So much information
So well organized
It's almost unfair

TC2000®

Version 12.3 ... a new beginning ...

Try it FREE for 14 Days at TC2000.com

Worden Brothers, Inc. • 4905 Pine Cone Drive • Durham, North Carolina 27707
Mon-Fri 9:00am - 9:00pm ET, Sat-Sun 9:00am - 3:00pm ET • 800-776-4940 • 919-408-0542 • www.Worden.com

Integrated Systems Approach To Technical Commodity Analysis

by JOHN E. ROSENSTOCK

When I first became interested in commodity markets, it was my great fortune to read the works of and speak with several of the most lucid teachers of market science and strategy. Each of these teachers had methods which were profoundly logical in their approach. In the early stages of my learning curve (which in this business never seems to flatten out), I became aware of two trading tools which provided me with the idea of a structure that lead to my "ultimate commodity trading tool." One of these was the Sibbet-Hadady Charts, or more importantly, the concept behind them which was to use several indicators for trading. It seemed like a very rational approach. The other idea was the very expensive computer system which had the capability of displaying charts on a TV screen eliminating the need for shuffling through a lot of paper. I decided to take the best of both of these concepts and create a real-time computer system that would provide all of the indicators one would want to watch, and allow for the flexibility to modify the indicators, as needed, in my research.

I believe the business of trading commodity futures can be broken down into three clearly distinct areas. The first, of course, is **timing**. The second is **strategy**. The third, and most important, is **risk management**. My concept of risk management was originally developed from the ideas of Dr. Richard Teweles. His thoughts appear in the book, **The Commodity Futures Game — Who Wins, Who Loses, and Why.** Dr. Teweles spoke of odds and risk/reward ratios. Now, for a speculator, there is nothing more important than determining the odds. "The odds of what?" you say. The odds of getting wiped out! Seeing as how most novice commodity traders manage to get completely wiped out in a very few months, it seems that the most important thing to calculate is the "probability of ruin, " a term used by Dr. Teweles. This is the basis of all risk management. Although it is all too often lacking, the prime responsibility a broker has to his client is risk management, and for a broker, this is sound economics. If a broker can keep his client alive until the client has learned his market lessons, the broker will have a very nice account, and this is infinitely less work than going out to drum up a new account every time some novice blows himself out of the market.

The risk management formula that I adhere to is as follows: **When initiating a trade, a stop loss order equivalent to seven percent of the total account balance should be placed. The stop can be less than this amount, but certainly should be no more than seven percent of the total account. An account should never be allowed to control positions that total more than five times the assets in the account.** For example, a $10,000 account should not have more than $50,000 worth of open positions of full contract value. This can be calculated very simply, and it amazes me that few traders consider that when they are buying a cattle contract, they are looking at $25,000 worth of cattle. Most people would never buy a home in so casual a manner. My form of conservative asset management in effect limits a trader to 20 percent margin, a figure which is quite speculative yet does not approach "out and out" gambling. These two risk management tools (stop limits and leverage limits) will prevent an account from being wiped out through all but a long series of losses. I believe this defensive posture is most applicable to highly leveraged vehicles like commodity futures.

Strategy can be defined as the investment approach or tactics taken in a given market. Some markets warrant an aggressive approach, while others a more constrained attack. For example, a market that has been basing for a period of time can be accumulated while in the base, and then as the price breaks out and during subsequent reactions, positions can be added. Markets that gyrate wildly dictate a hit and run approach of small positions established when the commodity is oversold or overbought, these positions must then be liquidated when fairly priced. The strength and number of confirming indicators should determine the size of a position.

Timing commodity trades is a true science, whereas strategy can be more likened to an art. Technical analysis seeks to refine all the known data about a market down to a point at which one can predict a future price trend. Now, looking at a commodity chart of any sort, one can see that price action is made up of waves. Everything ultimately is made up of waves or cycles. Using sound as an analogy, we see that a sound is produced in one of two ways. A violin can serve as an excellent example. If a string is plucked, there is an instantaneous sharp output, or an extreme wave pulse, which gradually dies down to a much lower amplitude of waves. If the string is bowed, however, the amplitude of the wave starts small, gradually increasing in size, until the maximum volume is achieved. The same is true of commodity market behavior. For example, currency markets are often "plucked" by central bank intervention. Grain markets are often "bowed" in a long period of basing accumulation before prices move up.

Frequencies generated by a string, or a market, produce harmonics wherein the original frequency is doubled, and that frequency is doubled, and that frequency is doubled, with the waves becoming smaller as the frequency is increased. This is often evident when a market rallies, retraces 50 percent of that move, rallies 50 percent of the retrace, etc.

At this point, we should say a word to satisfy proponents of the random walk theory. In any circuit, electrical or otherwise, there is always static of one sort or another. Interday price action is similar to static and is most definitely a random walk, but by connecting all the highs and all the lows one can see that the random walk occurs **within** the channel. This is "static" which occurs around the "wave" or "trend."

Since we have determined that markets are made up of waves, it is necessary to understand the components of those waves. The beauty of technical analysis is that it is easy to define these components, particularly for commodity markets. For each market day there are the following variables:

For each contract month —

open

high

low

close

volume

number of open contracts

For each commodity —

cash or "spot" price

total volume — all months

total open contracts — all months

Using these variables, we can work with regular indicators such as bar charts, close only charts, geometric formations, volume and open interest charts, gaps, Elliot waves, and recurring market cycles.

Also from the daily variables we can get a series of "derived" indicators that require mathematical computations to produce ratios between the variables. Examples of "derived" indicators would be; moving average charts, oscillators, point and figure charts, and spread charts.

Technical Analysis Indicators and how they can be used

Indicators	1. bar charts	2. geometric formations	3. net hedged	4. congestion	5. open interest (and price weighted)	6. volume (and price weighted OBV)	7. Elliot	8. cycle	9. cycle tuned trend	10. seasonal trend divergence	11. bullish consensus	12. close only chart (trend lines)	13. average daily price (trend lines)	14. basis & spread chart	15. spread deviation	16. accumulation/distribution	17. momentum	18. difference oscillator	19. range indicator	20. subharmonic/cycle divergence	21. volatility rating	22. stops indicator	23. point & figure counts	24. point & figure formations	25. moving averages (and weighted)
A. Choosing the commodities to review		●							●		●													●	
B. Strategy				●						●					●										
C. Commodities not to trade																	●	●	●						
D. Contract to trade	●	●	●		●	●								●						●					
E. Initiating trades		●														●	●		●						
F. Taking losses																	●				●	●			●
G. Taking profits							●	●			●	●											●		

Of these "derived" indicators, I have found the oscillators and moving averages to be the most useful. These indicators require a "cycle tuning" to factor time into the equation. Some years ago, Walt Bressert of HAL Commodity Cycles, isolated the three major trading cycles for the different commodities, these cycles are used to tune my indicators. The moving average I use is a Linear Weighted Moving Average (LWMA), it gives the most "weight" to the most recent days. For example, a five day LWMA takes (today's close $\times$ 5) + (yesterday's close $\times$ 4) + (previous day's close $\times$ 3) + (previous close $\times$ 2) + (previous close $\times$ 1) $\times$ divided by 15, to get today's number. Plotted consecutively, the resultant line chart gives a very true picture of the underlying market trend.

Whereas most trading "systems" use simple moving averages to signal entry **and** exit points, I have found that a moving average or "trend indicator" can best be used only to exit a market **after** the trend changes. For low risk market entry, I prefer to use reversal indicators which show when a market has stopped moving in one direction, but before it actually **changes** trend. For this, oscillators are superb. Oscillator theory is based on positive and negative values, and the graphic presentation of this looks like a sine wave oscillating back and forth across a neutral line. When an oscillator reaches an extreme value either plus or minus, this indicates an overbought or oversold market which provides excellent low risk entry.

Another reversal method that provides excellent low risk entries is the three-dimensional concept developed by Bill O'Hama. **This method requires charting all the contracts of the commodity to see if any months fail to make new highs or lows when the other months do.** This divergent price action in one contract month often indicates significant hedging activity which may reverse the trend.

Technical analysis is a well proven method in monitoring the price action of free markets that have broad participation in order to gain insight into the future price trend. To do this, the combined opinions of all buyers and sellers is measured. These opinions tend to become stronger if they turn out right. And, as the holders of these correct opinions acquire more capital, they tend to Increase their positions. This movement of capital from weak hands (wrong opinions) to strong hands (right opinions) is what causes price trends. This has nothing to do with supply and demand but with **winners** and **losers.** Traders using supply and demand projections are actually attempting to predict the future rather than just measure market motion. The fundamental approach works best if a trader concentrates on one market only. Technical analysis can be applied to numerous markets. With only technical Information, the technician can make very precise measurements which to him can leave little doubt as to the when and why of a position.

