

Foundations for Successful Trading

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Introduction

During the past three decades of trading, for every type of market, from commodities to stocks to all types of indexes, one thing is very clear - one needs to be able to trade successfully from pattern and volume. Once that skill is accomplished, then other techniques such as Gann or Elliott wave principles can be quite helpful. However, until one masters the art of trading from a bar chart, those techniques can be damaging. Gann and Elliott principles set up probabilities and to be successful one must be able to qualify those probabilities.

This can be accomplished with a “strong foundation of trading”. The purpose of this book is to develop this foundation. Of course, anyone who has traded for a few years understands that hope, fear and greed are our greatest enemies and I will spend time throughout this text discussing that subject.

You will also learn to *trade your knowledge* and not the market. The mindset of trading a market could force you to attempt to trade or position every movement the market makes and that is a mistake.

There are many ways to analyse a market but we must keep it simple and apply the proper weighting to the points of analysis. We will analyse pattern, which includes momentum. We will analyse volume, the driving force behind the markets, and wave structure or the number of drives up or down to each wave of movement. This can be helpful in determining if the trend in force is at risk of ending. We will determine the price level for support or resistance, which can be calculated very precisely.

We will identify three different types of trends. With this knowledge we will be able to understand the counter trend movements that unfold within each of those trends. In fact, understanding counter trend movements is knowledge that is critical to your success. With this knowledge you should be able to develop a vision, an ability to look at a chart and determine the probabilities for at least the next two or three weeks and, on occasion, the next two or three months. The principles and concepts presented in this text should allow you to develop the skills necessary to become successful in the markets.

Part 1

Patterns of Movement

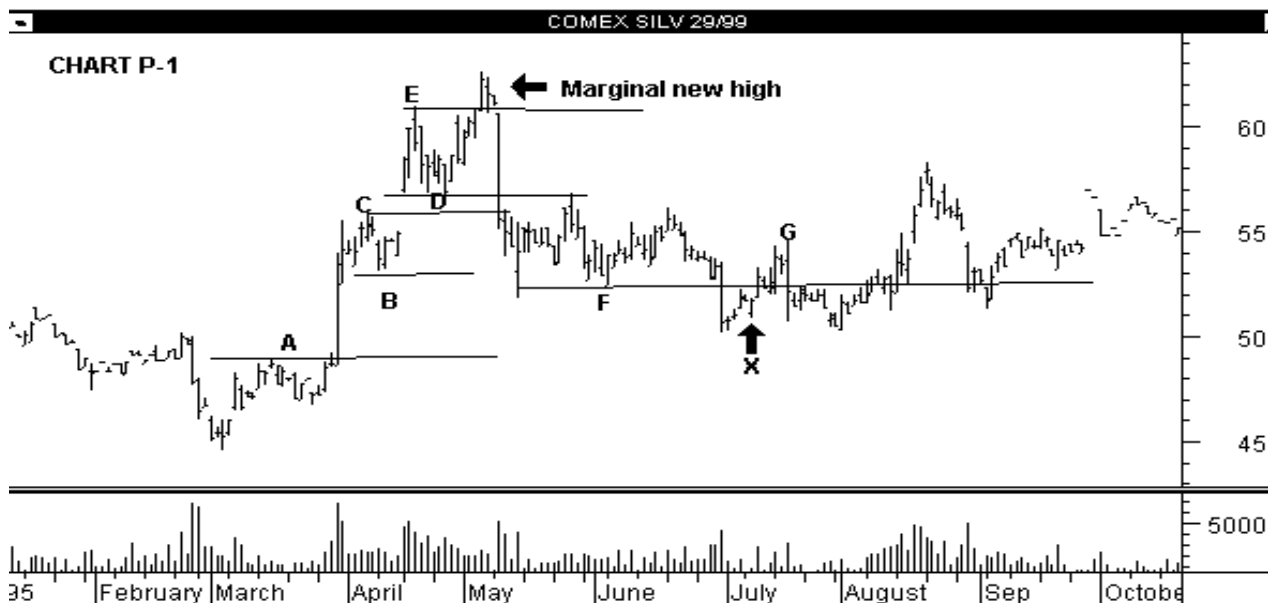
Part 1: Patterns of Movement

Understanding price movement and the patterns that develop on a chart and the probabilities those patterns represent are a critical factor in a complete analysis. The very first question must be, "Is this movement trending?" We need both weekly and daily charts to answer that question.

There are three basic types of trends, which we will discuss later in this text. But there are also four market phases as follows:

- 1) Bull campaigns and the consolidations and counter trend movements that develop in price and time while price is trending.
- 2) Topping or distribution patterns that develop at the end of bull campaigns.
- 3) Bear campaigns and the consolidations and counter trend movements that develop in price and time while price is trending.
- 4) Bottoming or accumulation patterns that develop at the end of bear campaigns.

For the purpose of this text, counter trend movements seldom exceed 12 trading days. When that occurs, it is an indication of a change in trend or the start of a consolidation.



On Chart P-1, the movements down from Points A, C and E are counter trends. The movement following the fast decline, after the "Marginal new high", is a consolidation. Most consolidations are choppy sideways movements. Sideways movements that price moves up into, and are very volatile, are indicative of a probable top.

Sideways movements (consolidations) that price moves down into, that become narrow and dull, are indicative of a base or bottom.

Part 1: Patterns of Movement

There are a few observations about trends that will facilitate our understanding of trends. Obviously, when a market is trending upward, it will have higher highs and higher lows. If you study trends, you will notice there are three very basic types of trends. The "normal" trending movement, a "creeping" trend and the "blowoff" movement.

The "normal" trend will develop a space between the high of a consolidation and the low of the subsequent correction (Chart P-1). Of course, this is true of a normal down trending market also. Understanding the significance of this space is very important to an analysis. Many times the space will indicate the probability of a strong movement in progress.

Notice the space between points "A" and "B" (Chart P-1). This is obviously showing support at a high level. The distance between "C" and "D" yields a different picture, and yet still indicates good support, i.e. double bottom above previous swing. Although from other analysis, the probability of a marginal new high and reversal was very likely.

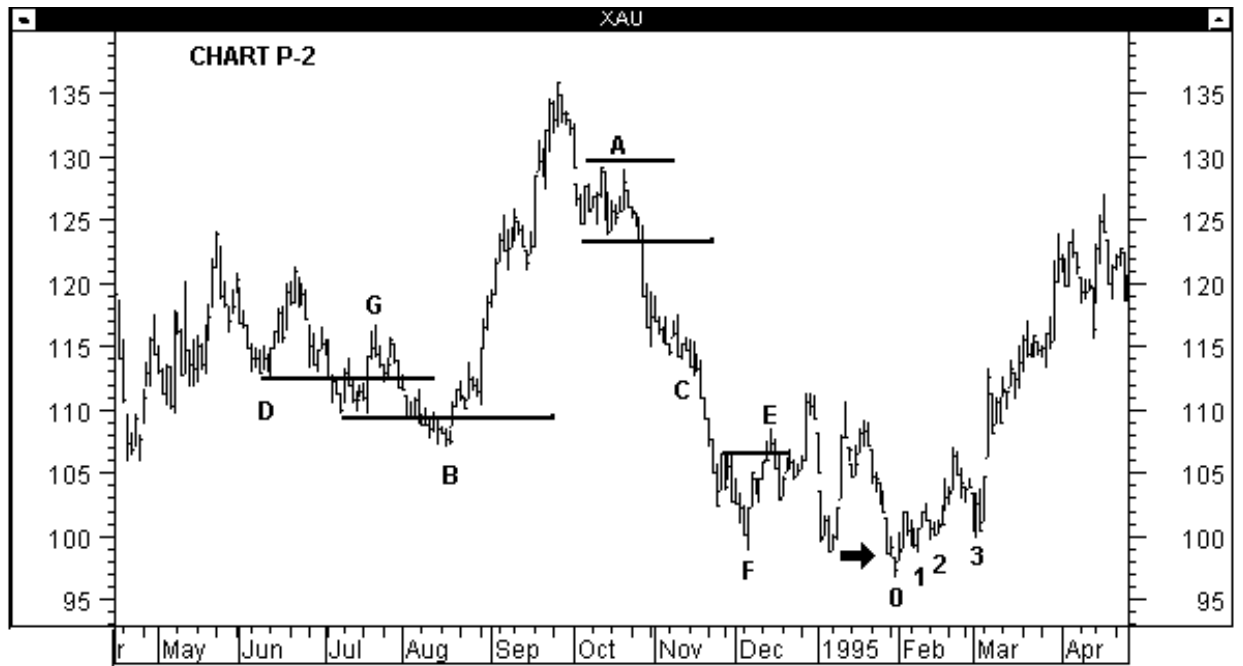
Notice how the price moved up into point "G", going well above point "F". Down trends seldom break below obvious support and recover far above the break away point "F" and still remain in a hard down movement. The trend could continue down, but a hard and fast movement down is unlikely.

If price had continued down at point "X", it would have indicated an extremely weak pattern. Rallying two days, showing an inside day, then starting down. Leaving a space between the rally high and the previous low (point "F") is a strong indication of a capitulation movement in progress. However, in this instance, price gapped down and recovered the previous days low, indicating higher prices. One of the most difficult aspects of trading commodities is making a decision about a position in the face of a large gap.

In some strong trends that last 90 days or longer, there will be a choppy consolidation where new highs will not be able to hold above the previous high. This is either a top or the start of a consolidation of the last move up. These consolidations, if they lead to a continuation of the up trend, will be roughly in the middle of the drive in time.

We will refer to these as mid-point consolidations. There is an example on Chart P-4, point "A".

There is another very important factor in understanding patterns. The probability that is indicated by the pattern is dependent upon the direction of the trend. For instance, if the trend is up and one sees what appears to be a double top forming below a high, then the probabilities are significantly higher for a top (Chart P-2, point "A"). In fact, this pattern represents a high probability top and shows up in commodities often.



Now notice the price action going into point "B". Look at the price action into point "C". Price action for the ten days is similar, yet the pattern at "C" resolved itself with a large capitulation down, and at point "B" the pattern produced a low and a reversal in trend. Point "B" appears during a move down that can develop little momentum and the previous low, point "D", offers little resistance to the rally, point "G". At point "C", price was trading well below "space" the previous consolidation (lower double top), and therefore in a weak position and offered the probability of a capitulation move down. At point "E" price moves above the last swing high, creating a higher high within the down trend. The probabilities are that price will now start to consolidate, or show a two thrust counter trend movement. The two thrust counter trend will be discussed in the chapter on Wave Structure. We need to be able to determine in advance what pattern would confirm which scenario. For instance, a "marginal break" of point "F" that has no follow through would indicate a test of the previous swing high. In this instance price shows a double bottom. An unlikely pattern for a low in a down trend, but is followed by a "marginal break", indicated at the arrow, this is then followed by a "3 high low" base pattern. We'll look at that very powerful pattern later in this chapter. Again, with knowledge of wave structures you will understand why a move above point "E" put the rally at risk.

Let's get rid of the traps, the Wall Street mentality that can be a disaster for most novice traders. "One should buy breakouts and sell breakdowns". This may be true 20% to 30% of the time. On an intraday chart, as a half hour S&P chart, close to 80% of all breakdowns and breakouts are immediately reversed and on many occasions that is the highest high or the lowest

Part 1: Patterns of Movement

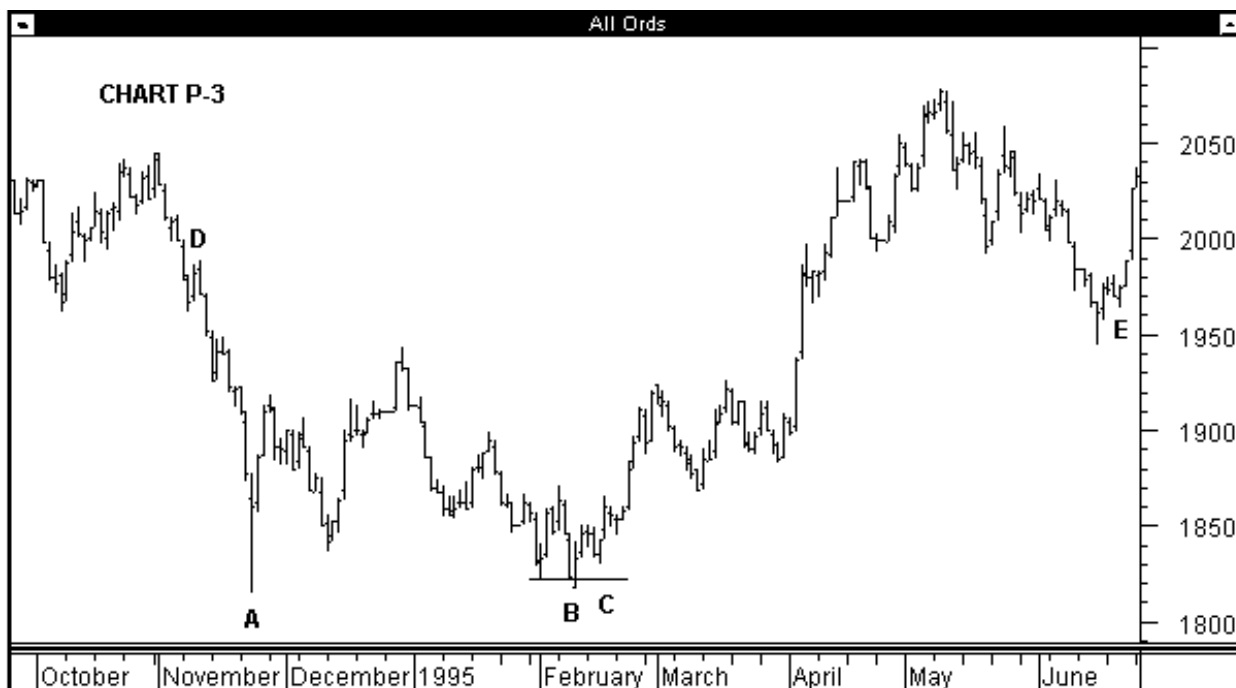
low for a long time. If you study many charts, you will discover that most fast moves develop from false moves above or below obvious support or resistance (Chart P-1 "Marginal new high"). This knowledge can set up some incredible trades with minimal risk. This is particularly true if you trade options. False moves are generally one or two days, but you need to research the markets you trade to determine for yourself what the probability is for the number of days to a false break. One of the objectives of this course is to understand, in advance, when the probabilities are high for a false break of obvious support or resistance.

One of the most important aspects of trends is understanding counter trend movements. Most traders spend their analytical time attempting to determine how they can pick exact tops and bottoms of reversals in trend. This is just a small part of the knowledge necessary to be successful in trading, and also one of the most difficult things to accomplish. Therefore, representing a low probability for success. Once you understand counter trends, then you will truly understand trends. For it is trends that you want to trade or position, and you will only understand a trend when you can understand a counter trend. On a daily chart, counter trends will be 1 to 4, or 7 to 12 days in length. The circumstances of when to expect 4 days, or 7 days, or 12 days will become clear with some study. For instance, in fast moving markets with high momentum these counter trends will be only one or two days, and reverse by the third day at the latest.

Your knowledge of counter trends is invaluable to pyramiding a position, entering a trend and also assessing the risk of a position at any particular time. For instance, if you purchase a position at point "A" Chart P-3, then when would that position be at risk? That can only be determined if you understand counter trends. In this instance, the trend was strong and price capitulated into the low. If you looked at 100 charts of this type of high momentum capitulation low, you would find that 90 out of 100 of the rallies would not exceed four days and 80% would be three days. So on the third day up, a long position would be at risk and a possible short sale may be warranted. Going down into point "B", you can see the market is having a difficult time moving down. There are three thrusts - each smaller than the previous. 23 days up - 29 days down and at point "B" a one day break that is immediately reverses is apparent. Markets that are going to reverse from down to up will almost always start with a higher low as occurred at point "C".

Once your knowledge of counter trends is complete, you will find that the first higher low and the first lower high will become areas on a chart quite easy to locate. Notice price rallied two days up from point "B" including the reversal day. When counting the days to a counter trend movement, I start the count with the first day that shows a higher high. So there was a one day rally, followed by an inside day (the high and low were contained within the range of the previous day), then two down days followed by an up day that moved above the previous high,

establishing a higher low. That is a very good indication the short term trend had changed to up. The counter trend move of down two days into point "C", is the normal way a market will produce a higher low. The normal counter trend will show an inside day of the fourth day, which then presents a very high probability for a higher low. The same can be said for lower highs in a down trend.



When a market trends, there will be counter trend moves, which most technical analysis books refer to as consolidation formations. In fast markets, they are referred to as flags, pennants, wedges or triangles. But the number of days is very significant and in many fast markets that is the only knowledge that will allow you to enter or pyramid your position.

During markets that have strong momentum the counter trend will be one to four days. In very fast markets the counter trends will be one or two days. If a market rallies two days and the trend is down hard, then price should move below the low that started the rally in one or two days. Notice point "D" on Chart P-3, see how the rally ended with a space between the counter trend high and the previous low. The same is true of the next counter trend rally, indicating a very weak technical situation. The two day counter trend going up into point "E" appears to be a very good short sale opportunity, but by the second day down price is still well above the low. The next day is at a new swing high, obviously this market is not going down. If it were going down it needed to move below that low by the third day.

In fact, point "E" is an ideal pattern to sell short. I had to search a huge number of charts to

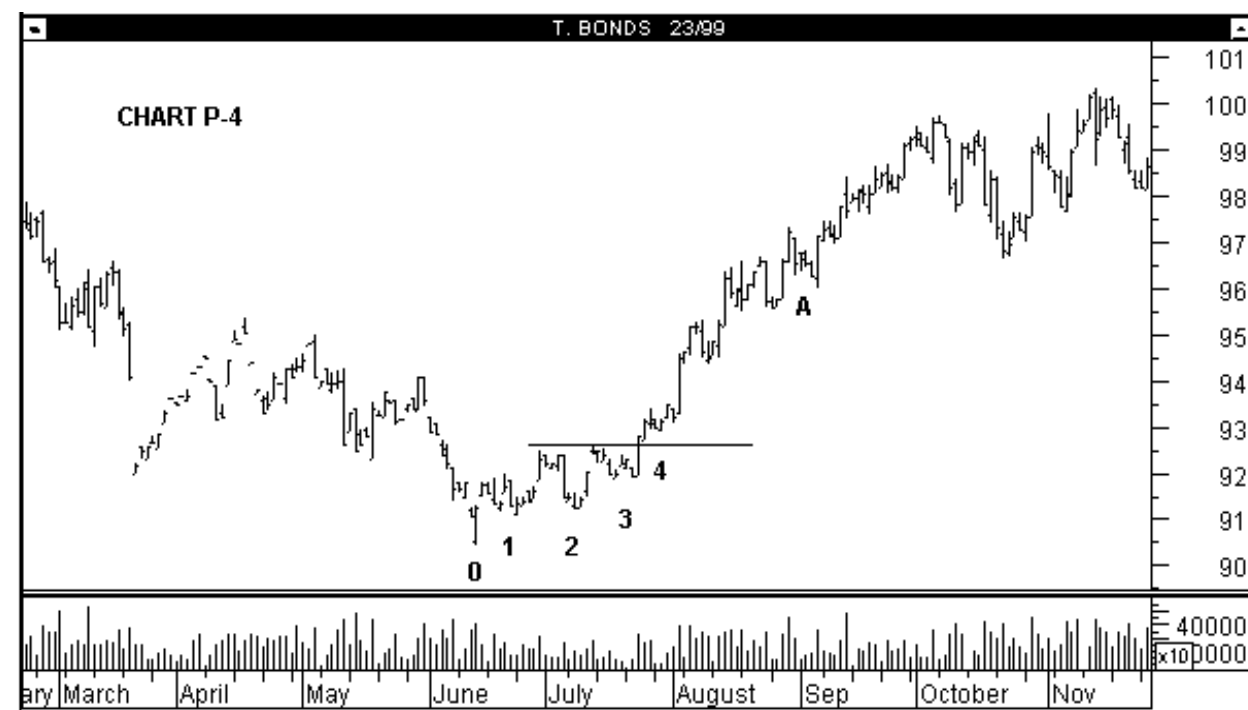
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find a pattern like this that failed to move lower. One of my purposes was to emphasize that you must always use a protective stop no matter how certain you are about the trade. There are no certainties in this business, only probabilities. But if I see that same pattern 10 times, I will sell short against it 10 times and win 8 of those 10 occurrences.

Go back to Chart P-1 and look at point "A". Notice price went up seven days, then moved down seven days and was still above the mid-point or 50% of the range of movement up. This is a very strong indication that a higher low is being established and a safe buy would be to buy a move above a previous days high after the seventh day. It would also be bullish if the volume were light on the selloff.

Where do fast moves start? We now know that they can start from a break of obvious support or resistance that is immediately recovered. The "false break". Fast moves also start from multiple higher lows and multiple lower highs.

Below is Chart P-4, this is the US T-Bond market. Please understand that price must come down into point "O". There must be a multi-month move down. This is because we are looking at a base being formed. Most bases have a higher double bottom and then start to trend, but on occasion a market will give the outstanding opportunity of a three or four higher low pattern.

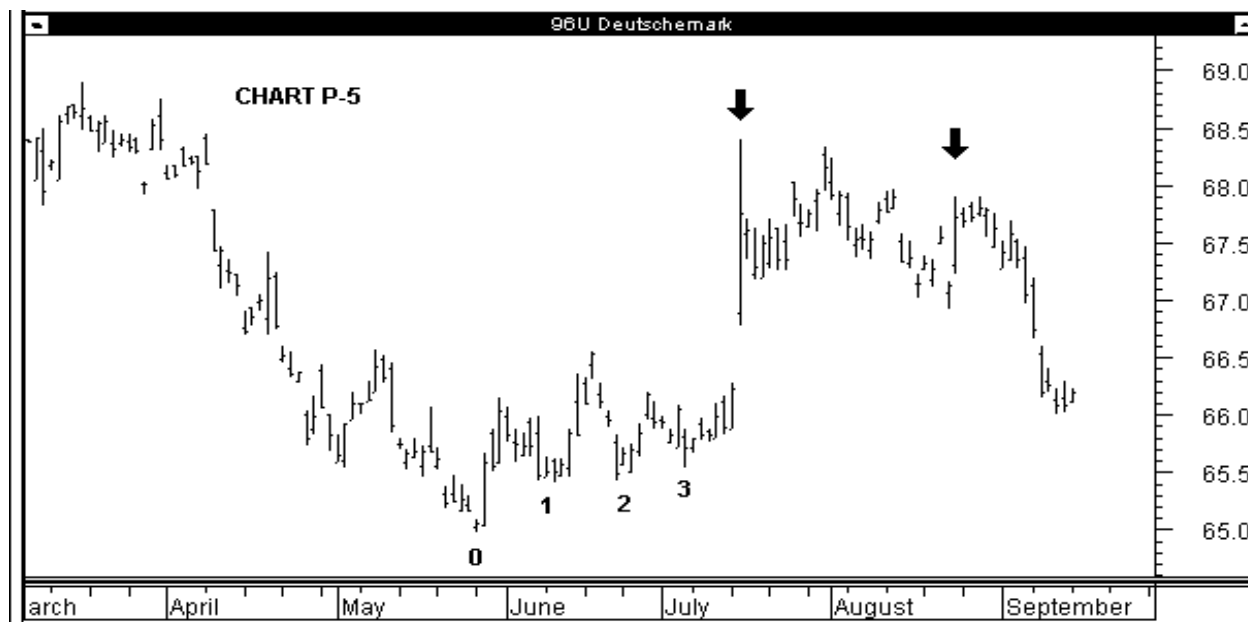


Note how low #4 has a space developed between the previous swing high, thus indicating the probability of a strong move up. You can also see that volume at the low "O" was less than the

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previous spike four days prior. Most importantly, volume was less at all the lows and significantly dried up at lows #3 and #4. Keep in mind that if this pattern is going to develop into an accumulation pattern, and start a fast move, price must fall into the development of this pattern. In other words, this pattern cannot develop during a consolidation within a bull campaign, but needs to develop after a bear run.

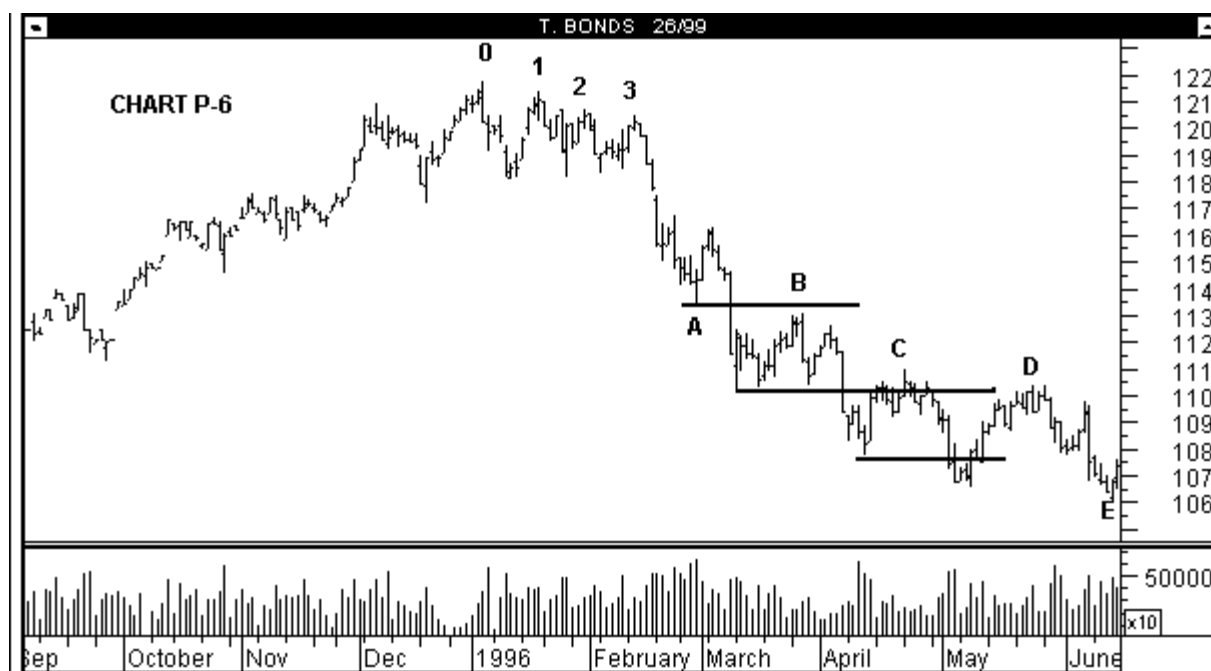
Chart P-5 illustrates the same bullish basing pattern. In this instance, price does not yield an opportunity to purchase after the breakout.



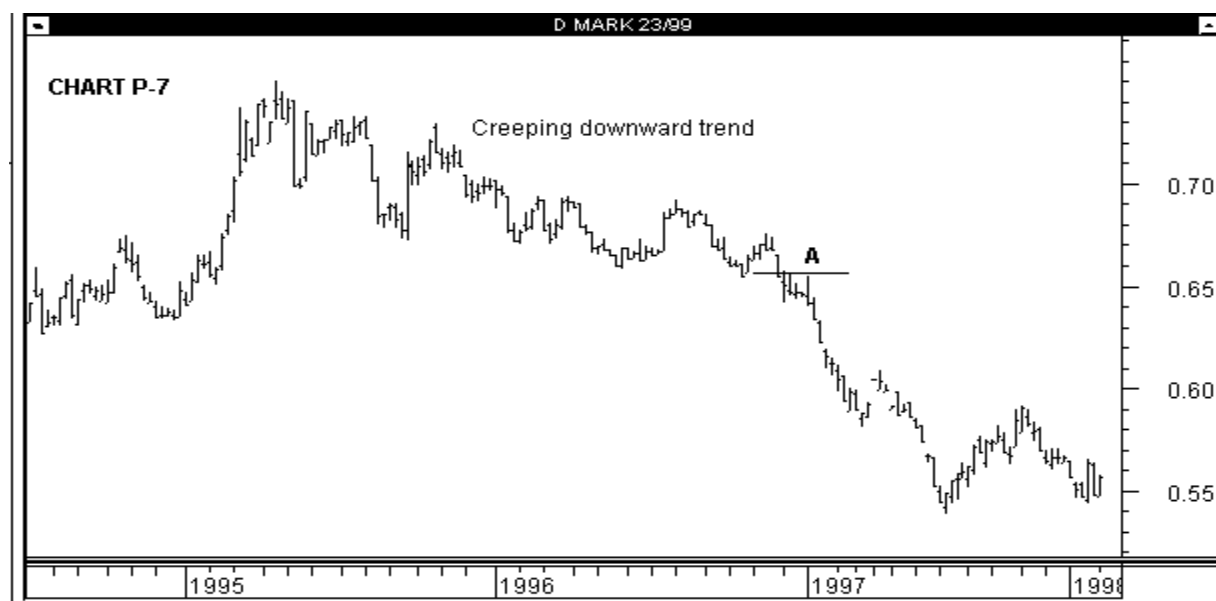
This pattern represents one of the few occurrences that "buying a breakout" could be warranted. Although, if one could recognise the probability of a three higher low developing, then one could look to purchase a test of the low #2, with a protective stop below that low and not below point "O". But you must also keep in mind that a higher double bottom (also lower double top) are powerful patterns and once the second higher low is probably, you should be looking for an opportunity to go long.

This pattern, in reverse, can develop after a strong advance (Chart P-6). This pattern did not produce an intermediate term movement, but was still very profitable. Notice the two spike movements indicated by the arrows, usually the first direction after a spike is the false movement. The movement of up two days against the high of the spike, followed by turning down (indicated by the second arrow) is a pattern that repeats. I usually employ the rule that if the spike is not exceeded by the third day, it is likely to reverse.

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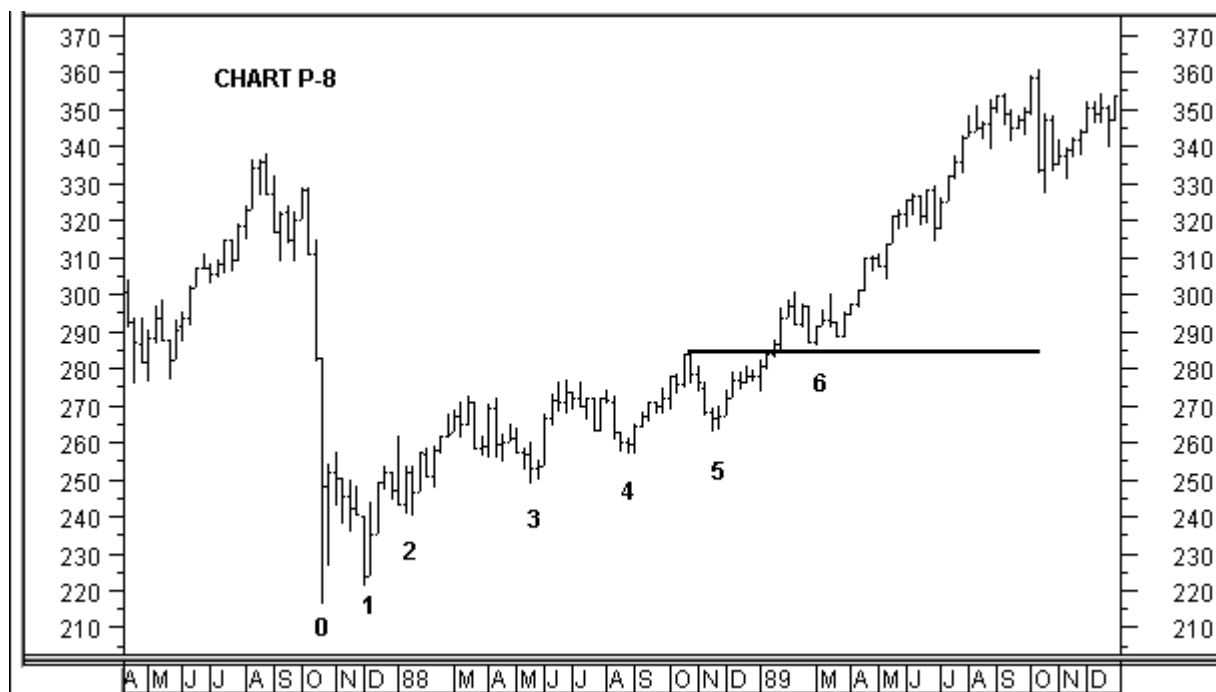
Notice the large volume at point "A", a very good indication the rally would be a counter trend. At point "B", the rally fails at the previous low and point "C" price pulls back marginally into the previous consolidation, but remains in a weak position. The rally into point "D" pulls back above the swing low and even retest the high at point "C". When this occurs a new low is usually a good buy, point "E".



Part 1: Patterns of Movement

On occasion a multiple higher low or lower high pattern will develop on a weekly chart and represents a giant opportunity. Chart P-7 is an example of the lower high pattern, and the key is of course at point "A" when the rally was stopped by the previous swing low. This is also a prime example of the creeping trend.

During a "creeping trend" price can not breakaway from a previous high in an up trend nor a previous low in a down trend. This type of trend will end by either finally showing a lower high that leaves a space and developing a capitulation type of completion (Chart P-7, point "A"). Both Chart P-7 and P-8 are weekly charts, therefore the patterns represent very significant distribution (P-7) and accumulation (P-8) and you could expect a movement in time at least as long as the pattern took to complete. Or it could show a higher low while trending down, as after point "B" back on Chart P-2, and reverse the trend. The number of days to counter trends in this type of movement are not as easy to determine as during the "blowoff" or "normal" trending movement. They seldom exceed 12 days and are usually close to the same number of days in each instance.



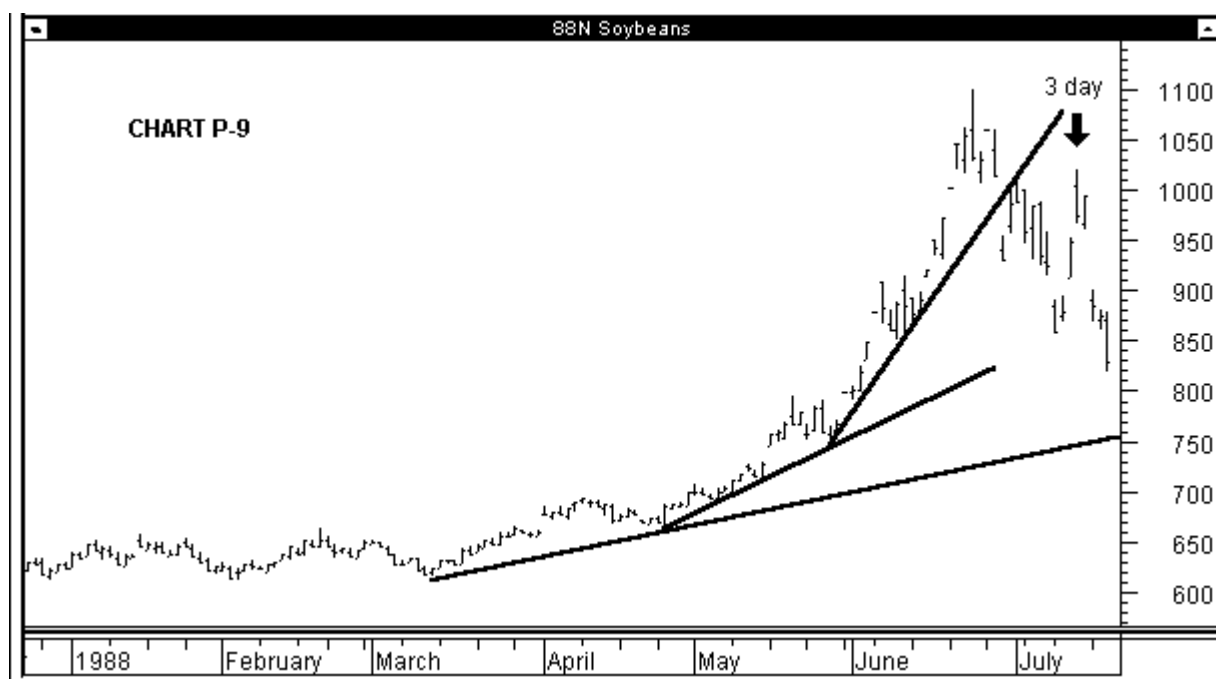
Keep in mind that this pattern analysis is applicable to weekly charts as well as daily. The magnitude of the movement is much greater from a weekly chart as the example used in Chart P-8.

Chart P-8 is the S&P 500 Weekly Chart. Again notice the higher lows and the space that developed at higher low #6.

Part 1: Patterns of Movement

When you decide to put on a position, you should first define that reason in writing. Then, define what price movement would prove that reason wrong. This is obviously where your protective stop should be placed.

Earlier I mentioned there were three categories of trends. The "Blowoff" is the easiest to see develop and you can make the most money in the shortest period of time if you understand this movement. Chart P-9 is a typical blowoff movement, you can see that each low does not reach the previous trend line but starts a new accelerated trend line. There are seldom more than five ascending trendlines. One of the keys to finding this pattern, was again the fact that a low could hold the previous highs on a correction, as occurred at the point indicated.

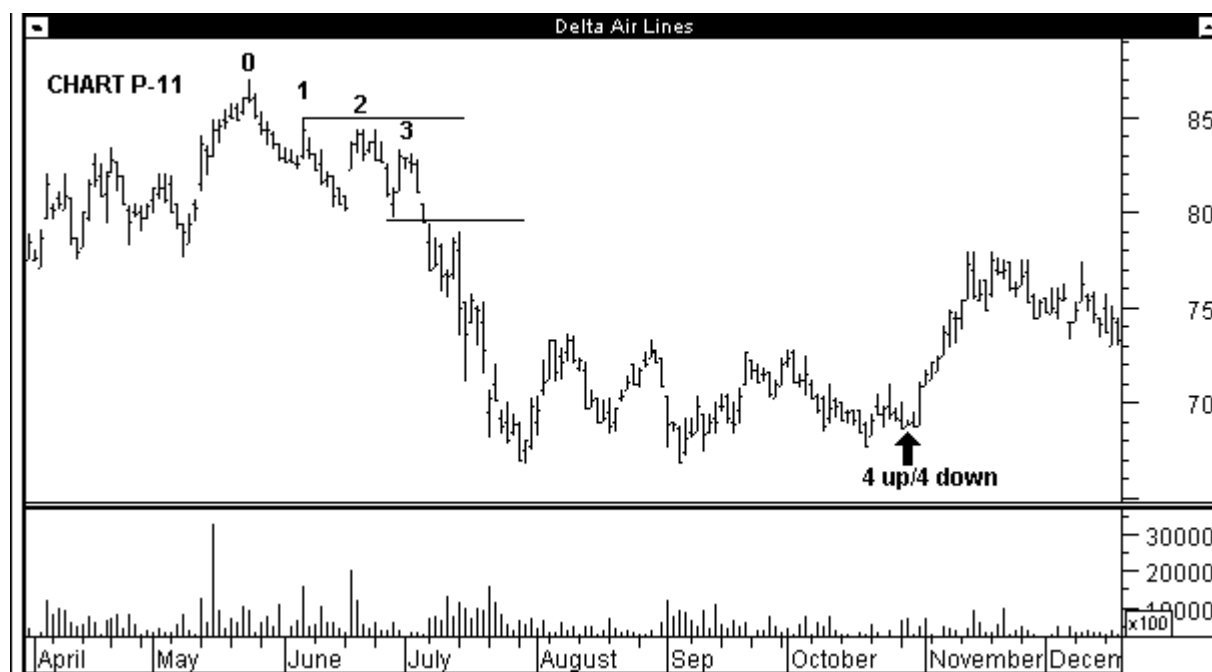
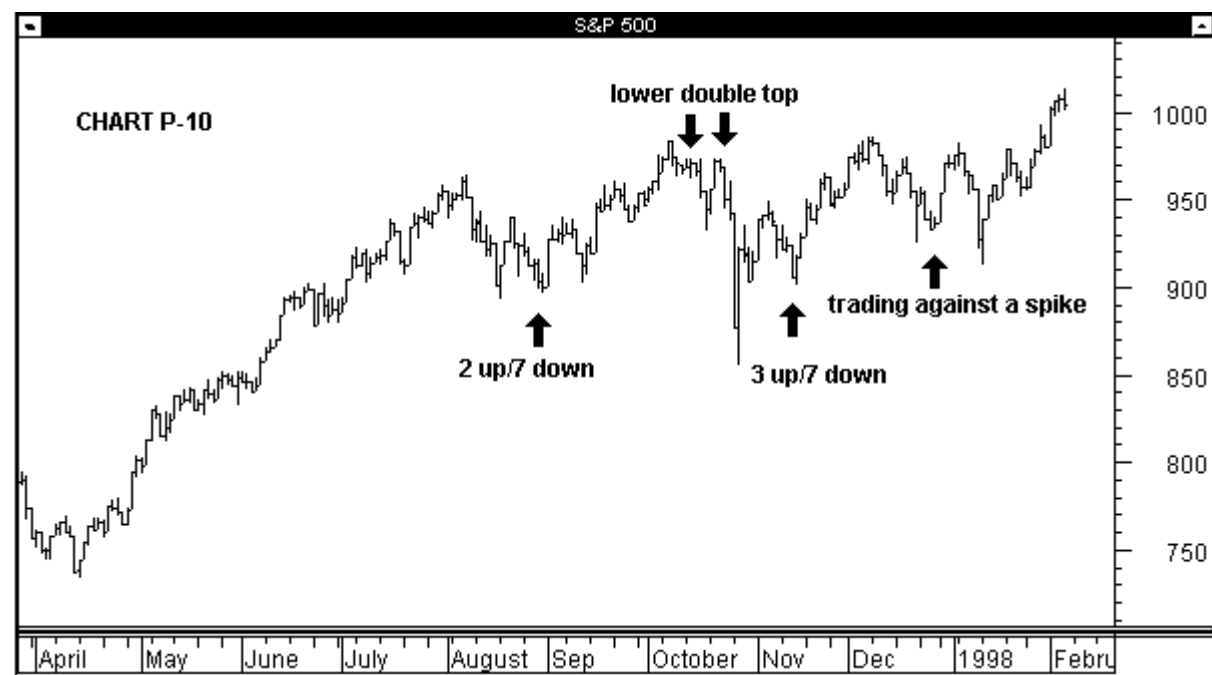


This chart is of soybeans during 1988. In commodities these blowoffs are short lived. You will find that most blowoff movements will be 90 to 99 days in length from the low where the high momentum drive starts. Notice the first large counter trend after the top was in place. It was three days, we sold short on the third day. The counter trend movements within a blowoff seldom exceed four days.

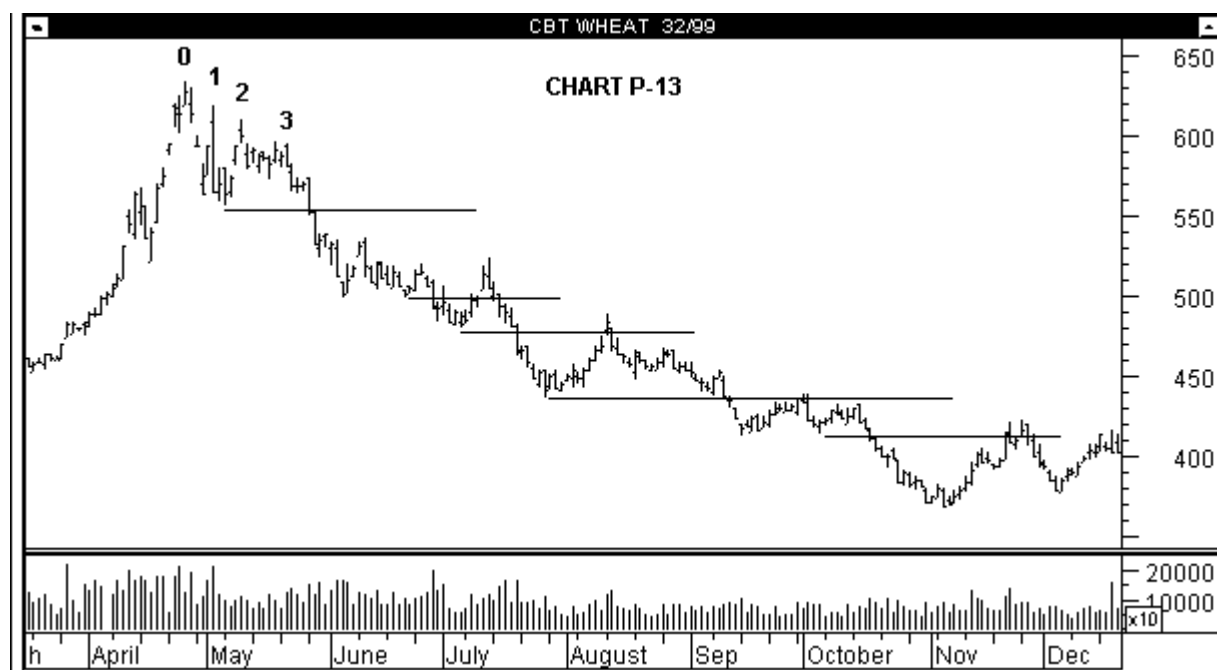
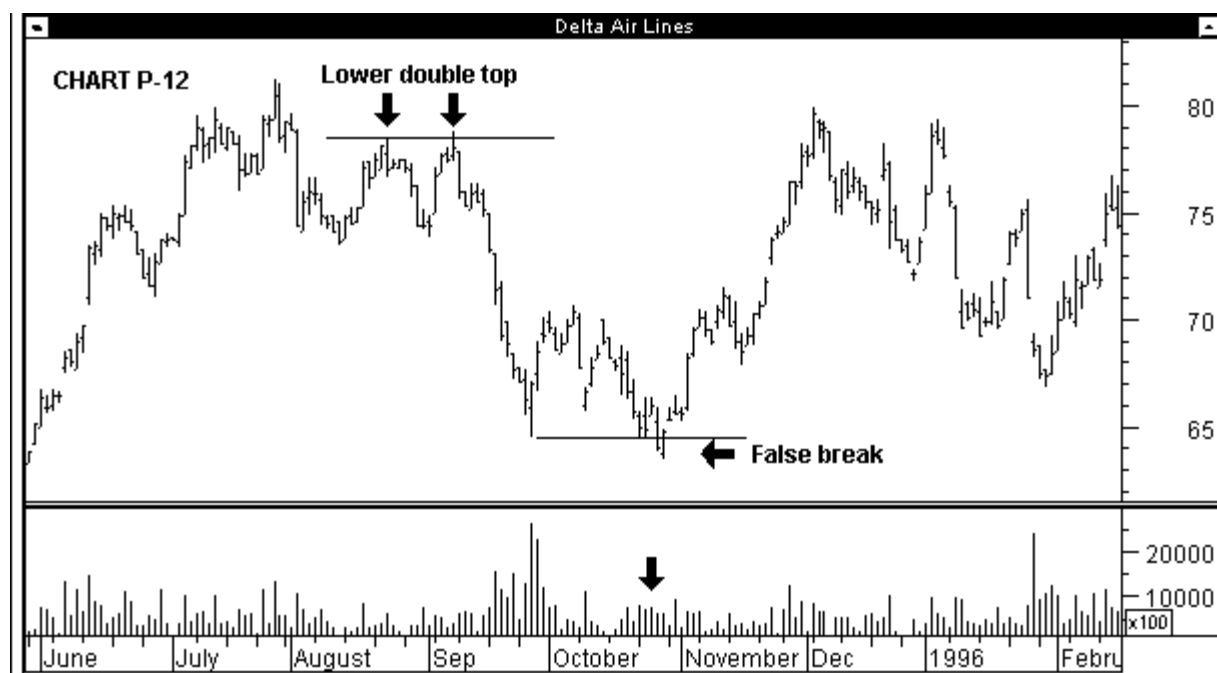
Always keep in mind that fast moves come from false breaks of obvious support or resistance. Fast moves also come from multiple lower highs and higher lows.

The following pages are charts, labelled with further examples of the patterns of movement discussed in this chapter.

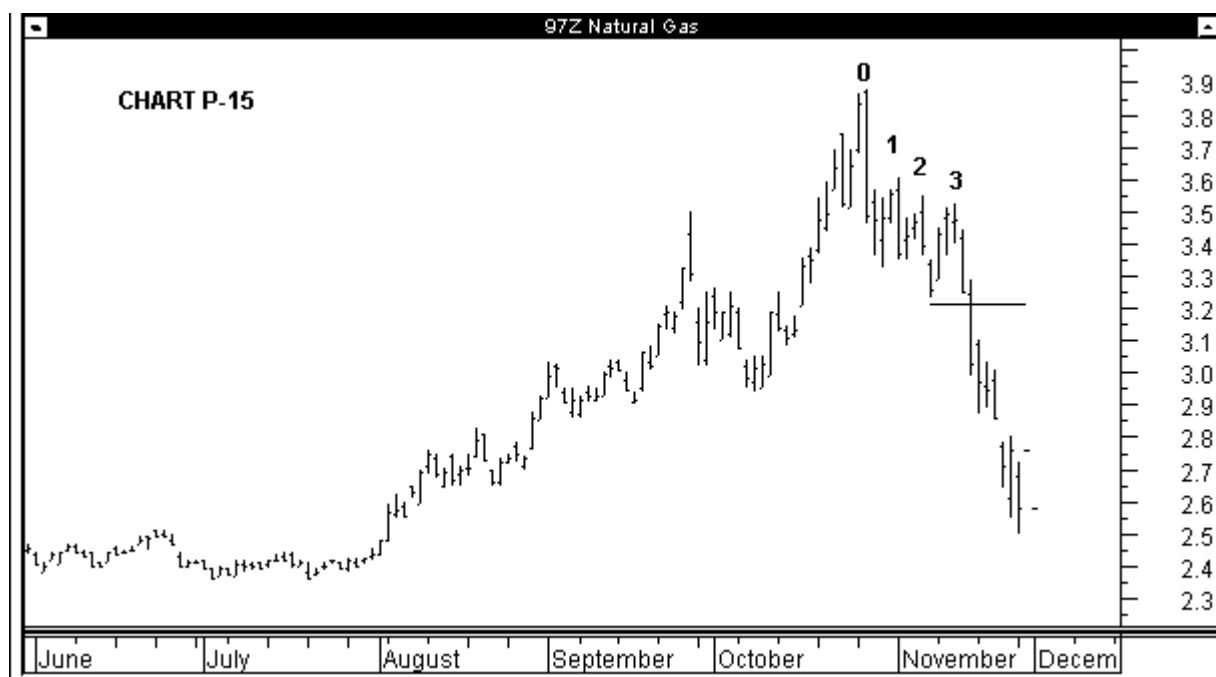
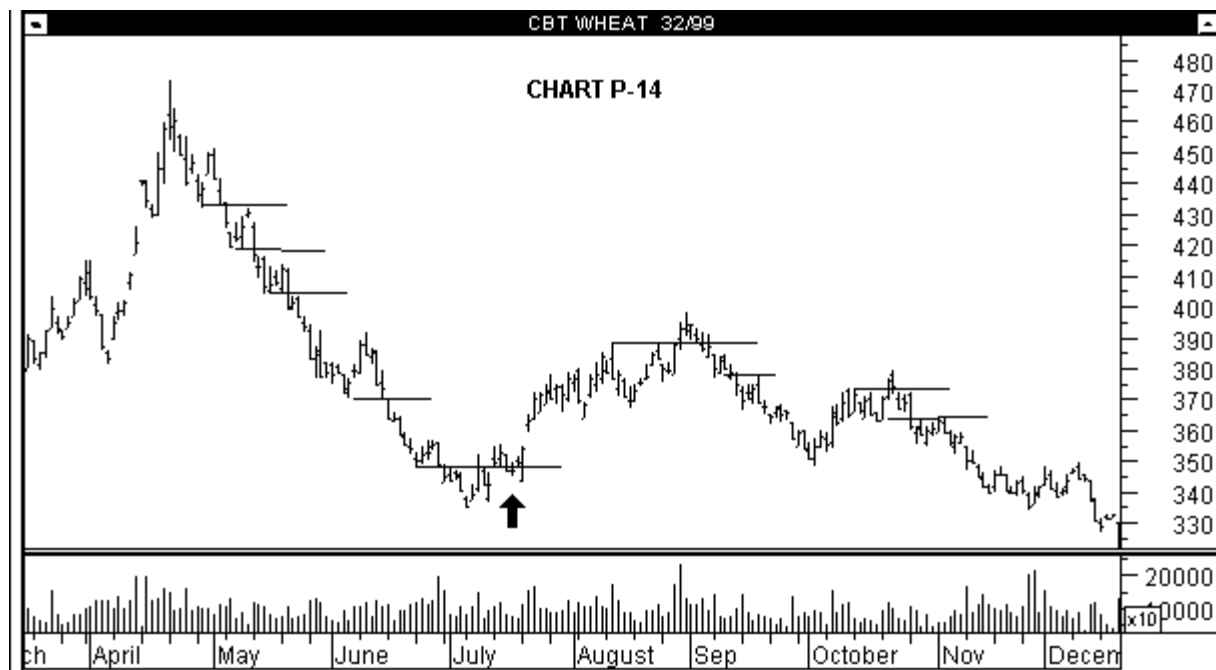
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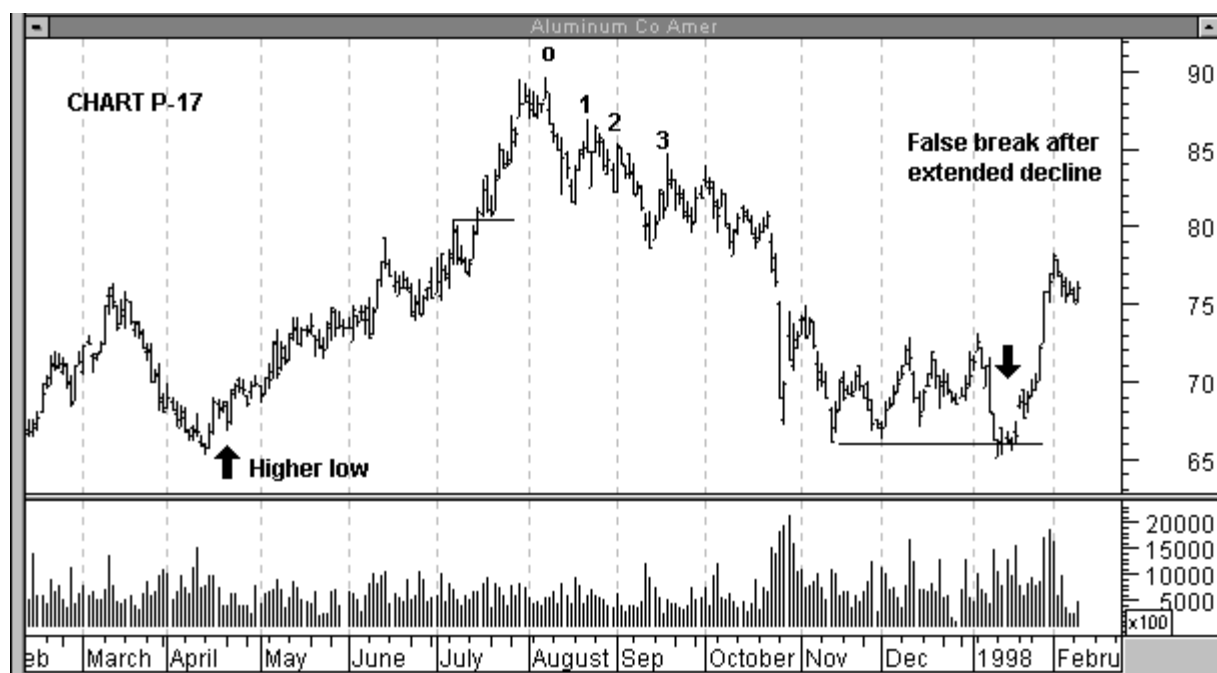
Part 1: Patterns of Movement



Part 1: Patterns of Movement



Part 1: Patterns of Movement



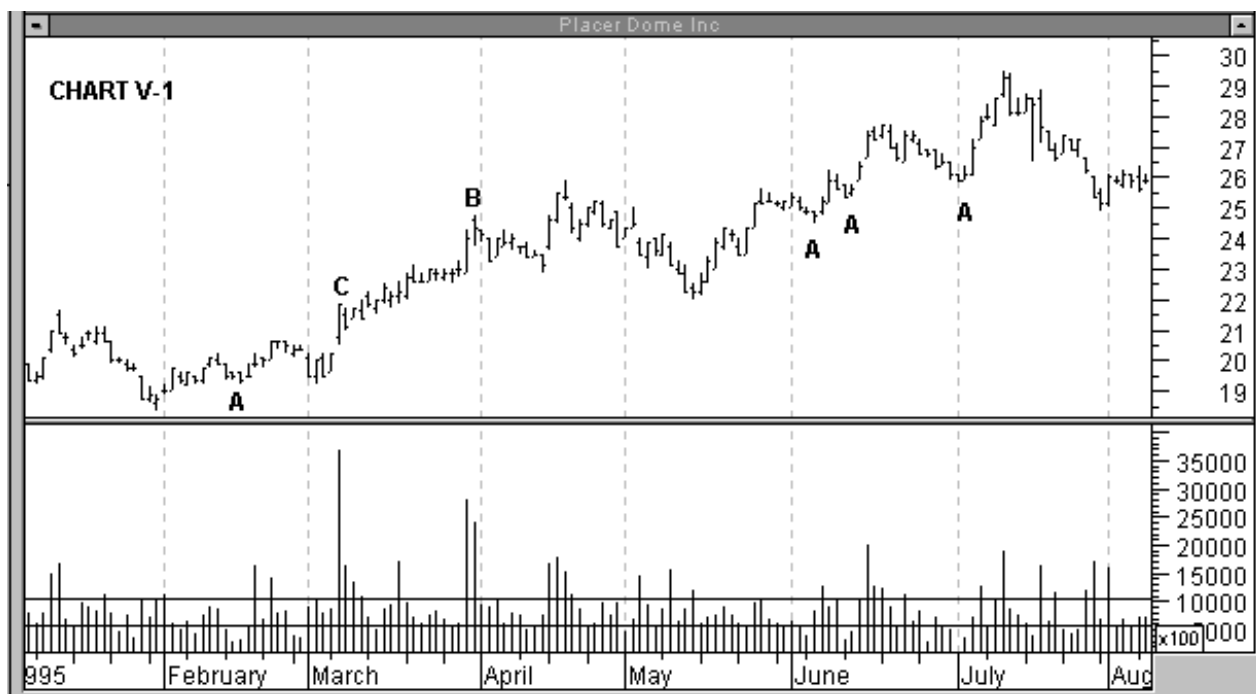
Part **2**

Volume

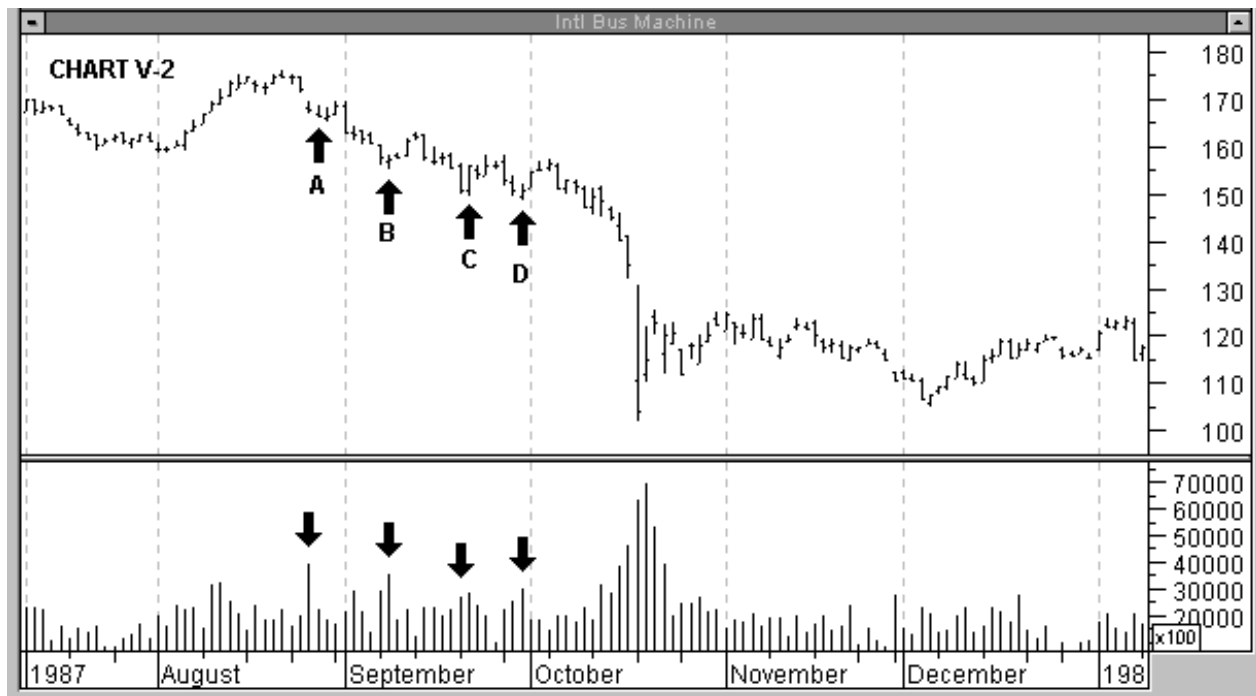
Part 2: Volume

The volume of sales is the real driving power behind the market and shows whether supply and demand are increasing or decreasing. The exact total volume figure is not as significant as its relationship to previous volume. One must be able to quantify the day's volume into three categories: low, normal or high.

A statistical approach becomes quite interesting with the availability of computers. However, I have found a simple mechanical method to be not only easier but more meaningful. I simply take a bar chart with a volume history. With a ruler, draw a horizontal line above what is obviously low volume (Chart V-1). High volume should also be obvious with large spikes in the volume bars. Then normal volume would be between the high and low designations. Approximately one-third to one half of all volume bars should fall into this category. Adjustments will need to be made due to the fact that as a bull campaign matures volume will likely increase and when many bear campaigns run for years, volume will decrease. However, this will be obvious and should not cause a problem.



In an idealised bull campaign, volume should increase as price increases. Counter-trends, or the sell-offs that inevitably occur in healthy bull campaigns, should have less volume. In many instances, the lows to these sell-offs will have light volume and indicate selling has ended (Chart V-1, points A). There are many instances where this low volume will be a very clear and undeniable signal, when all evidence is analysed. In a healthy bear campaign, volume should move up as price trends down. If price rallies and volume shrinks, the indication is the rally is a counter-trend and the bear campaign will resume (Chart V-2, points B, C and D).



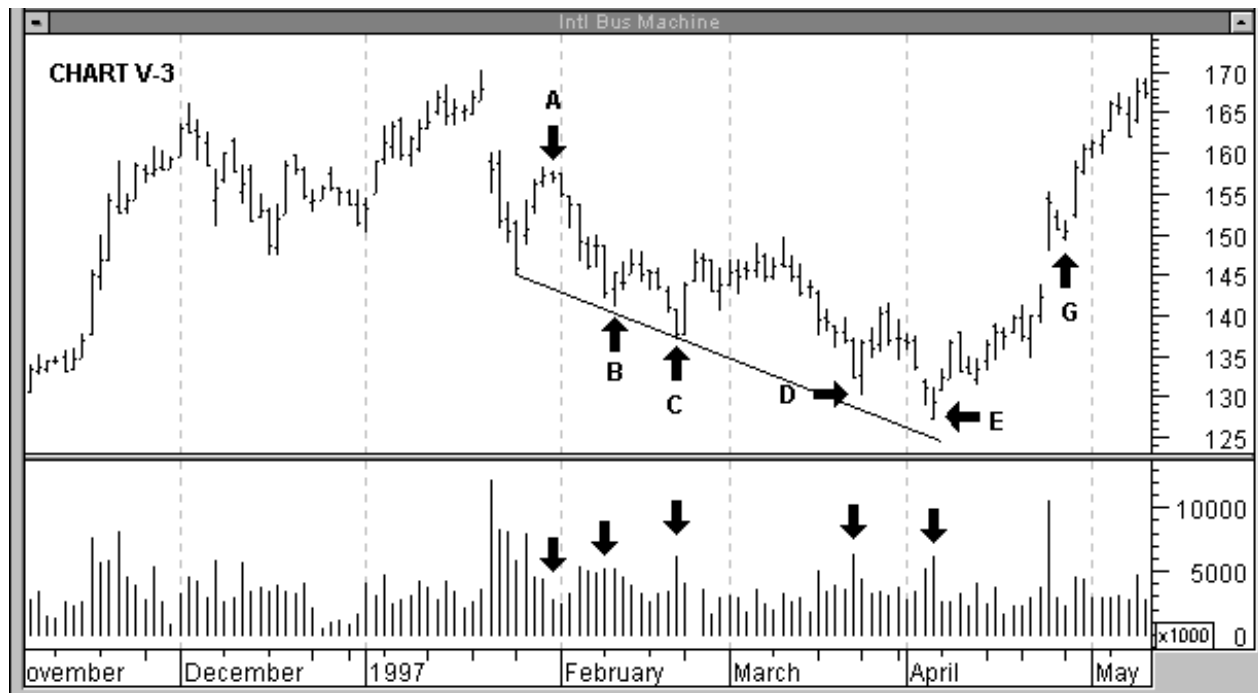
These are probabilities. There are no certainties in the markets. Analysing the volume during counter-trend moves can be very enlightening and confirm the health of the trend. Still, you must keep in mind that this is idealised. Some lows in bull campaigns do have average volume and some lows do have heavy volume. Those heavy volume lows are usually obvious as they will come at the end of capitulation (panic) lows. The capitulation low occurs more in commodities as they tend to be more fear driven.

When price is trending up and is far from its base, it can begin a move down with large volume from a new high or against resistance and find low on high volume. When that happens, it is an indication that the trend may be changing. This must occur close in time and price to the high, usually the same week. Then, if the subsequent rally has few buyers, indicated by less volume, you may be viewing the first counter-trend movement (Charts V-2 and V-3, Points "A").

Charts V-2 and V-3 are International Business Machines (IBM) and do trade very well by this analysis. Notice at the lows marked "B, C and D" how volume spiked up and on the subsequent rallies (three days) volume fell off significantly. The lack of buying interest at the top of the three-day rally was a very good sign that the trend was going to resume downwards.

Chart V-3 shows the same volume patterns while price is trending down. The movement down from the high occurs on very large volume. The first three-day counter-trend rally has volume drying up (Point "A").

Part 2: Volume



Points "B, C, D and E" are all large volume lows and the subsequent rallies have much less volume. Notice the sequence of lows that was discussed in the chapter on Pattern. Low "D" showed a loss of momentum and low "E" was a marginal break that immediately recovered. That day gapped down and the opening was the low for the day into point "F", but this was not a high probability counter-trend rally because the low was a pattern we could identify as a probable low for a large rally.

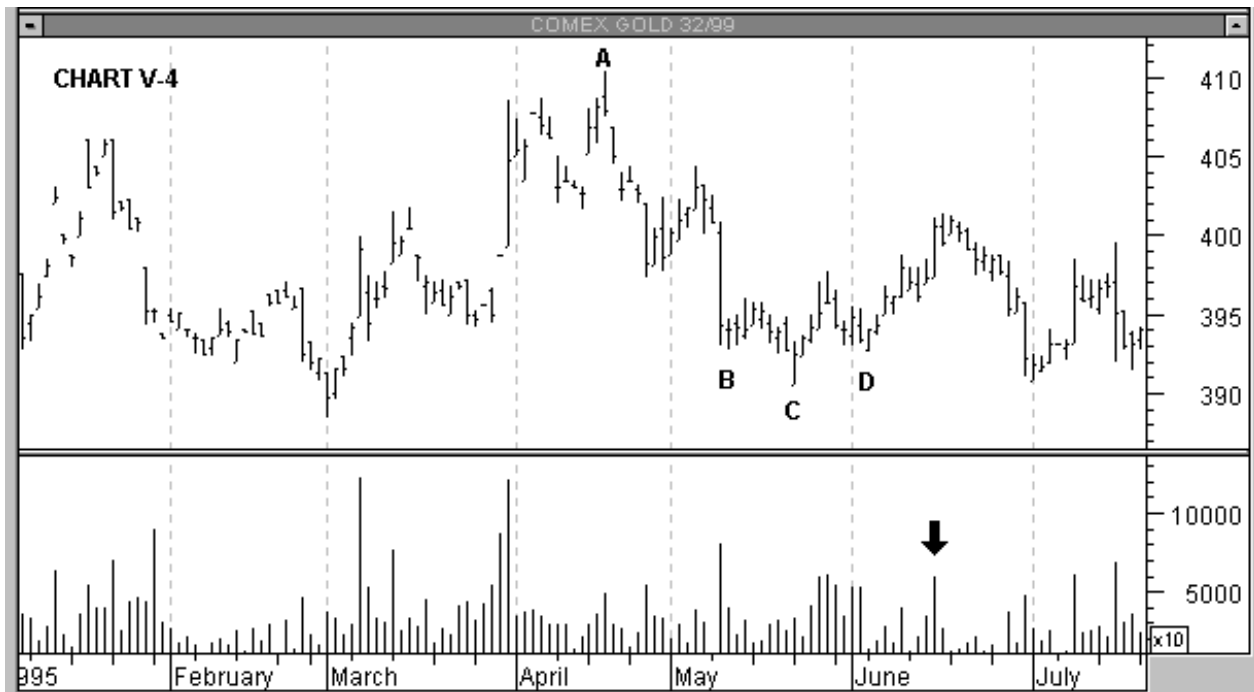
The rally that followed from point "C" did not have a loss of momentum, but did rally twelve trading days, thus staying within the same time period for a counter-trend movement. On the thirteenth day up from point "E", price gapped up, followed by an inside day, then a gap down that recovered the previous day's range (point "G"). The next day, price gapped up and moved above the previous high day, leaving a one day counter-trend at point "G", showing at least a move up to retest the old highs. Notice how volume confirmed the counter-trend.

We have seen how volume spikes will occur at the end of down trends that are capitulations. When the market is trending upwards, you will find that large volume spikes will either half or slow down the advance, as point "B" Chart V-1. This must also be viewed with the knowledge that a big volume day when coming out of a base pattern as point "C" on Chart V-1, is very bullish and indicates the start of an up trend. Did you notice the three higher low pattern prior to point "C"?

A divergency in volume related to higher highs or lower lows should also be noted. On a short term basis, a higher high than the previous high, that has less volume than the previous high

offers a probability of reversing the trend, again point "B" on Chart V-1.

The chart V-4 below is of Comex Gold, December contract, with total volume from all contracts. Gold had been range bound for a number of years, and was about to give its final rally before going into a bear campaign.

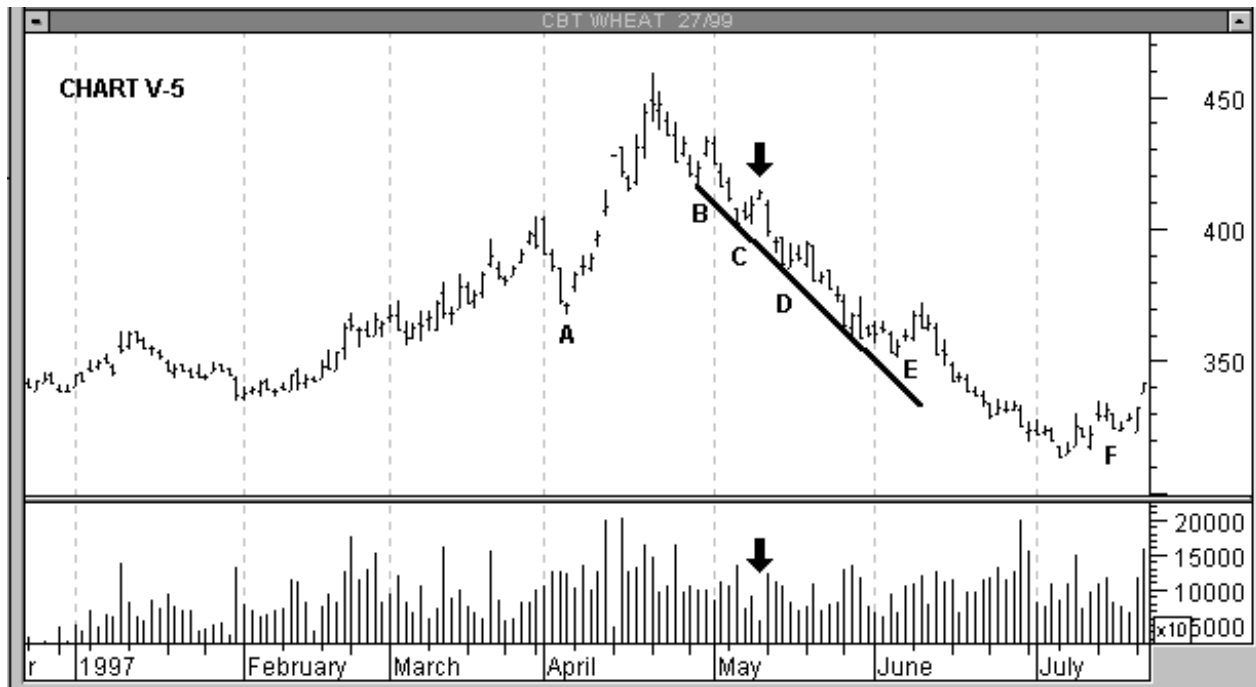


So this is a non trending market. You can see how price moved down from point "A" as the volume spikes gave lows for a counter-trend rally. Point "C" was a loss of momentum and less volume than "B", thus setting up the rally. Price rallied four days, then fell back five days (point "D"), and was still above the midpoint of the rally. This is a good indication the rally was going to continue by establishing a higher low. Notice the volume between points "C" and "D". The consistent high volume was an indication of buying interest. The symmetry between the lows at points "B" and "D" are further evidence of a base system. The rally was a disappointment. I purchased gold at point "D" due to the gap down to a new low, followed by the strong close with few sellers. Due to a non trending market I exited half of the position at the volume spike and was stopped out the second half, five days later.

Chart V-5 is CBT Wheat, July contract 1997. When looking to position a counter-trend or the first lower high in commodities, it is safer to position on the break of the low of the high day with a protective stop marginally above the high of that day. At point "A", price sold down four days (possible counter-trend) while the trend was up. However, the large volume made the subsequent rally a possible counter-trend.

Part 2: Volume

The low at point "A" stayed out of the base (January high) thus holding a strong position, but if you believed the rally would fail, then selling the break of a daily low would be a valid strategy. The fourth day gapped up and the fifth day was at a new high, obviously eliminating any possible lower high and keeping you out of a losing position.



Volume at point "B" was not particularly high, but gapping up, then reversing and showing a new low within two days (one day counter-trend) is an indication of a very weak market. The volume at point "C" was large and three days later showed a small range and low volume. Going short on the break of the low of the third day up with a protective stop marginally above the high of that day was a valid strategy. Notice how the rally from point "C" stayed below the low of point "B", leaving price in a weak position again. The same was true of the rally into point "D".

At point "E" we see the first momentum divergence. However, the rallies have stayed below the low at point "D", and even though volume was light and we could expect a rally, you should be reluctant to close out all of a short position because of the "weak position" according to pattern analysis. You could buy back one-third to one-half and bring the protective stop down on the remainder of the position.

Five days before the low at point "E", is a rally day that fell and closed on the low. This is a safe place to bring down a protective stop. The rally only moves up three trading days and broke to new lows three days later, indicating the probable resumption of the trend. Therefore, the volume started to increase, an indication price was starting to get close to a low. When the

probability of a higher low forming on less volume, point "F" occurred, it was time to close out the short position. A long position could be warranted, but could only be held for 12 days, on the protective stop brought up to the low of the twelfth day.

Extremely high volume or "blow off" volume is a warning that the trend in progress is in the process of exhausting itself. If price is a long time from the base or the top, the probability is good. In addition, if the market has been falling for some time (more than 90 calendar days), this "blow off" volume can come at a new momentum high for the trend.

The following are Mr W.D. Gann's rules for determining culminations by volume of sales. Obviously, you must also judge position by pattern, price, wave structure and time.

1) At the end of any bull campaign or rapid advance in an individual stock, there is usually a large increase in the volume of sales, which marks the end of the campaign, at least temporarily. Then, after a sharp decline on heavy volume of sales, when a secondary rally takes place and the volume of sales decreases, it is an indication that the market has made a final top and that the main trend will turn down.

2) If the market holds after making a second lower top, and gets dull and narrow for some time, working in a sideways movement, and then breaks out on increased volume, it is a sign of a further decline.

3) After prolonged decline of several weeks, several months, or several years, at the time a market is reaching bottom, the volume of trading should decrease and the range in fluctuation should narrow down. This is one of the sure signs that liquidation is running its course and that the market is getting ready to show a change in trend.

4) After the first sharp advance (when the trend is changing from a bear market to a bull market) the market will have a secondary rally after the first sharp decline. If the volume of sales decreases on the reaction and when the market moves up, advancing on heavier volume, it will be an indication of an advance to higher levels.

These rules also apply to the general market.

SUMMARY: Sales increase near the top and decrease near the bottom. Except in abnormal markets like the Dow Jones, October and November 1929 (and October of 1987) when the market was moving down very fast and culminating on large volume of sales, making a sharp bottom, from which a swift rebound followed. As a rule, after the first sharp rally, there is a secondary decline on decreased volume, as described above under Rule 4.

After thirty years of watching novices come and go, one of the major reasons they do not last long is their propensity to try to pick tops and bottoms of fast trending markets. It never pays to

Part 2: Volume

buck the trend in the last stage of a bull or bear market. In fast, advancing markets, in the last stages of the campaign, reactions get smaller as price works to higher levels, until the final section has ended. In the last stage of a bear campaign rallies get smaller as price works lower. Leaving those who buy, no chance to sell on rallies until the final bottom has been reached. It is much safer and easier to pick the first lower high (or counter-trend) or the first higher low (first counter-trend).

If you are trading a futures contract, then open interest should be added to the analysis. If open interest increases, then we should expect volume to increase. This will change volume categories slightly. The basic rule for open interest is similar to volume. It should increase in the direction of the trend. Quite often, one might get conflicting readings between open interest and volume. For example, in a healthy trend price may correct two to three days on light volume with open interest increasing, thus giving conflicting readings. However, since all analysis is a weight of evidence, one will find little problem with these circumstances. If a market is in a bear campaign and price rallies, volume shrinks and open interest drops, the probabilities are that the rally was short covering. Therefore, creating a counter-trend which would reverse and follow the main trend. When a bear campaign initially begins coming off the last high, open interest may decline. This is obviously different from the general rule of thumb, which states that open interest expands in the direction of the trend. So open interest can confirm a probability, but not necessarily deny the probability. In fast down trending markets an increase in open interest is a very strong indication of a continuation of the trend. One should also be aware of the week that options on the futures contract expire, as this will usually cause open interest to drop and has little to do with the trend. Also, in the agricultural markets, one must consider a seasonal factor which will affect open interest.

Again I need to emphasize volume is a part of a complete analysis. The idealized volume to price movement falls into the 65% category of probability. Often volume can be extremely helpful confirming lows in counter-trends during bull campaigns and highs of counter-trend during bear campaigns, or warning that a trend may have capitulated. Remember, extremely large volume (except in futures) usually signals the end of a trend while trending on the start of a trend which is consolidating. Volume combined with other analysis can be a concluding factor.

Part 3

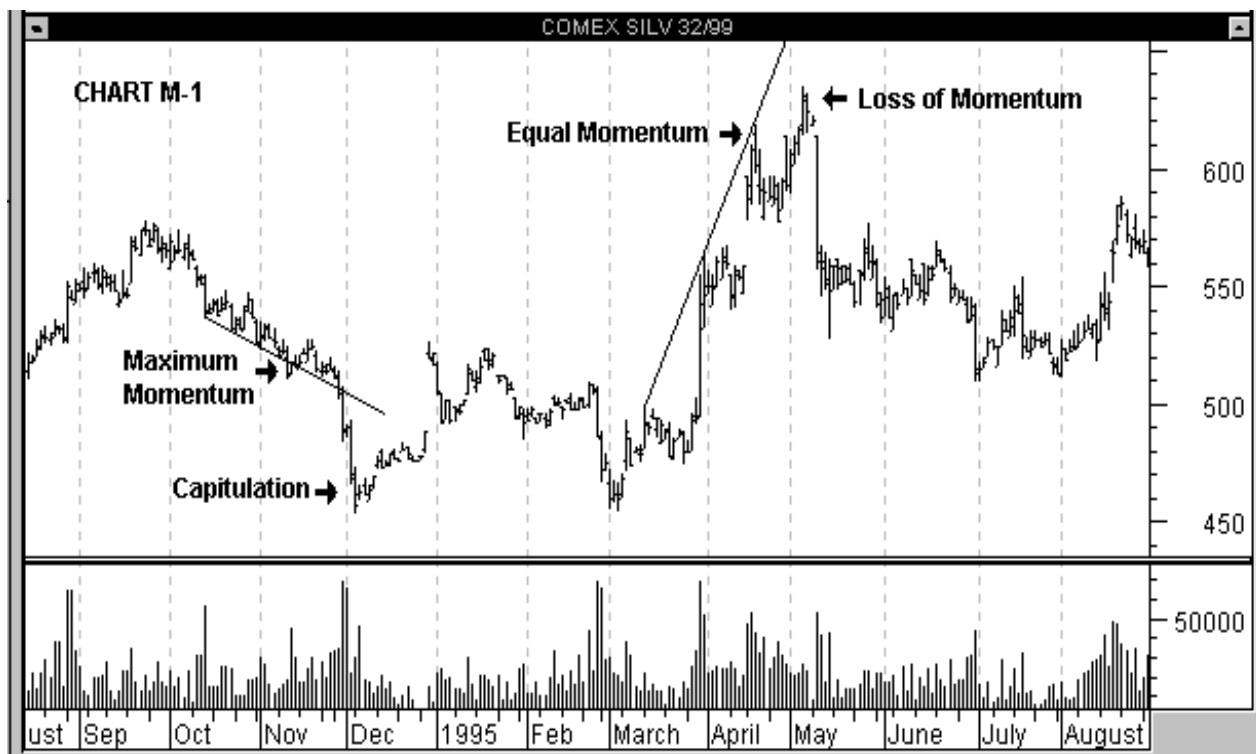
Momentum

Part 3: Momentum

Momentum is the force possessed by a body in motion or the measurement of the velocity of price in a given direction. Through the use of computers, there are now as many ways to measure momentum as there are items to measure. Most methods are either put into oscillators or viewed as indicators. Oscillators are usually the distance between two moving averages. The most popular indicators currently are RSI, MACD and Stochastic. They are measures of momentum, they just use a different mathematical approach and will usually give close to the same results.

The two most popular ways to use momentum analysis is to either confirm a probably high or low for a trend with a loss of momentum or to indicate a continuation of the movement due to a maximum or equal momentum reading. When price goes to a new high and a momentum index does not go to a new high, this is termed a divergence and signals a possible reversal of that trend. It takes significantly more knowledge than a simple momentum divergence to become successful.

There are very few momentum divergences that cannot be seen with the eye using a simple trend line on a chart (Chart M-1). When price failed to reach the trend line and turned down, it was from a loss of momentum. Findings lows with the use of momentum analysis can be a little more difficult. Many lows, especially in commodities, are maximum momentum lows. Again this is due to the "fear factor" this part of the commodities market.



However, those maximum momentum lows are usually obviously "blow offs" or capitulation

patterns with large volume as compared with the low marked "Maximum Momentum". Notice the higher low in March (Chart M-1). Price went seven days up followed by seven days down. That was the same number of days down as the number of days up, but was above the midpoint of the rally. Along with that time factor, there were also few sellers in the seven-day move down, indicating a high probability of the pattern setting up as a higher low.

The use of computerized momentum analysis, as a method of teaching oneself the patterns of movement that create a loss of momentum, is a very worthwhile learning tool. A loss of momentum does not necessarily indicate a reversal in trend, but could indicate a consolidation, which could be followed by a resumption of the trend.

Chart M-2 is the All Ordinaries Index, which represents the Australian Stock Market. Indexes trade like large capitalized stocks. They tend to take time for distribution to occur in up-trends before a change in trend occurs (provided it is not a "blow off"). In down trends they usually need a base pattern before reversing and moving higher, unless it is a blow off. Trend line "A" is not a normal trending movement, as each instance the market moves to new highs it was immediately pushed back and could not show a higher low above a swing high. Once price broke above the trend line and failed, it was then time to look for a lower high (3 to 4 day counter-trend), which did occur.



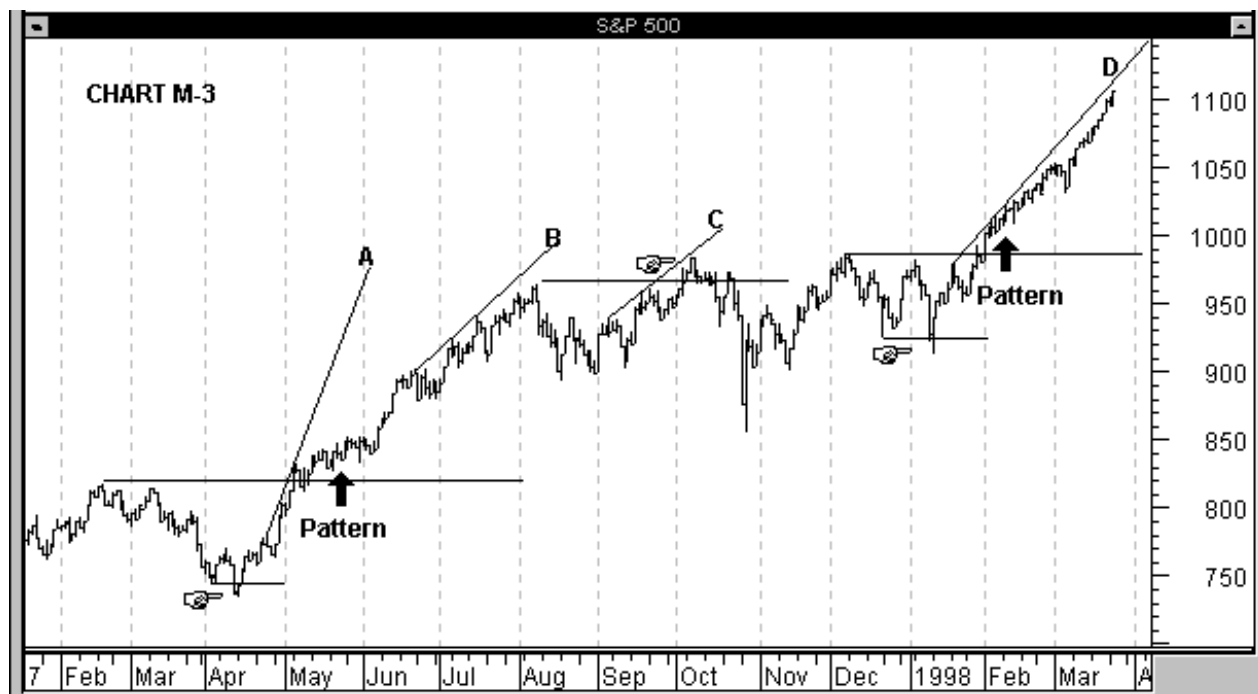
The move up following trend line "B" was far too steep to be meaningful. The high to the three-day counter-trend was the next point to start, and eventually the divergence (failure to

Part 3: Momentum

reach the trend) occurred. Please study the pattern of movement in that trend up. While it was struggling above the old high, it was producing a pattern that was noted in Chapter One, Chart P-2 Point C. You will see this same pattern in Chart M-3.

Another important aspect of momentum to understand is how each item you are trading responds to pitch or momentum. If you are going to trade anything, you must do your homework and develop the "vision" necessary to analyze in a historic perspective. Chart M-2 is the All Ordinaries, the Australian Stock Index. Historically, when this index is in a strong position and trending with high momentum or strong pitch, the counter-trends will be only one or two days and most of the time only one day against the trend. This obviously means that when the index goes down one day and moves to a new high for the trend the next, day, it represents a great buying opportunity. However, it also shows the trend is quite strong and a loss of momentum is simply a short term consolidation before moving significantly higher. This is a good example of why it is safer to look to sell short the first lower high during a momentum move, than to attempt to pick to ultimate high.

Chart M-3 is another index, the S & P 500 Cash Index. Trend line "A" obviously had too strong a pitch to be maintained, and as with trend line "B" on Chart M-2. You would need to wait for the first counter-trend before establishing another trend line.



Trend line "B" eventually showed a divergence. Trend line "C" showed a divergence, along with a false breakout. Trend line "D" could be valid, but the power of the movement, only 2 two-

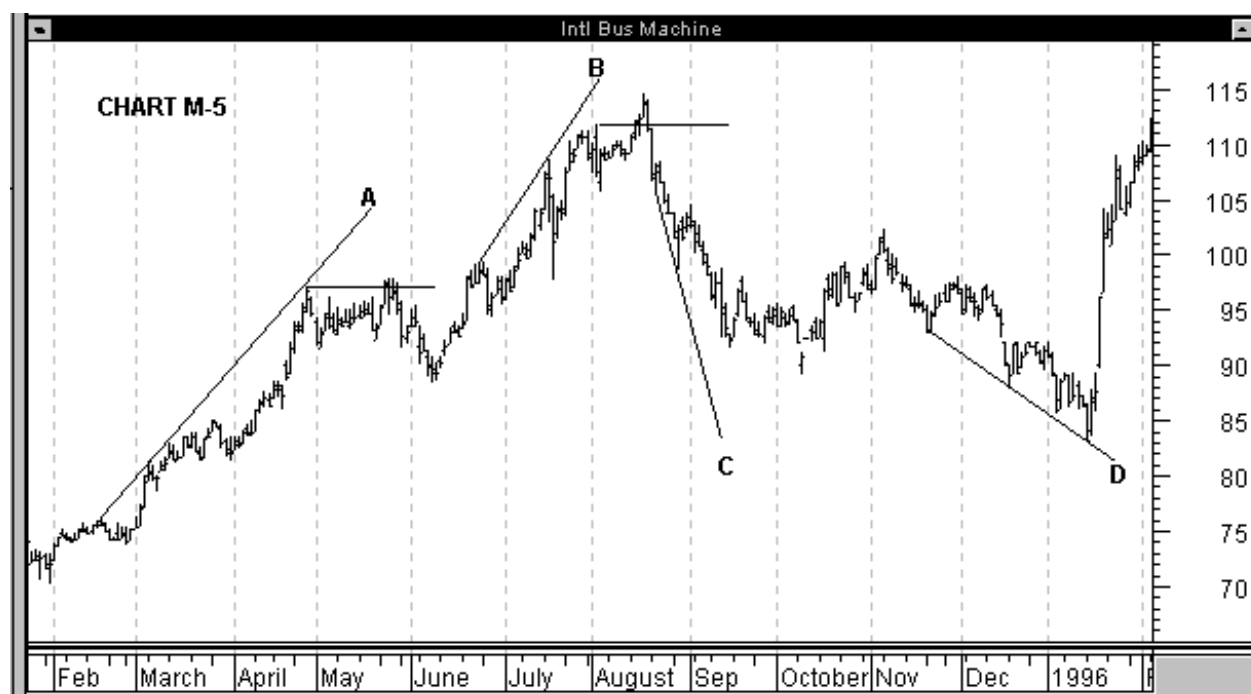
day counter-trends, could give a blow off top. If that occurs, it will produce very large daily ranges for two days and gap up to complete the drive. Please notice the "false breaks" (indicated by the pointing finger), and the fast movements that followed those patterns.

Chart M-4 is CBT Wheat. Remember, when a trend is so strong as to give only one to three day counter-trends, you must be very careful when assuming the trend is complete. There should be more than one divergence, and usually a probability of a higher low. There was a gap down, creating a divergence to trend line "B". If you had bought the higher low, your position would be at risk after twelve trading days, because if the trend were to remain down, that is the highest probability for the length of the counter-trend.



Chart M-5 is a large capitalised stock, IBM. Trend line "A" shows momentum balanced or equal into Wave 5, with a large space developed between swings. This was followed by a "false break", a two-wave structure down and a resumption of the trend. Price showed a divergence against trend line "B", but as with the previous drive, needed a seven-wave structure and a false break to complete the trend up. The down trend, which was very steep, showed a divergence, but did not complete with the false break. That false break was an island reversal that started a two-wave movement. The following trend down found a low on the trend line (no divergence) and changed the trend. An example of the need to always have a protective stop in the market. That drive down also was a seven-wave structure.

Part 3: Momentum



Another example of how markets find lows is found in Chart M-6. This is another large market - US T-Bonds.



Trend line "A" is established, then price breaks below it and shows a counter-trend rally that leaves a space between the rally high and the previous low, indicating a weak position. This is followed by a new low that diverges, but the rally is still stopped by a previous low. The next low

could be a buy, if price stays above trend line "B". You could not expect any more out of the rally than a test of the previous high. The greatest probability is for a sideways move. The market rallied twelve trading days and fell back for another false break and another retest of the high.

In summary, understanding momentum is important, but it should be accomplished by understanding the patterns that occur while trending and not the patterns that occur in oscillators or indicators. They are great learning tools, but trading based up indicators is like trading shadows on the wall. You must understand the patterns and counter-trends that develop during trending movements and then you know the significance of a momentum divergence.

Part 4

Wave Structure

Wave analysis of markets was first brought to the investment community by R.N. Elliott in the mid 1930's. Later A. Hamilton Bolton expanded on Elliott's work in wave structure. There are currently many text books on the subject. The original text by Frost and Prechter is still the best. The following is what Gann wrote about waves:

"A bull or bear campaign in stocks or the averages runs out in 3 to 4 sections -

Bull market

1st Section - Advance after final bottoms; than a secondary reaction.

2nd Section - Advance to higher levels, above the highs of previous week and of the first advance; then a reaction.

3rd Section - Advance to new high for the move. In many cases this means the end of the campaign, but you must watch for a definite indication before deciding that the 3rd run up means a change in the main trend.

4th Section - Often four sections are run out and this 4th move or run up is the most important to watch for the end of a bull campaign and a change in trend.

Minor bull campaigns of short duration, running one year or less, often run out in two sections, especially if the first section is from a sharp bottom. Therefore, always watch the action of the market after the second advance to see if it is forming a top and gives indications of a change in trend".

Bear campaign

A bear campaign runs opposite to a bull campaign -

1st Section - There is a sharp, severe decline which changes the main trend; then a secondary rally on which stocks are safer short sales. That marks the end of the first section.

2nd Section - Then there is a second decline to lower prices, followed by a moderate rally.

3rd Section - A third decline or move to still lower prices, which may be the end of the campaign.

4th Section - There is often a 4th move, when you must watch closely for bottom. In determining whether it is final bottom, you use all of the other rules ... watching old tops and old bottoms for definite indication that the trend is ready to change.

Minor bear campaigns of short duration, running one year or less, often runs out in two sections, especially if the first section is from a sharp top. Therefore, always watch the action of the market after the 2nd decline to see if it is forming a bottom and gives indication of a change in trend.

Part 4: Wave Structure

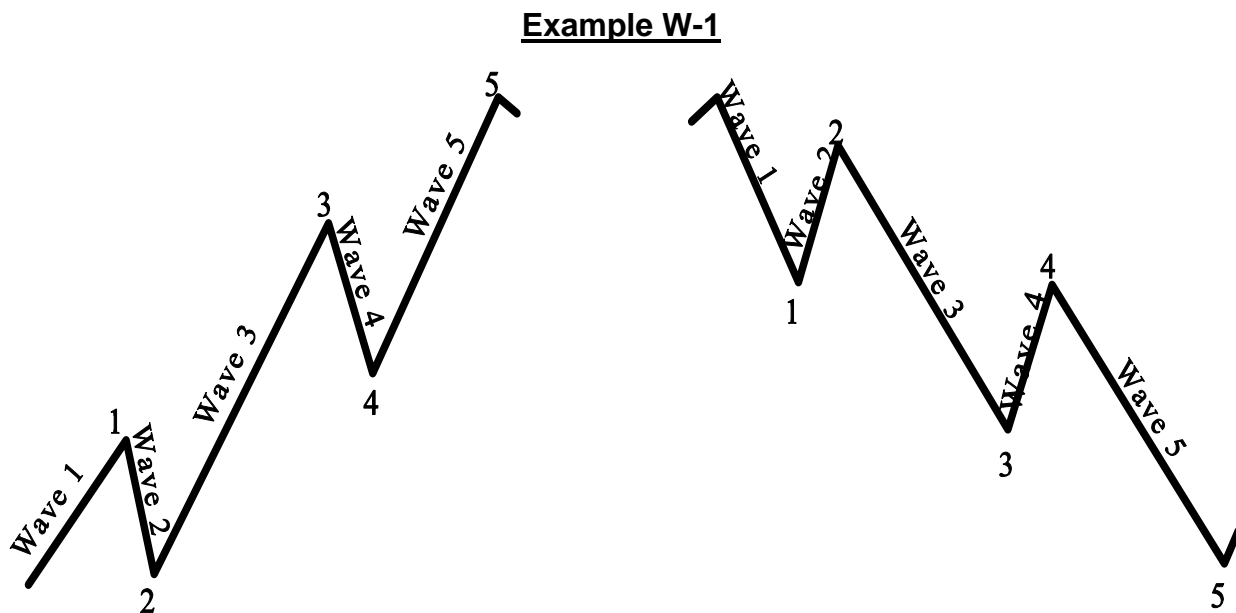
In extreme cases, like 1929 and the bear campaign which followed from 1929 to 1932, there are as many as 7 sections up or down. However, this is abnormal and unusual and only occurs many years apart."

Obviously this is very simplistic, compared to the work done by many Elliott analysts. I have personally found trading by Elliott wave principles to be difficult. But understanding the basic wave theory is a critical factor to market analysis. Most of my analysis is attempting to determine if three or four sections have run out - "Is this movement completed according to wave structure?"

One bit of knowledge to keep in mind when analysing price movement is that, as a general rule, bull markets go up longer in time, than they go down and bear markets go down longer than they go up. So, if there is a low to high six-week move up during a bear trend, you can assume the move down will exceed six weeks if the trend remains down.

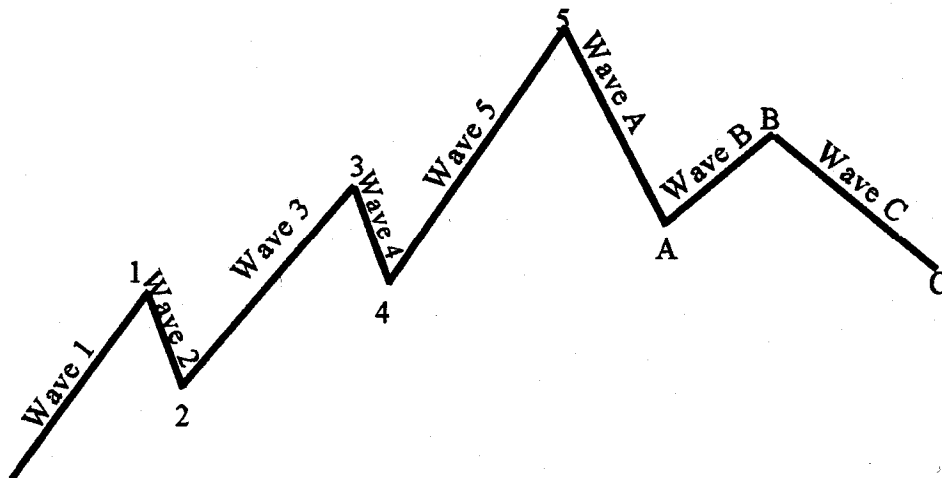
Wave analysis can create high probabilities, and those will be discussed. Moreover, wave analysis can offer a great many probabilities, but few afford good trading opportunities, and one need to know that difference. If price is in a sideways movement, I find wave analysis to be of minimum value.

The Elliott Wave theory states very basically that markets vibrate to a basic rhythm (Example W-1). That rhythm is five waves in the direction of the trend. Those waves - 1, 3 and 5 are called impulsive and waves 2 and 4 are termed corrective waves.



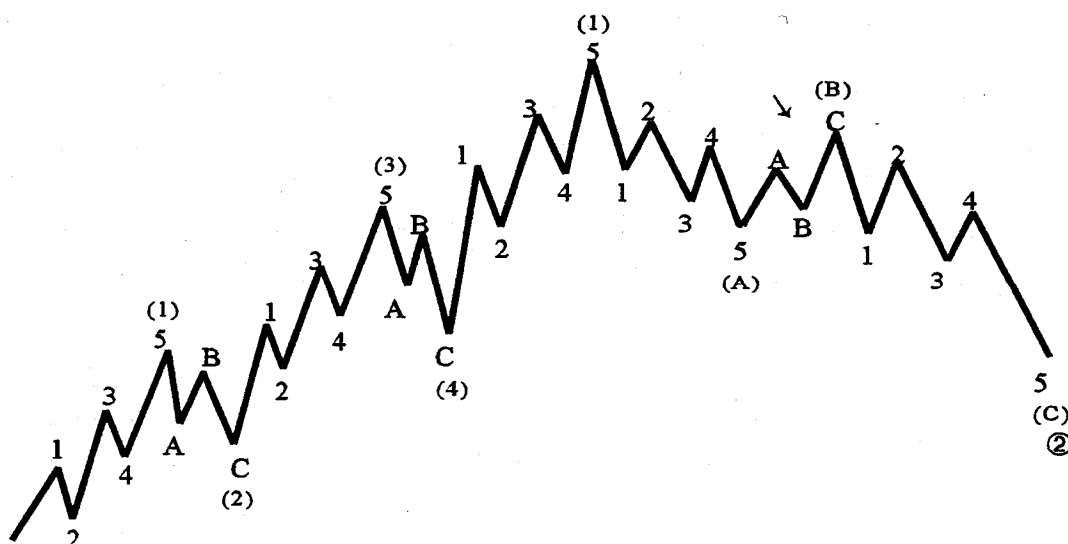
Once there is a complete wave structure, the trend will reverse and a three-wave move in the opposite direction should follow (Example W-2). This corrects the completed leg. An Elliott analyst would term this an "A-B-C" correction or a "three".

Example W-2



The complete leg up is referred to as a "Five". Of course, after a completed leg, price could reverse trend completely and have a five-wave move in the other direction. The question usually facing an Elliott analyst - Is this a "3 of 5" or a "C"? The theory goes on to state that this basic rhythm can be subdivided into waves of a lesser degree, or expanded into waves of a larger degree (Example W-3).

Example W-3



Part 4: Wave Structure

This does set up some obvious trading probabilities. For instance, one will constantly hear an Elliott analyst refer to a movement as impulsive or corrective. If at point 5 "A" (Example W-3), you could determine the move down was impulsive, then a three (A-B-C) would follow, thus setting up a short sale at some point above a swing "A" or point marked with an arrow on the chart. So through our ability to analyze the form of each wave and the number of waves, we can determine what the probability is for a movement (leg) to be complete. This obviously will help us in determining when our positions are at risk, or when to enter a new position.

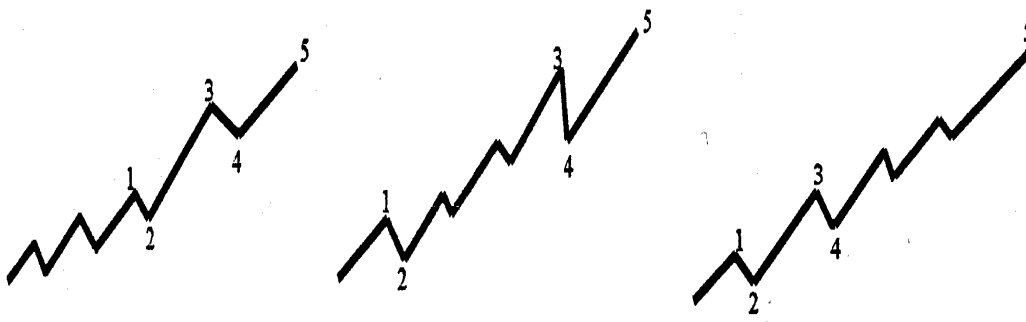
There are some rules offered by Elliott to help clarify where, within the wave structure, a market may be impulsive or corrective.

- 1) Wave 2 cannot go to new lows
- 2) Wave 3 can never be the shortest

3) Wave 4 seldom goes into wave 1. In diagonal triangles this can occur. This can also occur in futures contracts, but not in the underlying cash market. Again, such are probabilities, not certainties.

If it were only that simple! Waves can extend. These extensions occur in the impulsive waves - 1,3 or 5 (Example W-4). This will then show a nine-wave pattern.

Example W-4



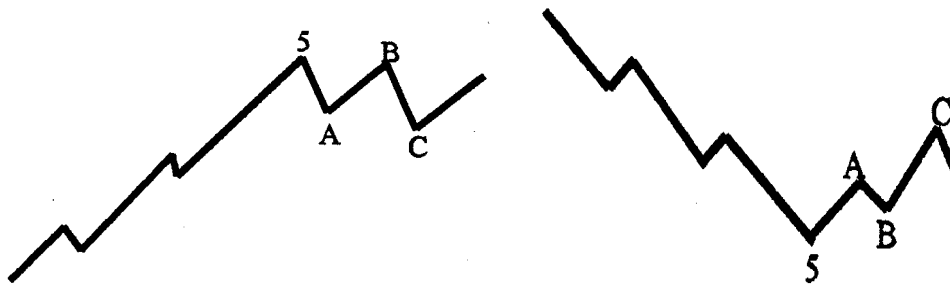
Extensions usually occur in the third or fifth wave, but can also occur in wave one. This makes it the most difficult concept to understand and apply during market movement. Only in hindsight is it usually clear and sometimes not even then. Only a good deal of experience while the markets are trading will help clarify what can be used for analysis.

Corrective phases using Elliott analysis leaves much to be desired. However, Elliott did discover a probability concerning corrective waves. He called this the Rule of Alternation. This suggests that corrective waves will differ in form within the same leg. These forms - or categories

- are either simple or complex. So within the same leg, if wave two is simple, then one could anticipate wave 4 to be complex. If wave 2 is complex, then wave 4 would have a probability to be simple.

A simple correction is also referred to in Elliott terminology as a "Zig-Zag" (A-B-C) (Example W-5).

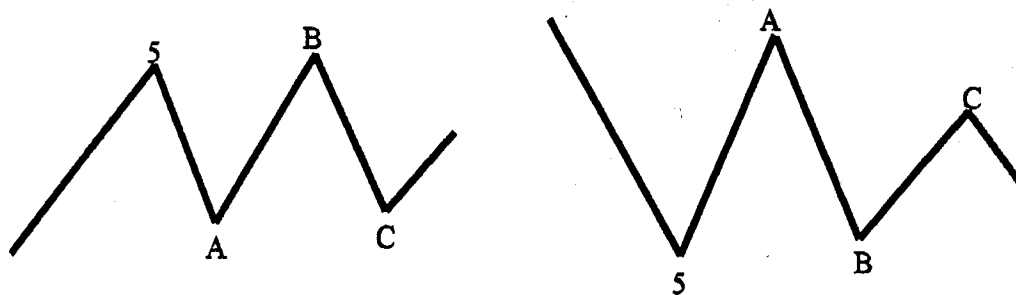
Example W-5



Complex corrections fall into three patterns; Flat, Irregular, and Triangle.

1) Flats: After the completion of an impulse pattern, the market corrects as wave "A" (Example W-6).

Example W-6

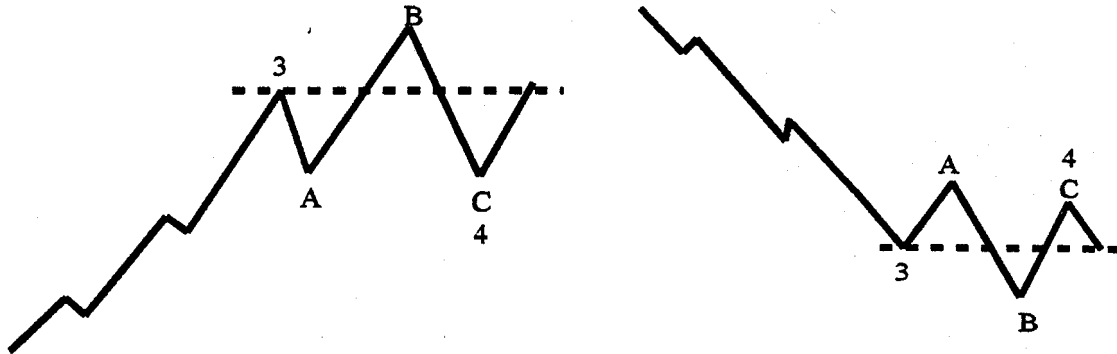


This is then followed by a retest of the old high that fails (Wave B) and is followed by a retest of the previous low (Wave C). In addition, there are double flats or "double threes" which produce a longer horizontal pattern.

2) Irregular - During this correction, the "B" wave will go to a new high in an up-trending market and vice versa (Example W-7). The "C" wave will go to the price level of "A" or through that level by a small amount. However, from my experience, if there is a 5-wave structure, followed by a "marginal new high" that represents a loss of momentum and immediately falls, I get short and assume a significant trend change. I have seen very few "irregular" patterns.

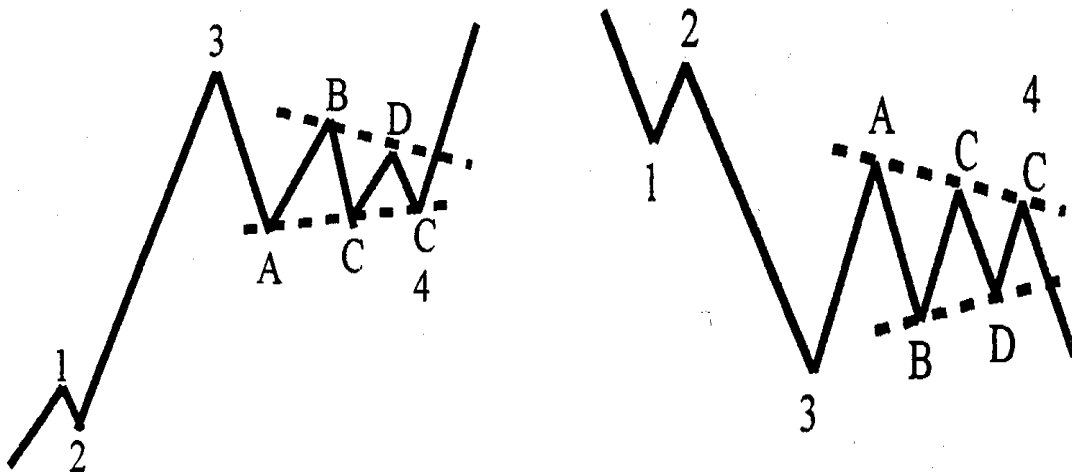
Part 4: Wave Structure

Example W-7



3) Triangles - The last category of corrections is triangles. These can take many forms as ascending, descending, inverted, right angle or symmetrical. There are two discoveries we can give to Elliott relating to triangles. The first is the probability that trends will contain five waves to complete (Example W-8).

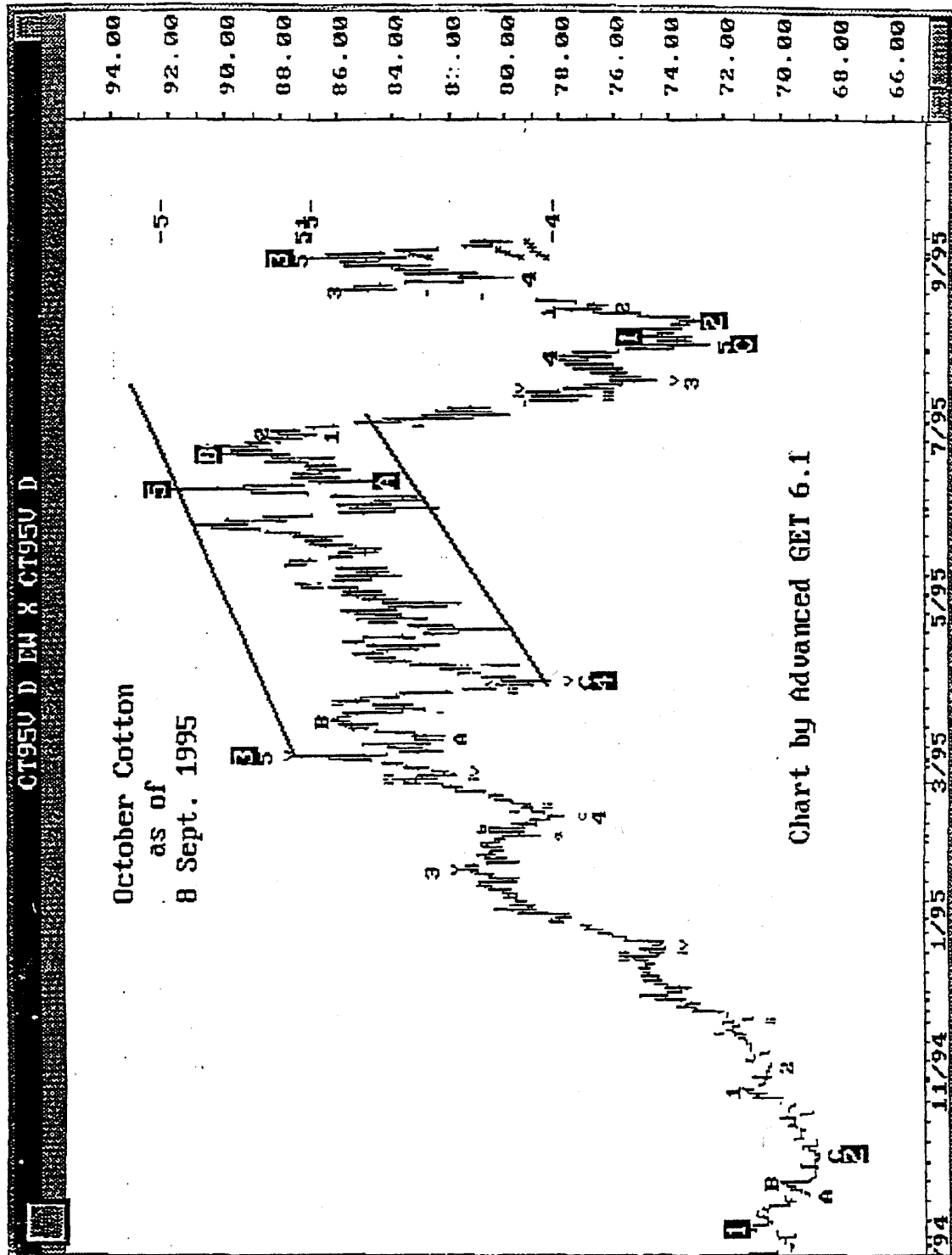
Example W-8



Of course, there are many exceptions to the five point triangle, and many triangles turn into horizontal patterns. Nonetheless, in specific circumstances, the knowledge of a five-point triangle will be helpful.

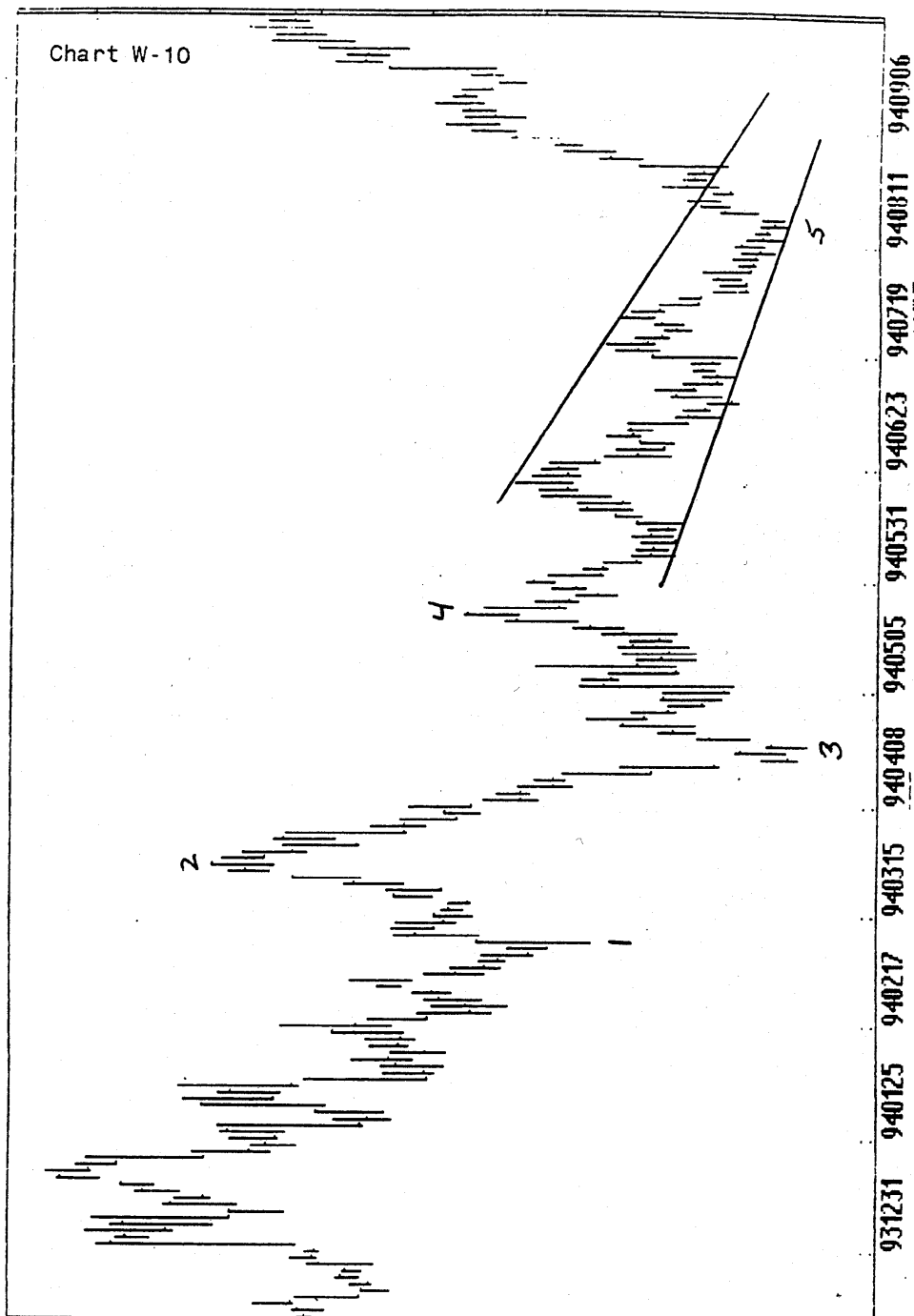
The second discovery is the diagonal triangle. This occurs in fifth waves which suggest an exhaustion of the trend (Charts W-9 and W-10). Chart 10 was produced with an Elliot wave program.

Example W9



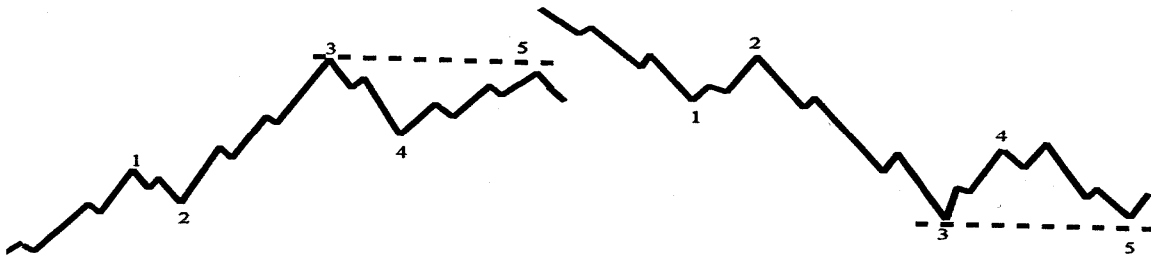
Part 4: Wave Structure

Example W10



We must also consider the possibility of a fifth wave "failure" (Example W-11). The key is determining a pattern Elliott referred to as a "failure" (failure to reach the old high), is that wave 5 needs to divide into five sub-waves.

Example W-11



There are a few points worth emphasizing in relation to wave structure.

If the trend is up and a completed wave structure is obvious at the high, then a move below point "A" (Example W-5) will put short positions at risk and could be the low that starts the next leg up. The same would be true of point "A" (Example W-5) in a down trend. We will look at this again during the chapter on positioning. Since wave 3 can never be the shortest when it is the shortest, then obviously this is not a completed wave structure. You must always view the weekly charts to determine the validity of your analysis. The "Elliott Count" is extremely subjective during a down trend, but I know if I can identify three drives in one direction. There is a possibility of terminating the movement, especially if it is occurring after an extended movement. The following charts are examples of this analysis of wave movements.

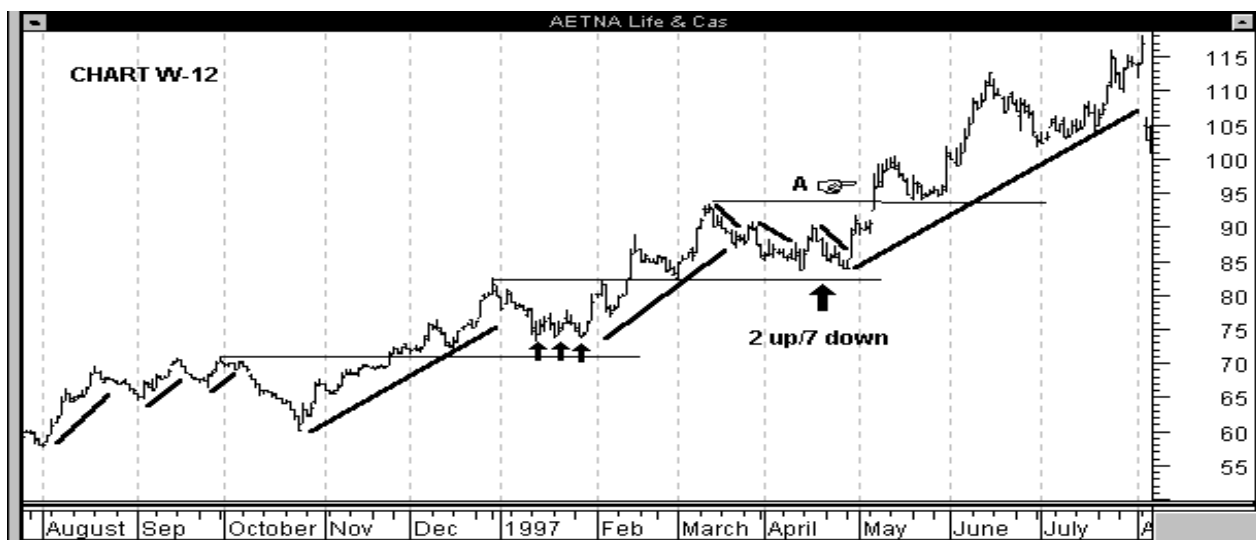


Chart W-12 is a US stock Aetna Life & Casualty Co. At the start of this chart price had been

Part 4: Wave Structure

moving sideways for almost a year. It then gave a three thrust pattern with each thrust smaller than the previous and price was unable to move much past the level of the first high. If this pattern occurred with a down-trend, then in all probability is a retest of the low from which it came as a minimum of the start of a new leg down in a bear campaign. In other words, this pattern can represent a counter-trend movement. Since this occurred while in a long sideways movement, there are no strong probabilities.

The next drive up breaks to new highs. Notice how there is no obvious wave structure within that drive up. In a drive that can only show one to three day counter-trends, with strong momentum, counting waves is not valid. The consolidation that follows holds a strong position by staying above the highs of the previous top and shows a triple bottom while trending upwards.

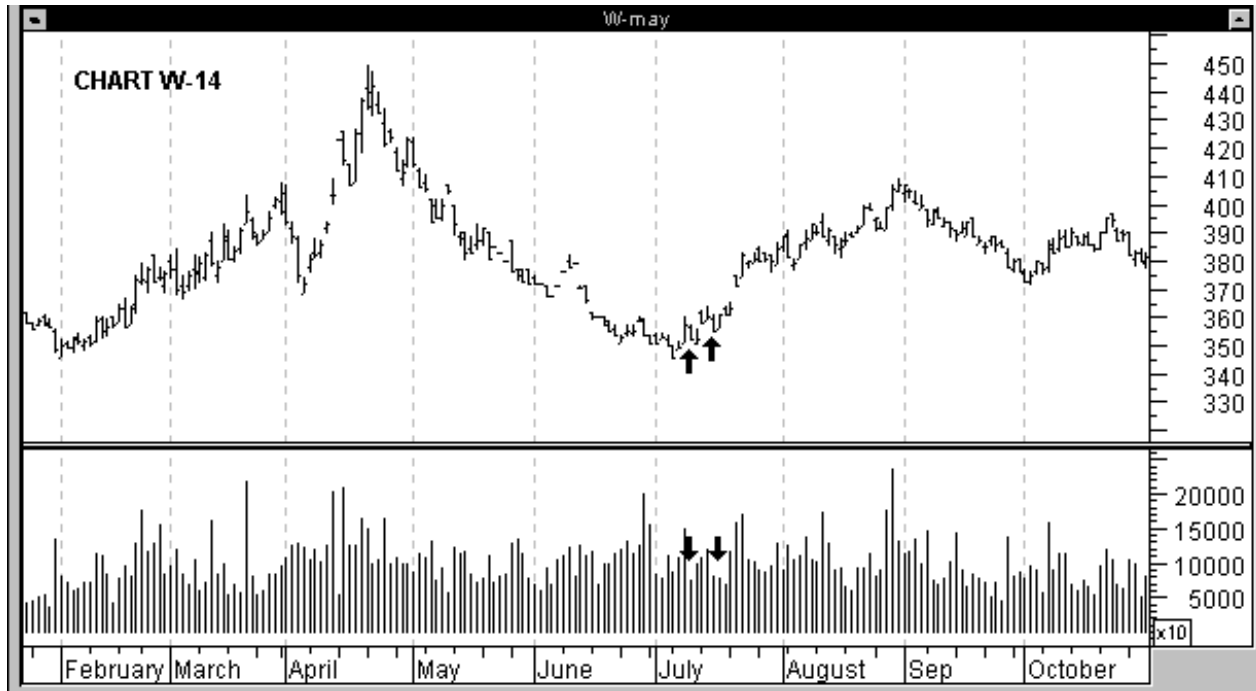
The next drive has three very clean drives, with the counter-trend being two days and ten days. The consolidation that follows has three small drives with the last drive showing a bull market "buy setup" - two days up, followed by seven days down that stays above the low.

The next leg has three obvious drives. "Point-A" could have been a "Wave 3", the next wave even subdivided. However, it did manage a new high, which in hindsight would have been an obvious completed wave structure.



Chart W-13 is continuation from Chart W-12. The three drives down are obvious. You can also see the three drives to the counter-trends. Not what you would anticipate, but a good lesson

in the limitations of this analysis. Notice again how an important low came from a false break, thus giving great credibility to the first higher low.



Often a move will start with two short waves, then accelerate, as occurred in Chart W-14. Of course the "Elliott Question" becomes "is this a weak 'ABC' or two higher lows and the start of a trend?" If volume significantly degrees on the sell-offs, the probability is the start of a drive up.

Chart W-15 is Comex Gold. Down trends can have more than five waves. Many times there have been seven, nine or even eleven waves down. At the December low you can see 3 thrusts down (5 wave structures), but wave 3 was the smallest and the December low was also maximum momentum. So it would appear from those two factors, a new low was probable. The counter-trend ran 13 days (the thirteenth day was a reversal day). Remember, after a series of two or three multi day counter-trends, you can anticipate the next one run as long as 12 days. That really could stop on 10 days or 12 days or as in this instance, reverse on the thirteenth day.

You can also see the counter-trend contained a small 5 wave structure, and not the "A-B-C" classic pattern. Again, volume was very helpful.

Part 4: Wave Structure

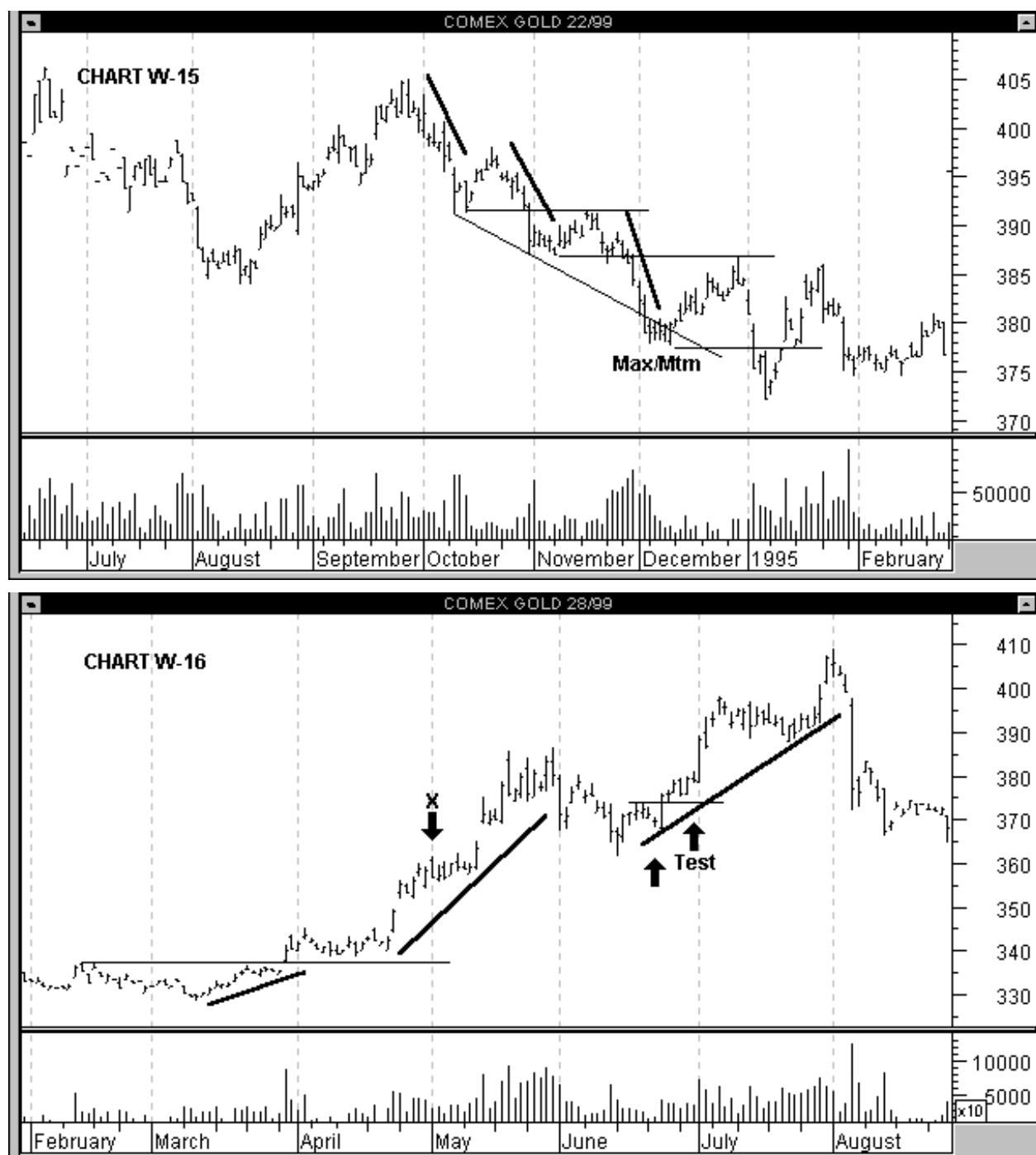


Chart W-16 is Comex Gold again. The first counter-trend stayed on top of the base price broke out from. That counter-trend was flat and should be viewed as four days down with a retest four days later. The next counter-trend was two waves, and lasted ten days down. Notice the first higher low after the two wave completion, and the successful test of that swing high.

The final drive was a clean five wave structure with wave four complex. The congestion at point "X" is the same pattern that occurred on Chart P-2 at point "C" on Page 7 and is a continuation pattern.



Chart W-17 is May Wheat. Starting at the April high, you can see that attempting a wave count when the market can rally only one or two days is not valid. When this does occur, much of the time price will show seven, nine or even twelve waves down. Of course, the space that may or may not develop between the lows and subsequent counter-trend is critical to the analysis. The October counter-trend was 13 days. The next counter-trend was nine days and produced a lower double top (in a down-trending market). That lower double top stopped at the price of the previous swing low, leaving price in a weak position. Also, if this is a counter-trend within a down-trend, then the next movement down will also come from a lower trendline, indicating a possible capitulation. Since the two drives down were equal in points (wave three would be the shortest) we could see a movement larger than the two previous waves. The next counter-trend was two waves in nine days, but was retested on the fourteenth day, showing another lower double top. Price then ran down to show a double bottom in a down-trend. A pattern that is not a high probability low. Price would need to show a higher double bottom or the three higher low pattern before I would believe the validity of a double bottom ending this down-trend.

Wave structure can indicate when your position can be at risk. This could cause you to tighten your protective stops or to possibly exit a position. It is only valid under specific circumstances, and only presents a probability, but when combined with other analysis, it can be a deciding factor.

Part 5

Price Level

Understanding where support and resistance are on a chart is obviously important. However, qualifying the significance of those price zones is more important. Determining the next probable zone is of equal significance. This is all done on the basis of trending, counter-trends or consolidating. With the use of bands, ratios, regressions, moving averages, etc, we can make the calculations of support and resistance zones extremely complicated and essentially useless. It is possible to find support or resistance every few ticks. Qualifying the significance of those price levels in relation to trending or not trending facilitates that process. The knowledge of counter-trend probabilities is obviously the insight needed.

First, let's look at the highest probability points on a chart for support and resistance. The obvious and most significant areas of supply or demand. Although supply or demand areas often occur at approximately the same level in a previous trend, it is not a reliable means of forecasting. Support and resistance within the same trend offer a much higher probability and the price reaction at those levels is more meaningful.

The best way to study trends is to make a book of bull and bear campaigns. If you are going to trade anything, you need to acquire all available data and reproduce charts of each campaign and study how price moves.

Assume you are going to trade gold and your preliminary analysis indicates gold may be in for a big move. The earliest data available from databases is 1972. Information on silver or gold stocks can be acquired with earlier starting dates of data and earlier assumptions could be analysed as to cycles. But let's use the time period from 1972.

First, we determine the largest previous range and divide that range into eighths and thirds. The charts to this chapter are at the end of this chapter in numerical order (Chart G-1 page 55). We can record these prices onto a card as Example #1. Then calculate those same geometric divisions with the next smaller range (Chart G-2 page 56). Fifty percent marks from the previous ranges should always be noted on your charts, even if price has moved out of that range or another range of some consequence had developed. For instance, Chart G-7 on page 62 is a monthly chart with range division from the 1987 high, down to the 1992 low.

If you had been looking for the subsequent rally to show resistance at a retracement value, it would not have been there for over a year. If you look at Chart G-6 page 61 you will see the multi-year rally ran into resistance at the powerful fifty percent mark of the previous range and finally spiked up to the 50 percent retracement of the last range. After the mid-point, the next most powerful divisions are $1/3$ and $2/3$, then quarters, then eighths.

All highs and lows are exact mathematical proportions of previous ranges. Even in the event that price moves out of a particular range, you still need to be aware of that previous range. For instance, Chart G-7 on page 62 has the divisions of the previous range down, even though price

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moved down out of that range, notice how support was shown at 1/4 of that range extended downward. Since the previous high was 50 percent of that range, then 1/4 was a harmonic relationship of 50 percent support was found at fifty percent of that previous range.

This is not unusual. Chart G-8 on page 63 is US T Bonds. If you were looking for support at a retracement of the rally, you would have been disappointed, but if you had been looking at the previous range (G-9 page 64), you would have support at the 50 percent mark. Mr Gann stated that important highs and lows may become fifty percent marks (mid-point of the drive) into the future.

Chart G-10 on page 65 is the S&P cash index during the 1990 decline. The range is from the July high down to the October low. Notice the double bottom at the 50 percent mark. (Point "A") Remember, don't believe double bottoms in down trends. If that low was important, it would project a possible mid-point and indicate the low price. When price rallied out of that low, it found resistance at 50 percent of the range down (Point "B"). At point "C" is the one day counter-trend that leaves a space above the previous swing high, indicating a strong movement in progress.

Chart G-11 on page 66 is the S&P Cash Index Inc. The first range is from the 1982 low up to the 1982 top (Point "A"). You can see the 1987 crash was a 50 percent retracement (Point "B") of that range. When price moved to a new high, the forecasted resistance would be that range added to the 1987 high. Points A, C, D, E, F, G & H where all support or resistance show on that range. You can also see that the higher low after the 1990 decline was on f of that range, indicated by the arrow. But what about the low to the 1990 decline? We had a mid-point projection that was exact, but there should be more. If we use the most current range from the 1987 low (Point "A") up to the 1990 high (Chart G-12 page 67) The support was found on 50%. If we take the last range up (Chart G-13 page 68), February 2 1990 low to the July 13 1990 high, the low was also 50 percent of that range added to the low. So that support was found three ways using previous ranges.

Let's look at the ranges in gold and see if we can learn from the analysis of these ranges. Chart G-1 on page 55 is the largest range recorded from the low in 1976 to the blow off high in 1980. One can see how the first major support can at the 50 percent mark of the entire range (Point "A"). There was significant base building before that rally. That rally carried price up to the 3/4 mark, which was a 50 percent retracement of the movement down, again a normal vibration (Point "B"). The key word here is vibration. If you will view these movements as vibrations, it will be easier to comprehend. After finding resistance at 3/4 of the range, price finds support at 1/4 of the range (equal distance from the mid-point). (Point "C").

NAME

December Comex Gold

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Chapter 5: Price Level

Once it is apparent that a low had formed in June of 1982, a new range would be calculated. This range is illustrated on Chart G-2 on page 56. Notice how the 1/3 and 2/3 points coincide with the high and low to the previous swings.

When price was rallying up from that low (Point "B"), there were other points to consider for resistance. The low before the last high - 527, and the magnitude of the previous rally (230 points). Adding 230 to the June 1982 low gives 541 as resistance. This gives us a zone of 518 to 541. Now, let's look at the range in Chart G-2 on page 56. The two closest resistance points are 1/3 at 528 and 3/8 at 555. Chart G-3 on page 57 is the weekly chart divided into those significant range divisions in monthly Chart G-2 on page 56. The second higher low was on the first 1/8 division. There was also a space between the previous swing high and the 1/8 division low (which was also, successfully retested). We could assume a new high would complete the wave structure. The previous swing developed from a 1/3 vibration. If we use the same calculation, we get an objective of 547. Chart G-4 on page 58 is a daily chart of the same time period. Is there anything in your analysis of wave structure and pattern that could indicate a complete movement? Chart G-4a on page 59 is the same picture, with volume included. The marginal new high was on less volume (the first of February). The four day retest (counter-trend?) was on significantly less volume. This drive took ninety-three calendar days. You can also see how volume decreased on the counter-trend lows.

What do we know about price support and resistance? That previous high and low within the current trend or sideways pattern will offer support or resistance. The low before the final high may offer significant resistance. The geometric division of the previous range, especially the mid-point, will offer resistance or support. The vibrations with the current range can offer a projection of resistance into the next range of movement. Important highs or lows can become 50 percent marks into the future, and depending upon the probabilities, can become a marks.

Let's look at a popular Australian listed stock - BHP, with respect to using previous ranges to project resistance for the next leg of movement. Chart H-1 is a monthly chart of BHP. The first range of movement (first leg up) from the 1982 low up to the 1987 high lasted 57 months. The retracement of that drive fell to the 50 percent mark during the sixtieth month from low (Point "A"). That move down was three months and is the normal counter-trend on a monthly chart. On occasion, momentum or pitch can slightly overcome these strong levels, but notice how the retest held the mid-point.

Now look at the projections from that range. The high was exact on 5/8 (Point "B"), and the lower high was at the 50 percent mark (Point "C"). The bear run down stopped at the top of the previous leg up, thus holding a strong position (Point "D"). Chart H-2 shows the range divisions of that leg up, from point "A" to point "B". The retracement of that leg also stopped at 50 percent

(Point "C"). Resistance was found at the 50 percent projection (Point "D") and the final high was at the 5/8 mark (Point "E"), as was the high of the previous leg up. With large capitalizes stocks such as BHP, time is usually needed for distribution before a change in trend can take place.

Notice there are seven legs to each wave, emphasizing the importance of historic research. When point "D" was hit, I felt another drive was possible to match the two previous drive of seven waves.

Another example of how to project with a swing range, is found on Chart H-3. the range from point "A" to point "B" has been divided into its proportionate parts. The retracement of that range fell to the 3/8 mark (Point "C"). When price moves to new highs and hits the 3/8 mark above point "B", that makes point "B" a 50 percent mark and therefore possible resistance. When a drive retraces between 1/4 and 3/8, it is indicative of a strong trend and evidence is needed before taking a short or put position. In this instance, point "D" has price gapped up into the 3/8 mark, then gapping down. There is also a pattern that indicates a lot of resistance. That pattern consists of three thrusts that cannot advance very far and pull back significantly below the swing high of the previous rally. The completion of this pattern would be confirmed by the day and a half counter-trend at point "E".

Chart H-4 is a continuation of that previous movement. The range down from point "A" to "B" is divided into its geometric divisions. The high at point "C" was a a projection. The sell off from that high found support at 50 percent of the range from "A" to "B". Notice the wave structure, with wave 3 subdividing and wave 5 showed seven waves into competition. Remember, these resistance levels represent probabilities. You need confirmation from pattern, wave structure and volume to justify selling the new high at point "C". Chart H-5 shows the range from the 1987 low up to the 1996 high. The low at point "C" was a 50 percent retracement, and since this stock has a history of retracing 50 percent, this was quite probable.

There is one last method to determine support or resistance levelsbut it is used only in a bear campaign. Once 50 percent of the last major range is broken, you should divide the high price into eights and thirds. Of course, 50 percent of the high is the strongest support. If this is a valid price vibration, the rallies will also be stopped by those divisions. Chart H-6 is BHP division of the high. You can see support was shown at 3/8 of the high, as also was resistance shown at the 1/4 geometric division of the high. This support coincided with the 50 percent mark (Chart H-5).

When something is trending, the counter-trends will likely be close to a one to one relationship with the previous correction. Chart G-14 is a chart of the S&P cash index during 1986-1987. I was trading options at this time. Due to the analysis of pattern, wave structure, price and volume, I felt a new high at point "A" would be a good high risk point to purchase a few puts. This is top picking to a high momentum movement, and obviously a high risk trade, and one that I

Part 5: Price Level

would not attempt today, but the S&P trades 90 day blow off cycles and price was approaching the end of that cycle. So when the last rally started up into point "A", I bought some puts the first time price broke a daily low. The next day price went marginally higher and closed weak. Now I had a good place for a protective stop - marginally above that high and I was to add to the position upon breaking that daily low.

So I owned a small put position at point "A". Now, I needed a place to sell my puts. First, I did the range divisions. Then I noted the number of points to each counter-trend movement. Those are noted on the chart. The last three corrections prior to point "A" had two days and 8.7 points, then one day down and 8.2, then one day and 5.8 points. From our pattern analysis, we know this is how "blow off" movements terminate. If the trend is going to reverse or consolidate, price should exceed (overbalance) the largest previous swing in the drive up. That was 13.6 points. One could also, determine that if the trend were to continue up, the low would likely match the 13.6 point correction. The largest correction in time was two days or 19 days. Remember, there is no retest, no counter-trend rally, no distribution pattern, just a possible high point. My job is not to pick the bottom, but to determine when my position is at risk in relation to the up-trend, and then close the position out when those price or time parameters are met. We know the normal counter-trend move in a strong move is three days, so three days down or thirteen points, whichever comes first - we'll exit. The arrow marks thirteen points. That was a sixteen point move down. The next day was an inside day, and the next day was an attempt at the low followed by a strong close. Price overbalanced but time did not. Maybe the trend is going to continue up, or offer a distribution pattern (false breakout). The next day, I buy some calls with a stop below the low of that day (Point "B"). Three days up, my position will be at risk. The next day price gives a wide range up, but this is the third day, so I sell my calls. The following day is a small range and retests the old high. The next day the market went to a new high, but could not hold it, and by mid-morning, I had the put position back.

What is my objective now? The largest move down prior to thirteen points, was twenty-six points or a target of 278. Viewing the range - one-quarter is 284, two-thirds is 278, three-eighths is 275. If one assumes that the last low becomes a 50 percent mark, then 278 is an objective. Since counter-trends are one to four, or seven to twelve days, this circumstance would fall in the seven to twelve category. If price falls seven days, my puts become at risk. So, whichever comes first - 278 or seven days, I'll close out my put position. The second arrow is 278. One should use precision to enter. However, exit when one can determine the position is at risk, especially if you are positioning against the trend. When trading with a trend, there are many times when the best strategy is to trade partial positions.

Chart G-1

COMEX GOLD 32/99 Monthly, T SQ-859.9@800131@959.9, Sc: 6.0 Bot: 90.0 Top: 990.0 1H: 1.0

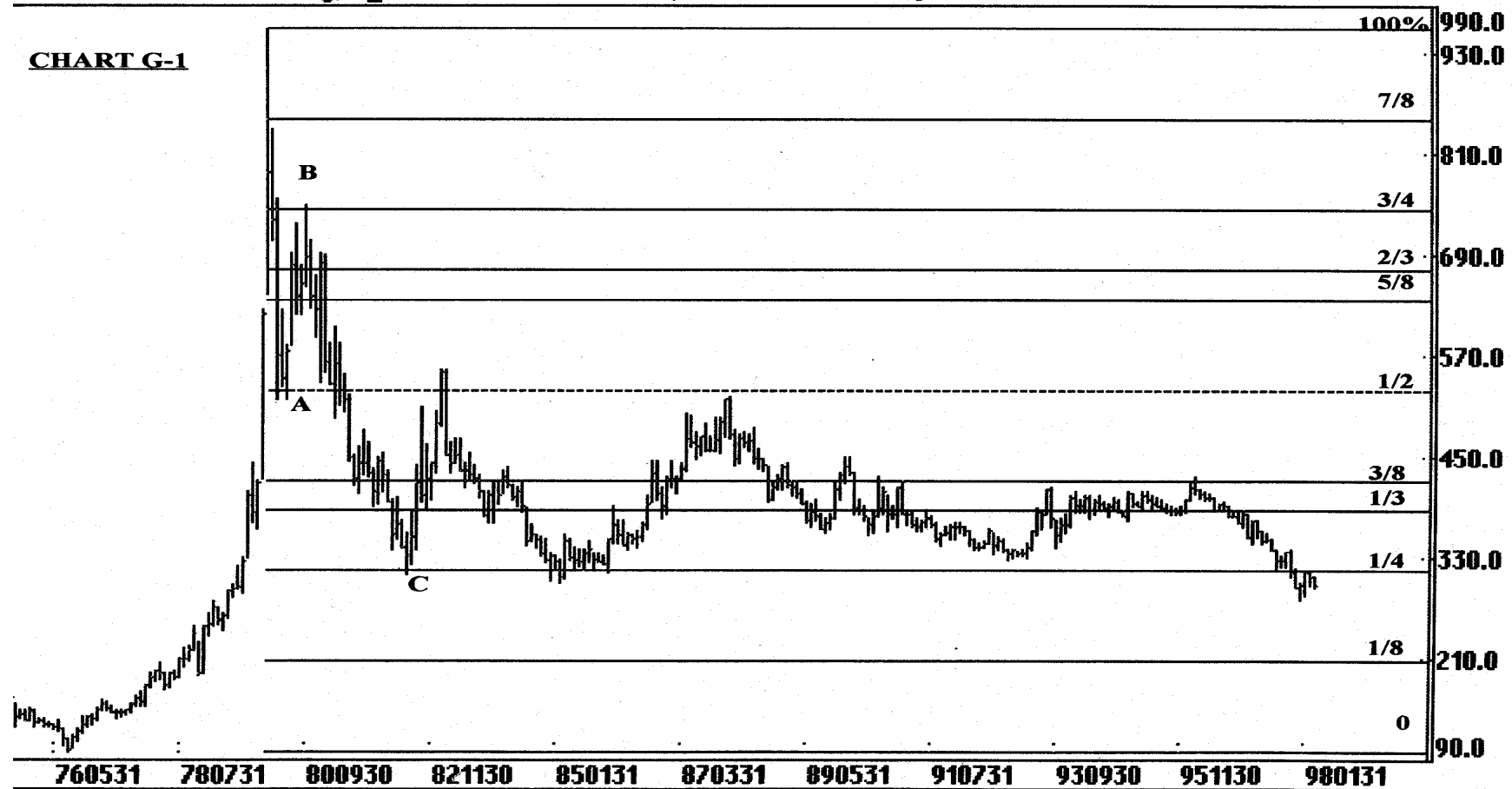


Chart G-2

COMEX GOLD 32/99 Monthly, T SQ-648.4@820630@311.5, Sc: 8.0 Bot: 0.0 Top: 1200.0 1H1: 1.0

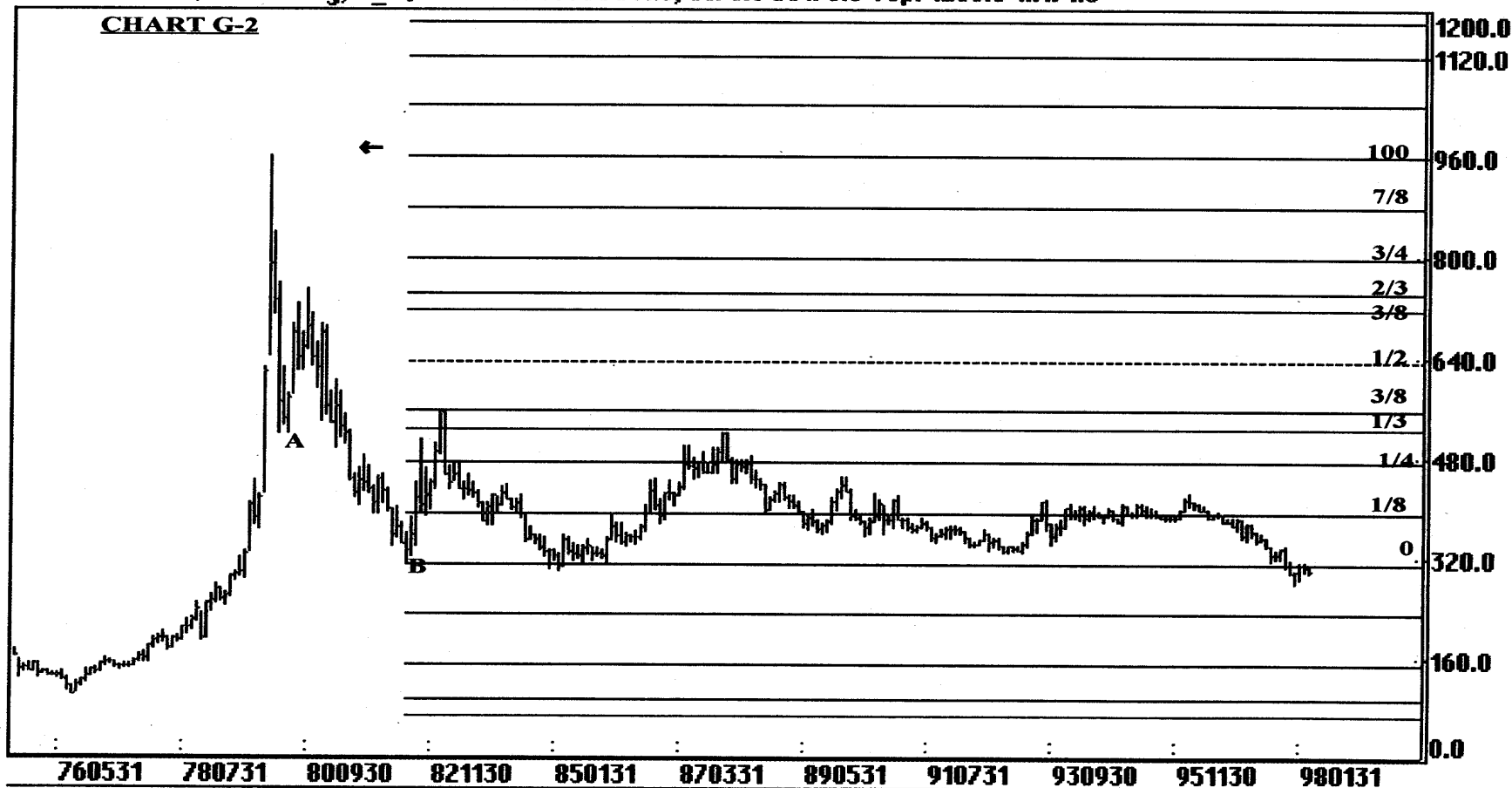


Chart G-3



Chart G-4

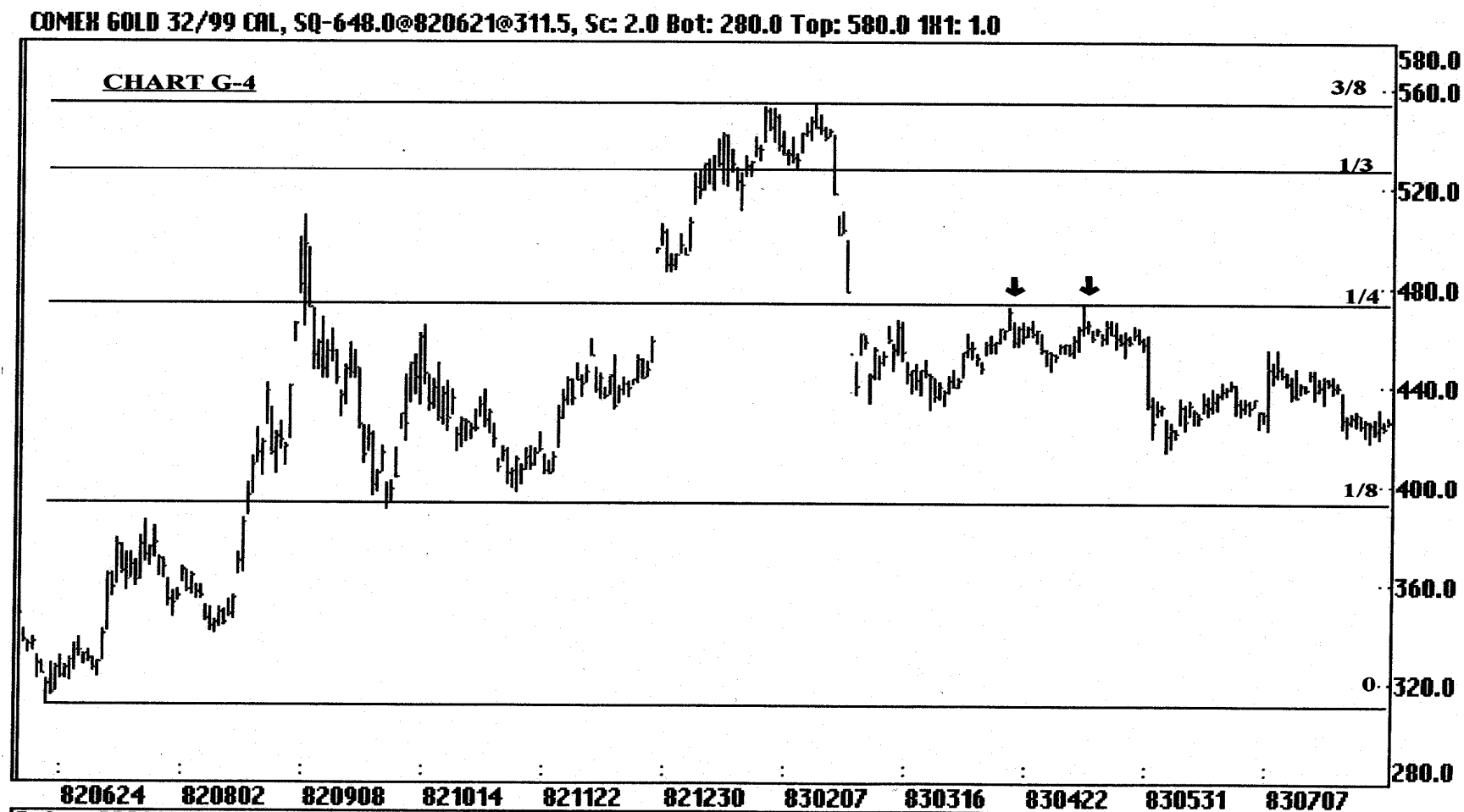


Chart G-4a

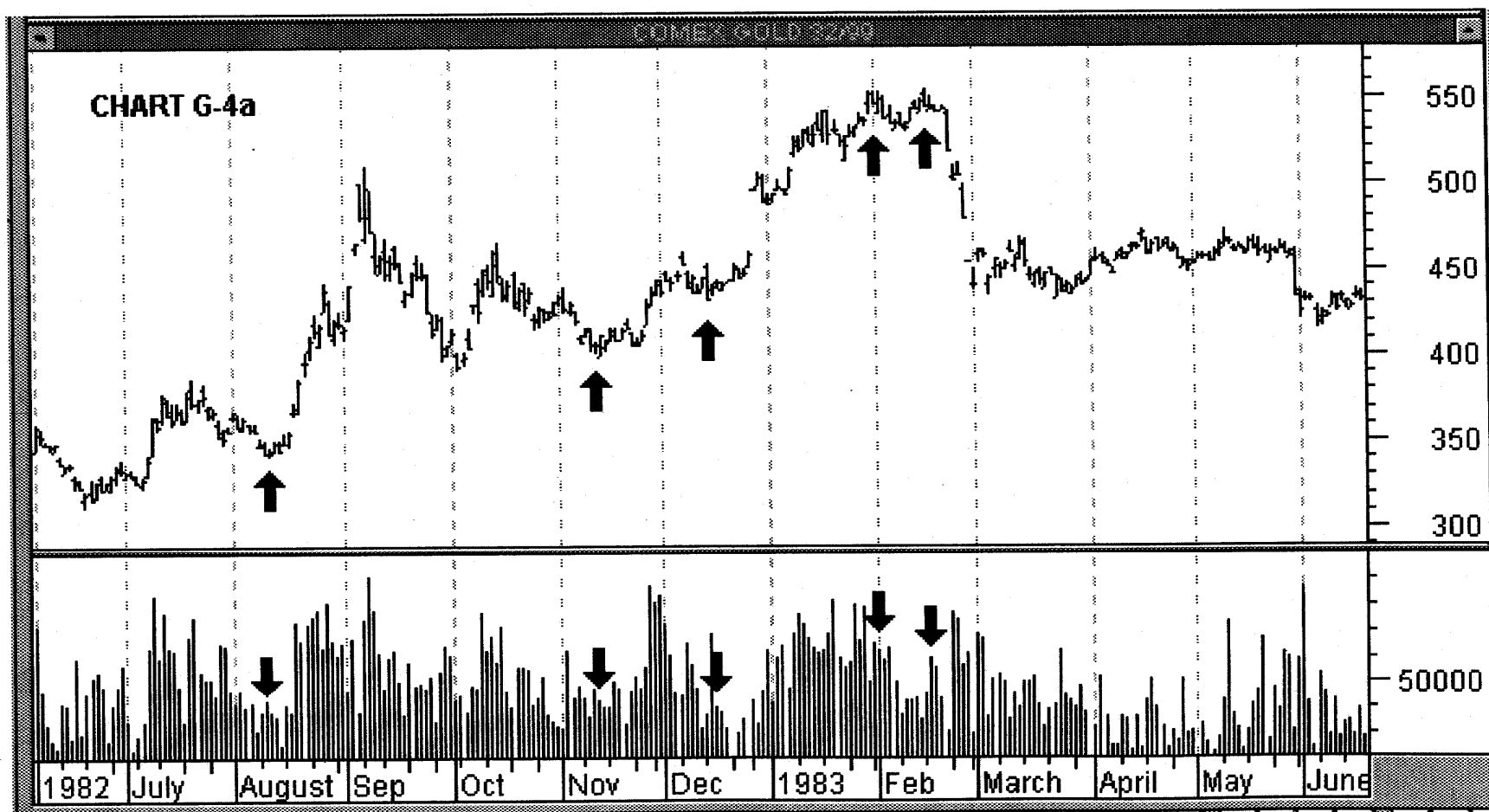


Chart G-5

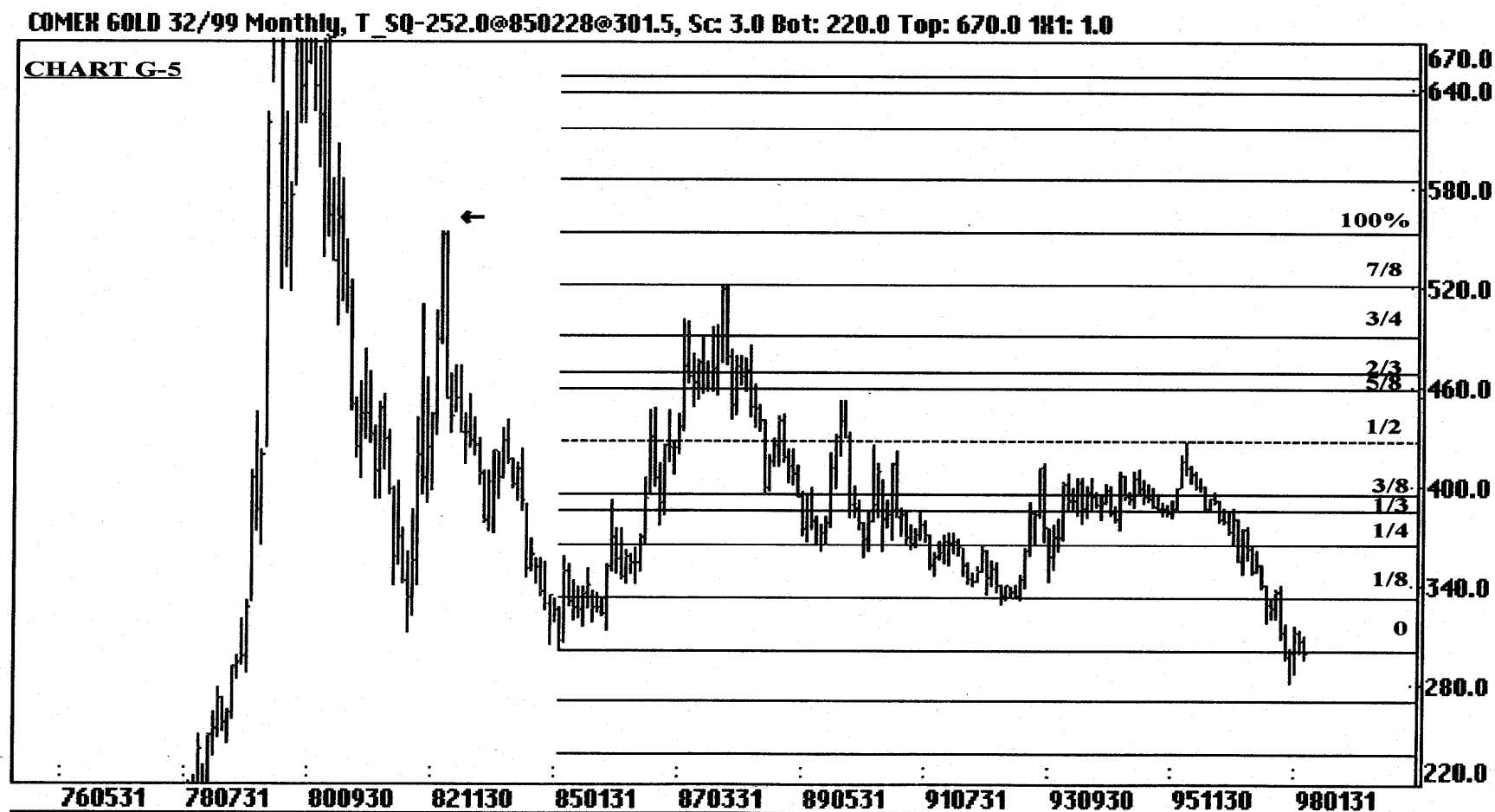


Chart G-6

COMEX GOLD 32/99 Monthly, T SQ-219.0@880131@520.5, Sc: 3.0 Bot: 220.0 Top: 670.0 IH1: 1.0



Chart G-7

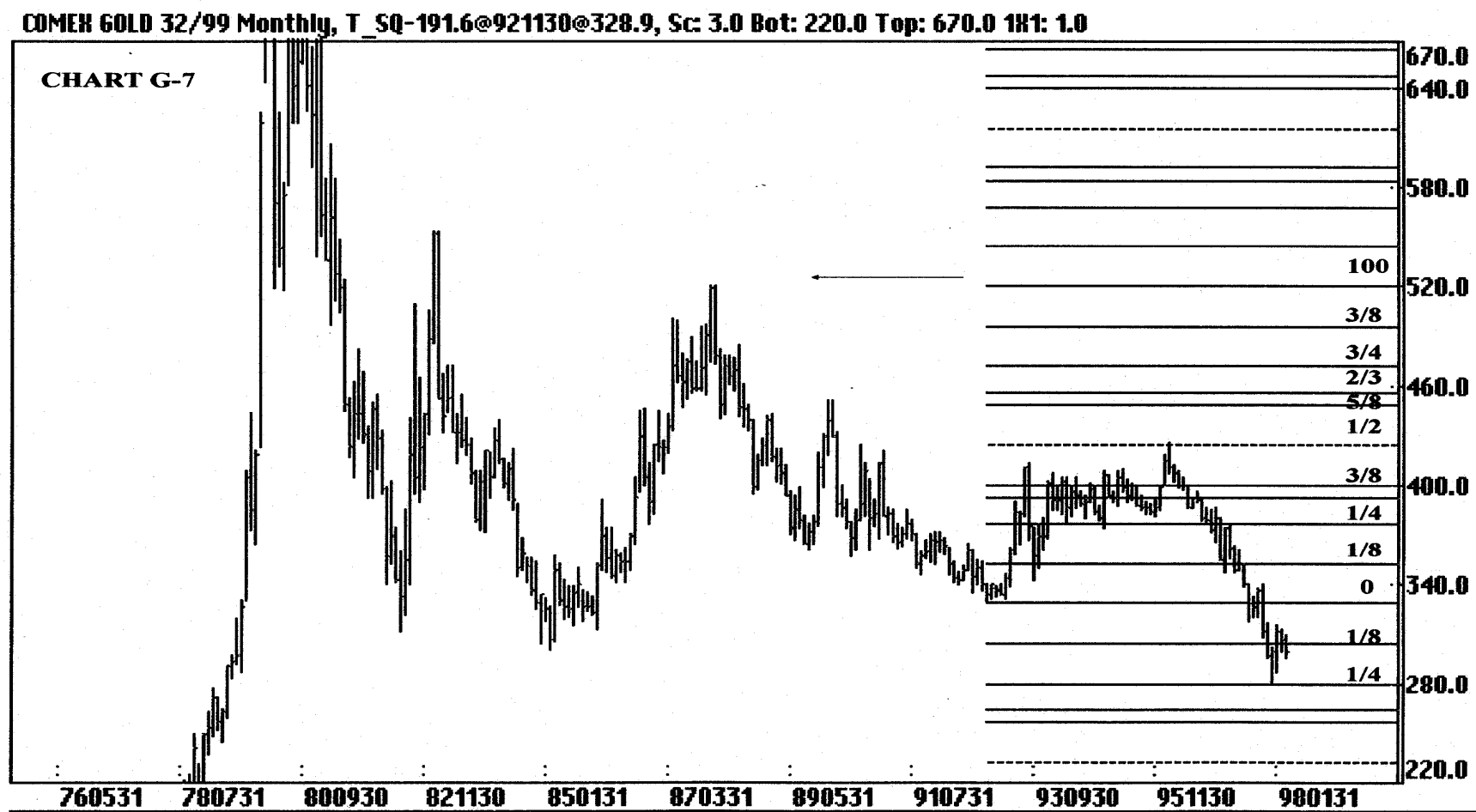


Chart G-8

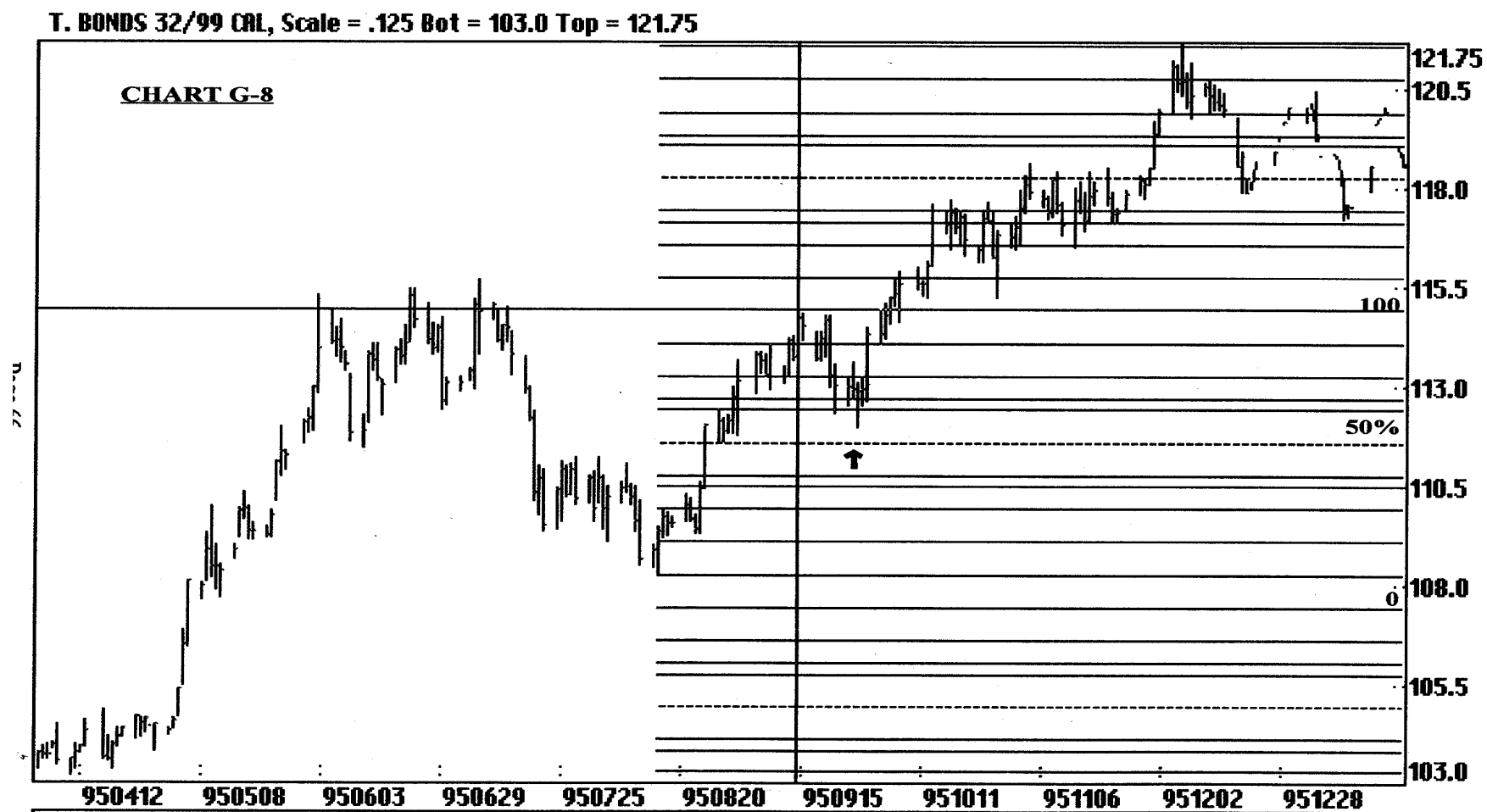


Chart G-9

T. BONDS 32/99 CBL, T_SQ-7.4062@950707@115.69, Sc: .125 Bot: 103.0 Top: 121.75 HK: 1.0

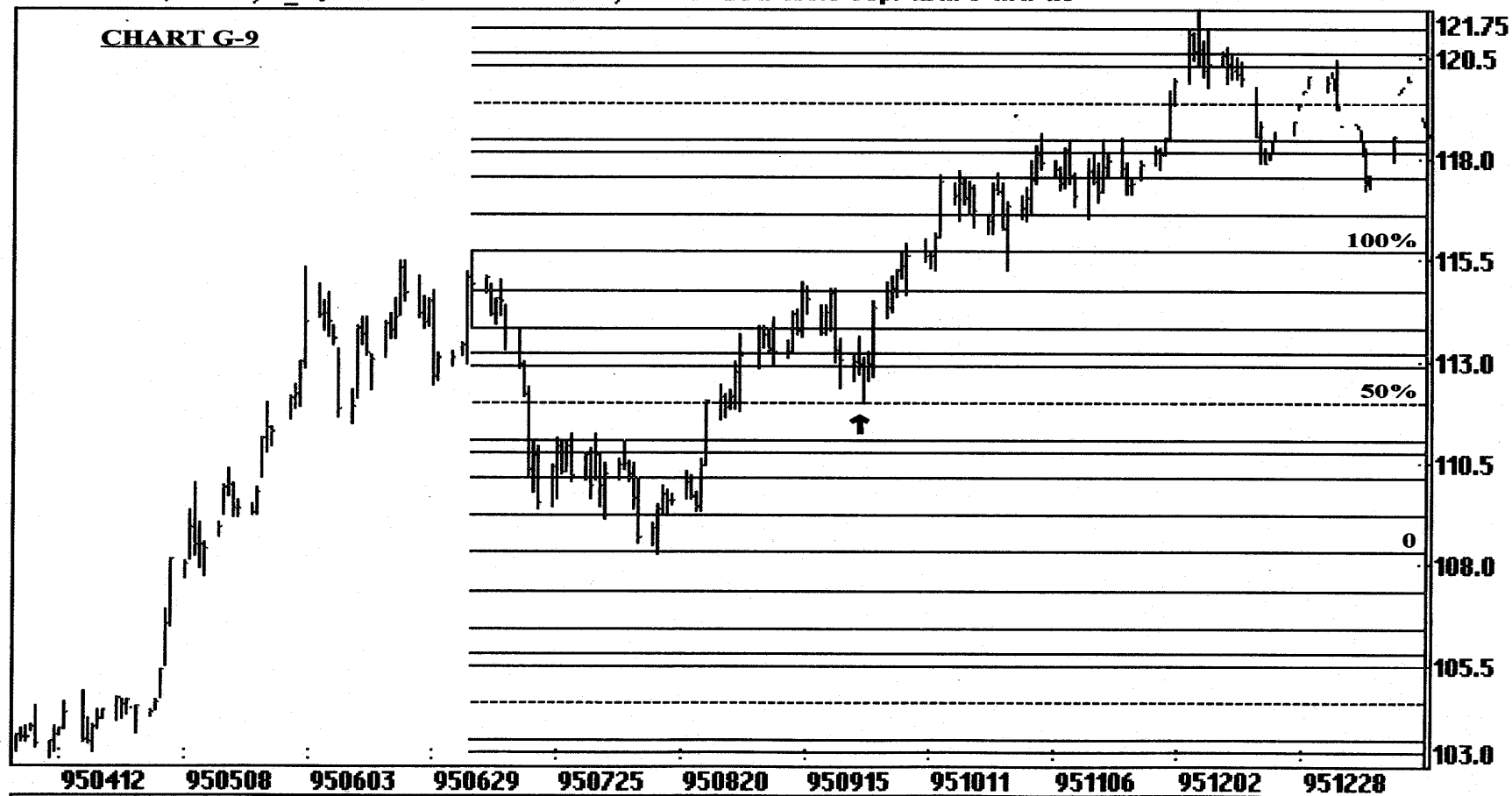


Chart G-10

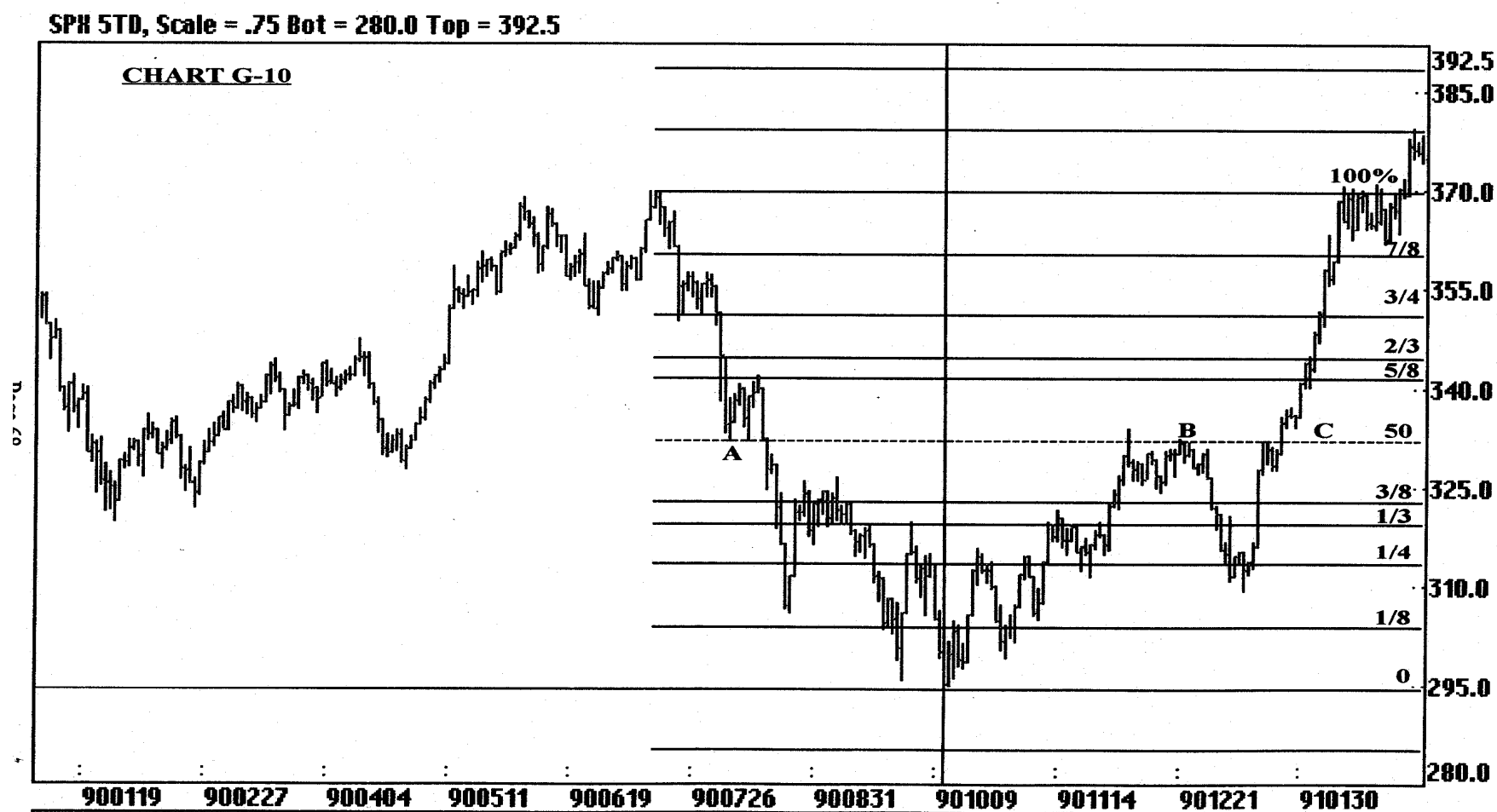


Chart G-11

SPX Weekly, T_SQ-236.45@870828@337.89, Sc: 2.0 Bot: 170.0 Top: 470.0 1H1: 1.0



Chart G-12

SPX Weekly, T_SQ-153.22@900713@369.68, Sc: 2.0 Bot: 185.0 Top: 485.0 HK: 1.0

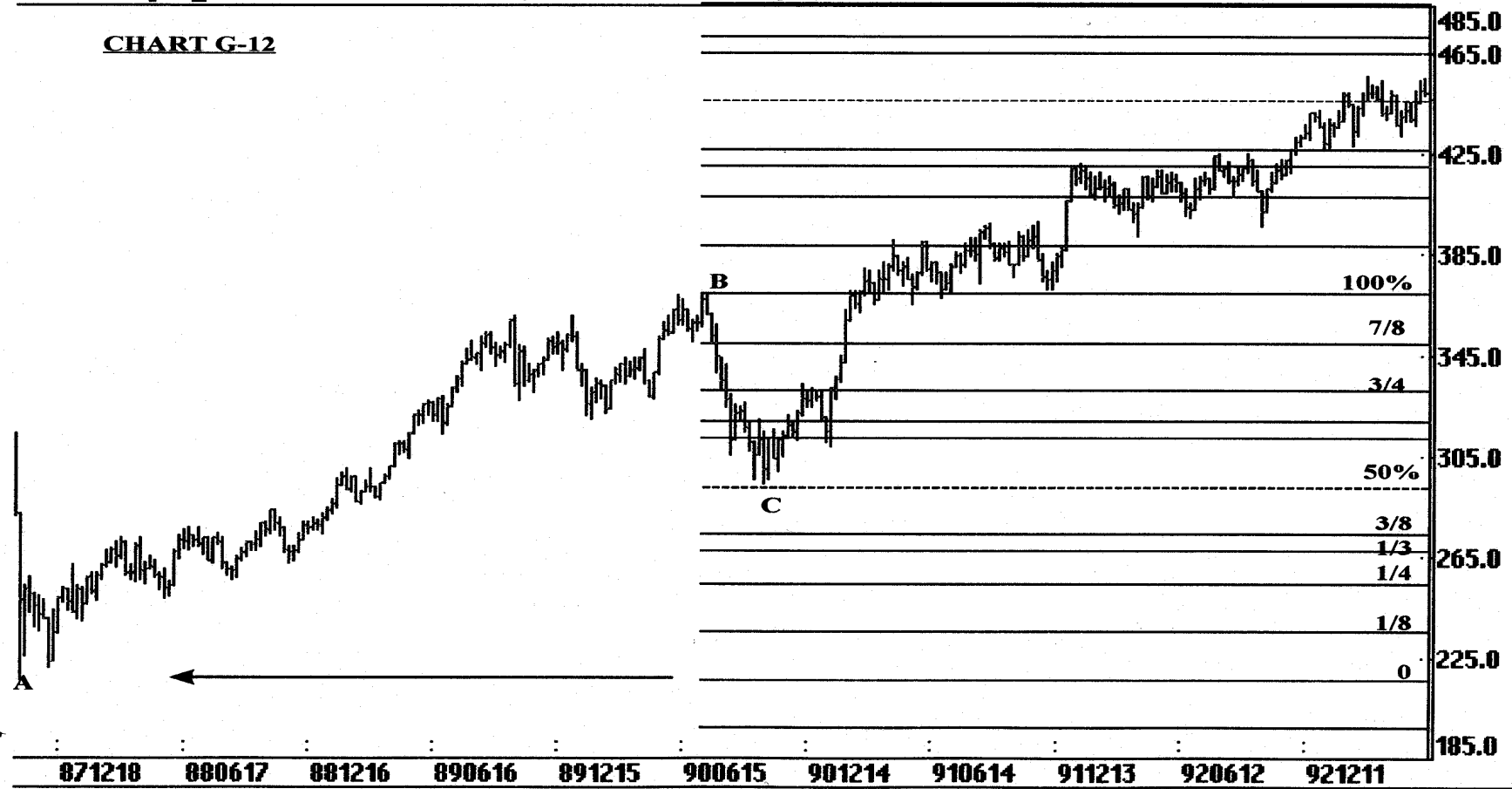


Chart G-13

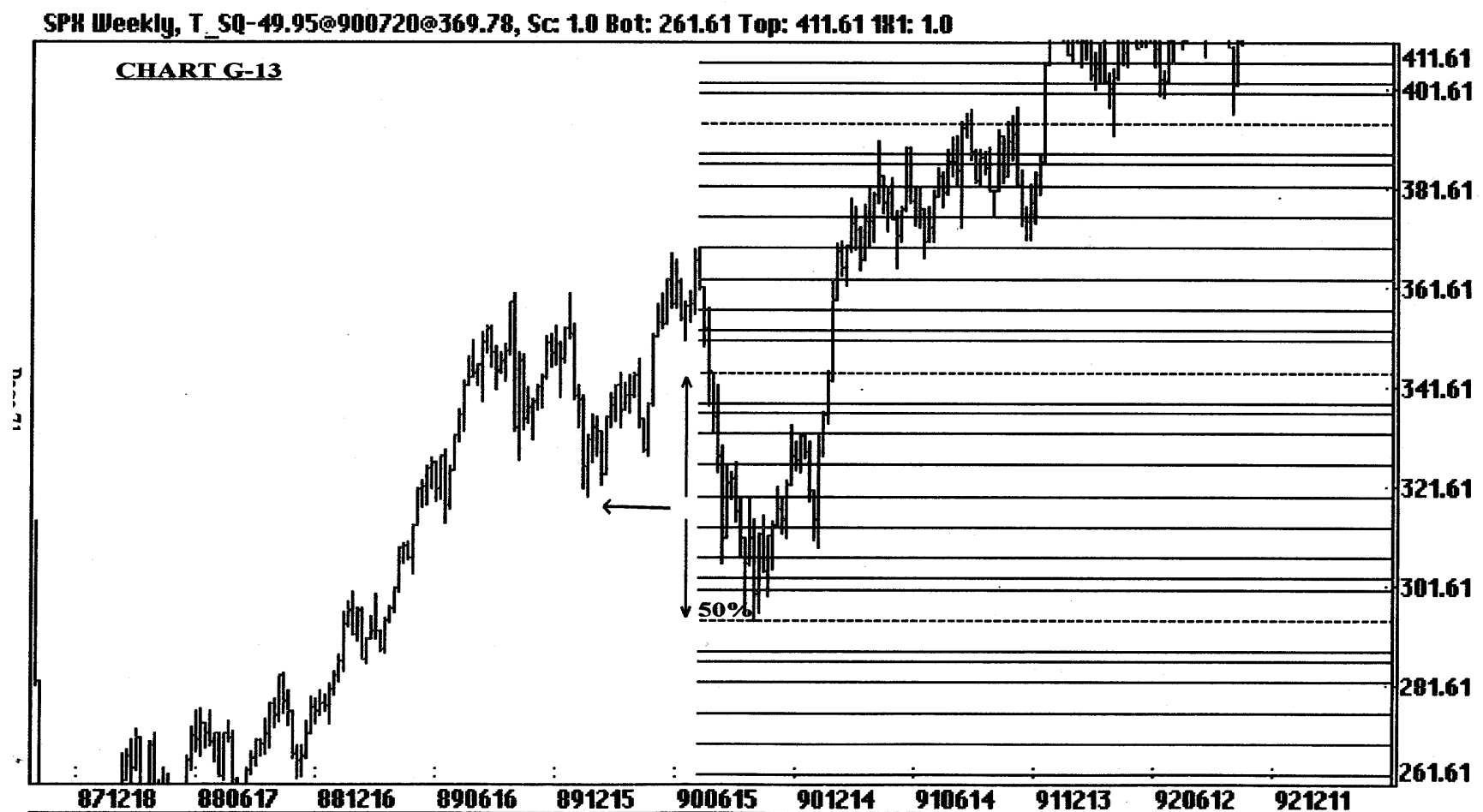


Chart G-14

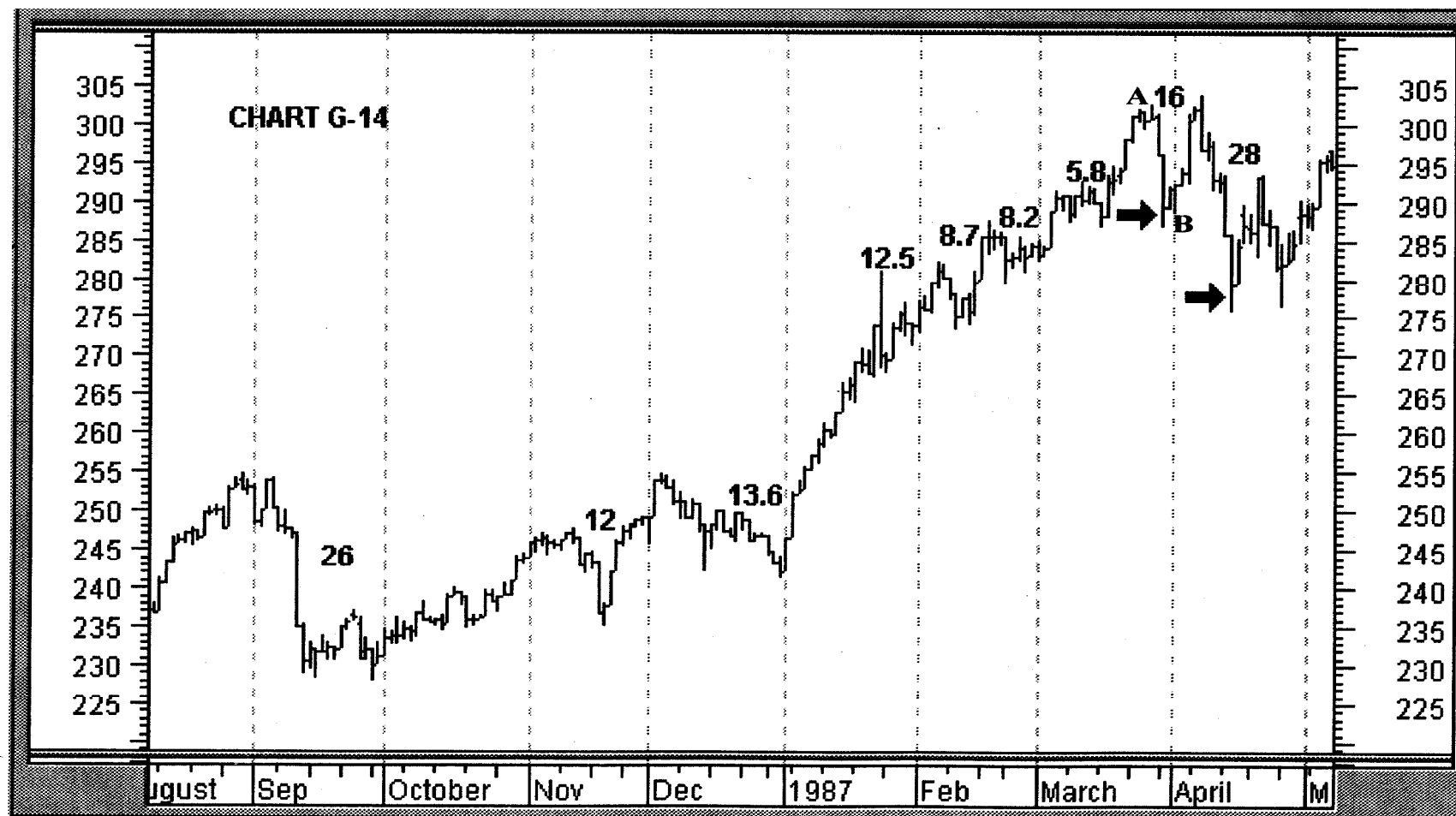


Chart H-1

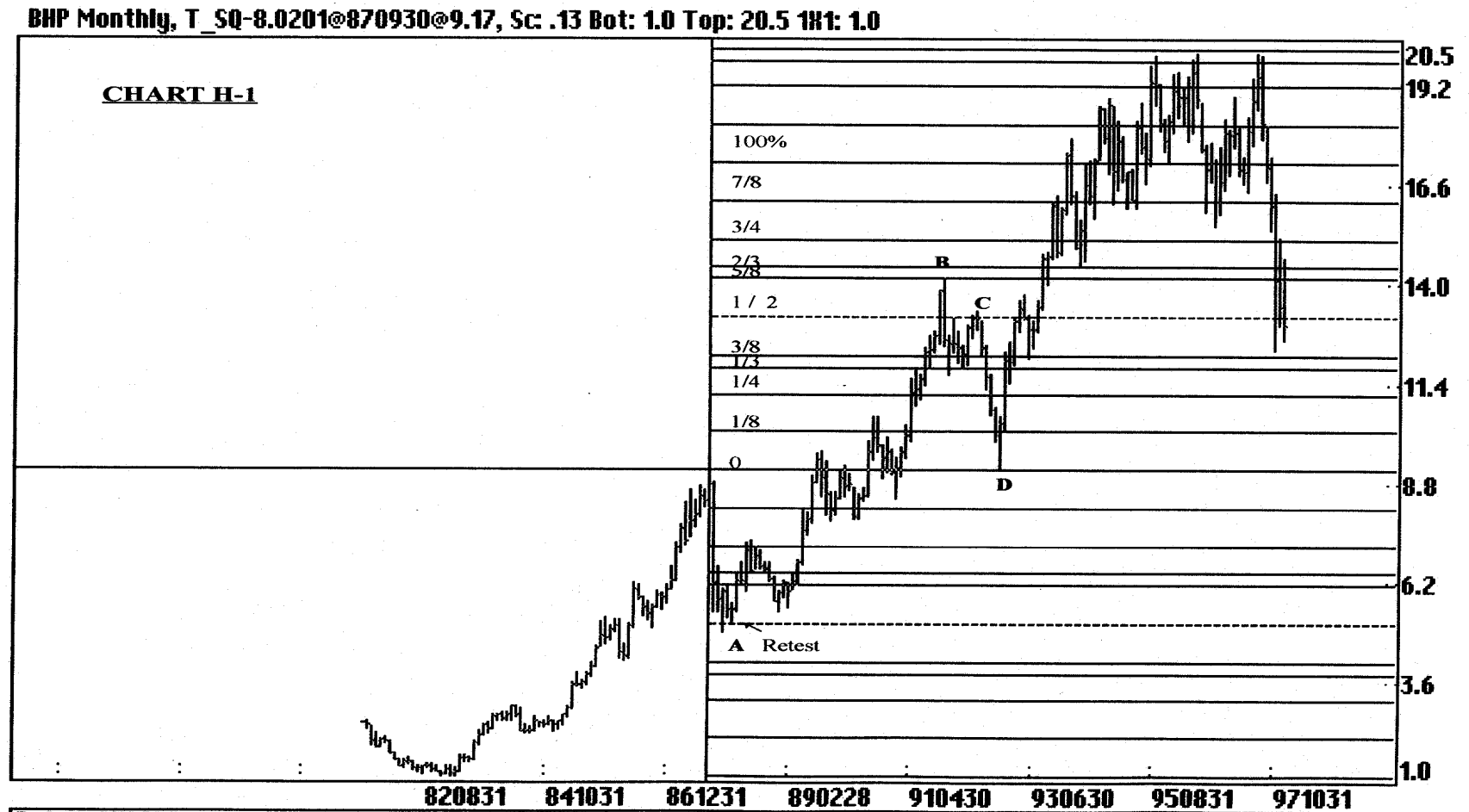


Chart H-2

BHP Monthly, Scale = .13 Bot = 1.0 Top = 20.5

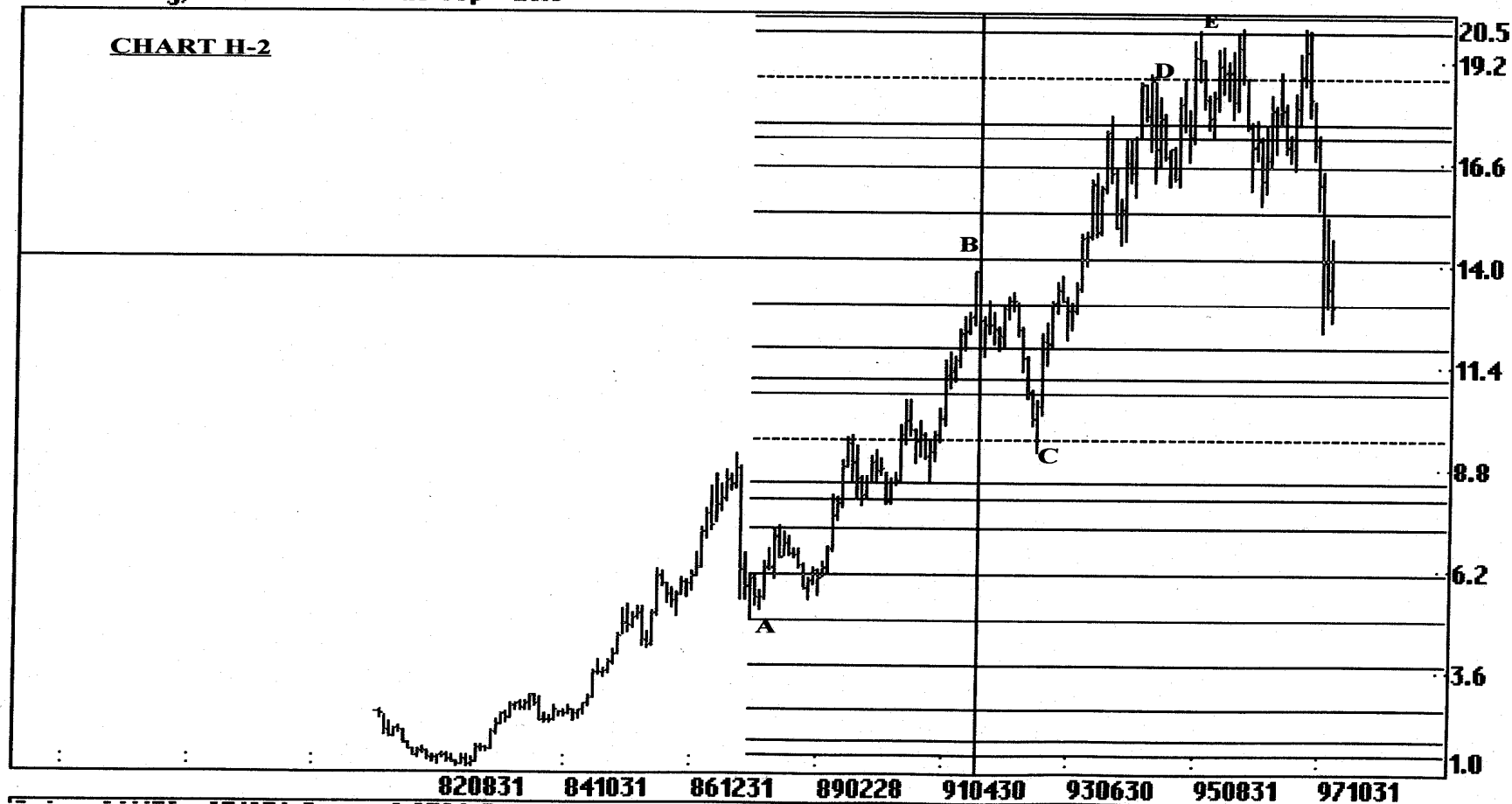


Chart H-3

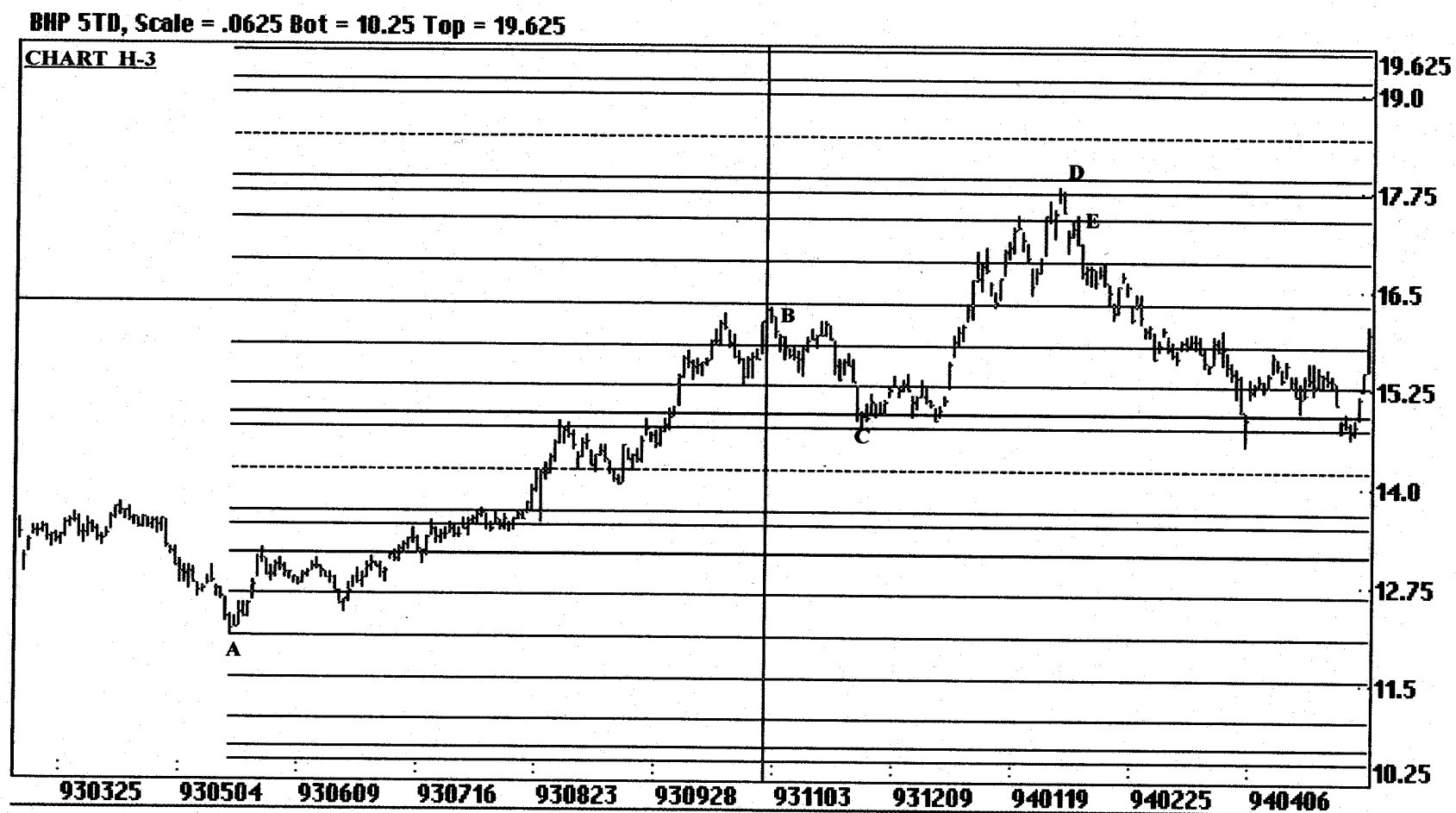


Chart H-4

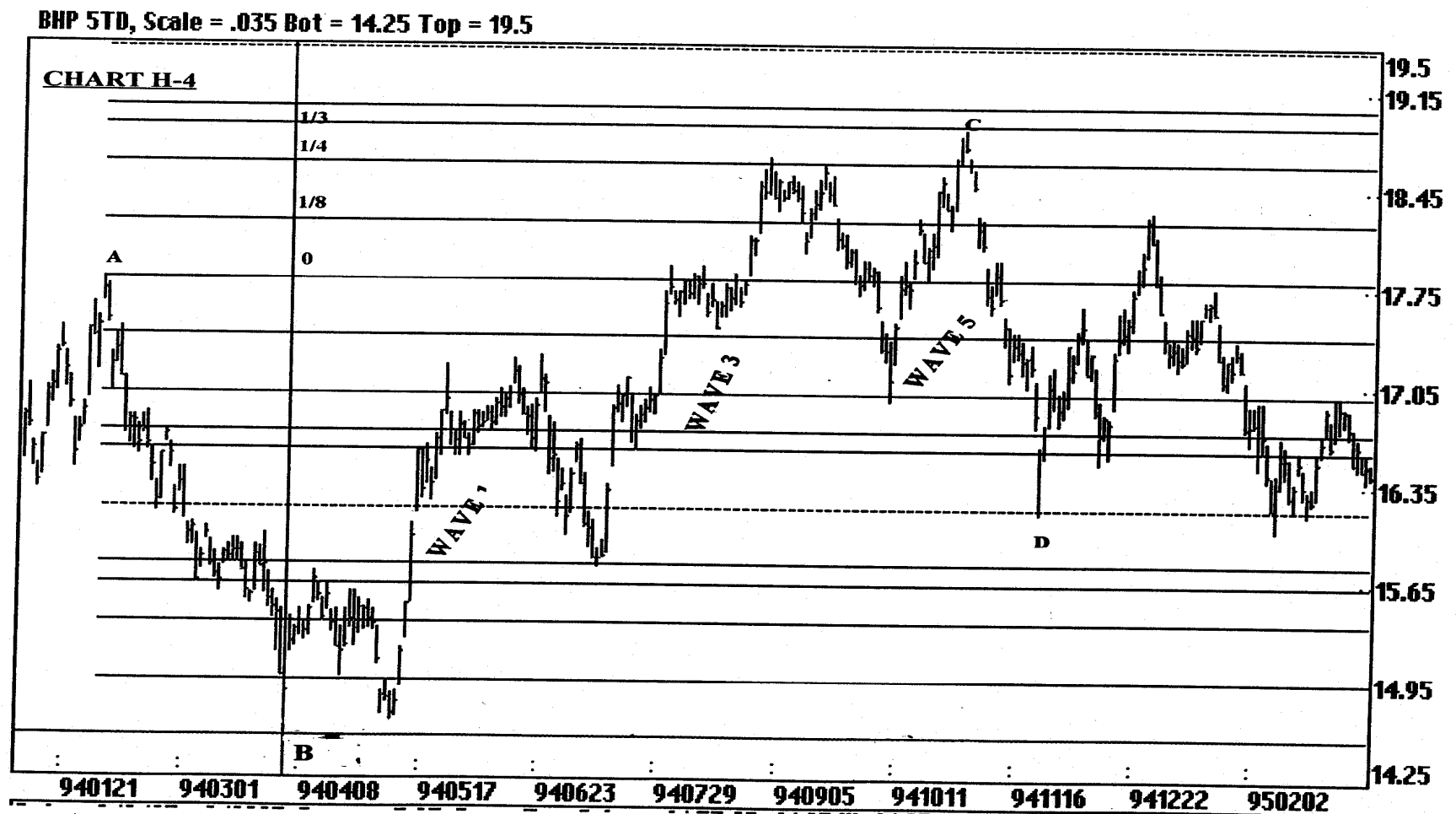


Chart H-5

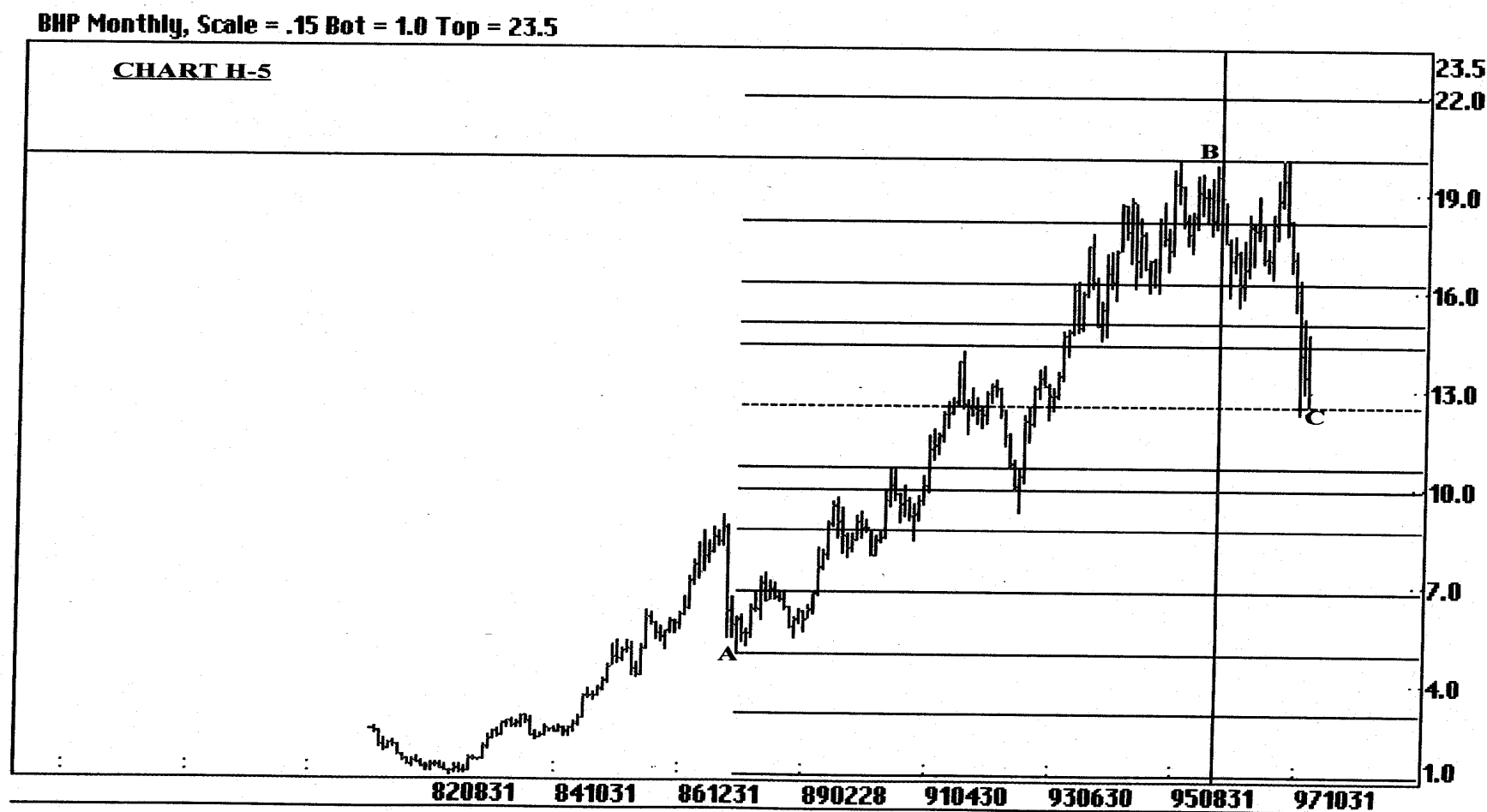


Chart H-6

