

SIGNALS GENERATED BY PRICE ... POWERFUL STUFF

Oscillators generate buy and sell signals, but sometimes they can get you in late or get you out late. On the other hand, signals generated by price can get you in and out earlier.

Inside days, or bars, are just one such price pattern that I'll start off with as an introduction to this powerful concept. The other price patterns are presented as you read on in this package.

An inside day is a two-day pattern with the first day consisting of a fairly sharp rally, and the second day's trading range completely encompassed by the first. This indicates that buyers have run out of steam, and are unable to push prices higher. Too much chocolate.

Inside days typically occur after a persistent short-term rally. But, when you see an inside day forming, it's often difficult to know if this particular price signal is worth reacting to. As confirmation, you can use stochastics to filter the move. In other words, is the tradable oversold or overbought, because only then will you be absolutely sure if the signal is correct. You want to make sure that you are trading with the trend.

The inside day price pattern is just one of four price signals. They are all presented in detail in the following pages. These are perhaps the most powerful indicators you can employ that will guarantee timely execution of winning trades.

I have also included some documentation on how to recognize a "Swing Change", and a price pattern called "TD DIFF", which is equally as powerful as the four that precede it – Inside Bars, Two-Bar Reversal, Outside Bars, and Key Reversal Bar. I would also encourage you to read up on pivot points in my book, and check out "Gaps" at www.tradingsmarts.com/gaps.htm.

INSIDE BARS

- 1. This pattern should be preceded by a sharp up or down price move. The formation of inside bars without a preceding strong trend generally does not signal a sudden balancing of supply and demand.**
- 2. The trading range of the first bar should be wide by previous standards. This confirms the strong underlying momentum of the prevailing trend.**
- 3. The trading range of the second bar should be much smaller than the first, which tells us the balance between buyers and sellers is much more evenly matched and the balance is tipping. The sharper the contrast between the two bars, the greater the potential for a reversal.**

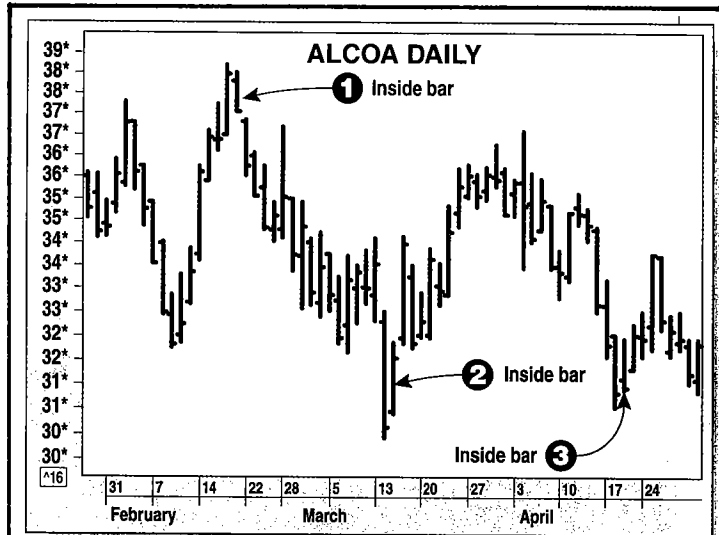


FIGURE 3: INSIDE BARS. When an inside bar forms after a runup or down, it's a signal that the balance between buyers and sellers may be tipping.

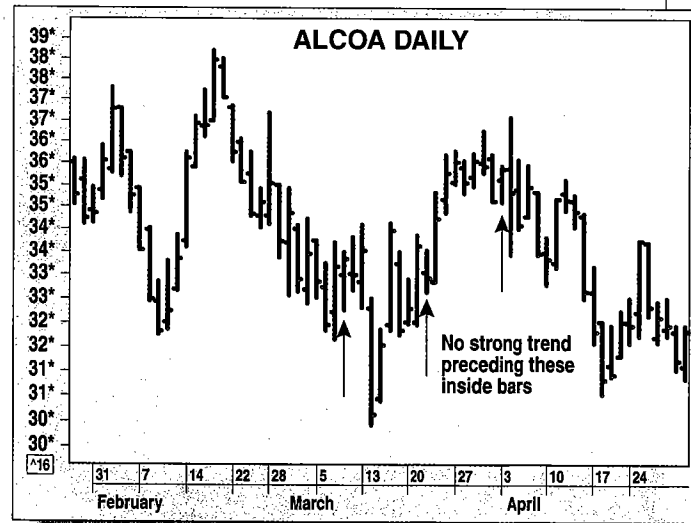


FIGURE 4: INSIDE BARS, BUT... The formation of inside bars without a preceding strong trend generally does not signal a sudden balancing of supply and demand. As a result, no indication of direction is given.

TWO-BAR REVERSAL

(RAILWAY TRACKS)

- 1. Signals exhaustion. Develops after a prolonged advance or decline.**
- 2. The first bar of the formation develops strongly in the direction of the prevailing trend. In an uptrend, we need to see the close of the bar at, or very close to, its high.**
- 3. At the opening of the second bar, the price should open very close to the high of the previous bar.**
- 4. A change in psychology takes place as the second bar closes slightly above or slightly below the low of the first bar, indicating a change in trend.**
- 5. To be truly effective, this must be a climactic experience. The two-bar pattern really needs to be preceded by a persistent trend, and the two bars in question should stand out as having exceptionally wide trading ranges.**

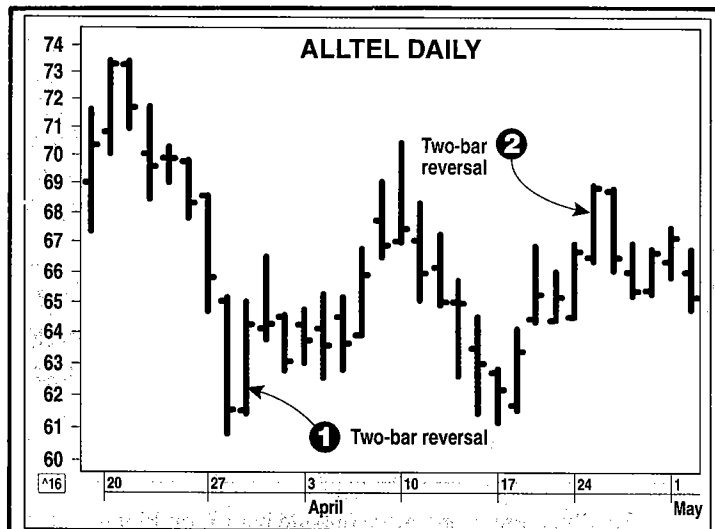


FIGURE 5: TWO-BAR REVERSAL. Prices start out in the direction of the trend, but by the end of the bar, they have dashed all expectation by reversing and closing near the previous bar's high/low.

OUTSIDE BARS

- 1. The trading range encompasses that of the previous bar. They develop after both down- and uptrends and represent a strong exhaustion signal.**
- 2. The opening price is at a higher level than the previous bar's close, but the closing price of the outside bar is not only down on the period, it also closes below the lowest point of the previous bar. If the price closes down a little, it is not as strong a signal as if it closed down sharply.**
- 3. Alternatively, prices open lower, then go lower still, before finally closing up on the bar.**
- 4. If the outside bar encompasses the trading range of three or four bars, it is likely to be more significant than if it barely encompasses one.**

CONSOLIDATION OR CONTINUATION OUTSIDE BAR

- 1. As an example, coming into such a bar in a declining phase, the bar opens on a positive note – on the high, above the previous close.**
- 2. Then, for the rest of the period, prices decline and the close develops at the bottom of the bar.**
- 3. This is definitely an outside bar, but the fact that it closes so weakly indicates it is not an exhaustion move in the classic sense.**

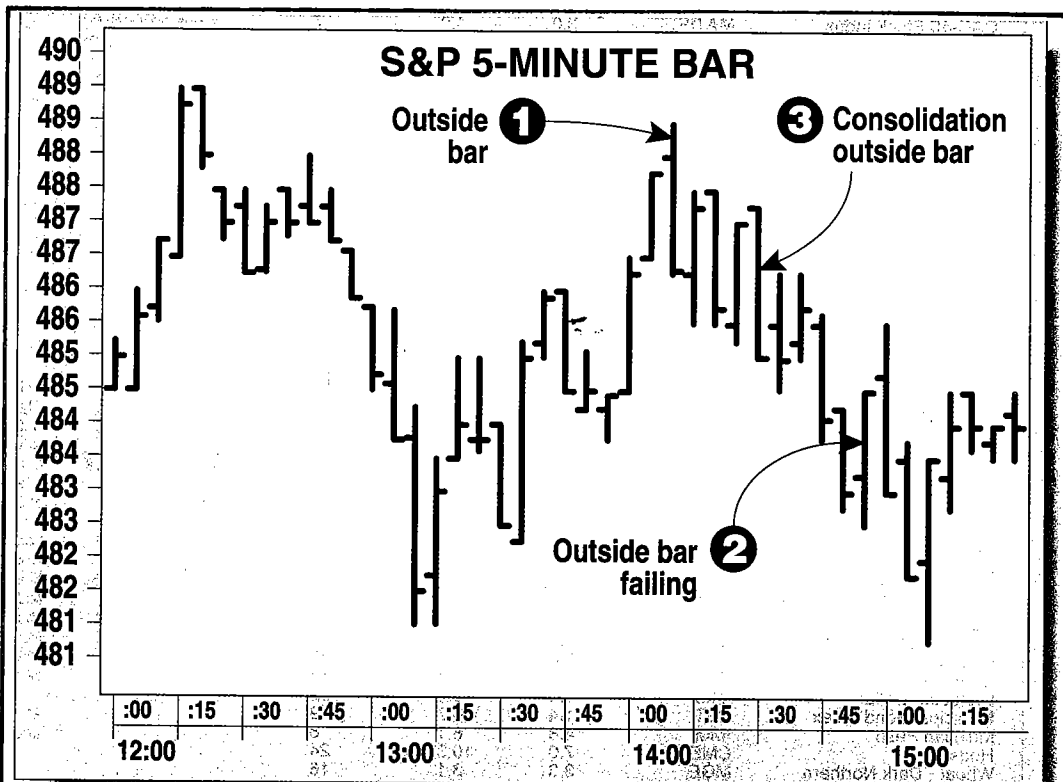


FIGURE 1: OUTSIDE BAR. Outside bars are bars in which the trading range totally encompasses that of the previous bar. They develop after both down- and uptrends and represent a strong signal of exhaustion. Here, you can see the low was achieved around one o'clock and the price zigzagged up for just over an hour. Then we reach a bar (1) that totally encompasses the trading range of the previous one. Note also the opening price developed at a higher level than the previous bar's close, but the closing price of the outside bar was not only down on the period, it also closed below the lowest point of the previous bar.

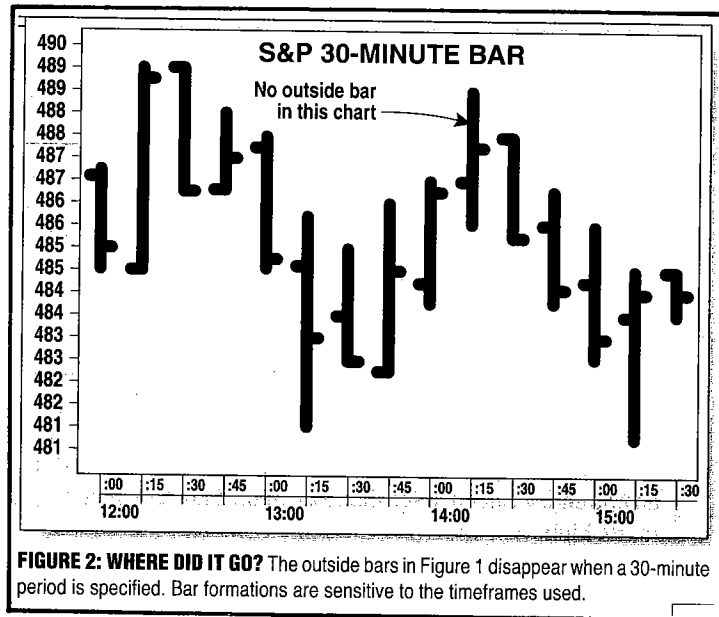
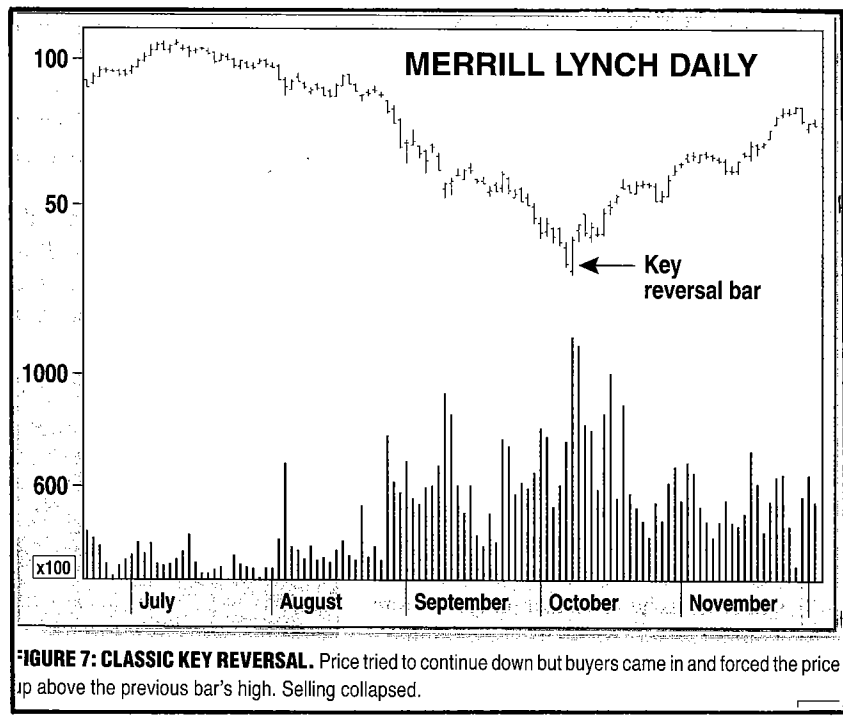
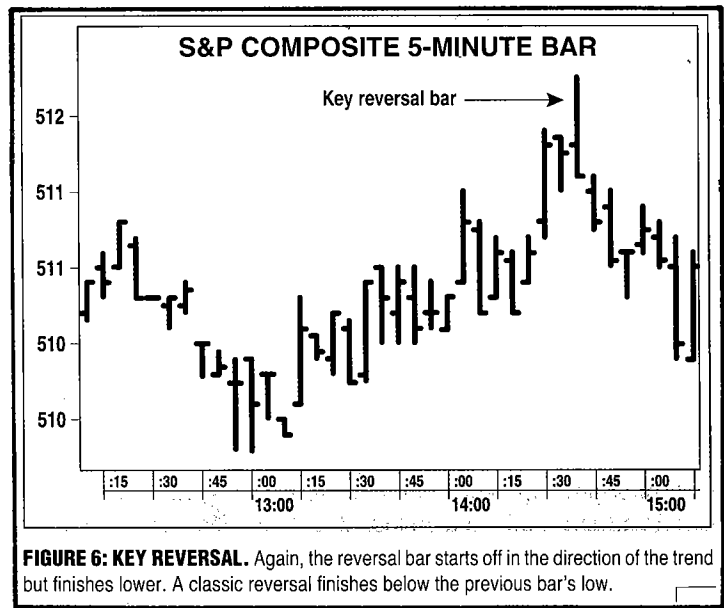


FIGURE 2: WHERE DID IT GO? The outside bars in Figure 1 disappear when a 30-minute period is specified. Bar formations are sensitive to the timeframes used.

KEY REVERSAL BAR

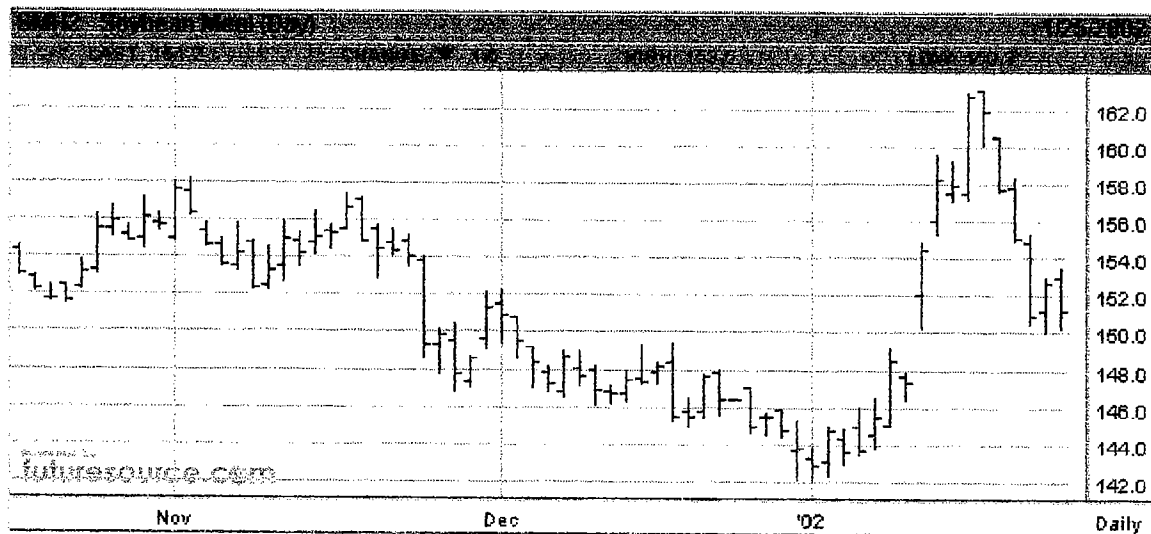
- 1. Develops after a prolonged rally or reaction. Often, this trend will be accelerating by the time the price experiences the key reversal bar.**
- 2. The price opens strongly in the direction of the prevailing trend – above the previous close.**
- 3. The trading range is very wide.**
- 4. The price closes near or below the previous close. A classic reversal finishes below the previous bar's low.**
- 5. Volume should be climactic on the key reversal bar.**
- 6. The upper end of the bar sticks out like a sore thumb above the previous two sessions. The price breaks out strongly to the upside but is unable to hold its gains, and by the close it gives up ground over the previous period.**
- 7. Alternatively, the price opens close to its low and closes higher, in the opposite direction of the prevailing trend.**
- 8. The extremely high volume is the tipoff that either buyers or sellers are exhausted and the next trend is likely to be down or up.**



SWING CHANGE

The three-bar pattern is the one that futures traders use. It denotes a change in the direction of price. The commodity establishes a low price as a swing point. Once the commodity closes above the high of the low day, that is a change of direction for an undetermined period.

You can see the swing point (Jan. 2/'02) in the Bean Meal chart below. The spot is marked with an X (price=142). It's also worthy of note that the commercial traders were heavily long - at an extreme position - at this same spot. This we know from the commitments of traders analysis we do that is provided with my book and service.



X

RULES OF THIS TRADE:

Here are the things to look out for when you are trying to spot this particular type of pattern:

- It works with daily prices, not intraday or weekly prices.
- The middle day of the three-day pattern is the lowest low of the three days.
- The last day (third day) must have a close above the prior day's high. The more extreme the better (i.e., more black than grey).
- Each day must have a trading range (i.e., OHLC not all the same).

Usually, the price pattern continues upward after this formation is in place; in fact, prices make a higher high the day after the formation ends 58% of the time, but this steadily decreases to 52% a week later. (About half the time, prices are still above the formation a week later.)

Although the example used has a commodities focus, this particular type of trade will work just as well for currencies, markets, and stocks.

“TD DIFF”

(Courtesy Tom DeMark)

One way of determining buying pressure is to subtract a price bar's low from its close. Likewise, determining selling pressure is achieved by subtracting the bar's close from its high.

Tom DeMark goes one step further and takes into account two consecutive bars in the definition of his TD DIFF indicator.

If the closing prices of these two bars are both lower than their respective previous bar's close, he compares the difference between each bar's low and close. If the difference is greater for the current bar, he suggests that price will probably rally.

Conversely, if the closing prices of the last two bars are both higher than their respective previous bar's closes, he then compares the difference between each bar's close and high. If the difference is greater for the most recent bar, he concludes that price will have a tendency to decline.