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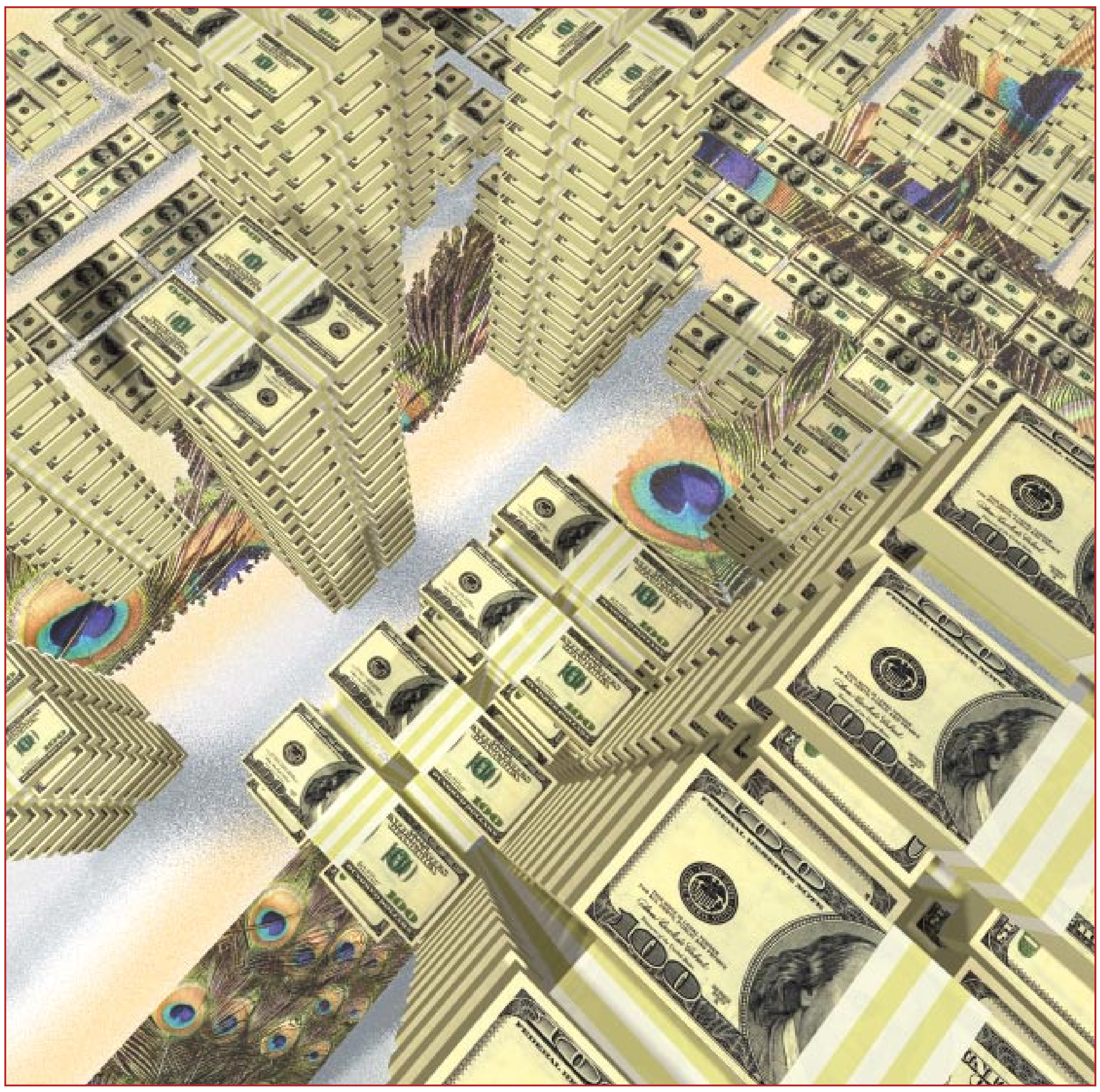

DXY DAILY VS. WEEKLY VS. HOURLY

FIGURE 1: DXY, DAILY FIGURE 2: DXY, WEEKLY FIGURE 3: DXY, 60-MINUTE

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Introducing A Powerful Way To Differentiate Retracements From Reversals

You've entered a market and are holding a position. But now the market is moving against you. Is this current move a retracement or a reversal? If it's a retracement, it is a temporary pullback, where prices will bounce off support and resume the direction of the original trend. If it's a reversal, prices will break through the support level and continue to move against the original trend. Retracement or reversal? It's a typical question that traders face every day. They wonder:

1. Shall I surrender and take the loss?
2. If not, how much money am I willing to risk?
3. Should I set a stop-loss based on a percentage or dollar loss? How do I choose a percentage or dollar loss that will work?
4. What if I take the loss and then the market resumes the trend that I anticipated? Do I re-enter the market?
5. How about sticking with my original strategy? Maybe I should hang in there no matter how much drawdown I experience?
6. Is there a way that I can identify the support levels when I buy?

Yes, #6 is the most important question! If you knew the market support levels, you could use them to test market strength. When a market tests the support level, if it cannot penetrate that level but instead resumes the anticipated trend, that movement more likely is just a retracement. If you wanted, you could even add to your position at that time. On the other hand, if the market penetrates the support level and closes beyond it , it is likely a reversal. You would do well to exit the position and cut your losses short. Identifying an objective support level is the key to determining if the current move is a retracement or a reversal. So now we ask, is there a way to identify objective support levels?

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THE MAGAZINE FOR INSTITUTIONAL AND PROFESSIONAL TRADERS™

TRADING NOW

Toward the end of 2009, the equity markets started showing signs indicating that either the bullish trend that began in March 2009 may be taking a breather or reversing. Is this an indication of what we can expect for early 2010? If you look at the chart of the Standard & Poor's 500, you will see that it began moving in a tight trading range from November to December. During the same period, the chart of the US dollar index seems to be indicating that perhaps the dollar is just tired of sliding down. These subtle signs show how market sentiment can change very quickly. The rise in the US dollar could have been the better than expected jobs report released in early December. You can see how other markets reacted to the gain in the US dollar. On the day the US dollar index jumped 1.7%, gold futures fell 4%. Oil also fell, as can be seen in the 1.3% drop in crude oil for January delivery. Most of the agricultural commodities also dropped.

As you can see, the markets are interrelated, and a small jolt that affects one market can affect all others. In this issue of **Traders**.com, we cover the metals and energy markets as well as sectors and indexes. Articles such as "QQQQ Regains Lost Levels" by Chaitali Mohile, Donald Pendergast's series of examinations of the Russell 2000, as well as "Dollar Dance" by Austin Passamonte and Mike Carr's "Analyzing Cash"; then there's "Crude Oil And the MACD Histogram" by Ron Walker, "Gold Nears Peak" by Alan Northam, and "A Strong Dow Resistance Level" by Koos van der Merwe, and many more. Even a glance will suggest that these varied markets are interconnected.

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

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

So keep an eye on those markets. Will the bullish trend continue forging its way up? Or will it be in freefall, floating its way down? One way or another, it'll be interesting to see what 2010 brings!

Jayanthi Gopalakrishnan

Jayanthi Gopalakrishnan,
Editor

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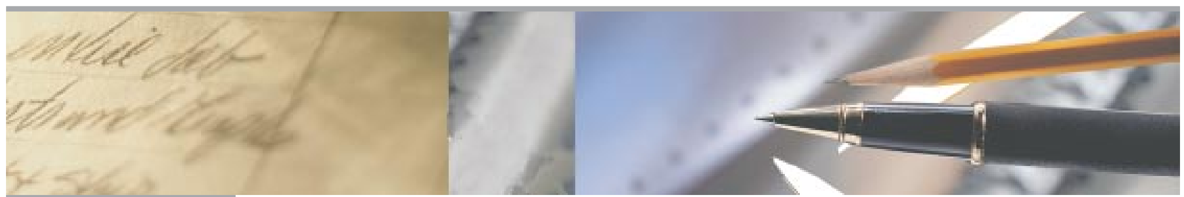

ARMS INDEX

TRIN, The Contrarian Indicator

by Ron Walker

In recent years contrarian indicators have become increasingly popular with traders, but the Arms index stands out as one of the favorites. Knowing how to interpret the index correctly can help provide a trader with timely entry and exit points.

Tradable: $TRIN

The Arms index is named after its creator, Richard Arms. It is also called the short-term trading index, or TRIN for short. TRIN is a contrarian indicator that has an inverse relationship with the stock market that helps determine if there is greater volume in rising stocks or declining stocks. The purpose of TRIN is to determine what actually controls the market.

TRIN is calculated taking the number of advancing issues and dividing it by the number of declining issues. This ratio is the numerator in the Arms calculation. The denominator is determined by taking advancing volume and dividing it by the declining volume. The formula is simple:

(Advancing issues/declining issues) divided by (Advancing volume/declining volume issues)

TRIN is the advance/decline ratio divided by the advancing volume/declining volume ratio.

TRIN generates signals when the market is overbought or oversold. A rising TRIN is bearish and lets us know that sellers are in control of the market, while a falling TRIN is bullish and lets us know that buyers are in control. Readings above and below 1.0 offer even more information. Readings below 1.0 is positive and indicates that the majority of volume is pumping into advancing issues, showing that buyers are in control. When the TRIN is above 1.0, it reflects that volume on declining issues is outpacing advancing issues, putting sellers in control of the market. This is a negative sign.

The TRIN indicator lets you know whether the bulls or bears are currently in power, helping a trader fine-tune entry and exit points. Divergences between the NYSE and TRIN can also form, giving additional clues of market direction.

Figure 1 displays TRIN in the 15-minute time frame. The upper window shows the New York Stock Exchange index (NYSE) in that same time

FIGURE 1: NYSE 15-MINUTE VS. TRIN. TRIN is used to determine market control. When TRIN is rising it is considered bearish, while a falling TRIN is considered bullish. Note the arrows between the NYSE and TRIN point in opposite directions. A reading below 1.0 indicates buyers are in control, while readings above 1.0 indicate that sellers are in control.

The purpose of TRIN is to determine what actually controls the market.

frame. When an extremely high reading occurs on TRIN in the intraday time frame it is considered positive, and when a low reading occurs it is considered to be negative for the stock market. Why? Because when TRIN peaks at extremes, then turns and starts to decline, the market is likely rising. In contrast, when TRIN makes an extreme low, bottoms, then turns and begins to rise, the stock market will begin falling. Note how the trendlines on TRIN move in the opposite direction of those on NYSE in the 15-minute time frame (Figure 1).

TRIN is highly volatile and can be smoothed out with moving averages. Richard Arms uses the 10-day simple moving average (SMA) in order to determine overbought and oversold conditions. He considers the market overbought when the 10-day SMA of the TRIN is below 0.8 and oversold when the TRIN is above 1.2. Using this methodology isn't always perfect, and it doesn't always work out. That's why TRIN should be used with other indicators to help a trader determine overbought and oversold conditions.

In Figure 2 you can see the TRIN in the 15-minute again (the lower window of the chart), but this time I have added the 10-day SMA. Note how most of the time TRIN moves above its 10-day SMA when the NYSE is falling. Remember, the 10-day SMA is added to help determine overbought and oversold conditions. So when the 10-day simple moving average is rising, the market is declining and sellers are in control. A falling 10-day SMA puts buyers in the driver's seat and the market should be rising. TRIN is most valuable when applied to intraday time frames. ■

FIGURE 2: NYSE 15-MINUTE VS. TRIN. Applying a 10-day simple moving average to TRIN helps smooth out the indicator. The market is considered overbought when the 10-day SMA of the TRIN is below 0.8 and oversold when the TRIN is above 1.2.

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This article was first published on 9/9/2009.
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INDEXES

TECHNICAL ANALYSIS

Mission 1100 For The S&P 500

by Austin Passamonte

Near-term market outlook for S&P 500.

Tradable: ES

When the Standard & Poor's 500 traded to the 660 price levels in early March 2009, rumors of its total demise were rampant and apparently unfounded. The rebound from there to current resting levels has been nothing short of amazing to most if not all market players. Is there no stopping this market at any near-term top? See Figure 1.

Should there be a near-term top found, it probably happens that beckoning gap is still open for nigh on 11 months and counting. ES 1100 was a breakway gap in classic fashion that lasted this long and will hold for (at the very least) a couple of sessions longer, and maybe more. In any event, it is inevitable that the gap will fill. When is always the great unknown, but in this case the "what" is certain.

FIGURE 1: ES, WEEKLY

FIGURE 2: ES, DAILY

TRADESTATION

Akin to the NQ charts, the daily picture of ES seen in Figure 2 shows a bullish hammer candle from August 27 followed by a bearish candle to follow. No fewer than three open gaps hang below current price levels, letting in quite the breeze in swiss-cheese manner of support — full of air pockets and holes.

ES 1005 is the nearest open gap, followed by 950 back at the venerable price magnet formed in triple-top fashion before the July breakout. It would be perfectly normal for a pullback to 1005 and even 950 with no technical damage at all to the overall rally structure. Below there ES 1100 heads to 900 gap in a hurry, with questions about further staying power arising.

Meanwhile, pre-Labor Day week is straight ahead. The light volume drift is likely to get lighter still. We cannot really pound stakes in the ground until that holiday mark is passed, but we may see some jockeying for position before then. ■

CHART ANALYSIS

QQQQ Regains The Lost Levels

by Chaitali Mohile

The PowerShares QQQ Trust was well equipped with the bullish factors to begin a fresh upside rally. Let's check the current and possibly the future strength in the rally.

Tradable: QQQQ

The weekly chart in Figure 1 of the PowerShares QQQ Trust (QQQQ) would reveal the technical aspects at the initial stage of the bullish rally. A higher bottom on the price chart of QQQQ was the first bullish indication followed by a bullish reversal candlestick formation, a bullish engulfing pattern. A long white candle of the candlestick pattern signifies a robust bullish strength and the developing positive sentiments among traders. If we try to locate the reasons for the higher bottom formation, then an overheated downtrend is what catches the eye. The average directional movement index (ADX) (14) in Figure 1 surged to 50 levels with robust selling pressure indicating the highly overheated downtrend. Since the trend indicator reversed from this level (50), highlighting a trend reversal possibility, the stock formed a higher low. However, the relative strength index (RSI) (14) added the bullish strength by moving above an oversold region at 30 levels. The higher low formed by the oscillator generated a fresh bullish force, supporting the bullish formation on the price chart.

The bullish crossover of the moving average convergence/divergence (MACD) (12,26,9) in negative terri-

FIGURE 1: QQQQ, WEEKLY. The 200-day MA breakout target would be the previous highs like $48, $52.

STOCKCHARTS.COM

tory was another major bullish reversal indication. We can see in Figure 1 that the momentum indicator turned positive and ascended toward the center line (zero line). Thus, the declining downtrend, the higher lows of the RSI (14) and the positive MACD (12,26,9) encouraged the bullish rally in March 2009.

Thereafter, there was no looking back for QQQQ. The first major short-term resistance of the 50-day moving average (MA) was violated during the upward journey. According to Figure 1, the trading session of September 16 closed above the 200-day moving average (MA) on bullish notes. Currently, the 200-day MA is the new strong support. The ADX (14) has slowly moved above the 20 levels with steadily increasing buying pressure, indicating a developing uptrend. The RSI (14) is healthily overbought and the MACD (12,26,9) is positive. In addition, the current bullish trend of the financial markets across the world would help QQQQ sustain above the newly converted support of the 200-day MA and rally higher in the near future.

The fresh 200-day MA breakout with the previous highs as the target can be a good buy setup for long-term traders.

The daily time frame would help us strike an intraday trade. The ascending channel in Figure 2 would be an entry-exit point for QQQQ. Earlier, the upper trendline was challenged twice, in June (S1) and in late July-early August (S2). The stock consolidated there, trying to break upwars. S1 and S2 were the profit-taking levels for buyers, and entry points for sellers.

Currently, the bullish rally from the lower trendline at $39.50 has moved closer to the upper trendline, gaining a profit of $4. The descending MACD (12,26,9) has surged above the channel resistance (see Figure 2), and the RSI (14) has slipped in an overbought zone. The ADX (14) in Figure 2 is indicating the developing uptrend, and therefore, the current rally has more upside. The upper and lower trendlines can be extended to identify the future trading system.

But if the upper trendline is breached, then fresh demand pressure might get generated. So those already long can add more to their position, and the fresh traders can trigger a buy setup. ■

FIGURE 2: QQQQ, DAILY. The MACD (12,26,9) descended after a bearish crossover, forming lower highs and lower lows. The upward breakout of the momentum indicator is a good indication of developing bullish momentum.

DETREND PRICE OSCILLATORS

Russell 2000 Nearing Critical Inflection Point

by Donald W. Pendergast Jr.

Up nearly 80% in six months, the Russell 2000 index may be ready to take a break, possibly correcting, some time within the next one to three weeks.

Tradable: .RUT, IWM

It's not often that a major stock index piles on gains of 80% in a mere six months; usually, a rebound of such magnitude will be seen only in an industry group or its component stocks. Does the R2K still have room to run, and, if so, for how much longer before a significant correction?

Regular readers of Traders.com Advantage (TCA) may recall an article that I published on August 7,

METASTOCK; VARIOUS WB EOD INDICATORS FROM PROFITTRADER

FIGURE 1: RUT, MONTHLY. With an initial time/price confluence turning point (calculated in early August 2009) projected for September 21, 2009, near the 623 level, the price action of the next few sessions should prove or disprove the validity of the assumptions used to make that projection.

2008, entitled, "Broad Markets Still Looking Healthy." In the article, I described a method to project time/price confluence areas for the weekly price cycle that most frequently governs the Russell 2000. Using the time and amplitude of the first cycle run higher from the early March low, I took the absolute number of points gained (+193) and the number of weeks (13) that it took to achieve those gains before the cycle topped out, multiplied each figure by significant Fibonacci ratios (the 62% and 79% ratios) and added them to the cycle low price achieved on July 10, 2009. This simple formula determined that the index was likely to make a second weekly cycle high sometime between September 4 and September 21, 2009. The formula also determined that the R2K, if it exceeded a price of 593, would most likely move up toward the 625 area. So how has this mathematical mess played out so far, anyway? Well, the 593 level is long gone, as the index has actually made it almost to 622, a mere three points shy of the initial calculation. We're also only a few days from the September 21, 2009, cycle top time estimate for this current weekly cycle move.

In the monthly R2K chart seen in Figure 1, check out the detrend oscillator (top panel) and note how high it is in relation to other significant peaks; it is already higher than the last monthly extreme reached during July 2003 (in the wake of the similarly powerful March 2003 reversal in all of the broad US markets) and is a few points shy of its all-time high reading, achieved in March 2000, just before the NASDAQ and R2K went into multiyear tailspins. Given that the market is nominally overbought, at least according to the monthly detrend oscillator, the previously mentioned weekly cycle time/price top-out projections take on an especially meaningful glow, especially since the R2K is also just a few points shy of its 50-month exponential moving average (EMA; blue line on chart).

The glaring exception to all that's been mentioned before is this — the monthly NASDAQ internal strength indicator (red indicator, bottom panel), which measures the rate of change in the index, the advance/decline ratio, the up/down volume ratio, and the ratio of new highs to new lows. This thing just keeps grinding higher and has actually reached its zero-line for the first "from below" zero-line crossover since June 2003, which was still very early in the last bull market, one that ran from 2003 to 2007.

Does all of this mean that the Russell 2000 index has to turn on a dime in the next week, never exceeding 623-625? By no means. However, given all of the confluences of price/time, detrended extremes, and resistance levels that are all coming into play at the same time, it might be wise to be more cautious about opening new long positions in the next few weeks. Existing long positions should be trailed more closely and/or sufficient profits taken as appropriate to your own needs. The next few weeks should be very interesting to watch as these time/price interactions play out in real time, with real money on the line.

The next weekly cycle low in this index isn't due until early to late November 2009, and with the quarterly price cycle still in a strong bullish phase, it might pay to keep your big deployments of cash on the sidelines until that weekly cycle low is confirmed. Stay tuned for more developments as they unfold. ■

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This article was first published on 9/18/2009.
See www.Traders.com for more.

CYCLES

Russell 2000 Weekly Cycle Target Hit

by Donald W. Pendergast Jr.

Market predictions are risky business, but when sound logic, based on repetitive patterns, is used to make a price target calculation, the results can be surprising.

Tradable: .RUT, IWM

Over the last few weeks I devoted a couple of articles to the projected price targets for the Russell 2000 index; my calculations, based on Fibonacci projections added to the point value of the March-June weekly swing move in the index (see my August 6, 2009, TCA article "Broad Markets Still Looking Healthy") anticipated that the R2K's upper target (based on an anticipated weekly cycle top) would be about 625.45 and that it should arrive on or about September 21, 2009.

Well, I almost choked on my coffee when I checked the Russell's daily OHLC (open, high, low, close) figures; today's high (which is the highest point ever reached by the index since the start of the powerful uptrending move that commenced in March 2009) came in at 625.31, only two days after the projected turning point. If indeed this is the cycle top, the projected turning price came within 0.14 of an index point of calling it exactly. Of course, perhaps today's selloff is just a minor setback on the road to higher prices, but even if it is, we can put the same Fibonacci formula to work to come up with a new target.

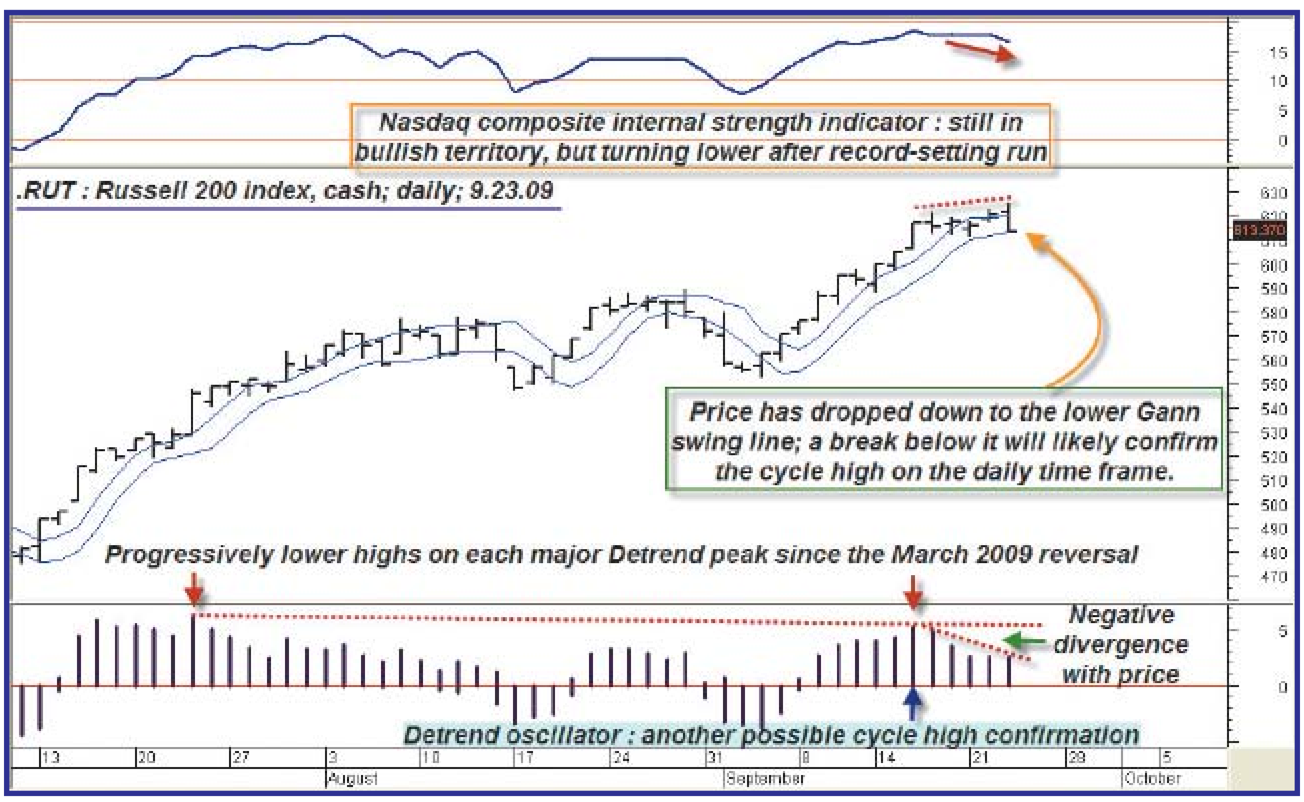

FIGURE 1: RUT, DAILY. With weekly and daily cycle highs likely in place on the R2K, it may be prudent to wait until this daily pullback plays out, perhaps near 565-575 at or around October 10, 2009. This time/price projection is based on a 20-bar daily cycle length and all key Fibonacci support levels.

Let's now look at a daily graph of the R2K and see what other goodies we can uncover as we seek to discern the near-term trajectory of America's most-followed small-cap index. See Figure 1.

This deceptively simple chart layout actually helps confirm the validity of the projected R2K time/price turning point that was calculated back in early August 2009. The calculation concluded that the R2K would run to 625.42 on or about September 21, 2009, and, while today's sharp intraday reversal in the R2K (it reversed a mere 0.14 of a point from the projected high) appears to be the initial evidence necessary to prove the time/price calculation was right on, it still behooves us to check other essentials like the internal strength of a related index (the Nasdaq Composite), the swing line characteristics of the daily R2K and the state of the detrend oscillator, which is terrific when used to measure extreme overbought/oversold situations, price-momentum divergence and cycle tops/bottoms.

So, let's start with the internal strength (top of the chart); yes, it's still very bullish but appears to be rolling over, suggestive of a daily cycle high. The detrend has already confirmed both a cycle high and price-momentum divergence, while the lower Gann swing line (blue lines on chart) are just barely acting as support in the wake of today's reversal. The Gann swing lines are based on a simple concept — any directional movement that causes a stock (commodity, exchange traded fund, whatever) to close above the three-period simple moving average of the prior three daily highs is viewed as a bullish development, particularly if the stock/commodity in question is also in a confirmed uptrend (as determined by Gann swing geometry). (In case you've never heard of Gann swing lines, you may want to look for an article in the October 1999 STOCKS & COMMODITIES for more information on the subject.)

The converse of the above is true on a bearish drop below the lower Gann swing line, which is what may be about to happen on the daily R2K chart. The lines also work very well as a simple channel breakout system all on their own; you just use the opposing line as your initial stop/trailing stop and let the trade rip, all else being equal. Now that we've determined that the most likely move for the R2K is likely to be down, let's see if we can't establish a few projected targets on the downside, just in case this analysis is correct.

Doing some basic cycle calculations, the Russell 2000 index isn't likely to make a meaningful daily cycle low until approximately October 9-12, 2009. That's about two and a half weeks from now, and given that both weekly and daily cycle tops are likely in, extreme caution should be used before initiating any long positions before then. Even with that, be aware that the index isn't even projected to make a weekly cycle low until sometime in November, so it might be a good time to scale back on dollar allocations or even just stay in cash for the next three to six weeks.

Here are some possible Fibonacci support zones to watch for as the anticipated early October daily swing low approaches:

1st support: 592-598
2nd support: 583-580-578
3rd support: 572-568-565

Just below those levels are two critical chart support levels, both of which are major swing lows, one at 552.27 and the other near it at 546.96. If either of those two levels are taken out, a much more severe corrective phase may commence. Cycle analysis isn't perfect, but, when combined with Fibonacci extension/retracement numbers, it can be a very useful market discipline that can help keep you on the right side of the markets. ■

FURTHER READING

Hartle , Thom [1999]. "Gann Swings And Intraday Trading," *Technical Analysis of* STOCKS & COMMODITIES magazine, October.

Russell 2000 Cycles And Supports

by Donald W. Pendergast Jr.

Since peaking late last month, the Russell 2000 index has been moving progressively lower toward an anticipated daily cycle low.

Tradable: .RUT, IWM

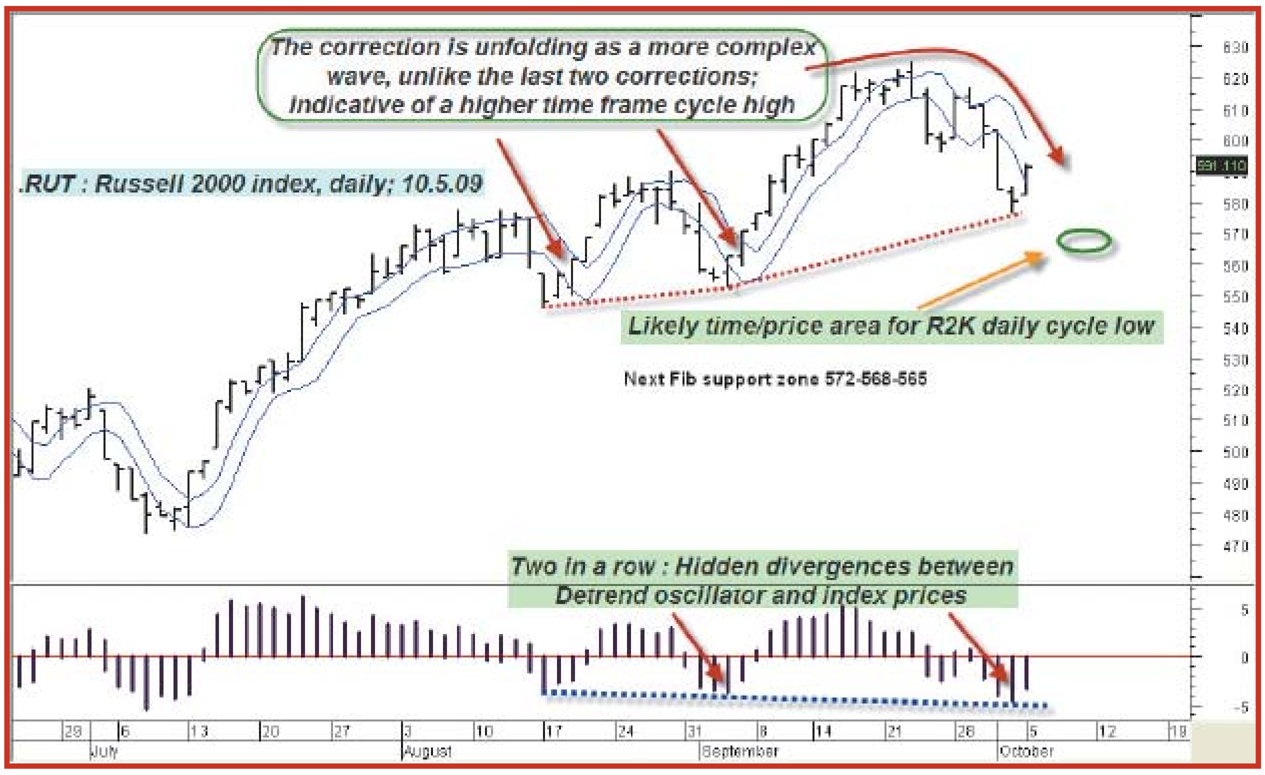

FIGURE 1: RUT, DAILY. The Russell 2000 index may bottom on its daily cycle by October 7–12, 2009, possibly between 572 and 565.

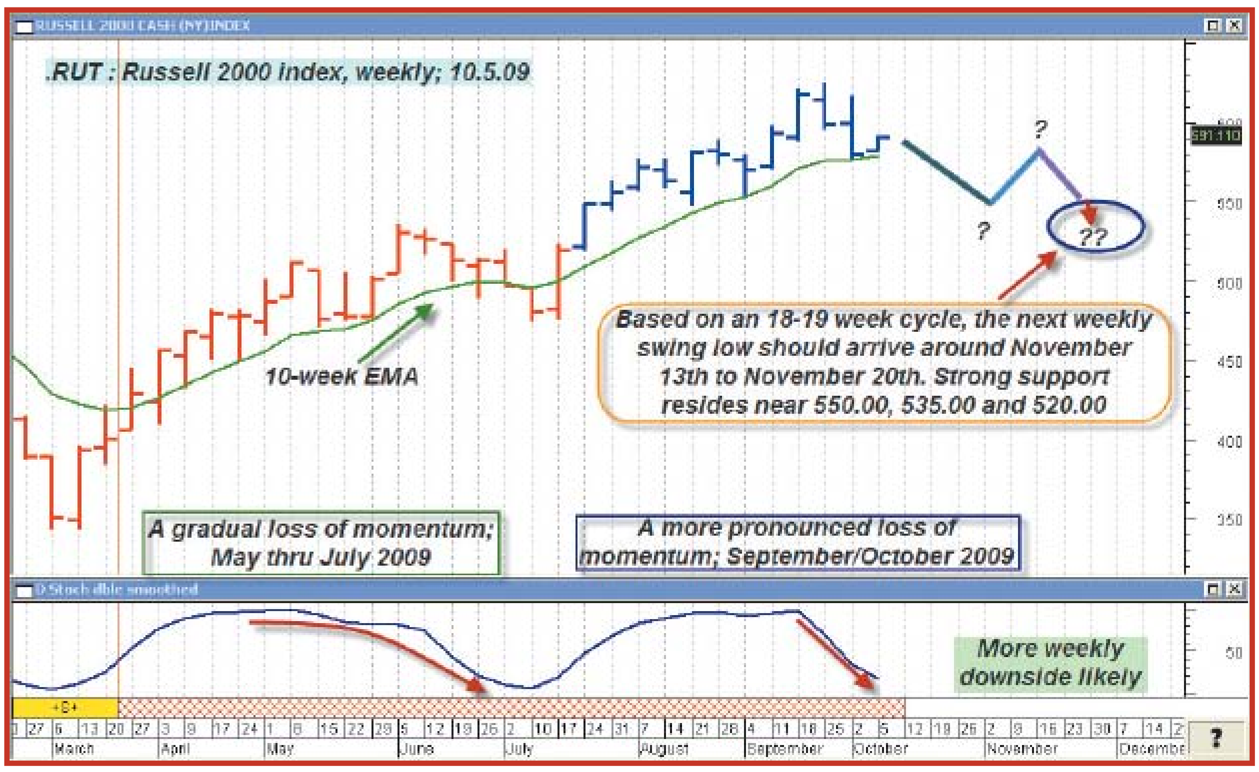

FIGURE 2: RUT, WEEKLY. While the daily cycle is due to bottom soon, the weekly cycle likely has another five to six weeks to go before a meaningful reversal occurs.

Based on cycle analysis, the Russell 2000 index is anticipated to bottom out (on the daily time frame) around October 7–12, 2009. Can we also calculate a possible price level at which to expect that reversal, should it arrive as expected? The answer is a qualified "maybe."

Figure 1 is the daily chart of the R2K; the index has had a modest retracement move, one lasting a week and a half — so far. Note how this correction has unfolded in a series of small waves, unlike the prior two corrections, both of which were simple pullback-type moves against a strongly rising weekly price cycle. This latest one is deeper, more convoluted, and is more likely than not to test the next set of daily Fibonacci support levels that span the range from 572 to 565. One reason to believe that lower prices are due is that the internal strength readings of the broad market indexes are lower now that they were at the last two swing lows made in August and September, respectively. If this analysis is correct, we may see a briefer selloff (lasting a couple of days) down to the support level prices (572–565), followed by an actual bottoming/reversal confirmation.

There is a modestly bullish omen on the R2K daily graph, one that also suggests the worst of this daily selloff is behind us; the detrend oscillator (bottom panel of chart) has tentatively printed its second straight hidden divergence against the index price. You don't see much written about this phenomenon in the traditional technical analysis texts, but it is a very useful tool when placed in the proper context. The concept is simple, if price keeps rising, putting in successively higher swing lows even as the detrend oscillator (or even a relative strength index [RSI], stochastic, commodity channel index [CCI], or stochRSI indicator) keeps making successively lower indicator lows, you have a valid hidden divergence. There will frequently be a reversal higher in the wake of such a divergence, with the strength typically determined by the size of the divergence. It's a fascinating pattern, one with above-average reliability, and that's why we need to watch what happens if and when the R2K gets near our anticipated time/price reversal zone. Even though the weekly cycle in the R2K is still heading down, a tradable relief rally on the daily chart is also a likely occurrence in the next week or so after the final (projected) washout into the daily cycle low.

And now a look at the R2K weekly graph in Figure 2. The double-smoothed stochastic (bottom panel of chart) does a good job of identifying the weekly price cycle in this index, and, right now, it's heading sharply lower with more downside likely to come. The current momentum of the double stochastics is more bearish than that of the previous drop into the July 10, 2009, cycle low, and that suggests that this cycle (currently 13 weeks old) will likely run the full 18 to 19 weeks typically seen in the R2K's weekly price cycle. If that is the case, don't look for a meaningful weekly low until at least mid- to late November 2009. The index does have some solid chart and Fibonacci support ranging from 550 to 520, so as the cycle plays out it should be easier to attempt to pick a more specific date/price to expect a reversal higher.

So we have two cycles to watch; the daily cycle, which is anticipated to bottom/reverse within a week or so, and the weekly cycle, which still has another five to six weeks to go before the bulls can finally start to prepare for a possible year-end rally. With the quarterly price cycle pointing higher, such a rally shouldn't be ruled out. ■

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This article was first published on 10/7/2009.
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The R2K Finally Tips Its Hand

by Donald W. Pendergast Jr.

The long-awaited intermediate top in the broad US markets may finally be in place, with a weekly cycle low due in about a month.

Tradable: IWM, .RUT, TWM

If you read my article yesterday, you learned about a relatively simple and objective way to use the spread between a short-term and a longer-term set of exponential moving averages to determine if a stock, exchange traded fund (ETF), or commodity was likely to stage a countertrend move back toward key moving averages that typically offer strong areas of support. When the method is combined with negative price-momentum divergences in the detrend oscillator, the results are often profitable. Well, the Russell 2000 index (.RUT, IWM) is likely offering such a trade setup on its weekly chart, right here, right now. Let's have a closer look and check it out (see Figure 1).

FIGURE 1: RUT, WEEKLY. No trade setup is a sure thing, but the combined power of a major resistance area, an overextended moving average spread, and a confirmed price-momentum divergence all appear to point to an impending pullback in the R2K.

There are several factors at work on the R2K weekly chart, all of which, when taken together as a whole, suggest that this index is in the beginning stages of a retracement move down toward key support levels. First is the fact that the index has failed to take out September's high of 625.31, a price level that was already projected to be a likely time/price turning point in this particular market. Next, take a look at the EmaRat indicator at the top of the chart; based on the percentage spread between the 12-period exponential moving average (EMA) and the 50-period EMA, this indicator gives fairly reliable advance warnings of a countertrend move whenever it moves above 1.05, with readings of 1.06-1.07 almost guaranteeing some sort of a tradable reversal. Right now, the indicator is at 1.063, and given the previously mentioned resistance at 625.31, it appears we may have a tradable setup. To confirm the likelihood that this is a tradable reversal, we need look no further than the detrend oscillator, which has already confirmed that a substantial negative price-momentum divergence is already under way. Now, all we need is to determine how to best play this short countertrend trade setup.

Aggressive traders can buy shares of TWM, which is the double-short ProShares Russell 2000 ETF, attempting to ride this small-cap tiger all the way down to the R2K's 21-week EMA level, which is about 565. That's the first profit target; the next target is the 50-week EMA, currently at about 552. Due to the lag inherent in moving average calculations, these EMAs may actually continue to rise for a few more sessions until the decline really starts to kick in. If you trade TWM, you stand to profit nicely if the index hits either of those two moving averages, being sure to take half the position off near 565 and the remainder off if it gets anywhere near 552.00. Risk control is of paramount importance when you're doubly short the market, so set an initial stop equal to this week's high (624.13) and then consider trailing the position with a two-bar trailing stop of the highs. Let the trailing stop take you out of the position, no questions asked, being sure to take logical profits at either of the mentioned EMA support levels. Remember, to go double short the R2K, you buy shares of TWM, you don't sell them, in order to initiate your short position.

Conservative traders can simply short the shares of IWM, an ETF that tracks the R2K very closely but without any extra leverage involved. Such traders might use a three-bar trailing stop of the highs, tightening it to a two-bar trail of the highs once the first profit target is reached.

While this method of using an EMA spread in conjunction with detrend divergence seems to offer more bang for the buck with liquid, highly volatile stocks, it also appears to work well in the major stock indexes, especially when such anticipated reversals occur at projected major time/price turning points. In the trade described here, all systems go for a proportional decline in the R2K for about the next three to five weeks. It should be fascinating to see how all of this plays out in the days just ahead. ■

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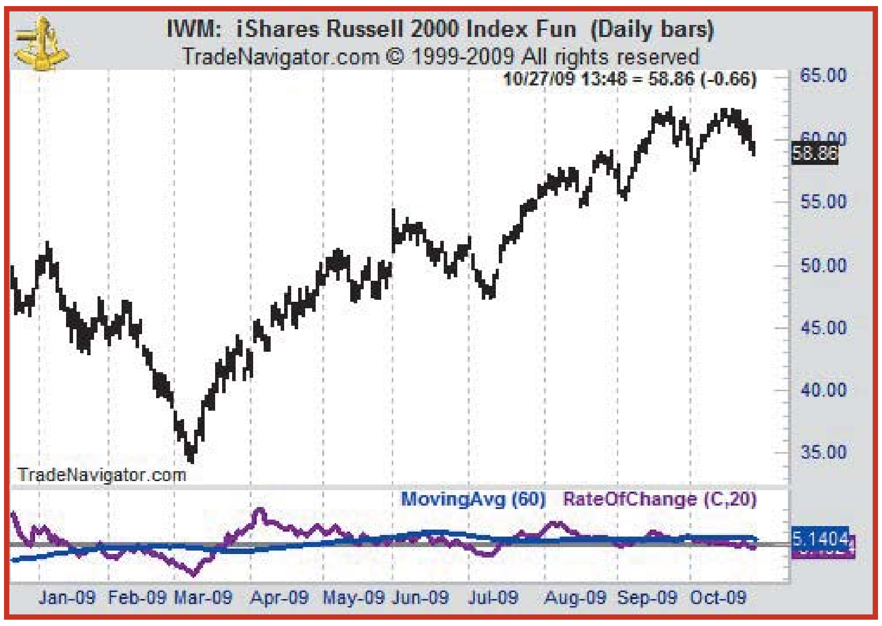

FIGURE 1: IWM, DAILY. Momentum failed to confirm the mid-October price rise and is now negative.

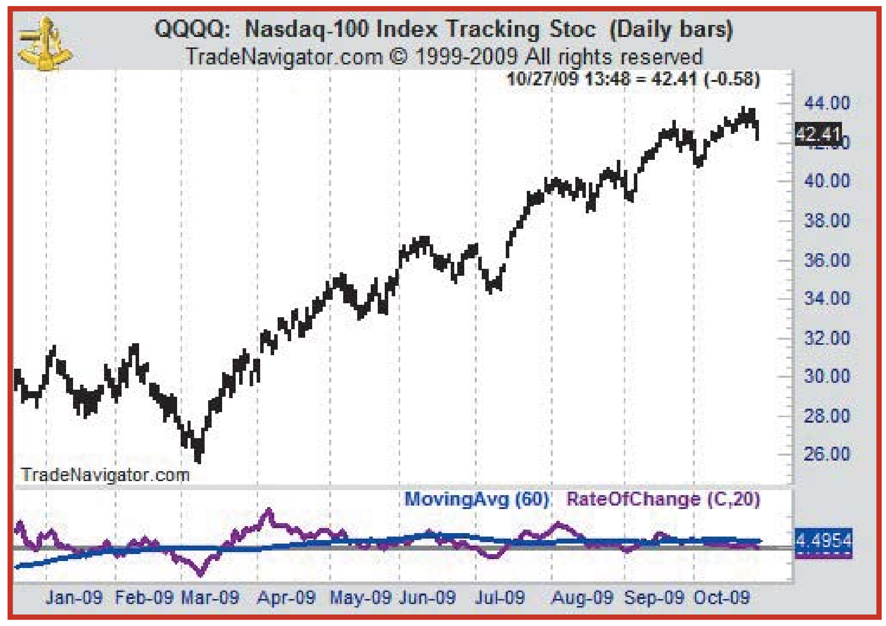

FIGURE 2: QQQQ, DAILY. The NASDAQ 100 is also showing a negative trend in momentum.

TRADE NAVIGATOR

Stock Indexes Showing Declining Momentum

by Mike Carr, CMT

The Russell 2000 is leading the way lower in momentum. This is a warning that price may follow.

Tradable: IWM, QQQQ

Using rate of change (ROC) to measure momentum, we see that the upside gains in all major stock indexes may be running out of steam. Small-cap stocks have led the market higher. Looking at the Russell 2000 (Figure 1), we see that the 20-day ROC is now negative and it is below the 60-day moving average. In this case, we are looking at the 20-day ROC because 20 days is about one month (figuring in weekends). The 60-day time period represents one quarter of market action.

Tech stocks were also a market leader to the upside and momentum is now barely positive (Figure 2). Movements below zero in this indicator have generally been associated with short-term price declines.

The other major indexes look the same. Now is a time to be cautious in the stock market and look for potential short opportunities. The ROC indicator has proven itself to be fairly reliable in the past and it is signaling that the bull market that started in March may be ready for its first significant retracement. ■

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This article was first published on 10/28/2009.
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Movements below zero in this indicator have generally been associated with short-term price declines.

FURTHER READING

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SECTORS

WEDGE FORMATIONS

Health Care Index Rally Restricted

by Chaitali Mohile

Is the Health Care Provider Index undergoing a short-term downtrend?

Tradable: $RXH

For the Health Care Provider Index ($RXH), the 390-420 area was a strong support-resistance zone. An evening star candlestick pattern within this range indicated a bearish reversal rally for $RXH. Thereafter, the rally retraced to a previous low support at the 350 level. This candlestick pattern is a cluster of three candlesticks, with first a bullish candle followed by a doji. The third candle is a decision maker, as only the bearish candle can complete the evening star formation. If a candle other than a bearish one appears, the short-term trading strategy might change. In Figure 1, the colored oval shows the evening star candlestick pattern and the two support-resistance lines tool highlight the zone at 390 and 420.

Since the moving average convergence/divergence (MACD) (12,26,9) and the relative strength index (RSI) (14) were not ready to give up their bullish hold, $RXH hurriedly established the support at the 350 level. The indicators and the price movements lead each another. Interpreting price action becomes easier due to the indicators. We can see in Figure 1 that the MACD (12,26,9) and the RSI (14) established support at the center line that is the zero line and 50 levels, respectively. The indicators surged dramatically, pulling the index above the various support-resistance zone. In addition, the average directional movement index (ADX) (14) surged with a heavy buying pressure, reversing a downtrend.

Gradually, the index reached another higher level. But we can see in Figure 1 that $RXH slowed down at this level. The small candles including various doji formed a rising wedge — a bearish reversal pattern. The rising wedge formation breaks downward, initiating a new bearish rally. The reason for this the bearish reversal formation is the negative divergence by the MACD (12.26,9) and the RSI (14). The wedge in Figure 1 has recently broken in a bearish direction, restricting the prior bullish rally. Although all the three indicators are declining, they have robust supports in the bullish territory. The uptrend remains intact; therefore, the bearish breakout may not turn in a serious correction.

The weekly chart in Figure 2 reveals another reason for the bearish breakdown. The rally that began on the bullish notes has reached the previous high resistance at the 450-460 level. The positive divergence by the RSI (14) and an overheated downtrend geared up the up move in March 2009. After reaching the prior top, $RXH has turned reluctantly to move higher. Currently, the index retraced to its immediate support of the 200-day moving average (MA). The 200-day MA is a long-term technical tool, extending robust support or resistance. The breakout or breakdown of this MA is considered a long-term trend reversal and watched by major technical analysts around the world. Therefore, the 200-day MA support for $RXH is the most reliable technical support that cannot be breached easily. In addition, the ADX (14) is suggesting a developing uptrend.

Hence, $RXH is likely to establish the support and would consolidate near the 200-day MA. Current financial turmoil would add volatility during consolidation, threatening the 200-day MA support. Therefore, the related stock should be traded carefully. ■

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This article was first published on 9/3/2009.
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FIGURE 1: $RXH, DAILY. The rising wedge bearish breakout has immediate support at the 420 level. The bullish indicator would prevent further downfall.

FIGURE 2: $RXH, WEEKLY. The index has hit the prior high resistance, and as a result, the price is likely to retrace at the 200-day MA support.

STRATEGIES

Analyzing Cash

by Mike Carr, CMT

An exchange traded fund can be used to spot trends in cash and offer insight into investor sentiment.

Tradable: USY

While institutions will turn to Treasuries, the dollar, or gold at times of panic, individuals usually think of cash as their first safe haven as they consider alternative investments. That means looking at how cash is performing as an investment should provide some insight into what the average investor is thinking.

The WisdomTree US Short-Term Government Income (USY) exchange traded fund (ETF) seeks to generate current income and total return in a manner consistent with low fluctuations in principal value by investing primarily in very short-tern government securities. The low fluctuation in value makes this ETF a good proxy for cash.

Typical technical analysis tools are shown in Figure 1. The small changes in value that occur on a daily basis make this a poor trading vehicle. Stochastics, relative strength index (RSI), and the moving average convergence/divergence (MACD) offer no real insights into a stock with such small trading ranges. This chart does show that stochastics appears to be a more responsive indicator — potentially useful knowledge for active traders.

In Figure 2, we look at a weekly chart of USY with a ratio of its price changes compared to the Standard & Poor's 500. Here we do find useful information. When the ratio is rising, investors prefer the safety of cash to the uncertainty of stocks. As the ratio declines, it is a good time to own stocks.

The peak in the ratio of USY/SPY occurred the first week of March, the bottom in stocks. This indicator can be used by traders as an adjunct to more traditional sentiment analysis to see what investors are doing with their money in real time. ■

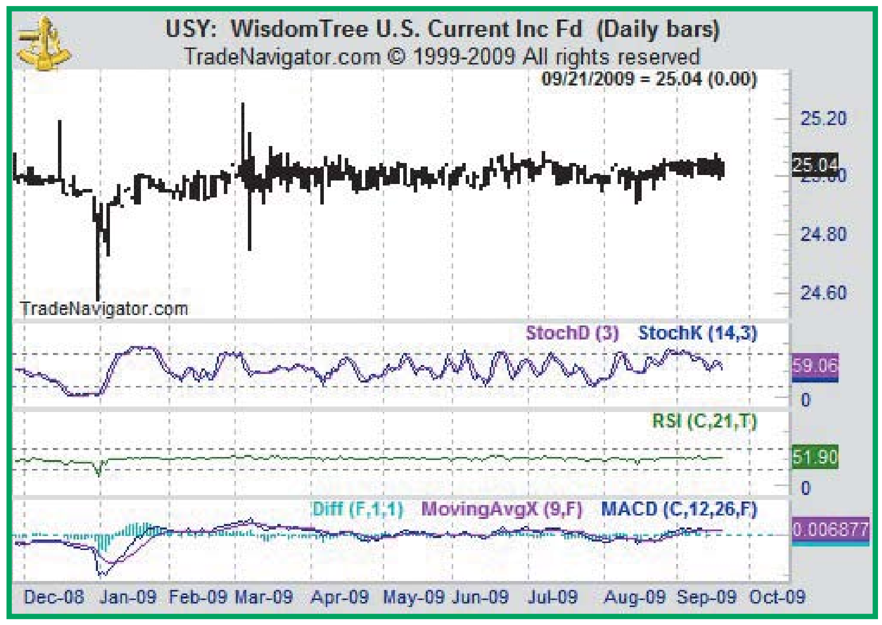


FIGURE 1: USY, DAILY. Traditional technical indicators require price fluctuations to be effective.

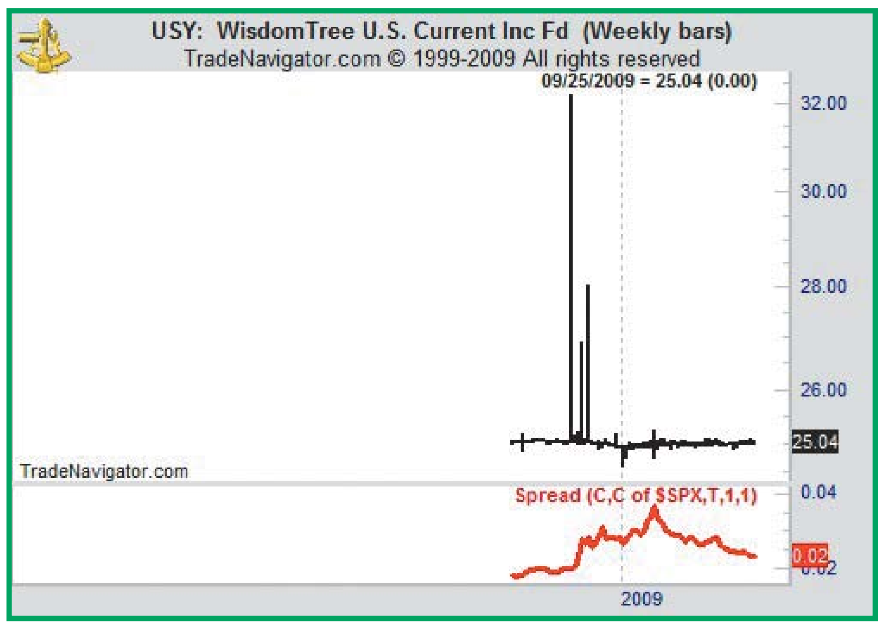


FIGURE 2: USY, WEEKLY. Relative strength analysis of USY offers insight into investor psychology.

TECHNICAL ANALYSIS

Heating Up

by Austin Passamonte

Here's the short-term to near-term outlook for heating oil futures.

Tradable: HO

We've ventered what is usually a bullish fundamental period for heating oil futures. The Northeast and Midwest portions of the US rely heavily on fuel oil to heat homes and commercial buildings through the winter. By far the largest percentage of population lives and works within the colder zones where fuel oil is a necessity next to food, water, and air.

Last year's colossal collapse came

FIGURE 1: HO, WEEKLY

FIGURE 2: HO, WEEKLY

with irrational speculation from hedge funds, which was widely denied at the time and then widely admitted and confirmed after the crash. Meanwhile, the plunge from $4.50 to $1.50 per gallon was a huge relief to consumers (Figure 1). Since then, fuel oil has spent the past several months basing for a potential push higher. Double-top resistance near the $2 level is on a third attempt to press higher now. When it comes to multiple support and resistance tests, third time is usually the charm.

July through September was one big flag-wedge type of consolidation pattern, upside break staged over the past five sessions at the time of this chart capture. Resistance at the $2 level is visible and notable, but price action holding above 1.90 support should chew through it eventually (Figure 2). A break back inside the visible wedge here negates upside potential should that happen.

1-2-3 projection off the most recent swing higher shows the $2 gallon level as yet another layer of magnetism. Quite possible price hangs out here for awhile, or trades above and back down into it as multiple tests of prior resistance now evolving into support (see Figure 3).

FIGURE 3: HO, DAILY

TRADESTATION

FIGURE 4: HO, DAILY

The same 1-2-3 projection label shows 2.12 and then 2.35 as the next immediate upside price objectives to some. One or both measures are probable soon if price continues its northward march. As frost settles into the northern parts of this country, seasonal pressures are ripe for price to move decidedly from here (see Figure 4). ■

WEDGE FORMATIONS

Computer Hardware Index Is Bullish

by Chaitali Mohile

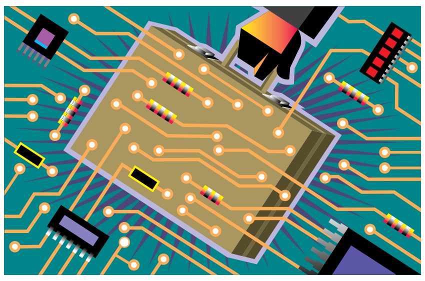
The Computer Hardware Index broke upward from a short-term bearish reversal formation and induced fresh bullish energy. Let us understand the significant supports that can carry the index higher.

Tradable: $HWI

We know that a rising wedge pattern is a bearish reversal, breaking downward. The pattern fails if the breakout occurs in an opposite direction, that is, in an upward direction and establishes new support. In Figure 1, the Computer Hardware Index ($HWI) formed a short-term rising wedge on the daily chart. The pattern formation began in May 2009 as the average directional movement index (ADX) (14) descended from a developed uptrend area at 35 levels. The trading range narrowed with the weakening bullish trend. At one point, the bears grabbed the trend; see the marked square in Figure 1. Since the bullish sentiments were much stronger, the increased buying pressure regained the trend. As a result, the rising wedge pattern that was supposed to break downside failed.

After the bullish breakout at 275 levels, $HWI retraced to test a newly formed trendline support. The pattern failure was the significant bullish indication for the index. The full stochastic oscillator (14,3,3) is healthily bullish, the ADX (14) is suggesting the developed uptrend, and the moving average convergence/divergence (MACD) (12,26,9) is comfortable in positive territory. Therefore, the entire scenario would drag the index higher, offering an attractive trading opportunity for the individual equities of $HWI. The upper trendline is the immediate and strongest support, followed by the lower trendline. If the index plunges to the lower trendline support, there is a possibility of the index moving in a narrow range with high volatility. In that case, traders can cut off their

FIGURE 1: $HWI, DAILY. The rising wedge pattern failed due to the bullish breakout. The index is sustaining above the fresh trendline support. Both supports were challenged immediately after the breakout.



long positions and stay neutral until the next directional breakout.

Although the rising wedge was breached upward on the daily time frame, $HWI continued to rally in an ascending channel on the weekly time frame. According to Figure 2, the index has violated the highest peak resistance of 2007 at 270 levels and made a new high at 304 levels. The index started the bullish journey in November 2008 but the bearish trend reversed in March 2009. Since then $HWI moved vertically upward, forming an ascending channel. The uptrend developed gradually, and the full stochastic (14,3,3) moved horizontally in an overbought zone without any hesitation. The MACD (12,26,9) after a bullish crossover in negative territory has steadily surged in bullish territory above the zero line.

Therefore, $HWI is likely to continue its upward rally within the channel. The indicators are suggesting high possibility of bullish breakout from an ascending channel. Those already long can hold on to their positions. I am hesitant to recommend any fresh positions in the middle of the rally. Any decline in $HWI can be bought as all three indicators are bullish.

To conclude, the bearish reversal pattern failure in $HWI has generated high demand for the individual equities of the index. The long-term ascending channel readily shows the road map for future trading. ■

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FIGURE 2: $HWI, WEEKLY. The real bullish strength in rally appeared in March as the downtrend reversed. The fresh rally moved up vertically, forming the ascending channel.

TECHNICAL ANALYSIS

FIGURE 1: DXY, DAILY

FIGURE 2: DXY, WEEKLY

TRADESTATION

FIGURE 3: DXY, 60-MINUTE

Dollar Dance

by Austin Passamonte

Short- and medium-term outlook for the US Dollar Index.

Tradable: DXY

More so this year than any other in recent memory, the USD index wags every financial market tail in rythmic fashion. Stocks, commodities, and currencies... they're all doing the dollar dance.

Starting with a daily chart of the DXY (Figure 1) shows where two recent 1-2-3 swings measured by Fibonacci projections both overlap initial objectives near the 76 level. After trading one session (Wednesday, September 23) inside that zone, the subsequent seven days forward marked the peak in stocks and current pullback there. Likewise, commodity markets are in lockstep accordingly.

The weekly chart (Figure 2) shows where the USD paused at 38% value twice, stepped its way down to 62% where it bounced once and wedged twice. Wedge break there has it headed toward the 78% level, with multiple layers of congestion right around there.

An inside look at the 60-minute chart (Figure 3) outlines the Friday reaction to nonfarm payroll and other economic reports. Low-high swing from September 30 through October 2 contained price action between actionable levels. It's pretty much a 1.00 range from 76.50 to 77.50 for what comes next. Further break lower marks a bottom for stocks and upward ascent renewed. Should the DXY pop back above 77.50 on its way to parts unknown, stocks will only go one way from there: straight south.

Like a peacock's tailfeathers, DXY fans out through all financial markets in rippled fashion. Until stocks return to moving up or down based on earnings, mergers and price/earnings ratios instead of doing the dollar dance, we'd better keep our eyes on the DXY for lead-proxy clues. ■

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METALS & ENERGY

TRADING SYSTEMS

Silver Monthly Uptrend Going Higher

by Donald W. Pendergast Jr.

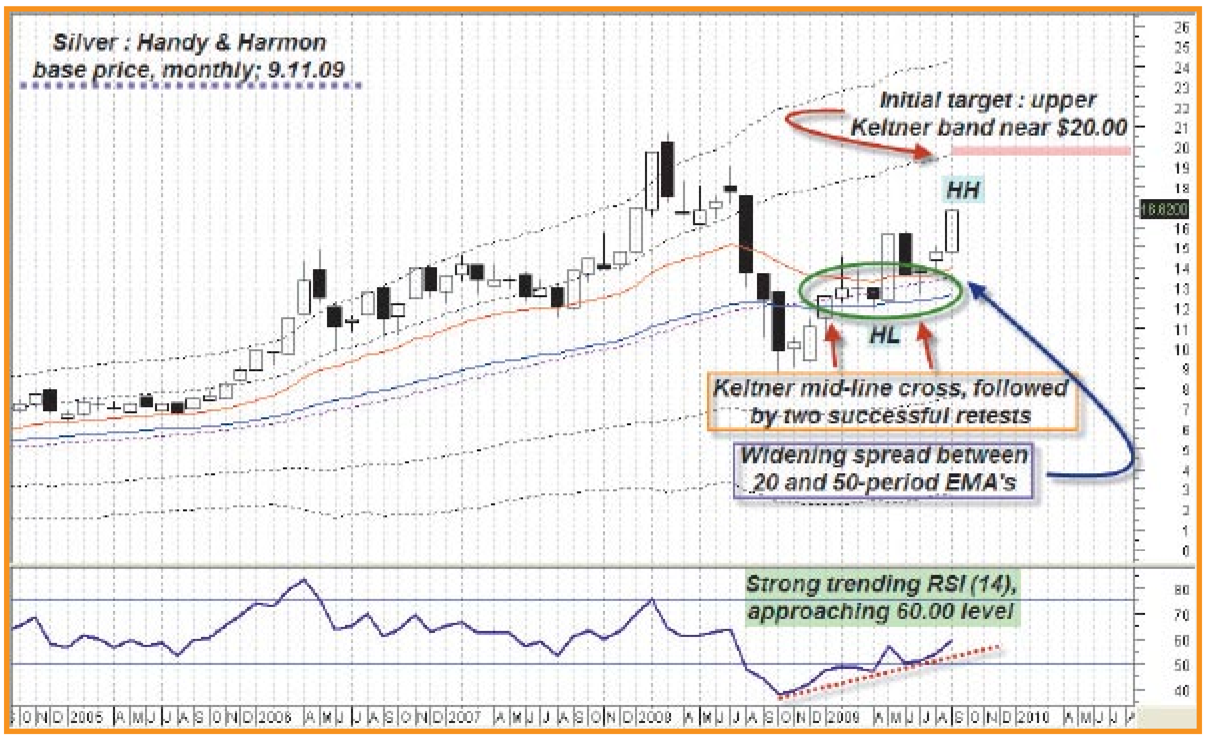
Silver makes much more powerful moves than gold, both higher and lower. Let's investigate the current state of the monthly silver chart to see if its current uptrend can carry higher from here.

Tradable: SI, SLV

In the wake of the 2008 commodity rout, cash silver lost about 57% of its value from March 2008 to October 2008, finally bottoming at \$8.81. Anyone tracking the weekly and monthly charts of the precious metal could see the serious technical damage done by the selloff, and many wondered if there wasn't another move lower waiting to play out after a modest retracement rally. Well, the rebound happened (no big surprise for an industrial commodity), but the widely anticipated second stage of the selloff never did, at least not yet. In fact, there is sufficient technical evidence to suggest that silver may very well be on track to meet or even exceed its March 2008 high of \$20.70.

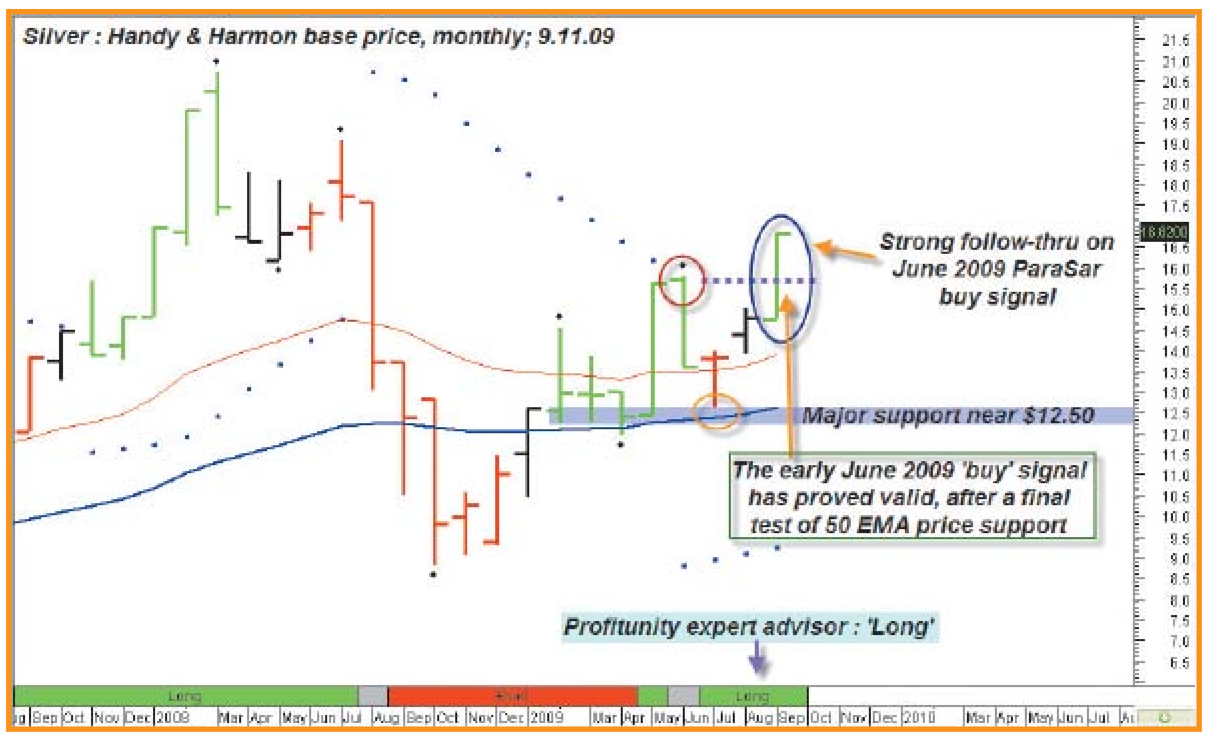
Figure 1 is monthly silver, overlaid with Keltner bands, a 20- and 50-period exponential moving average (EMA) and a relative strength index (RSI) (14). There's no secret formula to decipher; what we see here is a successful cross above the Keltner midline, followed by a pair of successful support retests prior to the new monthly breakout above the June 2009 swing high at \$15.80. Range on the breakout appears to be sufficiently healthy to propel silver up to a possible meeting with the next Keltner band near \$20. In addition, the monthly RSI (14) (bottom of chart) is just a few ticks shy of hitting \$60, which is another tipoff that this could be the start of another major monthly swing move in silver.

Moving to Figure 2, another monthly chart, we find that the parabolic stop and reverse system (ParaSar) issued a buy signal early in June 2009. While silver failed to carry higher at first, now that the important support test near the Keltner midline and the monthly 50-period EMA has proven out, silver has easily exceeded the original June ParaSar entry trigger price of \$15.64. Bill Williams' Profitunity MetaStock expert advisor (green ribbon at bottom of chart) has also joined the party, suggesting that long is the appropriate strategy at this time. Best of all, these bullish moves in silver are occurring during a favorable seasonal pattern for the commodity. Typically, silver will rally strongly from late August into late September, and it has a good track record of doing so for the past 40 years or so.



METASTOCK; WB KELTNER CHANNELS EOD FROM PROFITTRADER

FIGURE 1: SILVER, MONTHLY. Breakouts in the wake of successful tests of support (resistance) are usually worth further investigation, particularly if a significant swing high (low) has also been exceeded.



METASTOCK; PROFITUNITY, METASTOCK EXPERT ADVISOR

FIGURE 2: SILVER, MONTHLY. June's monthly ParaSar buy signal has finally been confirmed. Note how silver needed to test/retest the 50-period EMA near \$12.50 before launching higher.

With such a decent set of technical/seasonal patterns in place, why not consider selling far out-of-the-money silver put options, options that are extremely likely to expire worthless unless some extraordinary commodity market reversal takes place? If you can sell a December 2009 Comex \$11.50 silver put for approximately \$0.050 (\$250), you'll get cash upfront into your margin account, the option sold will have an extremely low delta (unlikely to expire in the money) and the option will also be losing time value on a daily basis, shedding ever-larger portions of its time value during the final 30 days prior to options expiration on November 23, 2009. Overall, this appears to be a very low-risk trade for silver bulls, given the bullish technical and seasonal aspects evident in the silver market. ■

ELLIOTT WAVE

Gold Nears Peak

by Alan R. Northam

Gold bugs are getting excited about buying gold once again since the precious metal is so close to making a new high, but caution is the order of the day. According to the Elliott wave theory, gold is about to go down and not up.

Tradable: GLD

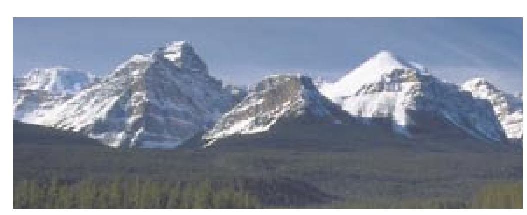
From early 2008 to late 2008, gold sold off in overlapping waves. From the Elliott wave theory, overlapping waves are known as corrective waves. The waves formed during market rallies occur in nonoverlapping waves. This is one easy way to identify market rallies and market corrections. Thus, the selloff during 2008 was a market correction to the previous market rally. Also from the Elliott wave theory, corrective waves are labeled with letters. I have labeled these waves with letters in Figure 1. The first three waves are labeled (A), (B), and (C) according to Elliott wave convention. These first three waves are known as a zigzag corrective structure. After wave (C) down is complete, the market rallies for three weeks and the peak of this rally is labeled (X). X waves are known as connecting waves that connect one corrective structure to another. Overall, the Elliott wave theory has identified 13 differing corrective structures, of which the zigzag is one. Since I have identified an X wave, it then follows that the market correction is not complete and there is yet at least one more corrective wave structure to complete before the correction in gold is over. Following the (X) wave, the next wave is a downward wave, labeled (A), which was completed in late 2008. Since I have identified an A wave, it then follows that there must be B and C waves left to complete before the market correction in gold is over.

With wave (A) complete in late 2008, wave (B) is now under way and is yet incomplete. I have labeled all the smaller waves that have gone into making up wave (B) so far. I will not go into a detailed explanation of all these subwaves to save time. However, I do want to point out that the current ABC corrective wave is not a zigzag but an extended flat. An extended flat is a market corrective structure where wave B extends beyond the origin of wave A. In our chart I have identified the origin of our wave (A) with a red downward pointing arrow. I have also drawn a red dotted horizontal line to the right of the origin of wave (A). From this chart we can see that wave (B) has moved above the origin of wave (A). This identifies the current corrective wave structure as an extended flat. From the Elliott wave theory we also know that waves C of an extended flat also moves lower than the end of wave A. Therefore, once wave (B) is complete, we can expect the market to once again sell off to something less than $68.80. There are ways to determine a high-probability price target, but I will save that for another time.

FIGURE 1: GLD, WEEKLY. This chart shows the Elliott wave count for the market corrective wave structure.

The question now becomes, "When will wave (B) end and wave (C) begin?" To answer this question, we need to identify the last part of the wave (B) corrective structure that I have labeled (a) and (b) with wave (c) still in progress. Waves C are subdivided into five smaller nonoverlapping waves according to the Elliott wave theory. Of wave (c) I have identified four of those five nonoverlapping waves and labeled them as waves i, ii, iii, and iv. This leaves subwave v to be complete. Once wave v is complete, that will also complete wave (B) and signal the beginning of wave (C) down. Wave 5s are normally the same length as wave 1s. This then provides a high-probability price target for the completion of wave v and wave (C) to be 106.50. If wave iv is not yet complete, the price target for the completion of wave (C) will be somewhat less.

In conclusion, there is some possibility that my wave count is incorrect and an alternative wave count to be the correct wave count. However, what is correct is that the move upward in gold from the late 2008 low is made up of severely overlapping waves, which are corrective in nature and does not signal that a bull market upward rally is in progress. As a result, caution is the order of the day with respect to expecting this market to go much higher from current price levels. Wisdom would dictate that five nonoverlapping waves in the upward direction off a significant market low be identified according to the Elliott wave theory before labeling that a bull market in gold is in progress. ■



AROON

Gold Prepares For Assault On March 2008 Highs

by Donald W. Pendergast Jr.

It's taken a full 19 months, but gold appears to be on the verge of exceeding the all-time highs made in March 2008.

Tradable: Gold, GC, GLD

Gold. Some people hate it and say it's the worst long-term investment in the world. Others love it for its ability to protect purchasing power during periods of monetary inflation. Some traders buy it at exactly the wrong time, after an already overheated move higher, even as frustrated investors sell it just before it bottoms and turns higher. Be it as it may, what is the current state of gold and is there a way to profit from it in the here and now?

Figure 1 is the Handy & Harmon monthly base price of gold, plotted back to late 2004. Note how consistent the recent action of the Aroon (14) indicator is over the past five years or so; every time the Aroon (14) closed above the 70 level (top blue horizontal line on its indicator window), gold went on to achieve substantial gains over the next three to eight months. The Aroon has just performed that technical feat again, right at a time when cash gold is just $15 from its all-time high and a significant chart pattern breakout is already under way. In addition, the relative strength index (RSI)(14) is maintaining a very bullish posture, with a reading now approaching 63.00. Check out the rising wedge pattern on the RSI (14); compare any breakout here with any further breakout follow-through on the gold price chart for further confirmation of this developing trend move. Finally, note the wide spread between the 20-period (red line) and 50-period (blue line) exponential moving averages (EMAs); eaven after the sharp correction in gold last year, these two EMAs are now suggesting that this is one commodity uptrend that is solidly back in the black.

Now, the tough part — how to play this move, just in case the breakout fails to carry through as expected or, even worse, starts another major leg down. As always, we can count on the option market to come to the rescue with an interesting idea or two. Here's the plan — consider building a gold short strangle, but do it one step at a time in order to take advantage of the current upthrust in the yellow metal of kings. Here's how:

FIGURE 1: GOLD, MONTHLY. Breakouts can be tricky, but the underlying momentum in monthly gold appears to favor further upside in this unique commodity.

1. Sell 1 February 2010 Comex Gold $750 put option for $2 or better. Use a limit order and be patient — a market order may net you a worse fill than expected.

2. Wait to see how gold handles the March 2008 high; in other words, wait for some strong follow-through — well beyond that price — to something over $1,150 or even $1,200 an ounce. At that point, premiums on out-of-the-money gold call options should be highly inflated. Consider selling a February 2010 Comex Gold $2000 call option, particularly when the weekly indicators are beginning to show some signs of weakening. You may be able to sell such a call for $3 to $4 during the next four to six weeks, knowing that gold would have to rise by $800 to $850 by late January 2010 (February gold futures options expiration) in order for it to expire in-the-money.

If you are able to sell both the put and the call in this manner, you'll likely collect a total of $500 to $600 in option premiums (before commissions). And if you wait to sell the February $2,000 gold call on further gold strength, the February $750 put will likely have withered away to next to nothing as gold rises in price. You could buy it back before expiration and book an early profit, or you may just decide to enjoy the ride and let it run until expiration. Meanwhile, the $2,000 gold call option will have a very small delta value, meaning that it will be unlikely to go in-the-money by February options expiration. Time decay will eat away at the option (both the put and the call) value every day, really accelerating during the final 30 days prior to expiration. And if gold rallies and then corrects hard after you sell the $2,000 call, you may even wish to buy it back early, ensuring a profit without having to wait for expiration.

While this trade isn't suitable for most traders, for those who trade futures, it may be worth a look. The open interest on the Feb 2010 $750 put is about 1,219 contracts, while the Feb 2010 $2,000 call comes in at around 919 contracts. This should be more than adequate to enable a decent fill on both entry and a possible early buyback.

Bottom line: For those who are bullish on gold through January 2010 (but not too bullish), selling a 750/2000 gold futures option strangle could be a no-nonsense way to profit from gold as it makes the time transition from one decade to another. ■

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Crude Oil And The MACD Histogram

by Ron Walker

The MACD histogram gives good signals. The slope of the MACD histogram is used to determine if a trend is safe. Divergences between the MACD histogram and prices can identify shifts in momentum. Center line crossovers can also pinpoint changes in trend. The histogram on the daily and weekly charts of crude oil recently sent a cryptic message to sell. Reading the MACD histogram is probably a bit simpler and more accurate than trying to read tea leaves to determine the future of crude oil.

Tradable: $WTIC

The moving average convergence/divergence histogram (MACDH) measures the difference between the MACD line and its signal line. In his book Trading For A Living, Alexander Elder defines the relationship of the slope of the MACD histogram by the two most recent neighboring bars. Elder stated that "if the last bar is higher (like the height of letters m-M), the slope of MACDH is up. If the last bar is lower (like the depth of letters P-p), then the slope of the MACDH is down." Elder's work was also expanded upon in an outstanding article published in Working-Money.com titled "Trading The MACD Histogram Parts I and II," published in December 2006. In it, Elder's "m-M" and "P-p" terminology using divergences is expanded on; when negative divergence appears on the histogram after an uptrend, and a pattern forms on the MACDH that resembles m-M-m, the article points out that it produces a change in slope. And vice versa, when a pattern that resembles P-p-P forms after a downtrend, a change in slope occurs to the upside.

The article concludes that as the histogram peaks, changing its slope from up to down, that it is the second "m" that triggers the short signal. This action should be taken only when a negative divergence appears. The MACDH ticks up and down quite frequently in the daily time frame and could generate false signals resulting in overtrading, so it might be more beneficial to pay attention to the slope of the histogram or act on a divergence when a m-M-m pattern appears when looking for a short entry. Divergences aren't as frequent, but much more reliable signals.

Why is the bearish m-M-m pattern such a powerful short signal after a bearish divergence appears? Because when the histogram stops rising and ticks down it is moving in the opposite direction of the trend. The trend is only safe when the slope of the histogram and prices are moving in the same direction. The article ascribes the capital and lower-case letters as a shorthand for momentum, which "can be used to spot short-term shifts in momentum."

Through August and September 2009, crude oil's continuous contract ($WTIC) traded in a range between $67 to $75. In Figure 1, crude oil broke below its intermediate trendline on September 1, 2009, shortly after prices peaked at $75. That fractured the trend that began in February 2009. Prices then trickled down to test the August lows near $67, where WTIC rested on support. After the pull-

FIGURE 1: $WTIC, DAILY. The breaking of the intermediate trend took prices back to the August lows. A bounce off support provided a successful backtest of that trendline and completed the head & shoulders pattern. Both the ADX and the MACD turned bearish shortly after the bearish m-M-m played out.

FIGURE 2: $WTIC, DAILY. WTIC peaked on September 17, producing a lower high.

back, WTIC made another run for the prior high. A quick jolt higher encouraged the bulls as prices bounced off August support and the 50-day simple moving average (SMA). But after the bounce, prices had trouble clearing the broken intermediate trendline and WTIC couldn't make a higher high. Therefore, both the diagonal trendline and the horizontal level of resistance maintained their authority, proving to be an insurmountable obstacle to overcome.

Further, prices had trouble clearing the mid-70s range all summer. After prices had peaked in late August (Figure 2), there were three separate attempts over the following weeks to challenge that high as the bulls and bears played tug-of-war, centered around the 20-day SMA. Finally, the bears yanked prices below the 20-day SMA, dragging the bulls through the mud.

This victory for the bears accomplished three things; first, it allowed prices to successfully backtest the broken intermediate trendline. Second, it produced a lower high. Third, it completed the right shoulder in a head & shoulders topping pattern in September. This would eventually lead to lower lows.

I want to draw your attention to a closeup of WTIC and the MACD histogram in Figure 2. WTIC peaked on September 17, producing a lower high. The next day, the histogram peaked. During the following session, on September 21, the histogram ticked down, completing a bearish m-M-m pattern.

It wasn't until two days later that the actual MACD (12,26,9) indicator itself crossed below the signal line. The histogram offered an earlier warning that momentum was shifting, accurately predicting the reversal.

Note how the two histogram peaks that preceded the m-M-m pattern were much higher in stature than the peak made in m-M-m pattern, showing that momentum to the upside was beginning to wane.

By September 24, prices broke support and put in a lower low, breaking the neckline of the head & shoulders top. It is interesting to note that the same day the m-M-m completed on the histogram, the stochastic (14, 3, 3) crossed below its signal line. Both indicators determine short-term momentum, and in this case moved in sync with one another, whereas the MACD helps to determine longer-term movements and is better suited for trend finding. Incidentally, the MACD's bearish crossover also suggests that longer-term trend is likely down.

Back in Figure 1, another trend-based indicator is in agreement with the MACD and the histogram. The average directional movement indicator (ADX) (14) has turned bearish. The ADX line bottomed out and has begun rising, strengthening the surging negative direction indicator (-DI). This is a bearish indication that a new downtrend is beginning.

In Figure 3, the weekly chart of WTIC reinforces the chances of further deterioration in price. The histogram's last bar printed a move just below its centerline, causing the MACD to cross below its signal line, flashing a sell signal. The prior two signals that were given when the histogram crossed above and below its center line proved to be very profitable. In mid-July 2008, a sell signal was flashed as the histogram broke below its centerline. Those that heeded to it were spared from a $98 catastrophe as prices dropped over the next five months.

FIGURE 3: $WTIC, WEEKLY. Center line moves on the MACD histogram have provided excellent entry and exit points. The price bars highlighted in yellow correspond with shifts in the center line. WTIC could have a double top in play or prices consolidate setting up a very large continuation pattern. The 40-week SMA will likely be tested.

Then after bottoming in December 2008, the histogram ticked higher toward its centerline. During the last week of January 2009, the histogram was lifted above its centerline and the bulls started to party with confetti and balloons. That signal shifted momentum to the upside, taking prices from $40 to the peak in August at $75, causing prices to almost double in that time. Both prior histogram signals seen on the weekly chart produced winning trades by a pretty hefty margin.

As far a price patterns in the weekly time frame, WTIC could be setting up a double-top pattern, with a confirmation line near $59. Note that WTIC reversed, putting in a distinct peak each time it touched the 200-week SMA. However, prices could begin struggling through a continuation pattern over the next several months in the form of a triangle or rectangle. With the penetration of the 20-week SMA, the next stop is likely the 40-week SMA near $57. There is good support just below that level at $55, as seen on the daily chart in Figure 1 (the dotted black line).

In conclusion, by using the MACDH to spot divergences on daily charts to find short and long entry points and the slope usually determines market direction. Using the MACDH information on the charts in conjunction with centerline shifts on the weekly chart to help determine the tide of the market can only increase the odds of a successful trade. But keep in mind that divergences aren't limited to the daily charts. Divergences that form in the weekly time frame are actually more powerful. ■

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Silver Strangle Play Both Sides Of The Market

by Donald W. Pendergast Jr.

Not sure which way silver will move in the next few months? Not to worry, there's a way to play such indecision by selling options.

Tradable: SI, SLV

FIGURE 1: SILVER, WEEKLY. While the future is unknown, we can still rely on probabilities, support/resistance levels, seasonal tendencies, and supply/demand fundamentals to create logical option spread strategies.

Silver has had a pretty good run over the past 11 months, rising by more the 90% from the sub-$9 crater that it crashed into after 2008's commodity landslide finally played out. It's actually been stronger than gold (in percentage gain terms) over the same time period, but unlike gold, silver has failed to reach the highs seen during March 2008. The weekly chart of silver also seems to imply that this commodity may be due for more pullbacks in price; fortunately for us, there is a way to play silver's short-term weakness and its longer-term bullish outlook.

Figure 1 is silver's weekly chart; while the metal has traced out a nice upward trending price channel, a glance at the detrend oscillator (top panel of chart) reveals that silver is progressively losing momentum even as a very reliable cycle indicator, the WB B-Line, is also suggesting that a medium-term top is likely to print soon, if it hasn't already. Going further, note the significant overhead resistance that spans the price range between $18.15 and $20.70 and then the significant support area near $8.81. This $10+ price range between major support & resistance barriers is likely to contain silver for the foreseeable future, and this leads me to suggest the sale of a far out-of-the-money (OTM) short option strangle. With silver usually being weak to flat during October/November (based on a reliable 40-year seasonal pattern) every year, selling a short strangle becomes even more appealing, especially for those who appreciate the value of time decay on a short option position.

Silver does have a rising weekly monthly price cycle (not shown here), however, so we're going to bias the trade to be a bit more OTM on the upside than on the downside. This shouldn't be an issue for long-term silver bulls (myself included), and will also help secure extra premiums on the put side of the strangle. Follow for all the key details.

Based on recent option prices, selling a COMEX March 2010 silver $30.00/$10.50 strangle should net nearly $600–650 cash for your futures margin account. As long as silver remains between $30 and $10.50 by March 2010 options expiration (February 23, 2010), the entire spread will expire worthless, allowing you to keep all of the premiums collected up front. Along the way, the value of both short options will slowly erode, due to the effect of time decay (positive theta). The biggest danger to this option spread is if silver mounts either an unusually strong rally or selloff shortly after the position is opened. In such a case, either the put or the call can rapidly increase in value.

Of course, the option on the other side of the spread will also have lost a large part of its value at the same time, thus neutralizing at least part of the sudden spike in the price of the underlying commodity. Should such a spike occur, the best strategy is to determine how likely it is for either side of the strangle to go in-the-money and to make the necessary adjustments.

For example, let's say silver breaks hard to the downside a week after you sell this spread, all the way down to $12. The short put would gain a great deal of value, while the short $30 call would lose a part of its value. In such a case, you could always buy back the short $10.50 put and roll out to a March 2010 $8.50 put, especially if you were confident that silver's strong support at $8.81 would stop any further declines between then and option expiration. You could even buy back the $30 call and sell a $25 call in its place, locking in some extra profit at the same time. The possibilities are numerous, and experienced option traders should have little problem with such a short strangle, no matter what the future may bring for silver.

If I were to enumerate the key skills needed for futures option sellers, here would be the basic list, in no particular order of importance:

1 Understanding of key S/R levels on multiple time frames.

2 Knowledge of option implied volatility.

3 A firm grasp of statistics and probabilities.

4 Familiarity with seasonal commodity price charts.

5 The ability to work a decent option fill price.

6 Knowledge of basic supply/demand for any given commodity.

7 The wisdom to know when to wait and when to act. ■

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Millennium Gold

by Austin Passamonte

Near-term to mid-term outlook for gold futures index.

Tradable: HG

Gold bugs have talked about $1,000 and even $2,000 per ounce gold prices for the past several years. Even when it traded in the $200-plus per ounce, such predictions were common. Well, it may have been a long wait, but at long last, gold has indeed hit the first millennium mark.

From July through August this year, gold wedged itself into a crisp apex pattern. A wedge low near 910 and high near 970, or a $60 span, predicted that far of a push away from the pattern, whichever way it inevitably broke; 950 breakout + $60 projection from there = $1,010 price objective to target. See Figure 1.

One year ago, $700 per ounce lows gyrated to current high levels in a staccato fashion. We couldn't even accuse gold futures of being deliberate or methodical in this chart. Wide valuation swings up and down eventually made way to where it is now. Where it is now happens to be at layered 1-2-3 swing projection targets from two of the major historical waves. That's where the current wedging finds itself magnetized to for now. See Figure 2.

That recent wedge pattern has a low–high span of $50 at its width (Figure 3). You know the drill by now: breakout pending from 1010 points toward 1060 while a similar breakdown near 990 points toward 940 objectives. One or the other is probable, sooner or later.

Gold prices reflect a fear of inflation to come. There was a time not long ago when $1,000 an oz. seemed unlikely to some. Perhaps even now, $2,000 an oz. seems equally incredulous. That type of speculation is merely that — idle speculation. What we can do is measure price direction one chunk at a time. Next chunk should be rather direct, $50 higher or lower. Time will tell. It always does. ■

TRADESTATION

FIGURE 1: GC, DAILY

FIGURE 2: GC, WEEKLY

FIGURE 3: GC, DAILY

VOLATILITY

Bullish Belt Holds Bolster The Bears

by Ron Walker

A series of bullish belt hold candlesticks have materialized on the daily chart of the VIX reinforcing a new base of support. But will these bullish belt holds bolster the bears?

Tradable: $VIX

The Chicago Board Options Exchange Volatility Index (VIX) measures the implied volatility of the Standard & Poor's 500 index options. When the index climbs higher, volatility in the stock market greatly increases. This index is used to gauge fear. The VIX is quoted in percentage points and estimates the movement of the S&P 500 over the next 30 days on an annualized basis. The current reading of 26% suggests that option traders in the S&P 500 (SPX) options anticipate SPX to move to the 26% range over the next 12 months. However, the VIX looks poised to move much higher in the coming weeks ahead. If the VIX begins to move higher, it would usher in an overdue correction in the stock market.

Figure 1 shows the VIX bottomed out at 23% in late July, and then sidestepped through August in a tight contained price range, all the while closing above 24%. In mid-August, the VIX clambered to a slightly higher high, but quickly lost steam and retested support. Regardless of a failed rally on the VIX, it still has successfully produced a higher low, with a groundswell of support at the 24% level (Figure 1).

A series of bullish belt hold patterns have cropped up each time that support touched near the 24 level. The bullish belt hold pattern occurs when the candle for that session opens at its low, then rallies hard against the previous trend and manages to finish the session near the highs of the day. The belt hold candle is a long wide range bar representing a reversal. The belt hold one-day reversal pattern is unique in that it has no lower shadow at the lower

FIGURE 1: VIX, DAILY. Circled in black are three bullish inverted hammers that formed at key support near 24%. Each inverted hammer was followed by a long bullish belt hold candlestick. The MACD, stochastic, and RSI each have confirmed the higher lows that formed a base of support at 24%. That may allow the VIX to clear the 50-day SMA.

FIGURE 2: VIX, DAILY. If the current belt hold produces a higher high, we will see the long-term downtrend broken here on the daily chart. Both the RSI and the MACD have long-term bullish divergences that are now beginning to build momentum on the VIX.

FIGURE 3: VIX, WEEKLY. The MACD on the VIX finally got a bullish cross on August 28. Bouncing off the long-term trendline should give the VIX the traction it needs to break out of the bullish falling wedge pattern.

end. Ironically, each time a bullish inverted hammer appeared at support it was followed by a bullish belt hold pattern (see that candle combinations circled in Figure 1).

In Figure 1 we can see that the VIX has had some trouble getting above both the 20- and 50-day simple moving averages in July and August. Both attempts failed. But the sequel of bullish belt hold candles might give the VIX the boost it needs to clear those two moving averages.

Figure 2 shows the daily activity of VIX over the past year. At the hard right edge of the price chart, you will see that the most recent belt hold candle nudged right up to the long-term declining trendline. The closeup of the daily chart in Figure 1 shows some very bullish signals that may cause the VIX to explode soon. The moving average convergence/divergence (MACD) (12, 26, 9) has confirmed a higher low and is creeping up to the zero line. The stochastic (14, 3, 3) and relative strength index (RSI) (14) also have higher lows. The stochastic got a bullish cross and is firming up above 20 (oversold levels); meanwhile, the RSI snapped above its median line of 50.

The weekly chart of the VIX in Figure 3 also looks to be revving up. The MACD histogram moved above the center line after it completed a long-term bullish divergence with the VIX. Currently, the slope of the MACD histogram bars is up (rising bars) in the weekly time frame and shows that bears are now back in the driver's seat. The MACD got a bullish cross on August 28, while the stochastic sprang above 20. A bullish falling wedge price pattern has formed off the primary trendline from the end of 2006. All these signs suggest that it is a favorable environment for short positions.

The current bullish belt hold needs a confirmation itself by a close that is above the high of the highest point in the candle pattern. In this case, we would need to see a close above the wick peak in the belt hold candle at 27.01%. That would push the VIX to a new high and break the downtrend, energizing the bears. ■

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TECHNICAL ANALYSIS

Kiss Crude Oil Goodbye?

by Austin Passamonte

Short-term and mid-term outlook for crude oil futures.

Tradable: CL

The past several years have seen a wild ride in crude oil futures (CL). The correlation of crude oil and the US dollar valuation has CL being played as a proxy currency. If they trade any tighter from here, we might as well create the symbol USD/CL for the forex world. We can only assume this current relationship will continue, and world turmoil in the currency world should keep crude oil futures equally volatile.

Looking at Figure 1, the weekly chart picture for CL (adjusted for continuous contracts pricing) shows a gentle trend higher relative to the wild V-turn of two years past. It has also topped off in wedging fashion, from June through now (purple line) and accelerated from September (thin navy blue line). Two weeks ago, the support line was broken, while this past week, we saw price rise back up and close right at that price mark.

Dialing down to the daily chart (Figure 2), we can see where this wedge formation broke down last week to the $65 level and traded back up to the $70 mark. That $70 level has been a price magnet since July, creating the midpoint of numerous daily open-close sequences.

A $5 price range on Wednesday (FOMC event) rallied right back into the wedge. Thursday was a sideways doji or session of unchanged indecision. Friday sold back out of the wedge and back below $70 again. This wedge has a value span from roughly $62 to $75, or $13 in width. When CL breaks away from this wedge pattern and makes the next directional push, it should be a straight path from $70 to $57, or $83 levels before the next pause and congestion is expected.

CL has spent the summer winding its way into a wedge formation. The inevitable break of this wedge is direction unknown, but distance measurable — $13 (low–high wedge range) from current apex point ($70–71) is the technical outlook for crude oil futures heading into the winter season ahead. ■

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TRADESTATION

FIGURE 1: CL, WEEKLY

FIGURE 2: CL, DAILY

XLF Retraces To Previous Support Level

by Chaitali Mohile

The higher tops could not stop the Financial Select Sector SPDR from retracing back to the previous support level. The fresh bullish rally is likely to move with a depressed mood.

Tradable: XLF

The Financial Select Sector SPDR (XLF) entered a robust uptrend in July 2009 and formed its first peak at $14.50. An overbought relative strength index (RSI) (14) restricted the rally, and as a result, XLF plunged a few points. The volatility in the sector increased due to the lower tops of RSI (14) and the higher highs formed by the price movement.

The second high was not as sharp as the first one. We can see in Figure 1 that XLF consolidated with the newly formed support of the previous high at $14.50. The moving average convergence/divergence (MACD) (12,26,9) also formed lower highs and lower lows. Thus, a negative divergence of the RSI (14) and MACD (12,26,9) pushed down the sector marginally below the support level (green line) from the third peak at $15.25. During the bearish move, the indicators established support in the bullish areas. In Figure 1, the RSI (14) turned upward with the support of 50 level and the MACD (12,26,9) sustained in positive territory.

This helped XLF regain its bullish force and surge above the resistance of $14.50. Since the RSI (14) has moved above 50 levels, the current price level would be the best place to trigger a long position. The target would be highly short term — that is, the previous high at $15.25. The average directional movement index (ADX) (14) that indicated the strong uptrend for the past three months has turned weaker by moving below 25 levels. The tangled movements of the positive directional index (+DI) and the negative directional index (-DI) suggest a consolidated price action in the current uptrend. Therefore, though XLF has initiated the bullish rally and has converted the resistance to support (green line), the price movement is likely to remain range-bound between $15.25 and $14.50.

The weekly chart in Figure 2 shows the strength of the two candlesticks. First is the bullish engulfing candlestick pattern at the bottom of the chart in March. XLF began a strong bullish rally after the candlestick pattern was confirmed by the reversal move of the highly bearish indicators. The RSI (14) surged from an oversold area, the ADX (14) declined from an overheated downtrend levels, and the moving average convergence/divergence (MACD) (12.26,9) underwent a bullish crossover in negative territory. Therefore, the bullish engulfing pattern initiated a robust bullish rally with the strong support of the bullish reversal indicators.

Since the rally was escorted by the positive momentum, XLF reached $13 without a single halt or consolidation. A big bullish candle formed in early May reflected the bullish force in the rally. XLF remained volatile for the next four months but sustained above the low of the bullish candlestick that is about $11 (see the marked rectangle in Figure 2). We can see that the sector established the support and surged above the high of the candle at $13.25 with a small gap up.

Thereafter, the vertical rally turned sideways. The support-resistance line tool used in Figure 2 shows a robust resistance at the level of $16. Therefore, the consolidation range is $14 and $16 (short term). The RSI (14) has moved vertically upward, highlighting the bullish strength existing in the consolidation. The uptrend is developing with an equal buying and selling pressure in Figure 2. In addition, the positive MACD (12,26,9) has slipped into positive territory. Thus, XLF would continue to move in the bullish consolidation range mentioned previously.

The trade recommended according to the daily time frame can be carefully carried further until the resistance of $16 is hit. ■

FIGURE 1: XLF, DAILY. Although XLF formed the higher highs, the negative divergence of the RSI (14) and the MACD (12,26,9) proved to be a stronger bearish force that retraced the sector toward its earlier support area.

FIGURE 2: XLF, WEEKLY. The support-resistance line tool shows the exact range for the consolidation of the sector.

SPY's 1-2-3 Price Reversal

by Ron Walker

The study of price behavior can help determine when actual shifts in power occur between buyers and sellers. A 1-2-3 price reversal defines the moment that occurs, clearly spelling out which group is in control.

Tradable: SPY

As a trend matures, especially after a steep grade, it is advisable to formulate a contingency plan in anticipation of a reversal. As traders, our job is to anticipate a reversal at its earliest stages rather than act on it after the fact. The earlier you spot a reversal, the greater the reward. The 1-2-3 price reversal is the basic setup. A setup is a price formation that can be acted on using any financial instrument once it has been identified on the price chart. Using a setup allows you to fine-tune your entry points, with a set of predetermined trading rules and guidelines. A trader must abide by certain trading rules in order manage risk properly. Using a setup is essential in lowering risk and allows a trader to keep his/her emotions in check without compromise. The 1-2-3 price reversal keeps us from jumping the gun on a trade and entering it prematurely. The tactics employed in the basic setup is incorporated into the chart patterns we trade each day in some shape or form.

The S&P 500 SPDRs (SPY) is an exchange traded fund (ETF) that mimics the performance of the Standard & Poor's 500. Here we will examine the price action that transpired between September 1 to October 1, on the SPY hourly chart (Figure 1). In early September, SPY bottomed out at $99, moving in a lateral range for several sessions before prices broke out and began a steep climb higher to peak just above $108. On September 23, prices broke the rising trendline that formed during that runup. The following day, prices continued to slide and broke below the previous minor low, which was made prior to the trendline break. Prices hit fresh lows for the first time as they sank down to the $104 level, closing below the 20-period moving average (MA). On September 25 prices bottomed, and then SPY snapped back on light volume the following day, causing prices to overshoot the 50-period MA, closing the week just north of $106.

The following Monday, on September 29, prices gapped up and charged toward $107, only to be met with a reversal bar (a bearish engulfing pattern) that printed a lower high in the 60-minute chart. Then prices made a series of lower highs as the 20-period MA got a bearish realignment with the 50-period MA. Unable to exceed the previous price peak, SPY hit the breaks on the advance and began backpedaling as prices edged back down as conditions worsened. Driven by fear, there was a pronounced decline on increasing volume as prices crossed below the previous price threshold. The price threshold is the doorway to a reversal. It is the line in the sand, and once prices cross below it, the downtrend is confirmed. Penetration confirms a lower high and a lower low, offering ample evidence that a price shift has taken place.

In this article I will flash the spotlight on a bearish 1-2-3 price reversal, but in a bullish scenario we look for the inverse of this setup. A price reversal is as simple as 1-2-3. Three conditions must accompany a true bearish price reversal. The first condition is that prices must break down from a consolidation or reversal pattern and make a lower low. In this example, SPY is breaking down form a double-top pattern. Second, prices must make a lower high. Prices must be too feeble to continue making higher highs and so create a lower high. Third and finally, prices break below the previous minor low that was made during the last selloff. When two of the three conditions meet, it increases the probability that the third condition will likely be the next logical move to occur.

This setup offers three distinct entry points for a trader to get short if specified conditions are met, but in order to manage risk one must abide by the rules of engagement. Remember, the no. 1 cause of financial ruin for a trader is the failure to set protective stop-losses. A short can be taken at point 1 as prices are breaking down from the reversal pattern, which amounts to a failed consolidation. The trade is triggered when prices penetrate below the trough that separates the two peaks. That minor low is the confirmation line of a double-top pattern. A stop should be placed just above the last minor high made near the 108 area. This entry point poses the most risk of the three we will discuss.

FIGURE 1: SPY, 60-MINUTE. This bearish 1-2-3 price reversal consisted of a breakdown from a double-top reversal pattern. A light volume rally established a lower high, and then a follow-through of another lower low.

FIGURE 2: SPY, 15-MINUTE. Here, we see that while a lower high was forming on the hourly chart, a head & shoulders top sealed the fate of a lower high on the 15-minute one. Note the extended pullback above the neckline couldn't exceed the high made in the right shoulder.

Once the selling is contained, prices rallied back up to point 2 to retest the prior high. There, a gap occurs, causing prices to peak at $107. After prices gapped higher, the next bar produced a reversal as a bearish engulfing reversal candlestick appeared, failing to set a new high. That put the skids on this attempted recovery rally. Note that after prices put in this lower high, SPY turned and made a series of lower highs. During this reversal, a trader can get short the moment the pivot reversal appears, with an initial stop just above the peak made during that session. The other option at point 2 is to wait until a lower high forms after the pivot reversal has begun or when prices move below the initial minor low made by the pivot reversal. This presents a micro version of the bearish 1-2-3 price reversal that can be seen in the 15-minute time frame (Figure 2).

Point 3 shows the follow-through that confirmed the lower high and lower low (Figure 1). The action that should be taken here is simple; we want to short SPY at $0.10 to $0.15 below the previous established low, with an anticipated short entry immediately after the horizontal trendline is fractured. The broken trendline is an indication of weakness after the lower high has been established. Taking a short here at the pivot reversal presents the least amount of risk of the speculative short entries. A more conservative trader can wait for a 60-minute bar to completely form, closing below the horizontal trendline.

In Figure 2, we can see that the 15-minute chart provided helpful information in timing a short entry during point 2 on the hourly chart. Short positions were considered when prices first fell below the 20-period MA on the 60-minute chart, which occurred at point 1 (Figure 1). But the 15-minute chart should be utilized to help us fine-tune our entry points for all the points. I want magnify what is going on in the 15-minute time frame during point number 2.

In Figure 2, we see that after prices rallied back up to form point 2, a small head & shoulders top was developing in the 15-minute time frame. A head formed as prices peaked near $107. After that, prices formed a lower high, creating the right shoulder, and collapsed through the neckline. This was also a bearish 1-2-3 price reversal for 15-minute traders. After prices collapsed, there was a brief extended pullback above the neckline, but prices were too weak to clear the peak made at the right shoulder. Resulting in a sharp reversal caused prices to plunge below point 3, confirming the 1-2-3 price reversal on the 60-minute chart. ■

HEAD & SHOULDERS

Going For ETFs

by Koos van der Merwe

On CNBC some time ago, Suze Orman advised investors to invest in ETFs for the dividend. "Buy them, enjoy the dividend, and don't watch them," she said.

Tradable: DBU-US

FIGURE 1: WISDOM TREE INTERNATIONAL UTILITIES, DAILY

At that time, had you bought exchange traded funds (ETFs), you would have watched with anxiety as they collapsed along with the market, but her advice — not to watch them but enjoy the dividend — was worth it. Many of them have returned to the price the ETF was when she gave her investment advice. So what is an exchange traded fund?

An ETF is an investment vehicle traded on stock exchanges, much like stocks. It will hold assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. Most ETFs track an index, such as the Standard & Poor's 500 or MSCI EAFE and may be attractive as an investment because of their low costs, tax efficiency, and stocklike features. Many pay an attractive dividend either monthly or quarterly.

Dividend ETFs combine the benefits of dividend investing with a low cost and diversification. They have been a hit with income-seeking investors, especially after the meltdown of 2008. When markets are falling, a dividend return becomes an important part of the investor's return. By investing in a dividend-paying ETF, you receive a broad exposure to dividend-paying stocks without the single-stock risk.

The two ETFs that pay the best yield as of this writing are both listed on the Toronto Stock Exchange. They are the iShares Canadian S&P/TSX Income Trust Index Fund (XTR-T) with a yield of 9.20% and the iShares Canadian S&P/TSX CPPD REIT Index (XRE-T) with a yield of 7.81%. In the US, the best-yielding ETF is iShares IBOXX $ INVTOP Investment Grade Corp (LQD-US) with a yield of 5.891% followed by Wisdom Tree Intl Utilities (DBU-US) with a yield of 5.620%. Of course, these yields will change with the movement in the market — if the share price falls, the yields go up, so you should buy on the dips to obtain the highest yield.

The chart I have chosen to watch is the Wisdom Tree International Utilities simply because it looks interesting (Figure 1). You should always keep in mind that the higher the dividend, the more investors the share will attract, so there is a good chance of a capital gain that is greater than the dividend paid.

The chart shows the following:

1. An inverse head & shoulders pattern with a target of $26.55.
2. The price has broken above the neckline and retraced to find support on it.
3. The stochastic indicator shown has given a buy signal.
4. The chart shows a resistance at $23.62, and a move above this level is a definite buy.

To conclude, with a dividend yield of 5.62% and a chart that looks as though the price should increase, whether it does or not, the ETF is very much a buy at present levels. ■

Dividend ETFs combine the benefits of dividend investing with a low cost and diversification.

DAY TRADING

Fibonacci, Trendlines, Divergences — Recipe For Reversal

by Donald W. Pendergast Jr.

Not every intraday trade setup works out this well, but the technical dynamics leading up to it are worth a second look.

Tradable: Gold, GC

Most new traders get frustrated when they attempt to analyze a chart using only one kind of indicator or trading technique. Even worse, if they try to actually make a trade using a singular technical interpretation of market action, their trading results are usually disappointing. Here's one way to combine multiple technical interpretations into a viable trading strategy that can actually make money over time.

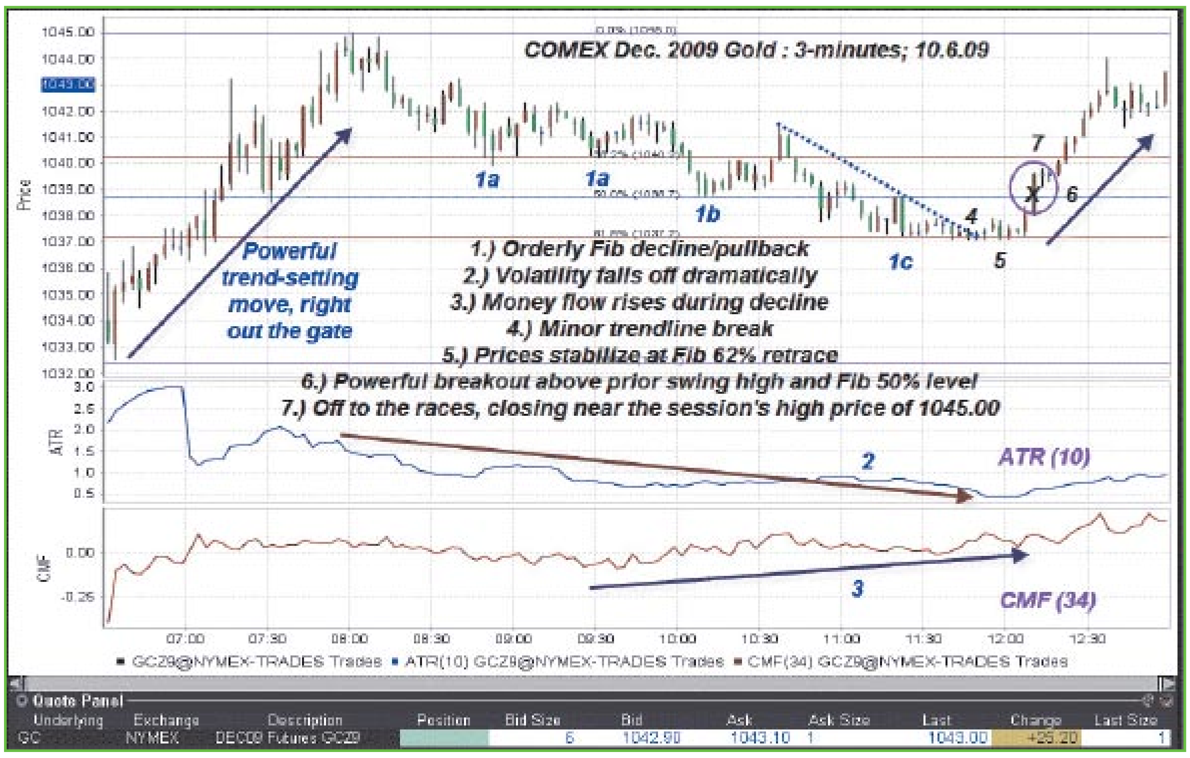
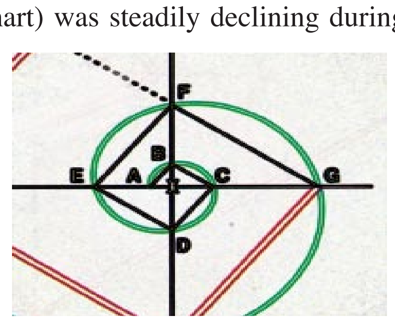


FIGURE 1: GOLD, THREE MINUTES. Price momentum and price–money flow divergences are reliable early warnings of potential trend reversals — on any chart, and in any time frame. Using Fibonacci support/resistance levels and trendline breaks can also help time such divergence setups.

Figure 1 is the three-minute chart for COMEX December 2009 gold. Gold made a strong run higher right out the gate this morning (October 6, 2009), tacking on a gain of about $11 in an hour and a half of trading action. While this is great news for those following the epic breakout in progress on gold's monthly chart, it also provided a healthy technical backdrop for this amazing intraday setup that printed a few hours after the initial run higher. A savvy intraday trader would most likely stretch a Fibonacci retracement grid between the morning low (1032.50) and the early morning high (1045), looking for possible low-risk long reentry points at key Fibonacci levels.

After placing the grid, the trader would note the approximate price levels of the 38%, 50%, 62%, and 79% Fibonacci retracement lines and then thoroughly evaluate the technical landscape on any touches of such levels on a pullback move from the morning's high. Since the intraday method that I follow relies mostly on money flow, intraday pivot points (not a major factor today, as price stayed above resistance level #2 [R2] for the entire session), momentum, moving averages, and average true range (ATR), it was little surprise to see at least several of these technical factors come into play as prices began a leisurely four-hour period of retracement and/or consolidation.

Note how each key Fibonacci level that was actually touched acted as significant support as the decline played out; the 38% level (top horizontal blue line on chart) was particularly strong, holding back the decline on two (see point 1a on chart) consecutive tests. Volatility (measured by the ATR — see the yellow indicator line below the price chart) was steadily declining during those two tests (see point 2 on chart) of support, but the Chaikin money flow (CMF)(34) (blue indicator line at bottom of chart) was not supportive of a significant reversal at that time.



Waiting a little longer, the Fibonacci 50% retracement also acted as support (see point 1b on chart) on one occasion, allowing quick scalpers to make a handle or two between 10:15 and 10:40 Pacific time (PT). This rally attempt quickly failed, however, causing a sharp drop down to another key Fibonacci support level, the venerable 62% retracement (see point 1c on chart). After hitting this level (near 1037.25) at about 11:10 PT, volatility began to drop off dramatically even as the money flow line continued to confirm that a bullish price-momentum reversal was likely in the works (see point 3 on chart).

Soon afterward, gold broke above a minor downtrend line (see point 4 on chart), a final retest of the Fibonacci 62% level proved successful (see point 5 on chart), and then price shot higher on a wide-range three-minute bar that not only took out a minor swing high, but also allowed price to actually reverse above the prior Fibonacci 50% level (see the X at point 6 on chart). Price continued to follow through, even taking out the Fibonacci 38% level on its way toward completing a reversal gain of about six points in just 45 minutes. Even nicer for gold bulls, prices closed near the high prices of today's session, at 1043.

Does every Fibonacci/volatility/divergence setup like this always yield equally profitable results? Of course not, but you'd be surprised at how often they produce a swing move worthy of engagement. Setups like this usually offer a very attractive risk-to-reward ratio (RR), especially when the stock or futures contact traded is also in a confirmed uptrend on its higher time frames. Gold certainly qualifies in that regard, making a setup like this nearly irresistible to experienced traders. In addition, you may experience better results when using both the 20- and 50-period exponential moving averages (EMAs) when trading a template similar to this; they were omitted for the sake of clarity on this particular chart. ■

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This article was first published on 10/8/2009.
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INDICATORS

STRATEGIES

Studying Indicators

by Mike Carr, CMT

Sometimes indicators just don't work. Typically, it takes a little more than looking at a chart with the default settings of an indicator to be a successful trader.

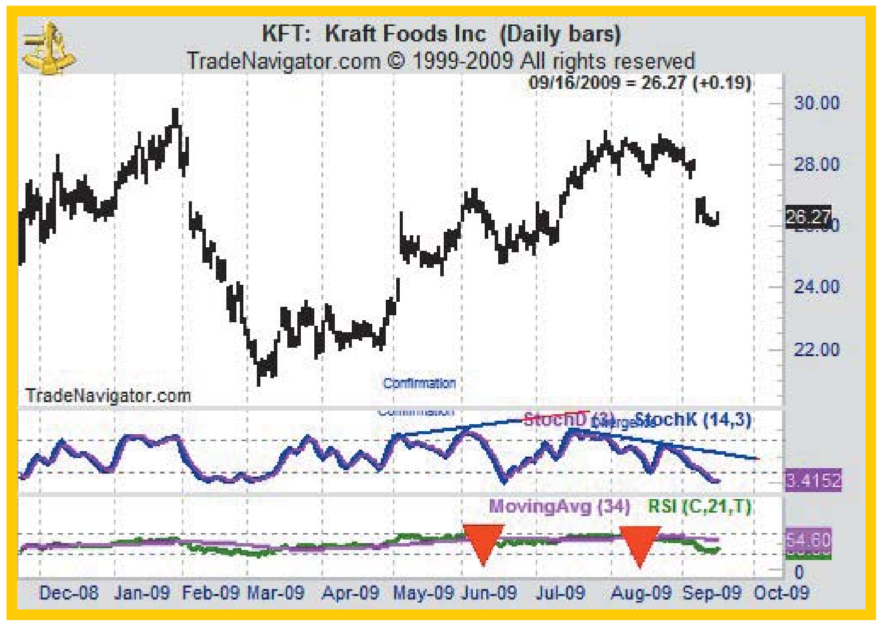
Tradable: KFT

In Figure 1 we have a daily chart of Kraft (KFT). Like almost all stocks, it is higher than it was at the March 2009 bottom. Many traders use stochastics to identify trading opportunities, and KFT was oversold on this indicator at the bottom and gave a timely buy signal. The stock moved higher in May and the stochastics confirmed the price action. Unfortunately, prices soon fell. Near the September top, the stochastics successfully highlighted a bearish divergence.

This is typical of the experience of new technicians. Sometimes an indicator works as advertised and at other times it doesn't. In the lower clip, we see the relative strength index (RSI) with a moving average superimposed. Here the idea is to sell if the indicator falls below the moving average.

Using that idea, we would not have been led astray by the confirmation in stochastics and would have been out of the long position a few days early when stochastics set up a divergence.

The bottom line is that trading is difficult. Using indicators just like the book says to will rarely lead to profits over the long term. Understand what the indicator is designed to do, and then look at how you can modify that to fit your style. In this case, stochastics is actually a slow version of momentum. The RSI is a faster measure of that. Applying the moving average to the RSI lets you see what very few others are, and that could be your trading edge. ■



TRADE NAVIGATOR

FIGURE 1: KFT, DAILY. Here's Kraft with stochastics and the RSI.

TRADING SYSTEMS

With RMO Sell Signals, Current Selloff To Continue

by Donald W. Pendergast Jr.

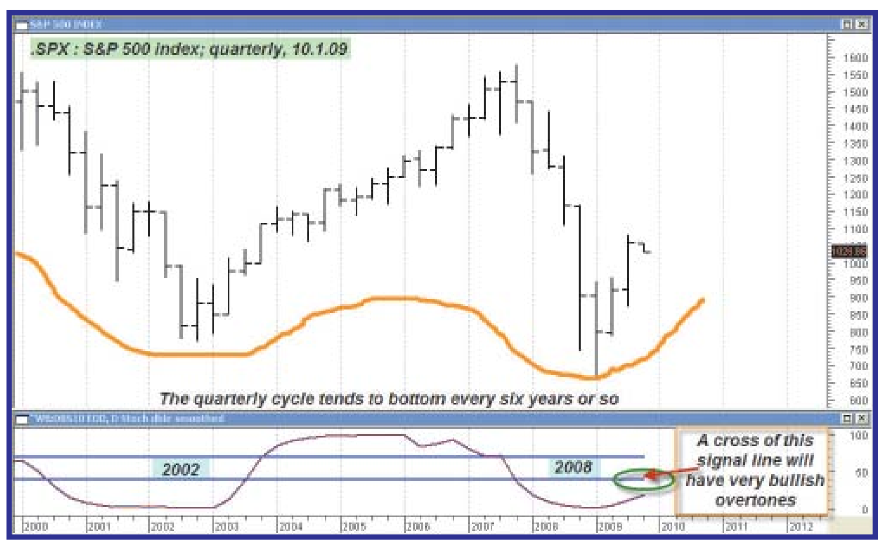
With 17% of the S&P 500 component stocks flashing new RMO swing sell signals, there can be little doubt that the broad US markets have put in a significant weekly high.

Tradable: QCOM

Some traders and investors saw the mammoth selloff of October 1 coming, while others didn't. Whether or not you were anticipating a significant turn, the fact remains that the markets have just put in a weekly cycle high that should remain in place for at least the next seven to 10 weeks, assuming that the bullish quarterly price cycles driving the Standard & Poor's 500 and Russell 2000 indexes will continue to remain in long-term bullish mode. We'll examine the broad-based nature of today's plunge first, investigate the long-term (six-year) market cycle and where we are currently within it and then take a look at a large-cap NASDAQ/S&P500 component stock that may provide us with a low-risk trade opportunity.

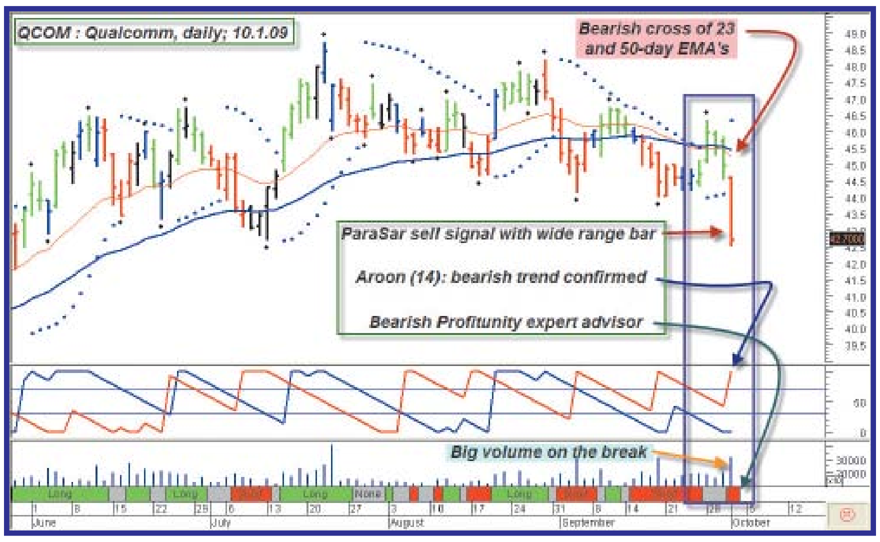
To prepare for this article, I ran both the Russell 2000 and S&P 500 component stocks through MetaStock's RMO Swing Trade Sell exploration and determined that 13% (almost 260) of the Russell 2000 stocks and more than 17% of the S&P 500 stocks (87 stocks) have produced RMO (Rahul Mohindar oscillator) swing sell trade signals. This is the largest quantity of such signals since earlier this year, prior to the March 2009 reversal. This provides more evidence that the anticipated weekly cycle highs in the R2K and SPX are now firmly in place, and that the broad market's direction is likely to be down, at least into the next weekly cycle low, currently due around mid-November 2009. In the meantime, R2K and SPX should make daily cycle lows on or around October 7–12, 2009. What this means is that very nimble daily based and intraday traders may find numerous setups on either side of the market (long and short) over the next six weeks or so; they need to be aware of that heavy downward pull of the weekly cycle, however, and to move in and out of short-term positions on very short notice.

There is reason for long-term bulls to remain optimistic despite the likelihood of increased turbulence in the coming weeks, and that's because the long-term (quarterly) price cycles in both indexes remains in bullish configuration. And with the economy finally showing some signs of recovery, it shouldn't be too hard for the big institutions to keep putting money to work as long as those cycles are pointing upward. In the .SPX quarterly chart depicted in Figure 1, you can get a better idea of the big market picture and see just how potentially bullish the next few years might be for the broad US market indexes. We may not see a run like the one we had from 2003–07, but if we get even two-thirds of that, there should still be plenty of upside remaining, and once we get past November's weekly cycle low, a solid year-end rally is very likely to materialize.



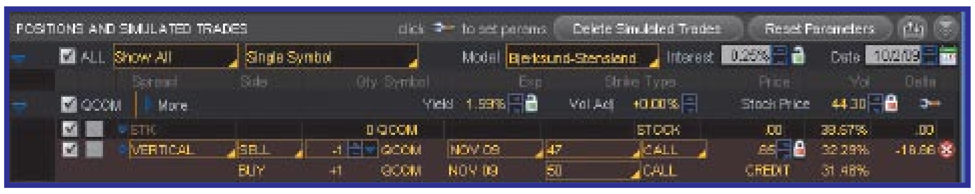
METASTOCK; WB DBS10 EOD FROM PROFITTRADER FOR METASTOCK

FIGURE 1: SPX, QUARTERLY. When short-term selloffs happen, sometimes it pays to take a step back and put everything into perspective. The current quarterly cycle (the six-year cycle) in the .SPX is still rising, and a cross above the lower signal line (green oval) will be especially bullish.



METASTOCK; PROFITUNITY - METASTOCK EXPERT ADVISOR.

FIGURE 2: QCOM, DAILY. It's not a good time to go long QCOM, however, at least not on a short-term basis. Waiting for a minor daily bounce may allow out-of-the-money call option sellers to command greater premiums.



THINKORSWIM

FIGURE 3: QCOM CREDIT SPREAD. Waiting for QCOM to bounce back to \$44.30 may allow November \$47/\$50 credit spread sellers to earn an additional \$0.23 more in premiums per spread — \$0.65 vs. \$0.42.

Right now, though, let's wallow in some doom and gloom as we figure out how to make some money off of this developing selloff.

Figure 2 is the daily chart for Qualcomm (QCOM), a name that most traders and investors have become familiar with since the late 1990s. QCOM not only has produced a new ParaSar sell signal (on heavy volume and with wide range), but the signal has arrived even as a bearish cross of the 23- and 50-period exponential moving averages (EMAs) has occurred and the Aroon (14) indicator has swung sharply to the bearish side of its range. Last, but not least, the Profitunity (Bill Williams) MetaStock expert advisor is also flashing a "short" alert (red ribbon at bottom of chart). The last time (September 2008) that QCOM made a bearish cross of the daily 23/50 EMAs, it proceeded to lose about 40%, but don't look for anything so dramatic this time (remember, the bullish six-year cycle is still driving this market). Expect a more orderly drop, first down to major support near \$39.85 and then perhaps down toward \$37.32. QCOM is fairly well correlated (about 0.75 to 0.90) to the big moves in the .SPX, .NDX, and .RUT, so look for it to bottom out sometime in November, along with the rest of the broad market, unless there are earnings issues or other corporate tremors afoot between now and then. Now, here's an option play for the more adventurous among those in the viewing audience (Figure 3).

I don't like to buy options, and I certainly wouldn't recommend the purchase of puts here, but selling a credit spread on a mild recovery bounce in QCOM over the next few sessions, well, I like that idea just fine, and here's why. QCOM is in a confirmed bear phase, with at least three heavy-duty resistance barriers separating it from the lower strike of the credit spread I'm going to recommend, but given the big range of Thursday's selloff, let's see if QCOM doesn't bounce higher by a dollar or two before it starts to head south again. That way, we can collect more money on a spread that has an exceptionally high probability of expiring worthless between now and November's option expiration on 11/20/09. Here's the trade setup — remember, we'll only get these credit amounts if the stock bounces a bit higher in the next few sessions:

Sell 1 November 2009 QCOM \$47 call option (AAOKM)

Buy 1 November 2009 QCOM \$50 call option (AAOKJ)

Net credit received: \$0.65 or better (\$65 in dollar terms)

QCOM has the 50-period EMA now acting as resistance (about \$45.40), and just above that two daily swing highs at \$46.35 and \$46.75, respectively. For QCOM to hit the short option strike at \$47, it has to take out all three of these resistances, and that isn't too likely between now and November options expiration, given all of the technicals already discussed.

The hardest part of this trade is waiting for the anticipated daily bounce to occur, this allowing collection of at least \$0.65 per spread sold. If you can get filled at \$0.65 or better, simply keep an eye on those three resistance areas as the trade progresses. Close the trade if the price of the spread doubles or if an unusually strong reversal sees QCOM close above \$47.00 before options expiry. If all goes as anticipated, QCOM should fall like a stone after a mild bounce higher, taking it down toward at least \$39.85, the first major support. That could be an excellent time to take partial profits, closing out a portion of the trade (if you sell multiple spreads) and letting the balance of your positions ride for as long as QCOM and the broad markets continue their projected declines. If in doubt, and you can buy the spread back for only 25–30% of what you received in initial credit, feel free to do so, walking away with relatively stress-free gains. When trading options and spreads, many times your first solid gain is your best gain, and you should be happy and take it without complaining. ■

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This article was first published on 10/2/2009.
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RATE CHANGE - PRICE

Rate Of Change

by Mike Carr, CMT

This indicator is rarely used but can provide valuable insights.

Tradable: HG

Most traders fail to examine what the indicator known as the rate of change really is, which is simply the percentage change in price over a defined period. For example, to calculate the 26-week rate of change, you would subtract the price 26 weeks ago from today's price and then divide that difference by the price 26 weeks ago.

One problem with it is that it just seems to be too simplistic to provide trading signals, and this is true. But it can be combined with a moving average and applied to trading strategies as a trend filter. This idea is shown in Figure 1.

In this figure, the rate of change in price is trading above its long-term moving average. A 34-week moving average is used, but there is nothing magical about that number. Waiting for the crossover to initiate a long position allows the trader to capture almost half of the move off the bottom.

Applying a moving average to an indicator is an overlooked technique, yet it is actually the basis of the well-known and widely followed stochastic indicator. In this case, the technique can serve as a trading signal or a trend filter as part of a more complex strategy. ■

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This article was first published on 9/30/2009.
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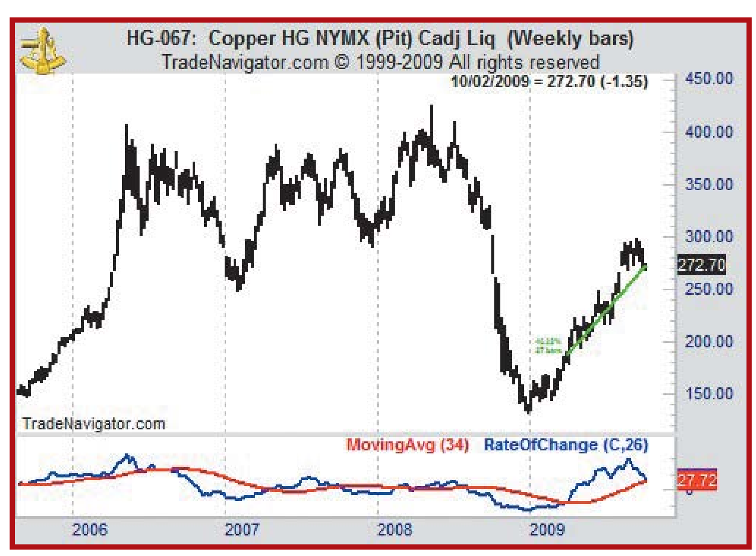


TRADE NAVIGATOR

FIGURE 1: COPPER. Here's copper with the 26-week rate of change and a 34-week moving average.

Trading System Basics, Following Momentum

by Donald W. Pendergast Jr.

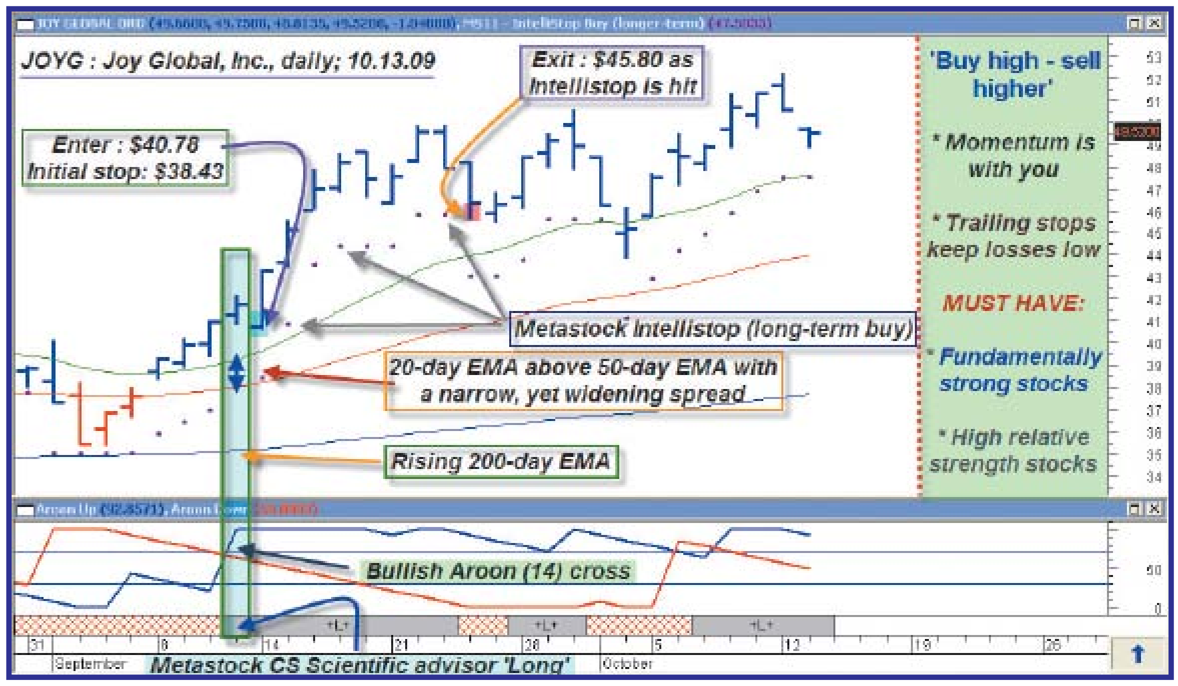
Generally speaking, the most reliable, profitable, and long-lasting trading systems are built around one or two proven concepts. Follow along as we seek to create a winning system, using ordinary trading indicators that are combined in an especially effective way.

Tradable: JOYG

Most traders have heard the phrase "Follow the trend." They've also heard that they need to "buy low and sell high" or to "buy high and sell higher." Obviously, there's quite a bit of leeway in the correct interpretation of those three sayings, and, in fact, each one of them could provide a sound basis for a winning trading methodology. For now, though, let's attempt to build an effective daily based trading system that agrees with the tenets of "buy high and sell higher." This method of trading is simple, fairly objective, and could produce healthy returns over time, depending on the fundamental quality of the stocks chosen.

Figure 1 is a chart of Joy Global, Inc. (JOYG), one of the world's major suppliers of mining equipment. If you have MetaStock v. 11, the following items were used to create this template:

- A 20-day EMA (green line)
- A 50-day EMA (red line)
- A 200-day EMA (blue line)



METASTOCK; CS SCIENTIFIC INC. EXPERT FROM METASTOCK V.11.

FIGURE 1: JOYG, DAILY. It ain't magic, but this particular MetaStock template could be the doorway to steady gains for stock traders with the self-discipline to adhere to its trading logic.

- An Aroon (14) indicator
- A MetaStock IntelliStop (MS 11 Intellistop Buy [long term])
- A MetaStock CS Scientific expert advisor (horizontal ribbon at bottom of chart)

You'll note a green shaded vertical box has highlighted one particular bar; this was on September 11, 2009, when all of the particular buy signals were generated for a long entry. Here's the logic that underpins this particular template — the first item you'll want to see is a flat to rising 200-day exponential moving average (EMA) where the price bars are also above all three of these key (the 20-, 50-, and 200-day EMA) moving averages. The 20- and 50-day EMAs need to be above the 200-day EMA and the 20-day EMA must also be above the 50-day EMA. In addition, and this is the most critical factor of the entire trade setup, the spread between the 20- and 50-day EMAs must be relatively narrow (the only subjective part of this trading method), with the spread between those two EMAs beginning to widen.

At the same time, you also want to see the Aroon (14) trend intensity indicator complete a bullish crossover (the blue line crossing the red line to the upside) and, if possible, a fresh CS Scientific expert advisor +L+ gray ribbon also having printed at the bottom of the chart. The combined power of the Aroon (14) and CS Scientific expert is a wonder to behold at times and almost guarantees some sort of an upward move in the stock or commodity in question. Adding the triple EMA configuration/confirmation only increases the trend-following effectiveness of the method, and frequently results in a decent, low-risk profit.

On the JOYG trade, the trade entry would have been made the day after the trade setup confirmation, going long at the open ($40.78). Applying the long-term Intellistop provided an initial stop-loss level of $38.43. Trade management would have involved nothing more complicated than adjusting the trailing stop in your brokerage account according to each new Intellistop calculation at the end of each trading session. You can see just how simple and effective this "buy high, sell higher" method worked out; the trade produced a gain of $5.02 per share or about 12.3% in only 10 days (the trade was exited on a break of the Intellistop at $45.80 on September 24, 2009), not a bad deal at all.

Before you rush out and apply this template in your MetaStock v.11 software, be aware of a few other factors that will be critical to the overall effectiveness of this method. First of all, you need to only use stocks that have attractive fundamental characteristics such as steadily increasing earnings estimates, low price/sales ratios, and/or healthy return on equity (ROE) ratios. In addition, you also need to select stocks that hail from industry groups and market sectors that are outperforming the broad market indexes. If you faithfully apply all that has been discussed here, you stand a good chance of making consistently good returns from the stock market over time, despite the occasional bump in the road. Even better, during confirmed bear markets, this method will keep you out of the market altogether, a comforting thought for those who were mauled by the big bad bear during 2007–08. ■

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Running With The Hype

by Koos van der Merwe

Batteries used in electricity powered cars are made with lithium. So you buy stock in a company that produces lithium, and if so, which company, and are you happy with your purchase?

Tradable: CLQ-V

Many start-up companies are tempting, especially when the price is less than 10 cents per share. Figure 1 is a daily chart of such a stock, Canadian Lithium (CLQ). You call up a chart (Figure 1) and note the following:

a. In December 2008, the price was 0.05 cents per share, but very quickly rose to 0.29 per share by February 2009. Volume is light with the occasional spike, but the stock nevertheless rose over 400%.

b. In February, both the stochastic and relative strength index (RSI) gave sell signals, and there were two days of strong volume, and the price then dropped to 0.12 cents by March 2009 when the stochastic oscillator gave a buy signal, not confirmed by the RSI. You decide that instead of buying tickets to the Vancouver Olympic Games for $600, you will buy 5,000 shares at 0.12 cents per shares of CLQ.

c. The stock price rises to 0.21 cents and then the price moves sideways until May, dropping to 0.16 cents and you berate yourself for not having sold at 0.21 cents and then bought those Olympic tickets after all.

d. Then, lo and behold, in one week the stock price jumps to 0.31 cents and you pat yourself on the back, take your profit of $950 and buy tickets for two events.

e. You smile at your cleverness as the share price drops to 0.20 cents by July, noting that at this price neither the stochastic nor the RSI has given a buy signal. You then delete the stock from your watchlist.

FIGURE 1: CLQ, DAILY

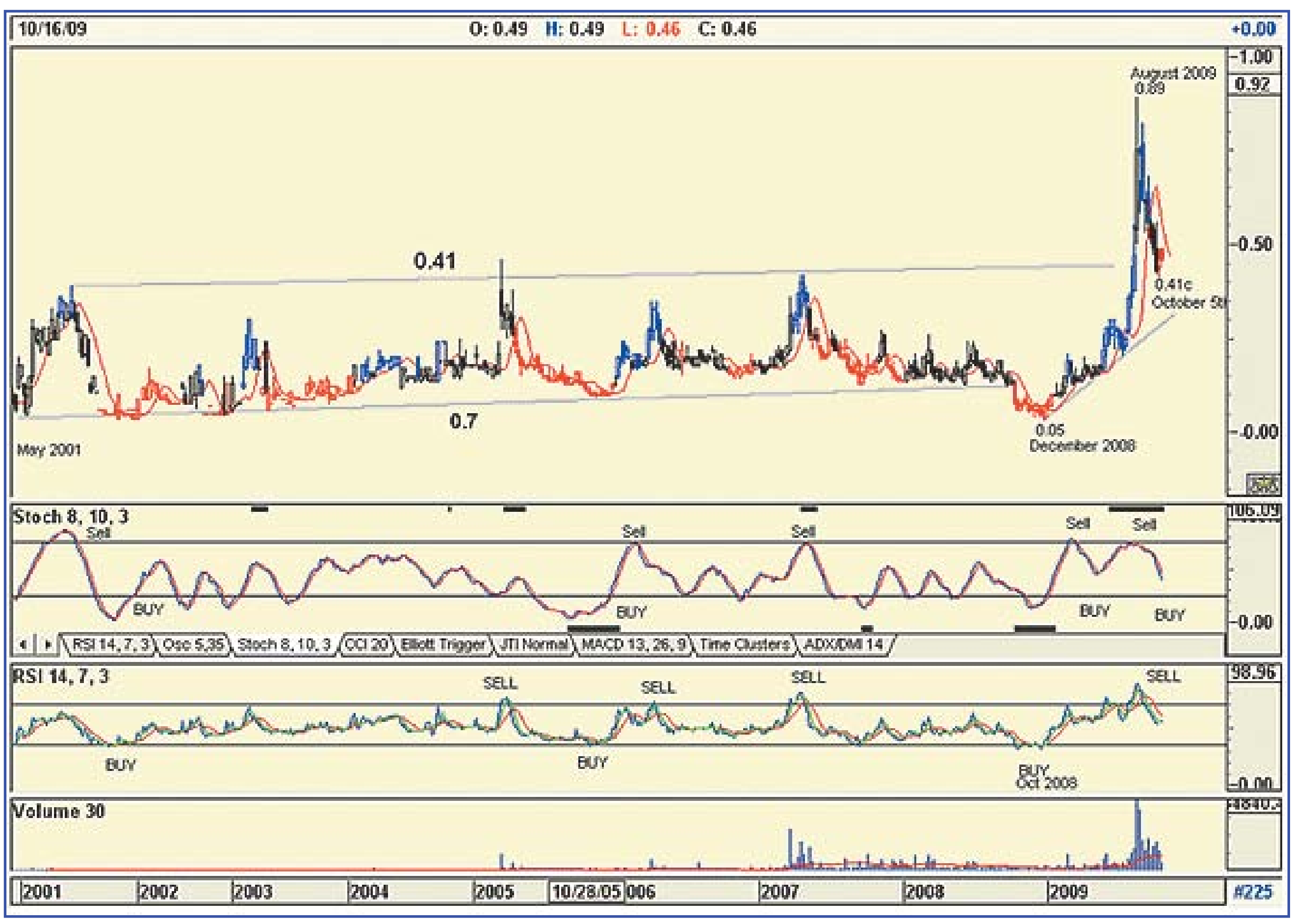

FIGURE 2: CLQ, WEEKLY

In September you go to dinner and the movies with friends. At dinner, your friend who is not a chartist says: "Thanks for that tip you gave me about that Lithium share. I sold it last week for 0.89 cents per share." You choke on the wine you are drinking. You rush home after the movie/dinner, and look at the chart, and see that no buy signal was given to suggest that the stock price would rise to such exorbitant heights. You do however note that the stochastic has given a buy signal, not confirmed by the RSI. Do you buy or don't you? Volume appears to be falling, but it is still higher than when you previously owned the stock.

Then by chance you look at the weekly chart (Figure 2):

You see that indeed the share has been trading in a range of 0.7 cents to 0.41 cents since May 2001. Only recently with the rise in the market from a deep recession has the stock price risen above 0.41 cents. You ask yourself, "Is this the result of hype in a rising market, or is this real?"

Caution is the better part of valor. You shrug and console yourself that the weekly oscillators are not giving buy signals, so you decide not to buy the share. But the daily chart has given a buy signal — and you have to still wonder. Is it hype, or is real? ■

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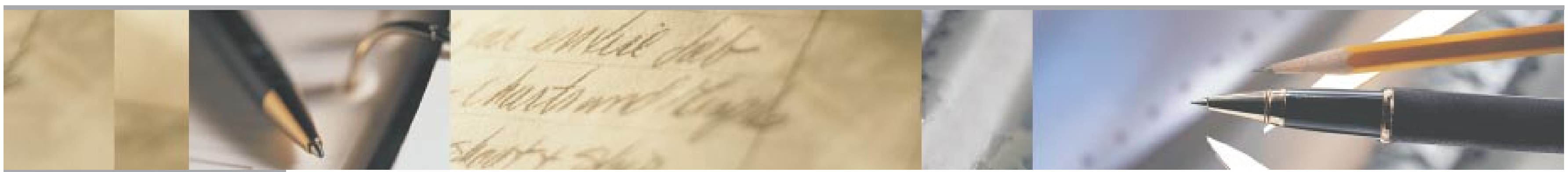

TRADING SYSTEMS

A Trading System To Build On

by Donald W. Pendergast Jr.

There is no holy grail trading system, but there are real-world mechanical methods that can make decent money over time. Here's a look at one system that shows a great deal of promise.

Tradables: AA, AAPL, ABT, etc.

I don't know about you, but I've seen trading systems advertised for sale at $5,000 and others that you can lease for about $200–300 per month. Certainly, at least some of these systems are worthy of such an investment, but is there a more inexpensive way to extract consistent profits from the stock market, perhaps with a basic system that almost anyone can construct in MetaStock, AIQ, or TradeStation? Perhaps there is, and hopefully the stock trading system I will describe here will lay a solid foundation that you can take and further fine-tune until it becomes something truly extraordinary. All you need is the patience of Job and the persistence of Thomas Edison, and you too could end up as the proud owner/operator of a profitable trading system if you are willing to work at it with all your heart, believing that you will find a way to make it work for you. With that advice taken to heart, let's take at look at the system.

Here's the Compuvision TradeSim Enterprise MetaStock exploration code for a long-only commodity channel index (CCI)–based stock trading system, one tested on a variety of large-cap stocks (about 300 stocks) that have continuously traded since at least January 1990:

```
EntryTrigger := Ref(Cross( CCI(12),-100),-1)AND CMF(34)>(0)AND CMF(144)>(0);
EntryPrice := OPEN;
ExitTrigger := Ref(Cross( 100, CCI(10)),-1);
ExitPrice := OPEN;
ExtFml( "TradeSim.Initialize");

ExtFml("TradeSim.EnableProtectiveStop",0);
InitialStop:=0.92 * EntryPrice;
ExtFml( "TradeSim.RecordTrades",

"CCI Long only", { Trade Data Filename }
LONG, { Trade Position Type }
EntryTrigger, { Entry Trigger }
EntryPrice, { Entry Price }
InitialStop, { Optional Initial Stop }
ExitTrigger, { Exit Trigger }
ExitPrice, { Exit Price }
START); { Recorder Control }
```

The essentials in the system are simple — buy the stock when the 12-period CCI drops below -100 and then sell it when the 10-period CCI rises above 100. A fixed 8% stop-loss was used on every trade; no trailing stop was used. In addition, both the CMF(34) and CMF(144) money flow indicators need to be above their respective zero-lines at the time of the CCI 12 drop below -100.

That's it, that's the system. In system designer terms, this system has only three degrees of freedom (three variables) to work with when screening for trades, and as most professional system developers will admit, the fewer variables that are included in any given trading system, the better. Systems with too many variables will typically give terrific back tested results, but when they are traded with real money in the real world, they tend to disintegrate. That's because of the detrimental effects of curve-fitting and overoptimization. Anyway, for an idea of what this simple CCI pullback system can do, take a glance at the trade distribution graph seen in Figure 1. Even a novice system designer can see that the basic guts of this simple system are based on sound technical logic that produces positive outcomes most of the time, with nearly 80% of the stocks producing a net profit over the 19-plus year backtest.

Figure 2 is a sample equity curve for the system; it is relatively smooth and produced remarkably modest drawdowns even during the savage bear markets of 1990–91, 2000–02 and 2007–08. Although the compounded returns of 8.60% seem modest, remember that 8.60% over a 19-plus year period turns $25,000 into more than $122,465 (which no doubt explains how "ordinary" people like janitors and truckers, who live within their means and who save every penny they can, often become millionaires by the time retirement rolls around).

The relative smoothness of the equity line is equally attractive, meaning that a respectable rate of return doesn't always have to mean a stomach-turning roller-coaster ride through the financial markets. For those intent on really making this system rock, all they would need to do is trade this system in a IRA or Roth IRA retirement account, letting the gains compound at a truly astounding rate. As a famous TV personality/businessman/investor once said (he's reputedly worth $400 to $700 million), "Those who understand the power of compound interest, earn it. Those who don't, pay it." How true that statement is!

Here are the basic portfolio management parameters that were used to run the system. You may find that different parameters may produce better (or worse) results, so take some time and think these critical issues through before actually trading this system with real money.

- Starting capital: $25,000
- Commissions: $0.008 per share, with a minimum commission of $1.00 for each side of the trade
- Total max # of open positions: 6
- Max # of daily orders: 1 (only one new trade a day permitted)
- Fraction of total trading capital per trade: 16.66%
- Margin requirement: 100%
- Enter trade at next session's open
- Exit trade at next session's open

This simple CCI 12/10 system isn't the be-all and end-all in trading system design, but it is an excellent starting point for aspiring system developers from which to begin their journey toward developing reliable systems that they can and will trade consistently and profitably.

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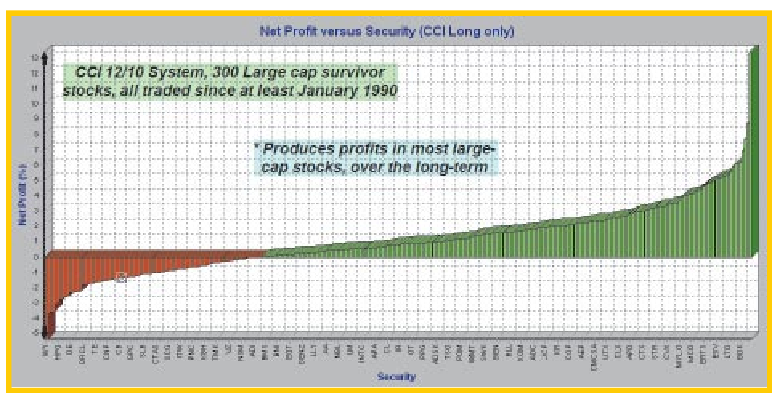

COMPUVISION'S TRADESIM ENTERPRISE

FIGURE 1: CCI 12/10. No system wins all the time, but this simple CCI-based method produced a net profit in more than 75% of the 300 large-cap stocks used during the 19-year backtest.

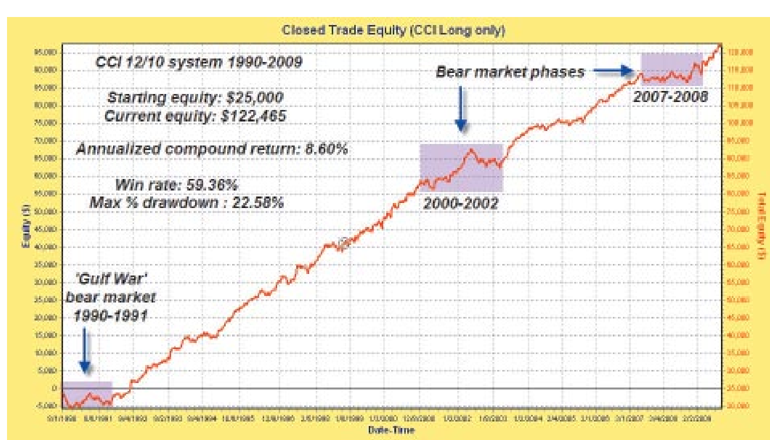

FIGURE 2: CCI 12/10. When evaluating a trading system, make sure that the equity curve is relatively straight, with modest drawdowns. The power of disciplined, long-term compounding can turn even a plain-Jane trading system into a movie star system, given enough time.

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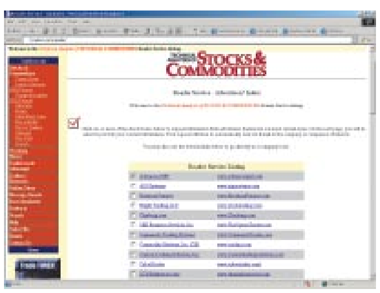

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TRADERS' GLOSSARY

DICTIONARY

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

Average True Range — A moving average of the true range.

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

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

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

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

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

Cubes (QQQQ) — Traded on the NASDAQ, cubes are ETFs that track the NASDAQ 100 index, which is made up of the 100 largest, most active NASDAQ nonfinancial stocks.

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.

Engulfing Pattern — In candlestick terminology, a multiple candlestick line pattern; a major reversal signal with two opposing-color real bodies making up the pattern.

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

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

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 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.

Moving Average Crossovers — The point where the various moving average lines intersect each other or the price line on a moving average price bar chart. Technicians use crossovers to signal price-based buy and sell opportunities.

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

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

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

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.

S&P Emini — Electronically traded, smaller-sized ($50 times the S&P 500) contracts of the Standard & Poor's 500 index.

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

Signal — In the context of stock or commodity time series historical data, this is usually daily or weekly prices.

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

Stop-Loss — The risk management technique in which the trade is liquidated to halt any further decline in value.

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

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

Trading Bands — Lines plotted in and around the price structure to form an envelope, determining whether prices are high or low on a relative basis and forewarning whether to buy or sell by using indicators to confirm price action.

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.

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.

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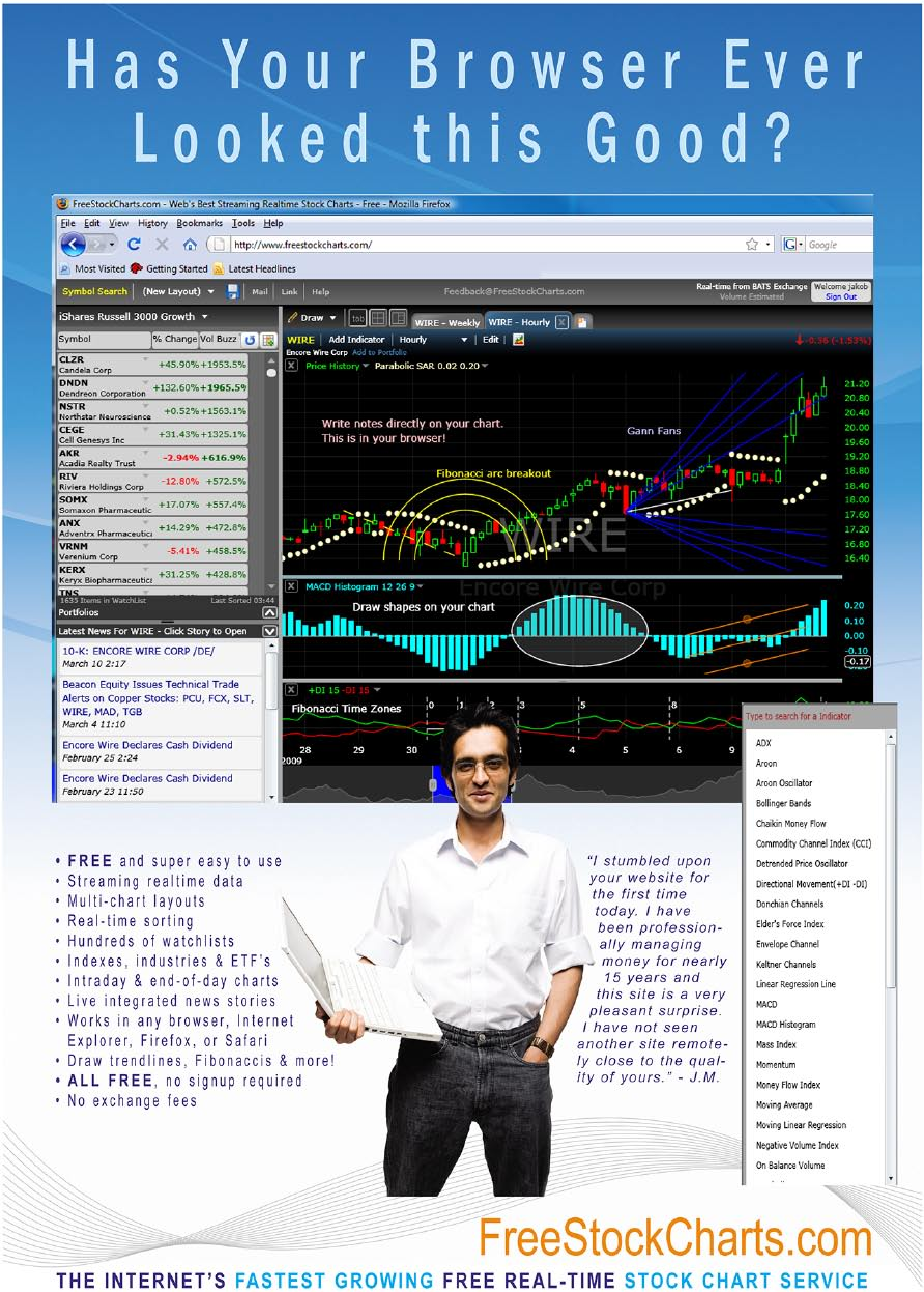
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