power behind the April breakout. SCHW found support around 17.3–18 in March and then surged above resistance with a long white candlestick in April. These April gains held over the last five to six weeks, and traders should be on guard for a continuation breakout. ■

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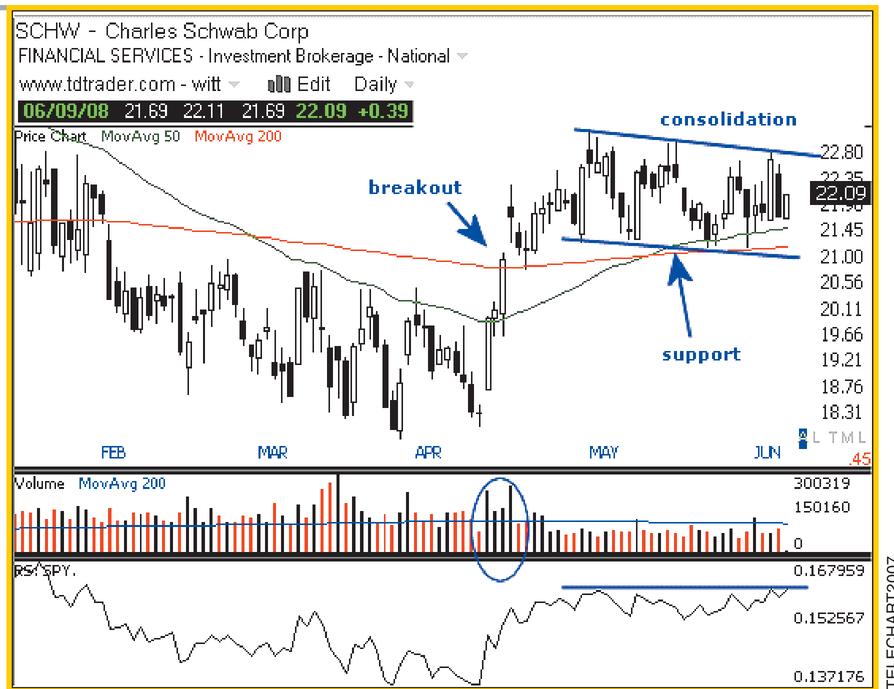

FIGURE 1: SCHW, DAILY. Here are daily prices with a high-volume breakout in April.

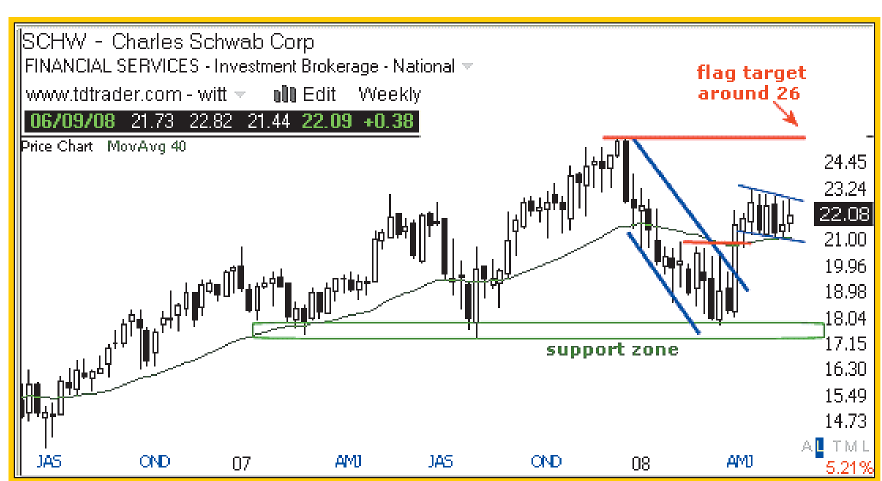

FIGURE 2: SCHW, WEEKLY. See the upside target and long-term perspective.

CANDLESTICK CHARTING

Inside Days For USO

by Arthur Hill

While the long-term trend for the United States Oil Fund ETF is certainly up, an extended harami shows hesitation that could foreshadow a correction.

Tradable: USO

Figure 1 shows candlesticks and focuses on the last two weeks of trading. The United States Oil Fund ETF (USO) surged above 110 with a gap and long white candlestick. After this surge, the exchange traded fund (ETF) formed a smaller black candlestick. The entire range of the black candlestick was within the range of the long white candlestick. An inside day formed and the two candlesticks formed a harami. With another three inside days, I would suggest that an extended harami is taking shape.

After an advance, the harami is a bearish candlestick reversal pattern that requires confirmation. Right now, the ETF is simply stalling after an advance and has yet to actually reverse. A move into the gap zone would start the reversal process and this could lead to a bigger correction in USO.

Figure 2 shows the five-month trend for the USO. The ETF is clearly in an uptrend with support around 98. The February trendline and early June low mark support in this area. Below 98, I am marking the second support zone around 87. This stems from broken resistance and the late April low.

For clues on the medium-term uptrend, I will be watching the relative strength index (RSI). The indicator moved into bull mode with a break above the 50–60 resistance zone in February (red box). During the entire advance, the 40–50 zone has acted as support for the RSI. A break below 40 would break this support zone and be bearish for momentum. ■

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FIGURE 1: USO, DAILY. Here are the last two weeks of trading. This ETF surged above 110 with a gap and long white candlesticks.

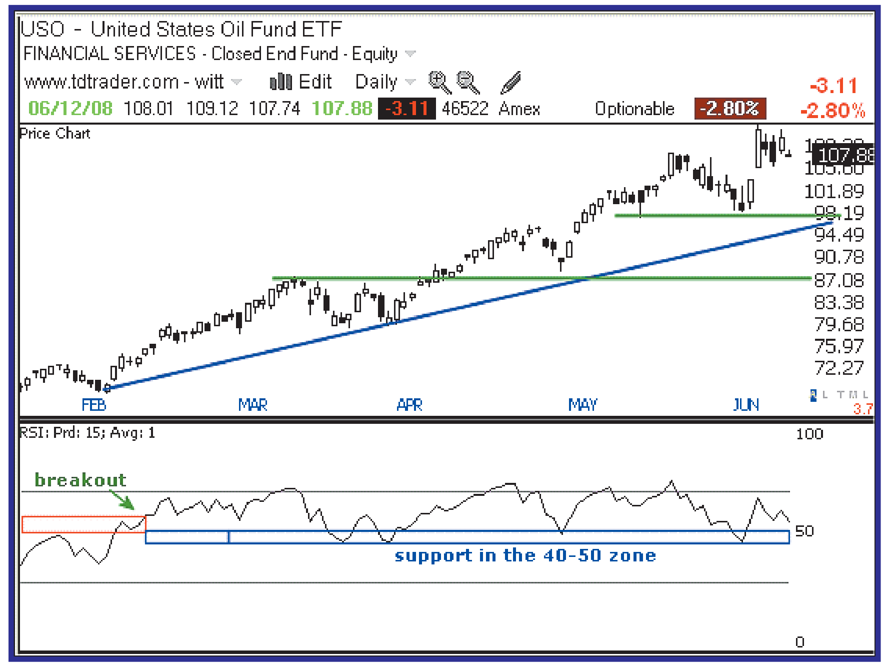

FIGURE 2: USO, DAILY. Here's the five-month trend for the USO. The ETF is clearly in an uptrend with support around 98.

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FIGURE 1: NEM, WEEKLY. NEM advanced above 50 and then corrected with a falling flag in 2008.

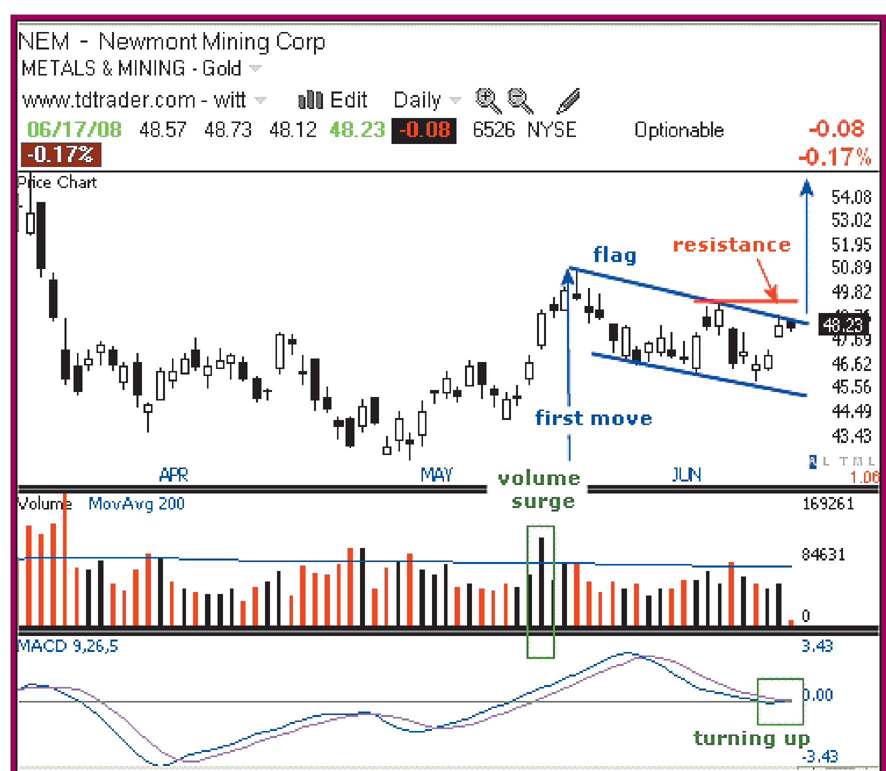


FIGURE 2: NEM, DAILY. Here, the stock surged from late April to mid-May and then corrected with a falling flag into mid-June.

A Pair Of Flags For Newmont

by Arthur Hill

Newmont Mining has falling flags working on two time frames, and a breakout on the daily chart would have long-term implications.

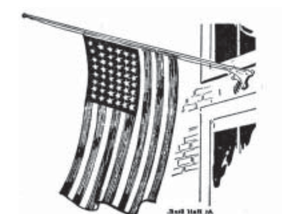
Tradable: NEM

Bull flags form after an advance and typically slant down. As such, they represent a correction after the advance. A break above the upper trendline triggers the first signal. A move above the closest reaction high completes the breakout. Once confirmed, a move similar to the first advance is expected.

On the weekly chart (Figure 1), NEM advanced above 50 and then corrected with a falling flag in 2008. The flag represents a zigzag correction of this advance. NEM surged back to 50 in May and then stalled at the upper-flag trendline. A break above this trendline and a move above the May high would be long-term bullish for NEM. The bottom indicator window shows the moving average convergence/divergence (MACD) turning up over the last few weeks and momentum is improving.

Figure 2, the daily chart, looks similar to the weekly chart. NEM surged from late April to mid-May and then corrected with a falling flag into mid-June. Upside volume surged one day, but then contracted as the flag took shape. Low volume during the flag is okay, but volume should expand to validate a breakout. A move above the upper trendline and early June high would be bullish and likely trigger a bigger breakout on the weekly chart.

The bottom indicator shows the MACD hitting support around the zero line and turning up over the last few days. Momentum is neutral when the MACD is around the zero line. The uptick in the MACD shows improving momentum, and further strength into positive territory would be bullish. ■



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A Head & Shoulders For Goldman

by Arthur Hill

Goldman Sachs formed a large head & shoulders pattern over the last four months, and a neckline support break would have long-term bearish implications.

Tradable: GS

Figure 1 shows daily candlesticks with the head & shoulders pattern extending from March to June. There was a one-day spike below 150, but the stock recovered the next day. With such a quick recovery, I elected to ignore this spike and drew trendlines from the other March lows. As such, the left shoulder formed in March to April, the head formed with the May 2nd high, and the right shoulder is currently under construction. Neckline support resides around 160 and a break below this level would confirm the pattern.

Downside volume and momentum are picking up. The decline over the last few days occurred with expanding downside volume, which shows in-

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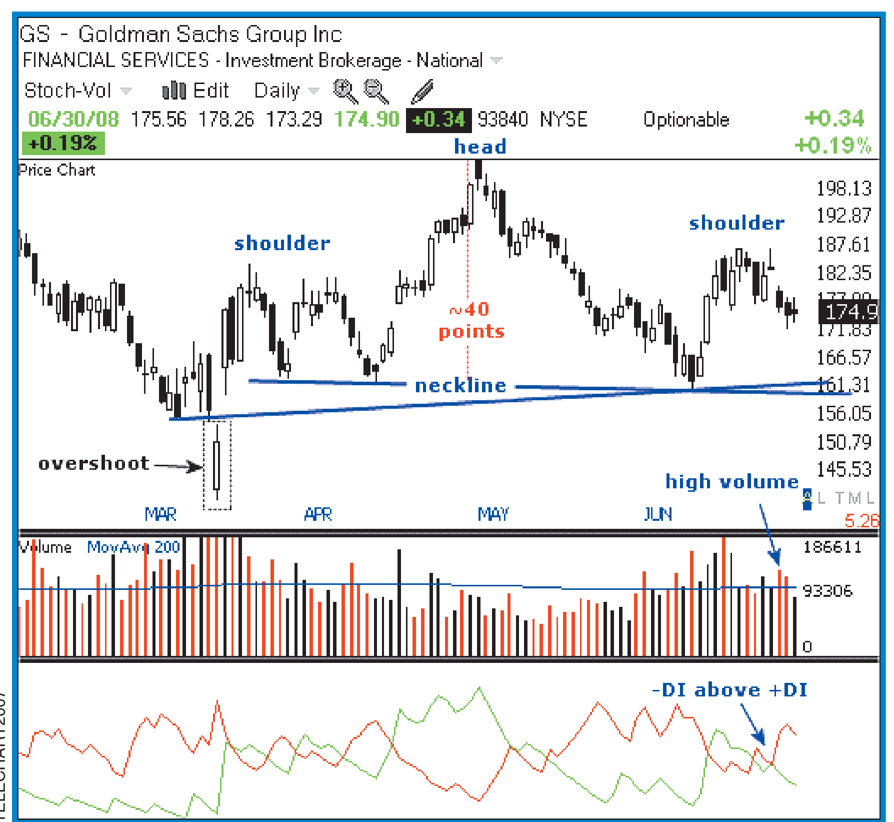

FIGURE 1: GS, DAILY. Here are daily candlesticks with the head & shoulders pattern extending from March to June.

FIGURE 2: GS, WEEKLY. GS is trading near a trendline extending up from June 2004.

creased selling pressure. The bottom indicator window shows a -DI (negative directional indicator) and +DI (positive directional indicator), which are part of the average directional movement index (ADX) system from J. Welles Wilder. -DI moved above +DI in mid-June, and this shows that downside momentum is also picking up. The final straw would be a break below neckline support. Such a move would argue for a decline equal to the height of the pattern (~40 points) and project further weakness to around 120 (160 - 40 = 120).

The long-term implications for this head & shoulders are clear on the weekly chart (Figure 2). GS is trading near a trendline extending up from June 2004. A break below this major trendline would argue for the start of a long-term downtrend. There are already signs of a long-term reversal with the other trendline breaks (red arrows). A break below the third and final trendline would fully reverse the long-term uptrend. ■

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METALS & ENERGY

ELLIOTT WAVE

Is Gold A Buy?

by Koos van der Merwe

Gold was a safe haven to a falling US dollar, but is it still one if the US dollar were to strengthen?

Tradable: GLDL

FIGURE 1: LONDON GOLD, DAILY. This chart of gold suggests strength.

ADVANCEDGET

JPMorgan Chase & Co. chairman and chief executive Jamie Dimon told bank investors on May 12 that while the current credit market crunch may soon be over, the US economy could still face a deep and extended recession that could last into 2010.

With US interest rates currently as low as they are, and the lessons fresh of Japan's decades long depressionary fight with a 0% interest rate, the question arises as to how low the US Federal Reserve is prepared to cut rates. Indications are that they will move much slower in the future. However, should the Dow Jones Industrial Average tank as expected (see my previous article, "What Is The VIX Telling Us?"), then they may be forced to cut rates further as they try to rescue the economy. This will have the effect of once again weakening the US dollar, causing gold to strengthen.

However, as with any economist, there may be two sides to this argument. Gold may strengthen simply because there is less gold being mined than there is demand. Discovery of highly profitable mines are less frequent than in the past, and even with better and more efficient mining techniques, there is a slowdown in production, if not yet, then in the near future. The days of panning for alluvial gold in streams and river beds rather than looking for the source of that gold and drilling for it is once again becoming an attractive alternative.

Figure 1, a daily chart of the London gold price, shows a wave count that suggests that gold has completed a fourth-wave correction and could soon start rising into a wave 5, with an immediate target of $1,080 per oz. The two indicators, namely a 20-period commodity channel index (CCI) and a 12-period relative strength index (RSI) are suggesting strength. However, the PTI (probability) of 34 is extremely weak, which is most probably the reason why the Advanced GET program is suggesting a target as low as $1,080.

The chart pattern that has developed is a pennant, and a breakout at $887.37 will confirm the buy signal given by the two indicators.

To conclude, I would be a buyer of gold at present levels. ■

STRATEGIES

A Conservative Bet On Oil By Buying Russia

by Mike Carr, CMT

While OPEC economies are almost entirely dependent upon oil, Russia offers a way to profit from high oil prices with a margin of safety offered by a more diversified economy.

Tradable: RSX

Market Vectors Russia ETF (RSX) recently broke out to the upside on a point & figure chart of relative strength (Figure 1). While this is a good signal, it should serve as a starting point for research by the technical trader looking for confirmation of a trade. Relative strength measures comparative performance. In a bear market, high relative strength may indicate that the stock is simply losing less than the overall market. That is the case with Russia. The MSCI Russia Index is down 1.4% year-to-date, compared with a 5% decline in the benchmark MSCI Emerging Markets Index.

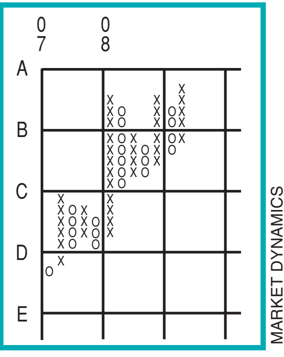

FIGURE 1: RSX, P&F. Relative strength, charted in a point & figure format, just completed a triple-top buy signal in RSX.

MARKET DYNAMICS

FIGURE 2: RSX, DAILY. The bar chart of RSX shows prices at new highs.

TRADE NAVIGATOR

The pattern and the moving average convergence/divergence (MACD) also offer bullish support for RSX (Figure 2). The stock gapped out of an extended basing pattern and cleared prior resistance levels. The wide triangle formation offers an 12-point upside in the stock, and the gap provides a clearly defined stop less than three points below current prices. The reward-to-risk ratio is roughly 4-to-1.

Fundamentals should be considered, or at least looked at, as part of the buying process, along with other technical indicators. Fundamentally, Russia was called an "exceptional value" by analysts at Goldman Sachs. The investment firm advised its clients to take advantage of what they called a "mispricing opportunity" in Russian equities. These analysts are looking for 20% gains over the next 12 months, with the catalysts for a rally likely to come from soaring oil prices as well as a decision to cut oil taxes.

With fundamentals confirming technicals, RSX represents a conservative investment in oil. As Figure 2 shows, Russia can be a volatile investment. But with the price of oil unlikely to dramatically break down, the volatility is likely to be on the upside. ■

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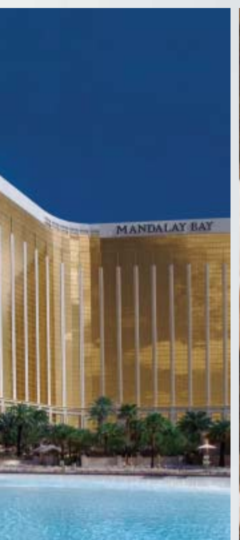

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Energy Select Sector Has Robust Breakout

by Chaitali Mohile

XLE shows the bullish symptoms to continue the upward rally by entering the new uptrend with a gap-up breakout.

Tradable: XLE

For XLE, the 78 level has been a very crucial support-resistance zone, with various upside rallies since September 2007 turning down after hitting this area. In Figure 1, the red & green indicate the resistance & support levels, respectively. The rally with the support of 70 in mid-March was an exception, as it consolidated near 78 instead of retracing back like previous moves. The consolidation formed a flag & pennant continuation pattern, which broke off in an upward direction and soon reached its targeted level (78 - 74 = 4 + 80 = 84). This breakout converted the 78 resistance to stronger support now. The moving average convergence/divergence (MACD) shifted in positive territory while the buying pressure also increased in a trend indicator. The trend gradually turned bullish as suggested by average directional movement index (ADX) (14). So even though the stochastic (14,3,3) was highly overbought, the bullish notes were robust, carrying the move ahead.

On this note, the stochastic (14,3,3) established support at 50 and turned upward for the next bullish run. Meanwhile, the price also retraced to the prior support-resistance zone (78). Along with indicators turning bullish, the price chart too showed the end of an earlier downward rally by forming a hammer candlestick pattern perfectly on the support of 78. This added bullish strength to the rally and to the confidence of traders. This helped the rally surge to higher goals, but price movement witnessed some volatility as it moved closer to the previous high of 84. Traders can watch the MACD (12,26,9), the shaky moves near trigger line and selling pressure increased marginally indicated by negative directional index (-DI) in ADX (14).

The gap-up breakout refreshed the bullish rally that was getting exhausted under the pressure. XLE is therefore ready to continue its present bullish journey with the target than can be measured with the length of the previous rally from 78 to 86. The length is 8 (86 - 78) so by adding to 87, we get the target of 95. The ADX (14) is indicating a developing uptrend above 20, and MACD (12,26,9) is equally positive toward the bullish rally. So overbought stochastic (14,3,3) may not damage the rally as the other two indicators have a bullish signal to continue the rally. Traders can enter the trade at a current level as the gap up is not high. The stop-loss can be observed at 85 in anticipation of a gap getting filled immediately.

On the weekly chart (Figure 2), XLE consolidated in a narrow range of 85 and 82.5 after a long advance rally of almost 10 points. For XLE, every upward move is followed by a marginal correction that strengthen the sector at different levels. Now the gap-up breakout resulted in a flag & pennant breakout on a weekly basis. The 10-point advance rally followed by a narrow range consolidation formed this bullish continuation pattern. Stochastic (14,3,3) at 89 level suggests more space for breakout rally, and also, MACD (12,26,9) is highly positive to carry the sector toward its new target. For long-term traders and investors, the target here would be the length of the flag pole plus a breakout level. Therefore, the length is 10, and added to 85 (breakout level), we get the target of 95.

Thus, with a gap-up breakout, the sector can be a good trading opportunity for traders and investors. The uptrend developing, the rally is likely to sustain its bullishness. ■

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FIGURE 1: XLE, DAILY. The red and green indicate the resistance & support levels, respectively.

FIGURE 2: XLE, WEEKLY. XLE consolidated in a narrow range of 85 and 82.5 after a long advance rally of almost 10 points.

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S&P 500	Futures	Forex	BSG Momentum
343 Winning 18.48% AVG PROFIT	21 Winning 31.69% AVG PROFIT	16 Winning 7.36% AVG PROFIT	81 Winning 40.29% AVG PROFIT
93 Losing 4.80% AVG LOSS	14 Losing 4.11% AVG LOSS	5 Losing 0.37% AVG LOSS	27 Losing 5.14% AVG LOSS

THIS WEEK'S TOP PERFORMERS

MOS:	Long for 701 Days	641.49%	TGIC:	Short for 526 Days	98.02%
POT:	Long for 715 Days	534.87%	ABK:	Short for 393 Days	97.48%
MCF:	Long for 645 Days	469.54%	XJT:	Short for 65 Days	86.89%

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IXYS IXYS Corp	Technology / Semiconductor - Specialized	▲	▲
ULTI Ultimate Software Grp	Technology / Internet Software & Services	▲	▲
CSGS CSG Systems Intl	Technology / Business Software & Services	▲	▲
SDA Sadia S.A. ADS	Consumer Goods / Meat Products	▲	▲
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Utilities Select Sector In Trading Range

by Paolo Pezzutti

An increase in volatility could initiate a new directional move.

Tradable: XLU

The utilities sector has been quite resistant compared to other sectors during the recent move to the downside. After the January 2008 selloff that brought prices from a high at $44.66 in November 2007 to a low of $36.05, prices have managed to recover more than 50% of their losses.

The Utilities Select Sector SPDR (XLU) retested the low in March and produced a positive divergence of many indicators, including the moving average convergence/divergence (MACD), as you can see in Figure 1, and then it started an up move during the past three months.

This sector is quite interesting, although it cannot be completely immune from the conditions of the market, so much affected by the credit crisis combined with the unexpected exploding prices of energy and other commodities. Its recent behavior has characteristics that could provide a good trading opportunity.

Most trends are born in trading ranges when the bands are parallel and flat.

Let's see how we can make use of the Bollinger bands to analyze the technical conditions of XLU.

Bollinger bands consist of three curves. The trend is measured by the middle band, normally a simple 20-day moving average, which is the base for the upper and lower bands plotted two standard deviations off that. These parameters can be changed according to your preferences. Bollinger bands can be used on daily, weekly, and monthly charts, but also on an intraday basis for scalping trades.

In Figure 2, you can see a daily chart of XLU and the Bollinger bands. From the width of the bands, you can get some good indications about the ongoing trend conditions.

When the bands gets narrow, you can expect an expansion in volatility in the near future. Prices are in a trading range and the bands tend to converge. Most trends are born in trading ranges when the bands are parallel and flat. See points A and B in Figure 2. When the bands widen sharply, you can then spot the beginning of a directional trend (point C). At the end of a trend, the band on the other side of the trend will reverse. That leg of the move is over.

From the Bollinger bands you can develop one indicator called BandWidth, which is a relative measure of the width of the bands. To calculate BandWidth, subtract the lower band from the upper one and normalize the result, divided by the middle band. The width of the bands is expressed as a percentage of the moving average.

One way of using this indicator is to spot a powerful setup based on volatility. If volatility falls to extremely low levels, that situation is a forecast of a sudden increase in volatility and a new sustained trend. A breakout from the trading range is characterized by a sharp increase of BandWidth.

In Figure 3, you can see that BandWidth is printing at very low levels. Prices are in a tight trading range and in a congestion during the last sessions. This would imply that XLU could be traded in a breakout mode.

It is interesting to note that XLU developed a similar pattern from mid-April to mid-May. That trading range actually did not bring a new trend, but led to the development of the ongoing sideways move.

The fact that XLU entered a congestion when most sectors entered a negative phase is quite interesting and indicates that investors look at this sector as a relatively safe, low-volatility environment. I would expect to see prices break out to the upside, continuing the up move. I would see the trading range as a pause in the ongoing move, not as a reversal pattern. It is difficult to predict the direction of the breakout and breakouts can also fail.

There are two options if you intend to open a position. Either you wait for the breakout, reducing potential profit but having indications about the direction of the future trend. Or you take a risk, anticipating the direction of the breakout. It is up to you and your trading style. The first resistance is at $42 with an objective at $44-44.50 to retest previous highs. Support is in the $40.50 area. See Figure 4. ■

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This article was first published on 6/17/2008. See www.Traders.com for more.

FIGURE 1: XLU DAILY CHART. MACD printed a significant divergence when prices retested the low of January 2008.

FIGURE 2: XLU DAILY CHART. Some examples of how Bollinger Bands can be used.

FIGURE 3: XLU DAILY CHART. Currently volatility is at very low levels, indicating that soon we could see a new trend emerge.

FIGURE 4: XLU DAILY CHART. Also from mid April to mid May a trading range was developed. Prices moved up only to form another low volatility formation.

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Coal: The Forgotten Commodity

by Mike Carr, CMT

A relatively new ETF provides investors with a way to bet on the price of coal, a valuable commodity but historically tough to trade.

Tradable: KOL

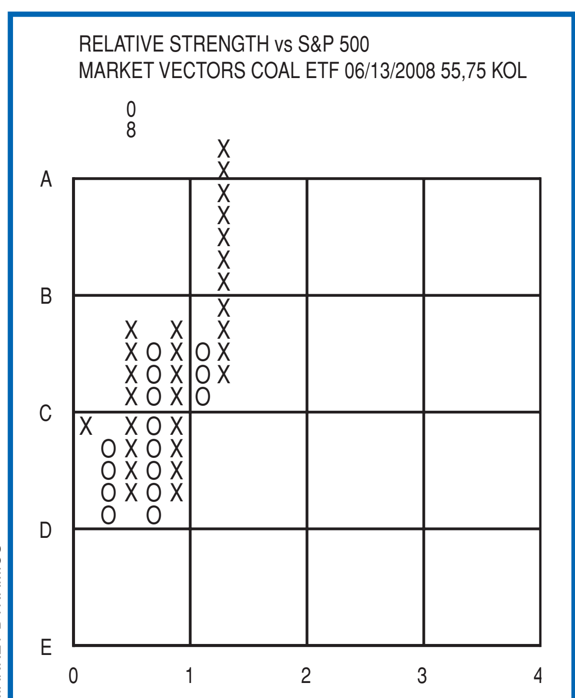


FIGURE 1: RELATIVE STRENGTH, KOL. Relative strength is strong in KOL, but has not yet reached extreme levels. An extreme level on these charts is usually considered to be a column of 20 consecutive Xs.

Market Vectors Coal ETF (KOL) has been among the strongest stock market performers over the past month. Relative strength (RS) tends to be mean-reverting over the short term, which means we would expect to see this short-term performance undergo at least a correction in coming weeks. Academic studies consistently show that RS works best when measured over periods ranging from three to 12 months.

KOL began trading in January 2008, offering a relatively brief history for technicians to develop opinions. In Figure 1, we see a chart of RS presented in a point & figure format. This shows that RS has been strong, but is not overextended at the current level. It is certainly possible that price can go higher from here based upon this chart.

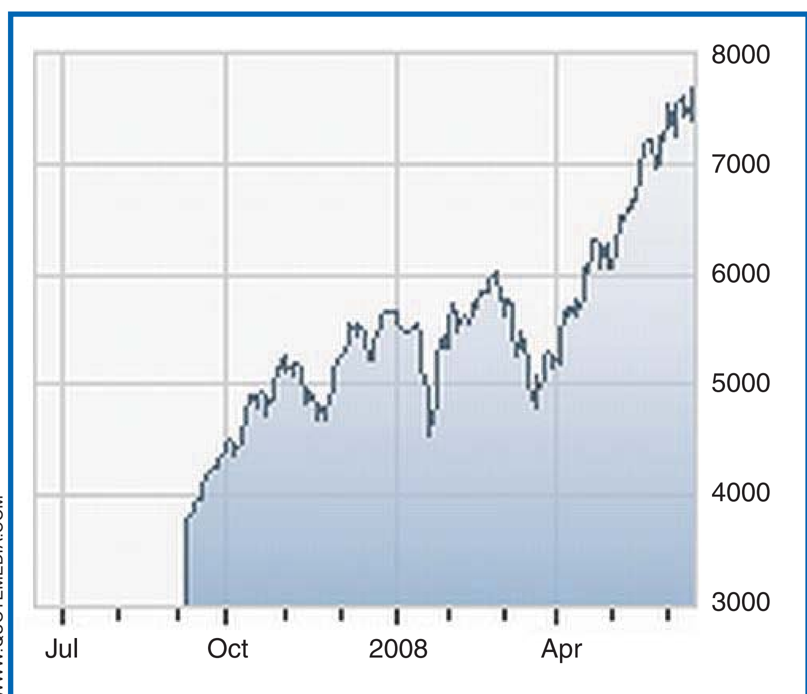


FIGURE 2: STOWE GLOBAL. The Stowe Global Coal Index is used as the basis of KOL. Moves in the two charts are highly correlated.

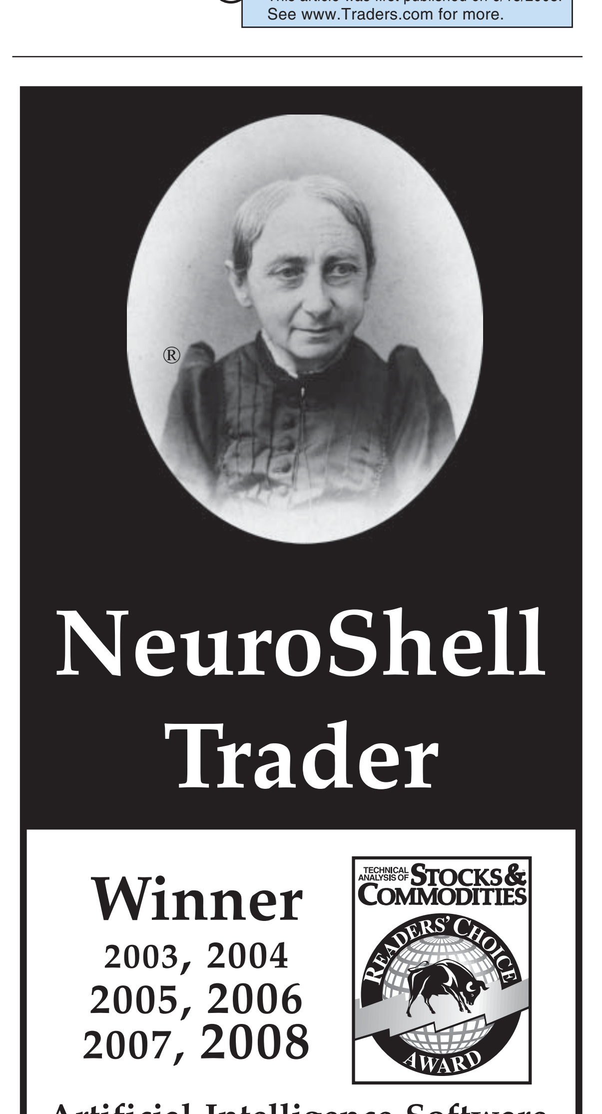
Academic studies consistently show that RS works best when measured over periods ranging from three to 12 months.

The underlying index for this ETF is the Stowe Global Coal Index (Figure 2). This index has risen by almost 60% in only three months. Moves like this are rarely sustainable, making it unlikely that the RS of KOL can continue higher.

The daily chart of KOL (Figure 3) shows that the stochastics indicator is extremely overbought and has been for some time. In addition, prices are extended, trading very near the upper Bollinger band.

Aggressive traders should consider shorting KOL. Given its short price history, a target is difficult to determine. A stop-loss would be arbitrary, based solely upon the trader's risk acceptance, and 10% to 15% would be the minimum tradable level of risk. To the downside, profits of at least 10 points are likely when price reverses. ■

FIGURE 3: KOL, DAILY. Stochastics is at an overbought level and has traced a small bearish divergence on recent price action.



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LINEAR REGRESSION CHANNEL

Forest Oil Set To Move

by James Kupfer

A convergence of technical indicators suggests that Forest Oil Corp. is ready to continue its trend up.

Tradable: FST

Forest Oil Corp. (FST) has been in an overall uptrend since January 2007, and in an even more definitive uptrend since March 2008. The stock recently pulled back from its recent high in order to consolidate. At this point, there appears to be a convergence of technical indicators suggesting that FST is ready to continue its trend up. See Figure 1.

First, the stock is near the bottom up its upward sloping linear regression channel. Circled in blue, you can see that the stock has either touched or at least come close to the channel on eight different occasions. Second, circled in red are the troughs of the Irwin stochastic indicator, an indicator similar to the Bressert double smoothed stochastic. The previous four times it has fallen below 20 (oversold) corresponds to relative low points in the stock's price. The value currently stands at 3.26, indicating a dramatically oversold position. Finally, the recent period of price consolidation has occurred on declining volume. As opposed to price dropping on rising volume, this demonstrates a lack of selling conviction. See Figure 2.

These are the main indicators in my analysis that signal a potential bottom. However, there is one significant red flag that bears watching. The relative strength index (RSI) is divergent from the recent move up, with new highs in price not reflected in higher RSI readings. I have drawn a downward-sloping red line in the RSI pane to make the divergence clear.

Around the $70 level represents a moderate-risk entry point in this analysis. I have initiated a position at $70 with a stop below the June 10th low. Bearing in mind the RSI divergence, I will not be greedy, so if the price fails to break $75 soon I will exit the position. ■

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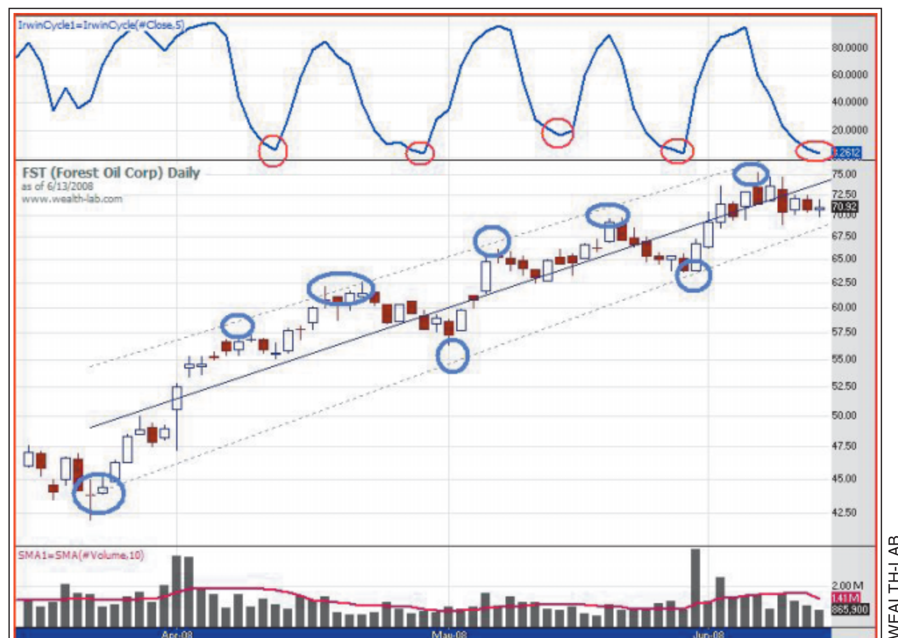

FIGURE 1: FST, DAILY. A convergence of technical indicators suggests that FST is ready to continue its uptrend.

FIGURE 2: FST, DAILY. A downsloping red line in the RSI suggests a divergence, however.

ELLIOTT WAVE

Where Is The Price Of Oil Going?

by Koos van der Merwe

To determine the movement of the oil price, I looked at the oil ETF.

Tradable: OIL

The iPath Goldman Sachs Crude Oil Total Return Index ETN (OIL) is a subindex of the Goldman Sachs Commodity Index. The Goldman Sachs Crude Oil Total Return Index reflects the returns that are potentially available through an unleveraged investment in the West Texas Intermediate (WTI) crude oil futures contract plus the Treasury bill rate of interest that could be earned on funds committed to the trading of the underlying contracts.

FIGURE 1: OIL, WEEKLY. Here's a weekly chart of the oil ETF, showing the Elliott wave count.

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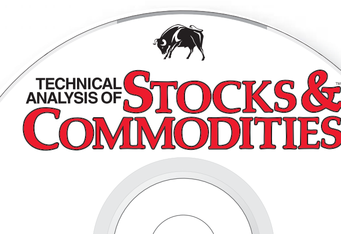

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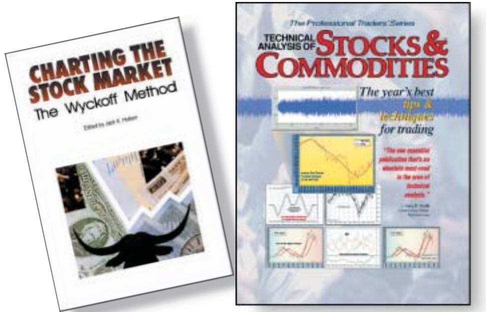

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Figure 1 is a weekly chart of the ETF, which shows how the price moved up strongly from January 2007 when the ETF traded at $31.38 to the present value of $83.29. This move gives us an idea of the move in the oil price, although when we consider that the price of oil moved from below $20 in 1997 to present levels (see Figure 2), an increase in the region of 595%, we have to wonder how we got here. Unfortunately, the ETF did not exist in 1997. The earliest data I have is from August 2006.

Figure 1, however, does show the ETF consolidating at present levels, and suggests that a wave 3 has been completed, with an 86% probability (PTI) of the price now falling into a fourth-wave correction. The targets are shown. Both the relative strength index (RSI) and commodity channel index (CCI) are suggesting overbought positions and possible sell signals.

Both the relative strength index (RSI) and commodity channel index (CCI) are suggesting overbought positions and possible sell signals.

Figure 3 is a daily chart of the ETF and refines the support and resistance figures given, suggesting that a break below the level of 79.53 could see the price falling to test the lower trendline and, ultimately, the targets of the fourth wave.

Figure 3 shows my preferred indicator, and rapid RSI confirming weakness in the ETF. Fibonacci retracement levels are suggesting targets of $71 and $64.

How accurate is the ETF in predicting the oil price? Considering the ETF is based on a crude oil futures contract, it is a prediction of the expected rather than the actual price of oil, but that expectation would be based on the movement of the actual oil price per barrel. For example, in January 2007, the oil price per barrel was $46.53, while the ETF was $32.03. The ETF was therefore conservative but as the oil price moved to $83.46 by December 2007 (an increase of 79%), the ETF moved to $57.87, an increase of 81%, a pretty good reflection of the movement of oil. According to the chart of the ETF, we should see a weakening in the oil price over the coming weeks. Referring back to Figure 3, one disturbing thought is that the recent formation looks very much like a flag pattern, and as we all know, a flag pattern signifies consolidation ahead of a move up. Let us hope that for once this pattern is a failure. ■

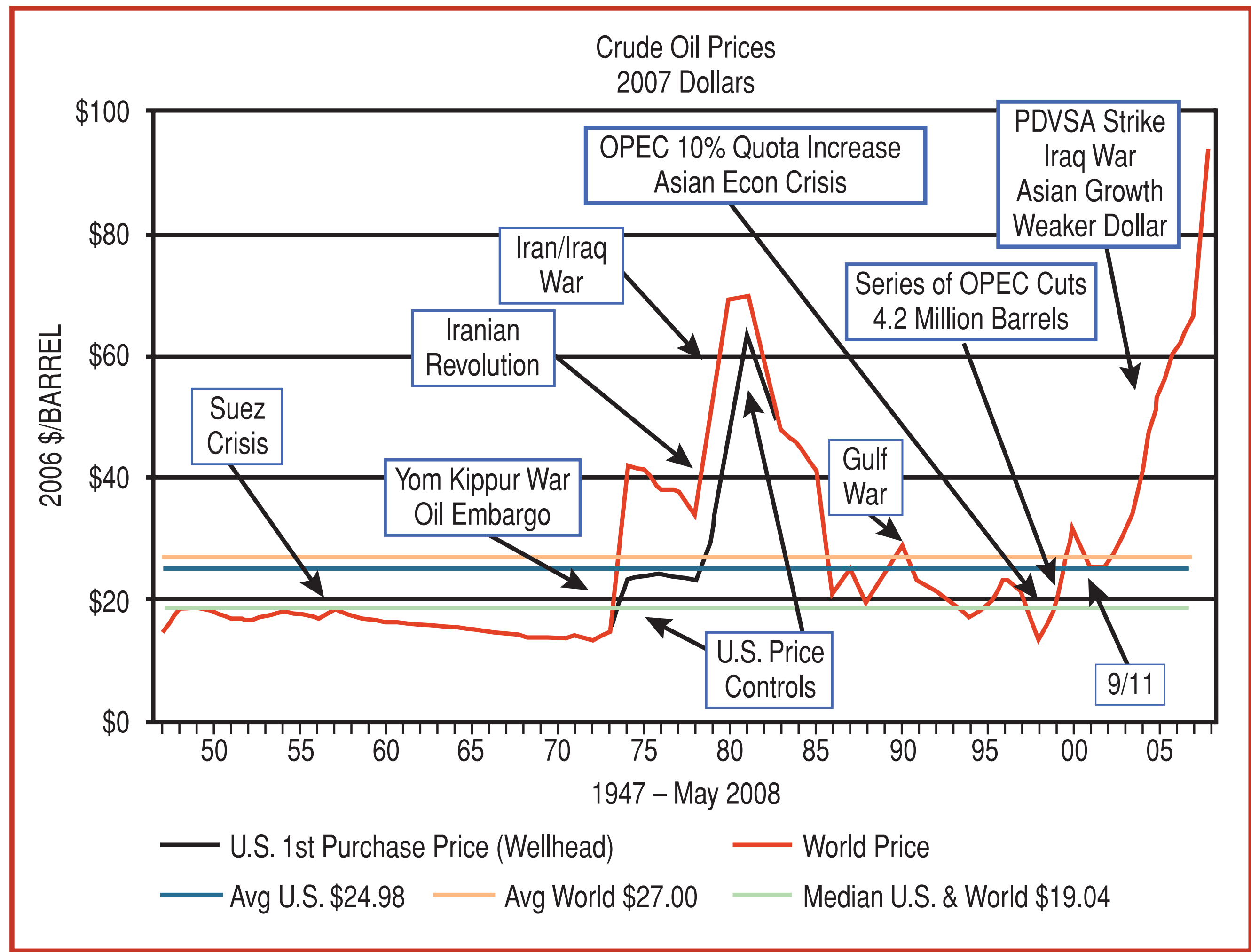

FIGURE 2: THE RECENT HISTORY OF OIL. The movement of the oil price, with historical events causing that movement.

FIGURE 3: OIL ETF, DAILY. This chart shows what could be a flag pattern forming.

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RELATIVE STRENGTH COMPARATIVE

Applying Relative Strength To ETFs

by Mike Carr, CMT

Using a nontraditional approach to relative strength, we find that QQQQ is a buy.

Tradable: QQQQ

Traditional relative strength analysis consists of comparing a basket of stocks or the components of an index to the overall market and determining which ones are the strongest. The strongest are bought and the weakest are avoided. This approach works very well. However, many traders fail to consider that relative strength analysis can be completed for individual stocks, a fact that is especially useful for analyzing index-based exchange traded funds (ETFS) such as the PowerShares QQQ (QQQQ), which represents the NASDAQ 100.

In Figure 1, we show the QQQQ with an indicator known as the momentum of comparative strength (MoCS). This indicator applies the standard moving average convergence/divergence (MACD) calculation to graphically capture the relative strength of an individual stock. Rather than calculating the indicator using the price of the security, a ratio of the close to a market index such as the Standard & Poor's 500 is used. In this case, when the blue line crosses above the red line, the individual stock is outperforming the overall market.

When analyzing index ETFs, an additional relative strength tool that can be used is the breadth of the index components. In this case, we look at the number of NASDAQ 100 stocks that are trading above their 10-week moving average. In a healthy market, the majority of stocks will be moving together. This view uses a point & figure chart to provide insight into the longer-term trend without being confused by the day-to-day price action.

Breadth confirms price in this case, with 68% of the stocks trading higher than their 10-week moving averages. Overall, the QQQQ presents a buying opportunity based upon relative strength analysis. The sell signal would come from MoCS in this analysis. ■

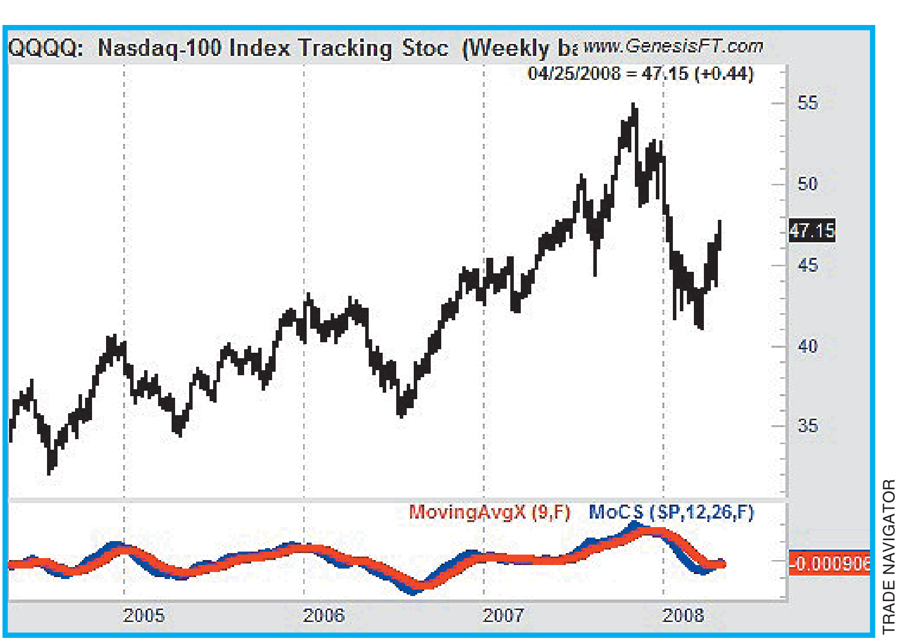

FIGURE 1: QQQQ, WEEKLY. The weekly chart has just offered a buy signal based upon MoCS.

> **Many traders fail to consider that relative strength analysis can be completed for individual stocks.**

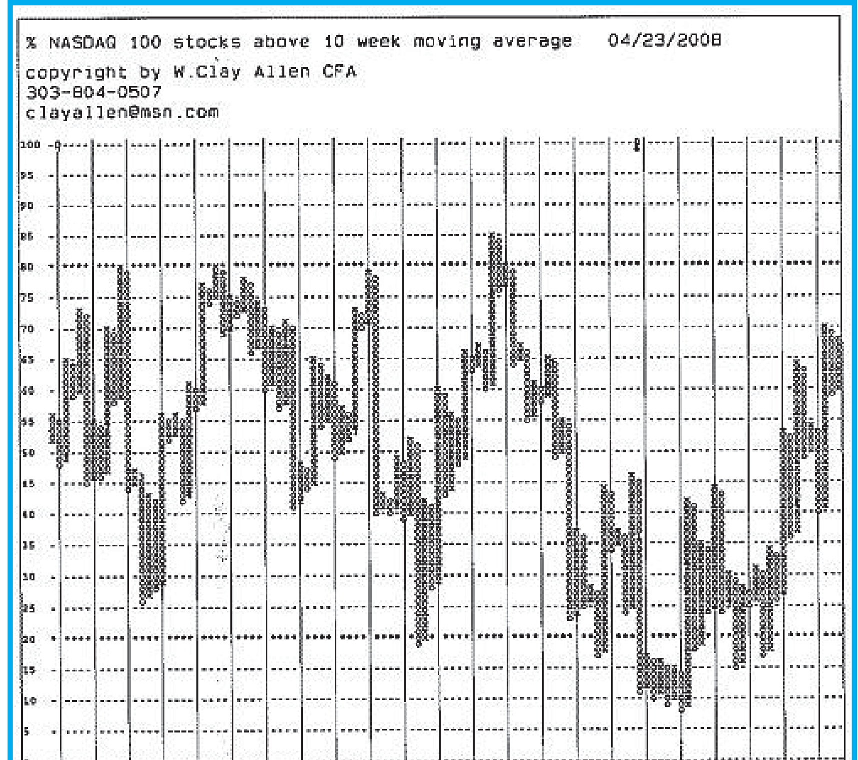

FIGURE 2: QQQQ. Higher lows and higher highs indicate an uptrend in breadth is in place, a healthy condition for a long position.

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Moving Averages Define Market Trends

by Alan R. Northam

Moving averages are a simple way of defining the short-term, intermediate-term, and long-term market trends. The timing of these trends also help traders in determining how long these trends should last.

Tradable: $NYA

Figure 1 shows the daily price bars of the Composite Index of the New York Stock Exchange from 2000 to 2008 to date along with three moving averages. I have shown the daily price bars in gray, the 10-day moving average in red, the 50-day moving average in blue, and the 200-day moving average in green. The 10-day moving average, shown in red, reflects the short-term trends of the market and lasts from a few days to approximately three weeks. The market is in a short-term uptrend when the 10-day moving average is pointing upward and is in a short-term downtrend when the 10-day moving average is pointing downward. The 50-day moving average, shown in blue, reflects the intermediate-term trends of the market lasting from three weeks to approximately three to six months. The market is in an intermediate-term uptrend when the 50-day moving average is pointing upward and is in an intermediate-term downtrend when the 50-day moving average is pointing downward.

The 200-day moving average defines the long-term trend of the market that can last from approximately six months to several years. When the 200-day moving average and the moving average is pointing upward, the market is said to be in a long-term uptrend known as a bull market. And when the 200-day moving average and the moving average is pointing downward, the market is said to be in a long-term downtrend known as a bear market.

Please note that these time frames for each of these moving averages are given for reference purposes only and can vary.

One way to mark the beginning and ending of a bull market and/or a bear market is to look for the crossover of the 50-day and 200-day moving averages. When the 50-day moving average crosses above the 200-day moving average, the market is defined as having entered into a bull market. This crossover is known as the "golden cross." The end of the bull market occurs when the 50-day moving average crosses under the 200-day moving average. This cross under is known as the "dead cross," signifying the death of the bull market and the beginning of a bear market.

In Figure 1, note that the 50-day moving average crossed above the 200-day moving average in 2003 and established the market in a long-term bull market that lasted for almost five years. Recall that bull markets last from six months to several years. In addition, note that the bear market that started in late 2000 lasted for about two and one half years. Bear markets last from approximately a third to as much as two-thirds the length of bull markets.

Finally, note that the 50-day moving average crossed under the 200-day moving average in early January 2008 and the 200-day moving average is pointing downward. This marks the beginning of 2008 as the date when the New York Stock Exchange Composite Index entered into a long-term bear market. After all, the bull market of 2003 lasted for nearly five years and it is well past time for a bear market to emerge.

In Figure 2, I have zoomed in on the daily price chart of Figure 1 to show more of the details of this market since the beginning of 2008. Note that the market entered into a short-term uptrend on two different occasions since the beginning of the bear market. The first occurrence was in late January to the end of February 2008, when the 10-day moving average pointed upward. The second occurrence occurred in late March 2008 and continues to this date. During the first occurrence, the short-term uptrend was confined below the 50-day moving average and is known as a short-term corrective rally within the confines of the intermediate-term downtrend. The second occurrence, however, is different, as the daily price bars not only started trading above the 10-day moving average but also traded above the 50-day moving average. In addition, the 10-day moving average crossed above the 50-day moving average. This short-term uptrend is known as a short-term market correction within the confines of a long-term bear market.

Figure 2 also shows that the market entered into an intermediate-term uptrend in early April 2008 when the market started trading above the 50-day moving average and the moving average started pointing upward. This intermediate-term uptrend is known as an intermediate-term corrective rally within a long-term bear market.

FIGURE 1: NYSE COMPOSITE INDEX, DAILY. Here's the daily price chart of the NYSE Composite Index showing 10-day, 50-day, and 200-day moving averages.

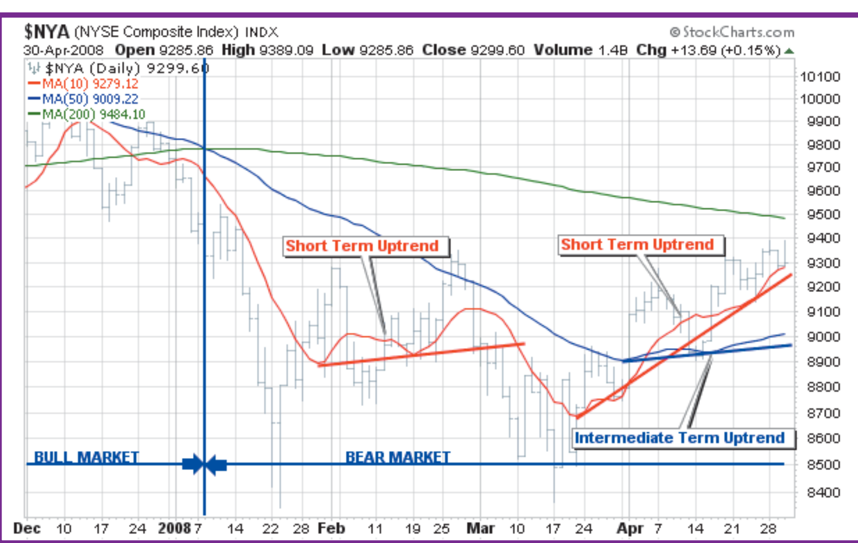

FIGURE 2: NYSE COMPOSITE INDEX, DAILY. Here's a closeup view of the daily price chart of the NYSE Composite Index showing short-term and intermediate-term corrective rallies.

Corrective rallies occur after the market has made a significant move such as downward. The market has a way of getting ahead of itself by moving too fast in one direction. In the case of a bear market, traders will always become overzealous and sell the market below its perceived market value. Technicians say that the market is oversold. Corrective rallies are periods when traders correct for their overzealousness in selling off the market below its market value.

One point that I want to emphasize is the timing of these various market trends. When a moving average, such as the 50-day moving average, turns upward, traders should be aware that this new intermediate-term uptrend will most likely last from approximately three weeks to as much as three to six months. Being aware of the typical time frames for the various market trends such as short term, intermediate term, and long term, will help to keep traders from entering into a market position too quickly. Waiting for these trends to run their course will allow traders to enter into the market at a much better price.

Moving averages are a simple way of defining the market trend or trends. From Figures 1 and 2, we see that overall the New York Stock Exchange Composite Index is in a bear market trend, as noted by the 200-day moving average pointing downward that could last from six months to several years. We also note that within the confines of this bear market, the New York Stock Exchange Composite Index is currently experiencing short-term and intermediate-term corrective rallies that could last from three weeks to six months. Note that the short-term trend is already more than four weeks old and is due to end. Once these corrective rallies have worked off the market's short-term and intermediate-term oversold conditions, traders will resume their selling, driving the market downward once again.

As a final note, the bear market is now only four months old and has not yet met the minimum time frame for bear markets. So traders should expect this market to continue selling off for several more months to come. ■

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ELLIOTT WAVE

What Is The VIX Telling Us?

by Koos van der Merwe

Is the VIX now telling us to be prepared?

Tradable: VIX

In spite of what the pundits interviewed on CNBC are telling us, it has become a matter of "Is it or is it not a recession?"

Charts, as I have previously said, have convincingly confirmed that the US is very definitely in a recession, and has been in one since October 2007.

Figure 1 is of the Dow Jones Industrial Average (DJIA) and starting to suggest that the recession — the down move may well be over. The chart shows that the DJIA has completed an ABC correction, and could now be tracing a wave 1 of a new bull market.

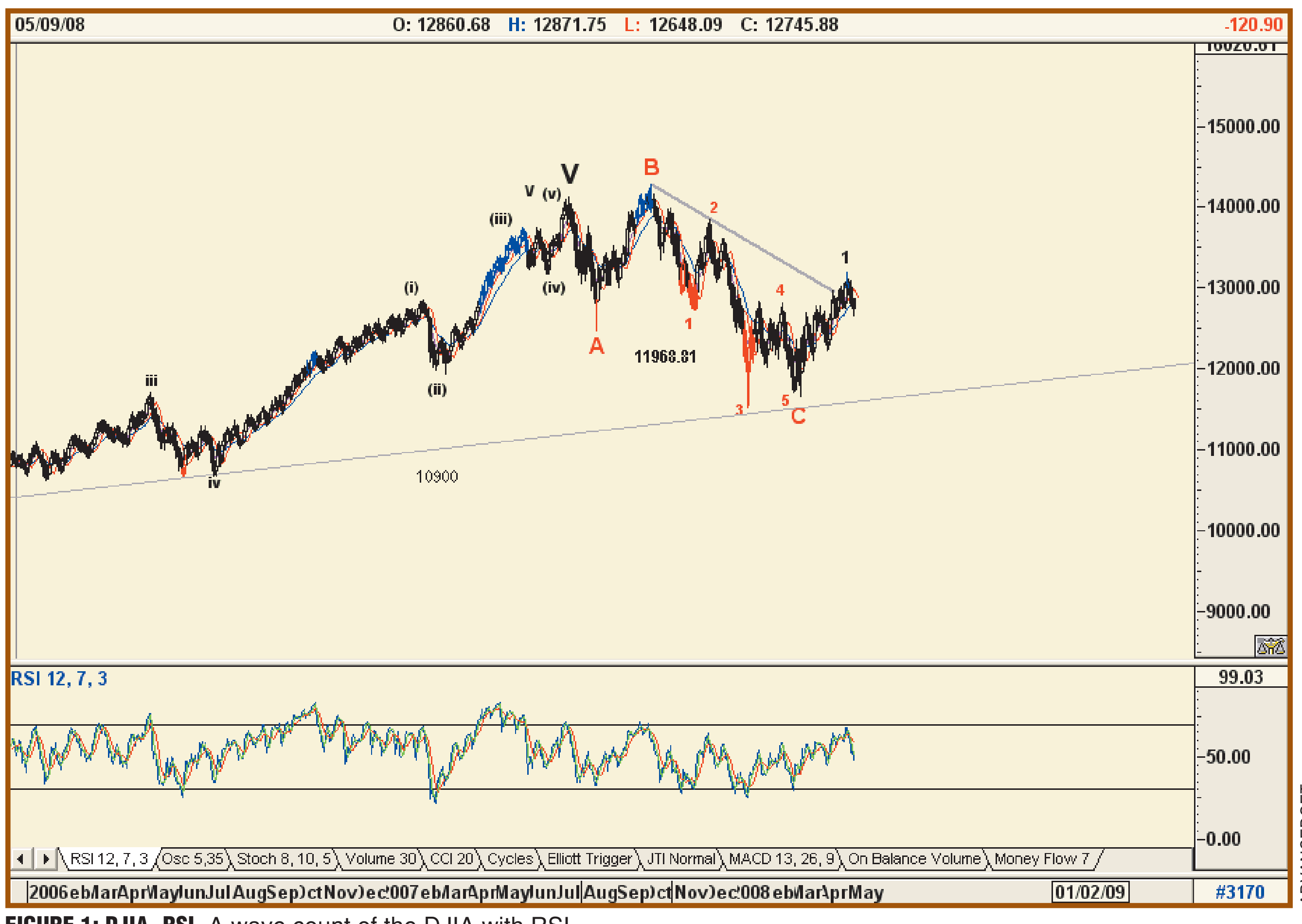

FIGURE 1: DJIA, RSI. A wave count of the DJIA with RSI.

If this is so, does this mean that the US recession is over?

Not yet, and for two reasons. The first is the relative strength index (RSI), which has not reached oversold levels, and suggests that wave 1 could still be in progress. The other is that although the VIX is approaching levels where previous DJIA buy signals have been given, a turn has not been cast in stone. This could only be the case if the DJIA breaks below the short-term trendline drawn on the chart.

After a wave 1 up, there is always a wave 2 down, and the VIX chart below is suggesting that the DJIA is about to fall in a wave 2. It has become not a matter of when, but a matter of soon.

Figure 2 is that of the VIX and the DJIA . On the chart I have drawn gray vertical lines when the VIX has spiked up, and red vertical lines when the VIX has spiked down. It is obvious just by looking at the chart that when the VIX is high, the DJIA falls, and when the VIX is low, the DJIA rises. Admittedly, the signals are not exact in that they do not pick up the exact turning point, but the signals given by the VIX are more than good, and have proved that they should be obeyed.

Figure 2 shows that the VIX is now signaling that a sell of the DJIA is on the cards, if not soon, then in the not-too-distant in the future. With the maxim "Sell in May and go away" on everyone's mind, this could be the trigger initiating the fall.

You, the investor, should sit back, hold your cash, and wait. For how long? Well, a wave 2 correction can be complex or simple. If simple, then wave 4 will be complex and vice versa, so the timing could be longer or shorter than anticipated. What one does know, however, is that a wave 2 is usually a 72% correction of wave 1, and that the majority of investors and the pundits always believe that it is a continuation of the downtrend and preach doom and gloom.

So being in the know, sit back and wait — and follow the advice given by every Boy Scout, which is "Be prepared," and stay in cash for now. ■

FIGURE 2: DJIA, VIX. A chart of the DJIA and the VIX showing buy and sell zones.

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Is The 200-Day Moving Average A Reliable Trend Indicator?

by Mike Carr, CMT

With major averages facing resistance at their 200-day moving averages, we test the reliability of this indicator.

Tradable: DJIA

Nearly all major stock market averages are approaching what is widely believed to be a significant technical level. In Figure 1, we show the Dow Jones Industrial Average (DJIA) with its 40-week moving average. This is approximately the same as a 200-day moving average, but we selected the weekly view in order to fit more data into the chart. While we are highlighting the DJIA in Figure 1, other major averages such as the NASDAQ Composite, Standard & Poor's 500, or any of the Russell indexes are in the same position relative to this moving average.

It can easily be seen in the chart that this moving average captures large portions of the trends. This is the appeal for commentators who can quickly point to the buy signal in mid-2006 that led to a gain of nearly 2,000 DJIA points over the next year. What can also be seen in Figure 1 is that there appear to be a lot of whipsaws associated with this strategy.

Whipsaws are trades where price initially moves in one direction but quickly reverses. The result is usually a series of small losses. Moving average signals are notorious for creating whipsaws, which makes it difficult for traders to use these systems.

Testing crossovers of the 200-day moving average as a buy signal yields disappointing results. In the DJIA dating back to 1900, there have been 185 long trades, but only 15.1% were profitable. Overall, the trader would show a small profit after nearly 108 years, but the maximum drawdown of 3,277 DJIA points exceeds gains of only 2,147 points. Results are even worse in the S&P 500, which shows only 8.3% of signals would have been winners since 1950. Signals in the NASDAQ Composite were correct about 36% of the time since 1985.

FIGURE 1: DJIA, WEEKLY. The DJIA is just below its 40-week simple moving average.

The problem with these crossover signals is the large number of whipsaw trades, often four or five small losers before the trend fully develops. While commentators will tout the 200-day moving average as reliable, traders are well advised to avoid acting on this news. ■

Whipsaws are trades where price initially moves in one direction but quickly reverses.

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by Dr. Charles B. Schaap

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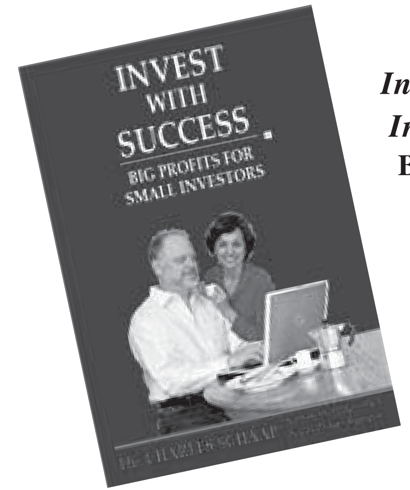

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Support And Resistance Lines Define Market Trends

by Alan R. Northam

Support and resistance lines not only help traders in identifying areas of support and resistance, but they can be used to determine the trend of the market.

Tradable: $NYA

Support and resistance lines can be used to define market trends. Figure 1 shows the daily price bars of the Composite Index of the New York Stock Exchange from 2002 to 2008 to date along with the support and resistance lines.

Bull and bear markets do not rise or fall in straight lines. Bull markets rise in waves and bear markets fall in waves. In Figure 1, the peak of each wave is marked by a horizontal red line and the bottom of each wave is marked by a horizontal green line. As you can see from 2003 to 2008, the NYSE rose from approximately 4500 to 10000 in a series of waves. The peak of each wave represents an area of resistance where the market could not move higher and the red horizontal line is known as a resistance line. The bottom of each wave represents an area of support where the market refused to move lower and the green horizontal line is known as a support line.

In a bull market, note that each support line is higher than the next and that the market never trades lower than the previous support line. In addition, each resistance line is higher than the next but also note that the market eventually trades higher than the previous resistance line.

Technicians say that the line or resistance is broken when the market trades through it. In a bull market, resistance lines are easily broken, whereas support lines are never broken. This rule is the key to identifying bull markets using support and resistance lines.

It is also possible to tell when the bull market is coming to an end by using support and resistance lines. I'd like to draw your attention to the middle of 2007. Note here that the market came down and traded right down to the support line that was drawn in early 2007. Also note that this is the first time the market traded down to a previous support line since the bull market started in 2003. This is the first sign that the bull market is tiring as it could not make a higher low where a new higher support line could be drawn. Further, note that the last resistance line drawn off the market peak in October 2007 was just barely higher than the previous resistance line. Again, this is a sign that the bull market is weakening as the peak in early October 2007 was just barely higher than the peak in early July 2007. The bull market then came to an end when the market traded below the support line drawn off the early 2007 wave bottom, or market low. I have identified this point with a red circle.

Figure 2 shows the daily price bars of the Composite Index of the New York Stock Exchange from 2000 to 2003 to date along with the support and resistance lines. Again in Figure 2 the peak of each wave is marked by a horizontal red line and the bottom of each wave is marked by a horizontal green line. As you can see, from 2000 to 2003 the New York Stock Exchange fell from approximately 7000 to 4400 in a series of waves.

FIGURE 1: $NYA, DAILY. The daily price chart of the New York Composite Index shows the bull market between 2003 and 2008 along with support and resistance lines.

FIGURE 2: $NYA, DAILY. The daily price chart of the New York Composite Index shows the bear market between 2000 and 2003 along with support and resistance lines.

In a bear market, each resistance line is lower than the next and the market never trades higher than the previous resistance line. In addition, each support line is lower than the next and the market eventually trades lower than the previous support line.

Technicians say that a line or support is broken when the market trades through it. In a *bear* market, support lines are easily broken whereas resistance lines are never broken. This rule is the key to identifying bear markets using support and resistance lines.

It is also possible to tell when the bear market is coming to an end by using support and resistance lines. I'd like to draw your attention to the middle of 2002. Note that the market came down and traded just slightly below the support line that was drawn off the July 2002 low. This new low provided a new area of support just below the previous area of support. This was the first clue that the bear market was losing its strength. Now see what happened in early 2003. Here the market traded down to the last support line drawn but did not break through it. This became the second clue that the bear market was coming to an end. After the market failed to break below this line of support, the market then started to trade higher and eventually broke through the resistance line drawn off the late 2002 high. This was the first time that a resistance line was broken since the beginning of the bear market in early 2001. With the market failing to break below support in early 2003 and the market breaking above the resistance drawn off the market peak in late 2002, the bear market came to an end.

In conclusion, bull and bear markets can be defined by support and resistance lines. In a bull market, support lines are never broken, whereas resistance lines are easily broken. When the resistance line fails to be broken and the support line is easily broken, it is a sign that the bull market is coming to an end. In a bear market, just the opposite is true. In a bear market, resistance lines are never broken and support lines are easily broken. When support lines fail to be broken and the resistance line is easily broken, it is a sign that the bear market is coming to an end.

However, I must flash a warning sign at this juncture. There will be times when using support and resistance lines to determine the market trend where a false signal will be given. When this happens, the market can continue in the direction of the major trend after giving a sign that the trend is coming to an end. In these cases, the second sign that the trend is coming to an end will usually be the correct signal, and in some rare cases a technician might even have to wait for a third sign.

One final comment. Looking back at Figure 1, see that the bull market came to an end right at the beginning of 2008. Use the rule of defining a bear market with support and resistance lines to determine if a new bear market is under way. ■

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SECTORS

MOVING AVERAGES

RTH Risk/Reward Ratio Favorable

by Alan R. Northam

The Retail HOLDRS is up against its 200-day moving average and downward sloping trendline. This is an ideal place to take a short position in this ETF, as the risk to reward ratio is highly favorable.

Tradable: RTH

Figure 1 shows the daily price chart of the Retail HOLDRS. There is a high probability that RTH is now ready to turn lower, and here's why. First of all, the 50-day moving average crossed below its 200-day moving average in early September 2007, establishing RTH in a long-term downtrend. This long-term downtrend will remain in effect until proven otherwise.

Second, we note that the downward-sloping trendline has been touched three times and has not been penetrated. The first touch came in mid-September 2007, the second touch came in mid-October 2007, and the third touch came in early April 2008.

Third, RTH moved too far away from its 200-day moving average by January 2008 and has been in a corrective mode since. This three-month correction finally moved up to and bounced off the 200-day moving average and the downward trendline in early April and is now testing this moving average and trendline for a second time this month.

From a technician's point of view, a trend that is in motion stays in motion until proven otherwise. RTH is in an established downtrend. In addition, any move against the trend in motion is considered a countertrend correction. Thus, the rally from early January 2008 is considered to be a market correction. And finally, for the trend in motion to remain in motion, the downward-sloping trendline must not be violated. A move above this downward-sloping trendline will be the first sign that the downward trend is in the process of changing.

FIGURE 1: RTH, DAILY. This bar chart of Retail HOLDRS shows a 50-day simple moving average, a 200-day moving average, and a downward-sloping trendline.

This is all fine and dandy, but how do you trade this ETF? From an educational standpoint, allow me to say that the current position of RTH is the perfect place to take a short position because the risk to reward ratio is extremely good at this point and the higher probability is that RTH will turn and move lower, as it is in an established downward trend. The risk comes from being wrong in taking a short position. However, with RTH up against its downward-sloping trendline, it wouldn't take much of a move higher to prove that the downward trend is reversing. So all that needs to be done in taking a short postion is to place a buy-stop just above the trendline to limit risk to a small loss in case RTH continues to move higher. However, should RTH bounce off the downward-sloping trendline, the reward is very good, as we can expect it to move to a new, lower price.

To reduce risk further, a trader could wait one of two more days to make sure that RTH is going to turn back downw before placing a short trade. However, reducing risk by waiting also comes at somewhat reduced profit potential. Personally, I would wait to see if RTH was going to turn back down before taking a short position. Reducing a potential loss is a better money management plan than trying to maximize a potential gain.

Just remember that trading can result in loss of capital, and any decision to trade this exchange traded fund is your own. ■

MOVING AVERAGES

Pulte Fails At The 200-Day Average

by Arthur Hill

Pulte Homes (PHM) failed to break long-term resistance, and a recent downturn in momentum opens the door to lower prices.

Tradable: PHM

Figure 1 shows Pulte (PHM) with the 200-day moving average (blue). Pulte surged to this key moving average in late January but was turned back on the first attempt. Despite subsequent breakout attempts in February and March, the stock failed each time and never broke through. Long-term resistance held.

The red line shows the 20-day moving average of the 200-day moving average. Yes, it is a moving average of a moving average. This simple technique shows when the 200-day is trending lower and when it turns up. The 200-day is moving lower when it remains below its 20-day moving average — such as now. A worthy upturn would forge a crossover and suggest that the tide (trend) was turning.

Figure 2 shows PHM in 2008 with an inverse head & shoulders pattern. This pattern is potentially bull-

FIGURE 1: PULTE, DAILY. The stock surged to a key moving average level in late January, but was turned back at various attempts in the next two months.

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ish but requires confirmation with a break above resistance. PHM did not break resistance and did not confirm the pattern. Instead, PHM declined to the January trendline and broke the late March low. While there is potential support from the January trendline, the failure and support break are bearish.

Momentum is also bearish. After surging in late January, the moving average convergence/divergence (MACD) formed a lower high in April and this showed waning upside momentum. A bearish signal line crossover followed this lower high and the indicator moved into negative territory over the last few days. Momentum is now bearish and it would take a move above the signal line to suggest otherwise. ■

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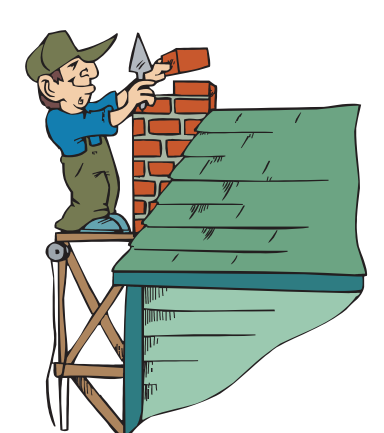

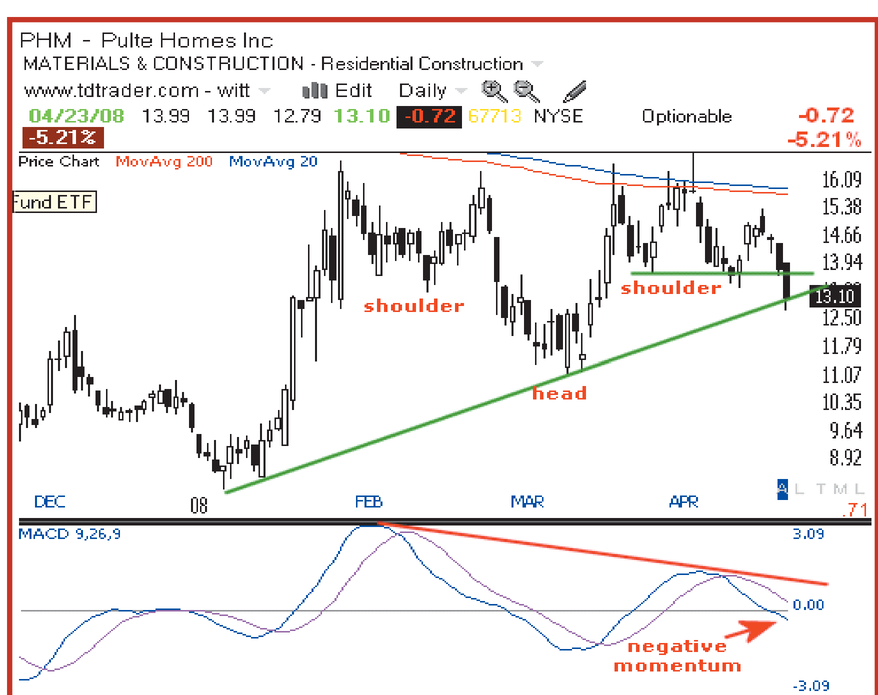

FIGURE 2: PULTE, DAILY. The inverse head & shoulders pattern is potentially bullish, but requires confirmation with a break above resistance.

ELLIOTT WAVE

Homebuilders Headed South

by Alan R. Northam

The SPDR S&P Homebuilders Index has completed its corrective wave pattern, signaling that this index of homebuilders is now headed south.

Tradable: XHB

Figure 1 shows the daily price chart of the SPDR S&P Homebuilders Index (XHB). In this chart, note that XHB made a major bull market top in February 2007. Since then, XHB has been trading in the downward direction.

Note that from February 2007 to January 2008, XHB moved lower in five waves, waves 1, 2, 3, 4, and 5 (see blue numbers on chart). These five waves then form wave (1) of a larger five-wave move to the downside (see red number (1)). This is the fractal nature of waves, where waves 1, 3, and 5 subdivide into five subwaves. If we were to look closer at the wave structure of wave 1 down, which ended at the end of March 2007, we could identify five smaller subwaves within wave 1. We could also identify five subwaves within waves 3 and 5 by looking more closely at their wave structures.

Waves 2 and 4 of a five-wave structure are corrective waves. These corrective waves form differently from waves 1, 3, and 5. Wave 2 normally forms as a three-wave zigzag structure and is labeled waves A, B, and C, but can evolve into other corrective wave patterns as well. Wave 4 usually forms in a corrective wave pattern that is different from wave 2. So if wave 2 forms as an A, B, C zigzag, then we can expect wave 4 to form a different corrective wave pattern.

Despite these differences, what these two waves have in common is that they are both corrective waves that move in the opposite direction as waves 1, 3, and 5 and are not to be confused with the start of a new trend in the opposite direction. In looking at our chart, we can see that from January 2008 until the end of March 2008, XHB has been trading against the main trend in a corrective manner and has formed an a, b, c zigzag corrective pattern.

Another characteristic of zigzags is that they normally stay within channel lines as indicated on the chart. Sometimes the end of wave c can occur at the channel line, verification that zigzag patterns are complete is for the market to move below the price minimum of wave b. I have identified this price level with a horizontal support line labeled S. As we can see from the chart, XHB has now closed below this support level, verifying that the market correction is now complete.

With wave (2) complete, wave (3) down is now headed south. Wave (3) should unfold as a five-wave structure due to the fractal nature of waves. Therefore, we can expect wave (3) down to unfold as five subwaves, waves (i), (ii), (iii), (iv), and (v). Waves (i), (iii), and (v) will trend in the downward direction and waves (ii) and (iv) will be small corrective waves. Once completed, wave (3) down should be at a price level much lower than the price minimum of wave (1). When will we know that wave (3) down is complete? When the subwaves of wave (3) count five.

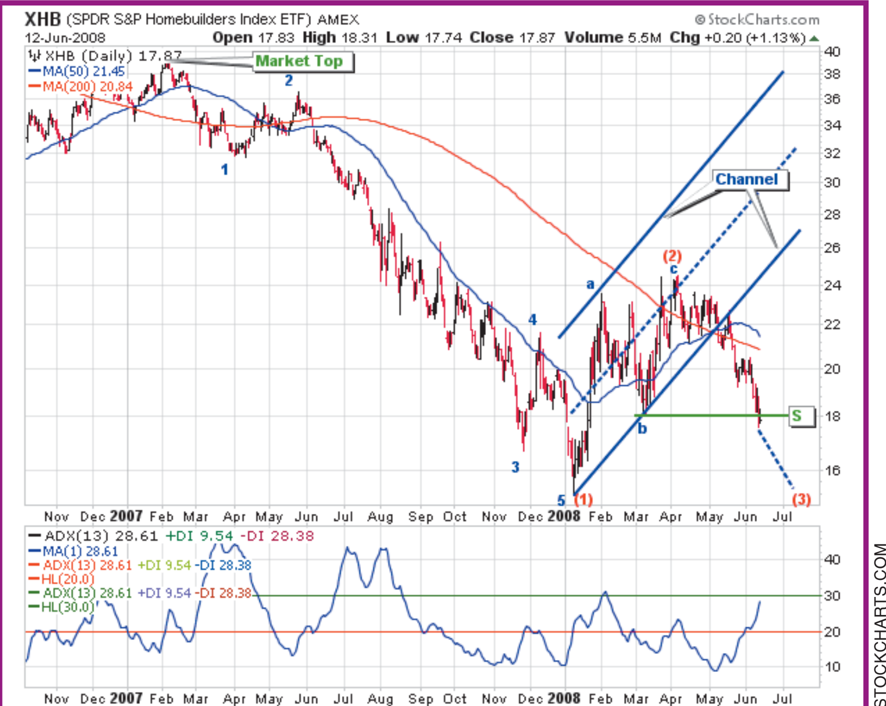

FIGURE 1: XHB, DAILY. Here's the Elliott wave count.

One of the characteristics of third waves is that they travel the furthest distance in the shortest amount of time, indicating that momentum is at its greatest. Therefore, one way at trying to identify when wave (3) down should end is by watching a momentum indicator such as the average directional movement index (ADX). By monitoring ADX, we can watch for it to rise to a peak and then start to turn back down. The peak in ADX is a measure of maximum momentum, and once it turns back down, it is an indication that momentum is starting to slow down. When momentum starts to slow down, that means that the move in wave (3) down is drawing to an end and will end when momentum has fully run its course.

Other momentum indicators can also be used, so use the momentum indicator of your choice.

In conclusion, once wave (3) down is complete, expect a corrective wave (4) to follow, and once corrective wave (4) is complete, the final wave (5) down will begin. Once wave (5) down is complete, then expect the market to retrace a large percentage of the complete move down from the market top. XHB is headed south, so enjoy the ride. ■

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RELATIVE STRENGTH COMPARATIVE

Using Sector Strength To Identify Buys

by Mike Carr, CMT

Relative strength offers traders a way to identify top-performing sectors, and exchange traded funds offer a way for investors to trade these ideas.

Tradable: SWH

A useful exercise for all traders is to scan a list of the strongest sectors at least once a week. This provides a great starting point for daytrading, since the strongest sector will include the strongest stocks. Relative strength (RS) usually identifies the largest gainers over the recent past, and these are also usually the most volatile stocks. Volatility is a requirement for short-term trading since the goal is to maximize gains in the shortest possible time.

Among the groups leading the market in RS is the software group (Figure 1). The point & figure chart of RS allows us to easily observe the larger trend without being distracted by the day-to-day market noise. We can see that the software group has been basing for a few years and has just completed a clear buy signal.

With this insight into the longer-term trend, we identify a trading candidate. In this case, Merrill Lynch Software HOLDRS (SWH) is an ETF representative of the sector index shown in Figure 1. The next step is to look at a weekly chart of SWH (Figure 2). There we see that prices have just closed above their upper Bollinger band. We look back on the chart to see that this has happened before. In those instances, buying with a stop at the 20-week moving average would have led to two winning trades and two losers.

Using the daily chart in Figure 3, we can fine-tune our trading strategy. The chart shows a rounding-bottom pattern nearing completion. Aggressive traders can enter the trade at current levels, and conservative traders can await the completion of the pattern, entering on a buy-stop at 44.50 or 45.

The 20-day moving average has provided a good indicator of the trend. To avoid a whipsaw, a 5% band would be effective. This places the current stop level at 39.85, meaning a trader would have a risk of about 10% on this position. ■

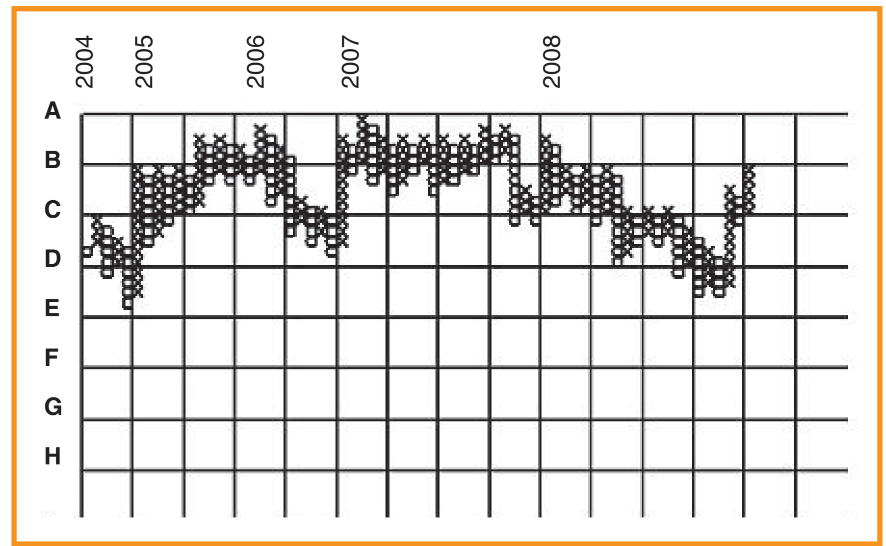

FIGURE 1: RELATIVE STRENGTH. On a point & figure chart, we can see that the RS of the software sector has just broken a small downtrend and is on a buy signal.

FIGURE 2: SWH, WEEKLY. Price is moving sharply higher.

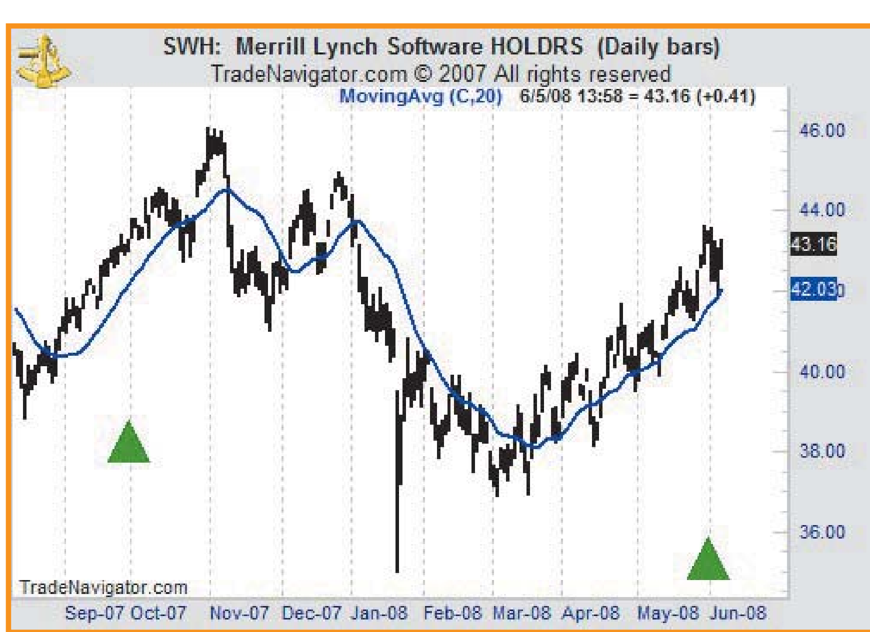

FIGURE 3: SWH, DAILY. The daily chart of SWH can be used to time the trade entry and stop-loss points.

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Technology Select SPDR Ready To Break Down

by Alan R. Northam

XLK made a market low in mid-January and has been trading in an upward trend ever since. However, the evidence points out that this uptrend is nothing more than a bear market rally that is about to end.

Tradable: XLK

XLK made a major bull market top in October 2007 and has not made a higher high in almost a year. In Figure 1, note that XLK has been forming a triangle pattern made up of lower highs and higher lows. Also note that the 50-day moving average crossed below its 200-day moving average in mid-January 2008. As long as the 50-day moving average is below the 200-day moving average, the trend remains in a long-term downtrend. With this market in an established long-term downward trend, any rally is considered a countertrend move until proven otherwise. As we can see, XLK has been trading higher since mid-January in a countertrend rally. Over the last several trading days, however, XLK has broken down below its 50-day moving average on two occasions, indicating weakness and signaling that the countertrend rally could be coming to an end.

Looking at the trendlines, note that XLK moved up to and has bounced off the red downward sloping long-term trendline on two occasions in May and June, indicating that this line of resistance is holding. Since then, XLK has been trading in the downward direction and is now faced to challenge support at the intermediate-term trendline. I have included the short-term trendline on the chart. This trendline shows that the market picked up some upside momentum in mid-March until it ran into resistance at the long-term trendline. Since that time XLK has broken down below this short-term trendline, indicating that XLK is running out of upside momentum.

Looking at the relative strength index (RSI), I have shown the intermediate-term trendline and the short-term trendlines for RSI, which correlate to the intermediate-term trendline and the short-term trendline on the price chart. Note in mid-May that RSI broke down below its short-term trendline in mid-May, signaling that the increased momentum of XLK that started in March was about to come to an end. Then in early June, XLK broke down below its short-term trendline on the price chart. Now I want to draw your attention to the red circle on the RSI chart. Note that RSI has now broken down below its intermediate-term trendline. This now signals that there exists a high probability for XLK to break down below its intermediate-term trendline on the price chart. With XLK now facing the intermediate-term trendline on the price chart, XLK could break down below it immediately.

As further evidence that XLK could be ready to break down below its intermediate-term trendline, we also noted that the moving average convergence/divergence (MACD) has just crossed below its zero line, generating a sell signal. This is an indication that XLK is ready to move lower. Confirmation of this signal will come when the MACD red signal line also crosses below its zero line.

On-balance volume (OBV) also confirms that XLK is in a downward trend and that the rally from mid-January is a countertrend rally. Note that the OBV has been in a downward trend since November 2007. This indicator is telling us that there has been insufficient volume to propel this market higher. Further, note that during the market rally from mid-January the OBV continued to move lower, indicating a lack of buying pressure to continue to move this market higher. A market needs increased volume to move it higher, but a market can fall without volume.

In conclusion, XLK is in a downward trend and the rally from mid-January is nothing more than a bear market rally. The OBV indicator shows that there is insufficient volume pressure to move this market higher, indicating that the countertrend rally will ultimately fail. The evidence of the weakening RSI and MACD indicators suggest that there is now a high probability for XLK to break down below its intermediate-term trendline and to resume its selloff immediately. ■

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With this market in an established long-term downward trend, any rally is considered a countertrend move until proven otherwise.

FIGURE 1: XLK, DAILY. This price chart shows moving averages and trendlines. In addition, RSI, MACD, and OBV are shown below the price chart.

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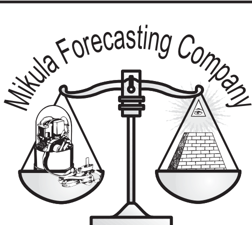

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Is HongKong iShares Coming Out Of Bearish Phase?

by Chaitali Mohile

Certain patterns and rallies indicate declining bearish force. Will the EWH really break through the resistance to begin a fresh bullish run?

Tradable: EWH

The robust uptrend turned weaker from November 2007, according to Figure 1. EWH slumped from 23.5 to 16.5 in six to seven months. The declining rally also had huge gaps down that hurriedly touched the lower levels. The bearish trend was soon in action, which later became stronger as the price touched lower lows. The relative strength index (RSI) (14) touched 30 and the moving average convergence/divergence (MACD) (12,26,9) was also dragged into negative territory.

By mid-March 2008, the downtrend overheated and began declining while the price formed a base at 16.5. Thus, the upside was born and the EWH surged toward the first resistance at the 19 level. While this resistance level was tested and retested for the fourth consecutive time, an inverted head & shoulders pattern was formed with a neckline that is at the 19 level. The inverted head & shoulders is a bullish reversal pattern that is typically seen in a downtrend. This reversal pattern indicates the beginning of a bullish rally if price breaks out above the neckline. As of now, volume is not so encouraging, but a breakout may bring in a sudden growth in volume. The RSI, MACD are also turning bullish, which could support a breakout in the near future. See Figure 1.

The positive directional index (+DI) has turned heavier than the negative directional index (-DI) and the average directional movement index (ADX) (14) has moved above 15, indicating a healthy bullish consolidation under way. The MACD (12,26,9) is back in positive territory, adding confidence amongst traders. Meanwhile, the RSI (14) has established support at 50 levels and looks like it is ready for a further bullish move. Some bottom formation is seen among the indicators, which enhance the possibility of a bullish breakout. But traders should wait for a breakout confirmation that sustains above the neckline support before initiating any long positions. But overall, EWH is ready to resume its fresh rally after a long time.

In Figure 2, you can see that after breaking below the 50-day moving average, EWH rallied back up to the moving average and then retraced. But the correction was not severe enough to hurt any trading positions. But a breakout above this resistance would indicate a robust rally ahead. EWH is again ready to approach the resistance for the second time. The indicators are more bullish this time than earlier. The -DI is declining, whereas increasing in buying pressure is seen by +DI running upward. Again, the RSI (14) has moved vertically toward the golden level of 50. And the MACD (12,26,9), though still in negative territory, shows the bullish interest to move ahead of zero line, thus violating the 50-day MA resistance would bring back the bullish sentiment.

A short note about the monthly chart to add confidence among traders: The chart has formed a hammer candlestick pattern. The hammer candle is a bullish reversal pattern that suggests an end to the downtrend (hammers the downtrend) and the start of a new uptrend. The long-term uptrend is very well maintained by a marginal decline from the overheated levels. In addition, the RSI (14) has a U-turn within the bullish area. So the hammer along with positive indicators on the chart is indicating a new beginning for bullish traders.

Thus, EWH will soon have bright days ahead on confirming breakouts from the resistance. ■

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FIGURE 1: EWH, DAILY. This chart shows an inverted head & shoulders pattern. On breakout the downtrend would turn to uptrend and a new bullish rally would begin.

FIGURE 2: EWH, WEEKLY

FIGURE 3, MONTHLY. The downtrend is hammered by the hammer candlestick pattern. Thus, the fresh rally is likely to begin.

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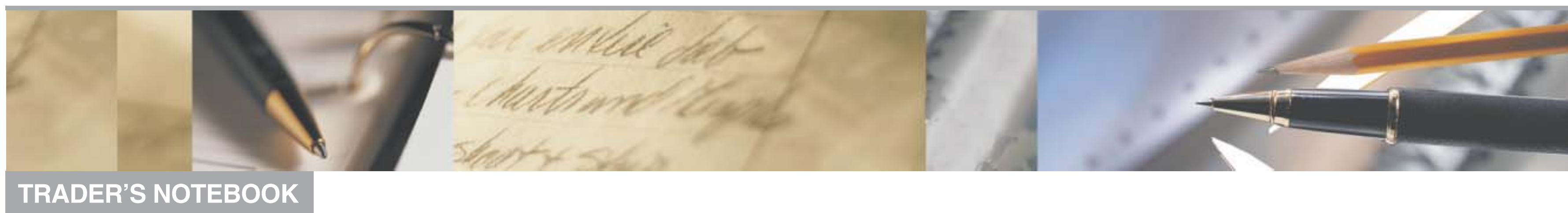

TRADER'S NOTEBOOK

Drilling For Profits

by John Devcic

What's the best way to profit in oil?

On the radio, on TV, and in the newspapers, the price of gasoline is at the top of everyone's list of things to talk about. Crude oil prices are quoted every night on the evening news. Congress is holding hearings about what can be done about the surging prices in both crude oil prices and gasoline prices. There is no doubt that crude oil is in a bull market. What are some ways a savvy investor or trader can play this move in petroleum prices? Here are your options for profiting from the rise in oil.

FUTURES CONTRACTS

Where's the most obvious place to trade the price of oil? The futures market. The oil contracts traded that affect gas prices is light sweet crude oil traded on the New York Mercantile Exchange (NYMEX). Futures contracts can fluctuate quickly and sharply. If your brokerage firm does not trade futures contracts, you will have to open an account with one that does. Of all the options on playing the move in oil, the most direct way possible is buying light sweet crude oil contracts. The contract itself is rather large as it controls 1,000 barrels of crude, so you will be putting a small amount down and controlling the entire contract. This is the true power of the futures market. Leverage is what allows traders to make a lot of money quickly on relatively small moves in price. The reverse is also true — you can lose a lot of money quickly.

Crude oil on the NYMEX currently trades in every calendar month. If you look at a futures quote, you will see something like this: CLQ8. "CL" is the ticker symbol for the light sweet crude oil contract. The "Q" stands for August and the "8" stands for 2008.

There is an alternative for those who are not ready or confident enough to trade the full contract. It is called the crude oil mini contract, which is traded on the NYMEX. The mini contract will control only 500 barrels of crude. The minimum tick size is two and a half cents a contract or $12.50 a contract compared to the one cent a barrel minimum tick size, which equals $10 per contract on the full contract. The mini contract has an advantage in that you are still buying and profiting from the move in light sweet crude, but mini contracts do not require you to place as much of an initial margin as the regular contract does.

Still not confident enough to trade a light sweet crude oil futures contract, no matter if that contract is a mini? You can also purchase options on the crude oil futures contract. Options on futures contracts are similar to those on stocks. Your losses are limited to what you paid for the option, but your potential for profit is not capped. Keep in mind that options are wasting assets, and time is their greatest enemy.

- **Pros:** Futures contracts allow the most direct way to profit from the move in oil.
- **Cons:** May need to open a new account in order to trade. Trading commodities carries a lot of risk, especially for inexperienced traders.

STOCKS

Not interested in trading futures contracts? You can trade individual stocks that derive their profit from oil. Begin by looking at sectors that are affected by crude oil. Within these sectors you will need to find the stocks that move higher as crude oil prices move higher.

Integrated oil companies are the total package they produce, refine and sell oil to the public. They go by names like Exxon Mobil (XOM), Chevron (CVX), ConocoPhillips (COP), Royal Dutch Shell, which is an American depository receipt (ADR), and BP (BP). Big integrated oil companies will not directly profit from higher oil prices. So far, year-to-date performance of these big integrated oil companies has not been good. They are all down for the year.

Smaller oil companies will get the bulk of their revenue from the exploration and production of oil. Hess (HES), Marathon Oil (MRO), Anadarko (APC), Occidental Petroleum (OXY), and Murphy Oil (MUR) are examples. These companies will generally profit from higher crude oil prices because they are making more money by charging more for the crude they sell. This group has seen a better year-to-date stock performance versus the big integrated oil companies. Hess is up 25% for the year. Anadarko is up 14% for the year to date. Occidental is up 11%, while Murphy Oil is up 7%.

At the other end of the spectrum are the refiners, which are being hurt by an increase in the price of oil. Refiners will not profit from the price of oil going up. This group has seen better days. Valero (VLO) is down 34% for the year, while Sunoco (SUN) is down 46%. Tesoro Corp. (TSO) is down 55% for the year, and Frontier Oil (FTO) is down 33%. Refiners have been beat up all year and will probably continue to suffer as the price of crude continues to soar.

Oil services are companies that keep those oil drilling platforms working and running properly. They have seen a rise in their stock prices since the price of crude has been going up. Schlumberger (SLB) is up 3% for the year, while Halliburton (HAL) is up 33%. Baker Hughes (BHI) is up 8% for the year.

- **Pros:** These are stocks and will allow traders with brokerage accounts to quickly trade on the price of oil.
- **Cons:** Requires more time and effort to decide between sectors. Once you choose the sector, you still need to pick individual stocks.

EXCHANGE TRADED FUNDS

Exchange traded funds (ETFs) are another way to play the move in oil. The ETF you choose will purchase futures contracts so they are not a direct play on the futures market. The goal of the ETF is to move in tandem with the move of the underlying futures contract. In the case of oil, when the price rises, the price of the ETF should also move up. While not directly investing in the buying and selling of the actual oil contract, buying an ETF is an excellent alternative to purchasing futures contracts. ETFs are traded like stocks so they do not have any of the drawbacks or restrictions that can come with buying a mutual fund. If you think the price of oil is due for a downturn, you can short the ETF.

There are a few choices when it comes to trading oil with an ETF. OIL is the ticker symbol for the iPath S&P GSCI Crude Oil Total Return. It is linked to the Goldman Sachs Crude Oil Return Index. The United States Oil Fund (USO) is a commodity pool that purchases futures contracts on the NYMEX and ICE exchanges.

The Powershares DB Oil Fund (DBO) tracks the Deutsche Bank Liquid Commodity Index trading light sweet crude contracts. United States 12 Month Oil Fund LP (USL) tracks the price of light sweet crude oil delivered to Cushing, OK.

- **Pros:** Fewer options than stocks make choosing easier. They allow you to play the price of oil without buying or selling the futures contract.
- **Cons:** ETFs are a derivative and so it is not like trading the actual oil contracts. Point moves are not the same between oil and ETFs that track oil.

There are many choices available to the investor and trader who want to profit from the move in oil. The most direct way is the buying and selling of light sweet crude oil contracts. This solution will not work for everyone and with the risk involved with futures trading, you should make sure you are prepared to enter this volatile market. For those of you who want to buy and sell stocks, you can buy individual companies whose profits are derived from the business of selling oil. Or you could choose to purchase an ETF. Whatever you choose, there are many ways to trade oil. ■

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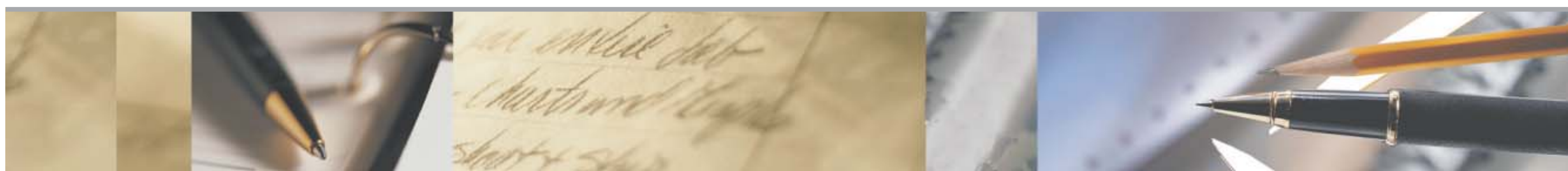

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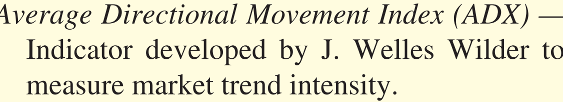

Average Directional Movement Index (ADX) — Indicator developed by J. Welles Wilder to measure market trend intensity.

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

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.

Exponential Moving Average — A variation of the moving average, the EMA places more weight on the most recent closing price.

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 — 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.

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.

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

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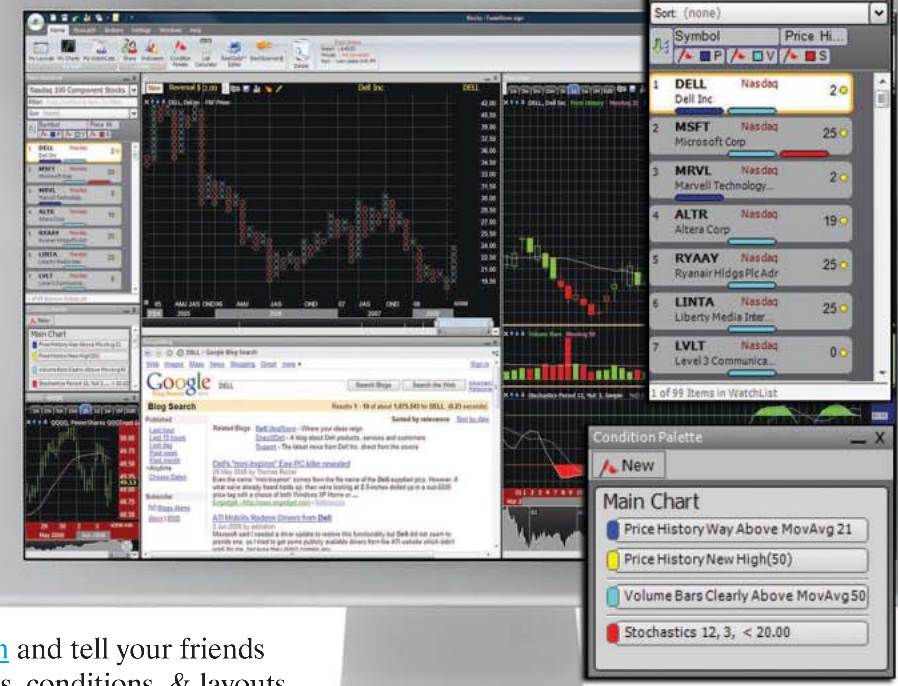

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