TSR TRADING GUIDES

THE TECHNICIAN'S TOOLBOX

GALEN WOODS

The Technician's Toolbox

TSR Trading Guides

Galen Woods

Contents

Notices & Disclaimers

First Edition, July 2015.

Published by Galen Woods (Singapore Business Registration No. 53269377M).

Contact Information

Galen Woods can be reached at:

- Website: http://www.tradingsetupsreview.com
- Email: galenwoods@tradingsetupsreview.com

Financial Disclaimer

Trading is risky. Please consult with your financial adviser before making any trading or investment decision.

The information contained within this book including e-mail transmissions, faxes, recorded voice messages, and any other associated content (hereinafter collectively referred to as "Information") is

provided for informational and educational purposes only. The Information should not be construed as investment/trading advice and is not meant to be a solicitation or recommendation to buy, sell, or hold any securities mentioned.

Neither Trading Setups Review nor Galen Woods (including all content contributors) is licensed by or registered with any regulating body that allows us to give financial and investment advice.

Trading Setups Review and Galen Woods makes no claim regarding past or future performance. While there is always a risk a loss when considering potential for profits. Losses connected with trading futures contracts or other leveraged instruments can be significant. Hence, you should consider if such trading is suitable for you in light of you financial circumstances bearing in mind that all speculative trading is risky and you should only speculate if you have sufficient risk capital.

Trading Setups Review and Galen Woods does not manage client assets in any way. Trading Setups Review is an educational service, not an advisory or stock recommendation service. All examples are provided for educational purposes.

You agree that Trading Setups Review, Galen Woods, its parent company, subsidiaries, affiliates, officers and employees, shall not be liable for any direct, indirect, incidental, special or consequential damages. All trades and investment decisions in your account are at your own risk. There is no guaranteed trading performance.

Members and readers agree to indemnify and hold Trading Setups Review, Galen Woods, subsidiaries, affiliates, officers and employees harmless from any claim or demand, including reasonable attorneys' fees, made by the member or any third party due to or arising out of a member's use of the service.

Company names, products, services and branding cited maybe trademarks or registered trademarks of their respective owners and the owners retain all legal rights. The use of trademarks or service

marks of another is not a representation that the other is affiliated with, sponsors, is sponsored by, endorses, or is endorsed by Trading Setups Review or Galen Woods.

Trading is risky. Please consult with your financial adviser before making any trading or investment decision.

Affiliate Disclaimer

Trading Setups Review seeks to provide you with the best trading resources. As a result, we have included useful links in our articles.

Some of these links are affiliate links. It means that we might receive a commission from your purchases made through those links. But you do not pay more.

For transparency, you can view an up-to-date list of our affiliates here.

However, we include links (affiliate or otherwise) in our articles only if we feel that they provide value to you.

Please don't hesitate to contact us if you need any clarification.

About TSR Trading Guides

The articles in this series of trading guides were first published on Trading Setups Review, where they are available for free reading.

In this series of guides, we have organized selected articles into common trading topics with an exclusive introduction from Galen Woods. The objective is to present a better learning experience for serious readers.

You can find out more about Galen Woods by clicking here.

1. Introduction

The Dow Theory, which laid the foundation for technical analysis, focuses on price. It all started with price.

Along the way, trading indicators were developed. They were great tools and helped to clarify price action when used correctly. However, at some point, some traders went overboard and overloaded their charts with dozens of indicators. They obscured price and missed the true value of trading indicators.

In a comeback attempt, a group of price action purists formed. They claim that trading with price alone is the only way to trade. They reject all indicators. They want to trade with "naked charts" and "price action only".

Rather than focusing on either price action or indicators, I advocate an open approach. Price action is a tool. Just like any other trading indicator. With any tool, the best way to learn it is to use it. Judge each tool on its own merits and recognize its drawbacks.

In a nutshell, don't reject any tool because of its label.

Wilder's array of indicators is a notable example of quality trading tools. His trading indicators has survived the test of time: ADX, RSI, Parabolic SAR, ATR. These are excellent indicators to start with.

2. What is the Best Day Trading Indicator?

Best Day Trading Indicator

If you are looking for the one Holy Grail day trading indicator in this chapter, you're in for a rude shock.

I am not giving you any sure-win "buy when green arrow appears" indicator. But you may get more than that.

Before you search for the best day trading indicator, answer the following questions.

2.1 What do you want to use the indicator for?

The choice of your day trading indicator depends on what you want to do with it.

If you want to find trends and trade them, moving averages are your best bet.

If you want to find momentum that has stalled and an impending reversal, an oscillator will have hints for you.

If you don't understand what is trend and momentum, you should stop your search for the best day trading indicator, and learn more about technical analysis before continuing.

(Start with Technical Analysis: The Complete Resource for Financial Market Technicians.)

2.2 Do you know how to use the indicator?

Most free off-the-shelf trading indicators do not print green and red arrows to tell you when to buy and sell. Before you choose an indicator for day trading, you should learn how to use it.

Although your trading software will draw the indicator for you, learn how to build the indicator. You do not need to memorize the formula, but you need to understand what pieces of data goes inside it and its working logic.

Learn how to interpret the indicator and the impact of different as covered in the next chapter.

An indicator is a tool. You must know how to hold it and how to wield it. Don't hold the knife by its blade without realizing.

2.3 Why does the indicator work/fail?

Indicators are fallible.

Actually, that's an understatement. We don't really call things that can bankrupt us overnight "fallible". And indicators will, if you use them mindlessly.

Understand the drawback of your chosen day trading indicator. Moving averages lag and oscillators can stay oversold/overbought for eons.

You will find improved moving averages that cut the lag. You will learn to find bullish divergences instead of just buying when the oscillator is in the oversold region.

However, none of these is the panacea and every indicator has its drawbacks. (Even those that cost $999/year.)

2.4 What is the best day trading indicator for you?

The questions above belabor the same point. **You** decide what is the best day trading indicator.

With your demands, skills, and trading experience, you will find the day trading indicator best suited for you.

Stay open-minded because almost all trading indicators are suitable for day trading with the right settings and trading experience.

You should take a look at Jean Folger's informative article on using trading indicators effectively.

If you need some suggestions to kick-start your learning process, try the three day trading indicators discussed in chapter 3.

3. Best Settings For Trading Indicators

42 is the answer to everything, but it is not the best setting for trading indicators.

Before we discuss what are the best settings for trading indicators, we need to recap on an important principle of trading indicators.

3.1 Trading Indicators - An Important Principle

Smaller settings lead to more sensitive trading indicators that produces more signals. However, smaller settings makes the trading indicator less reliable.

Larger settings give us more reliable but less frequent signals. And indicators with larger settings lag.

It seems that there is a spectrum of settings for indicators. On one end, sensitive but unreliable. On the other end, reliable but lagging. So, is the perfect indicator setting somewhere between them?

Yes. But the perfect setting is not available in real-time. It is only available in back-testing.

Fortunately, we don't need perfection for trading success.

3.2 How to Choose the Best Settings for Trading Indicators?

Start with the default indicator settings

Always start with the default setting for the trading indicators. This is very important when you are trying to learn a new indicator.

The default settings are what the inventor of the indicator used. The default settings are also the most common among traders. Hence, most of the learning resources including trade examples use default settings.

The default settings for some common indicators are in the list below.

- 14-period Relative Strength Index (RSI)
- 20-period Commodity Channel Index (CCI)
- 14-period Stochastic Oscillator
- 20-period Bollinger Bands (with 2 standard deviations bands)
- 12, 26, 9 periods for Moving Average Convergence Divergence (MACD)

If the default settings work for you, there is no need to meddle with them. Unless you understand how the indicator works and you know what you want.

Consider what you want to do with your trading indicator

If you know what you want your indicator to do, you can apply the principle above to adjust the indicator settings.

For **trade triggers**, smaller settings work because they do not lag and is able to pinpoint trade entries. For example, to use prices

closing above the 3-period simple moving average as a long trade trigger is reasonable for a short-term moving average. The 2-period ADX (covered later) is another example of adapting an indicator as a trade entry.

However, using a 3-period moving average to figure out the market trend is a joke. The average of the past 3 prices hardly sums up the market trend. A longer term moving average is more suitable for **assessing the market trend**. The 50-period and 200-period moving averages are commonly used as long-term trend filters.

When you lengthen the indicator period, you can even use oscillators to find the market trend. I use a 100-period CCI to check trends on daily charts.

Experiment with different settings for indicators

If you feel that an indicator is really not doing its job well with default settings, you can experiment with different settings and see how the indicator behaves.

Don't bother with the difference between the 20-period indicator and the 21-period indicator. To help you with choosing parameters for your experiment, you can use Fibonacci numbers that are commonly used in trading. Some of the common choices are 3, 8, 21, 55, 144, and 233.

Experiment for indicator settings that suits your trading style and purpose, and then **stick to it**. Do not change the settings regularly or blame your indicator settings for poor trading performance.

3.3 Conclusion: Trader and Trading Tools

Ultimately, the best settings for trading indicators depend on your understanding of the indicator, your purpose of using the indicator, and you.

Do you know how to use the indicator? If you don't know how to use the indicator and interpret it well, the setting of the indicator doesn't matter.

Focus on learning how to use the indicator, and not on hunting for the elusive perfect setting. Constant tinkering with the settings will only obscure your learning journey.

4. Three Practical Day Trading Indicators

With the tons of trading indicators out there, it is a Herculean task to go through them one by one.

To get you started with day trading, we suggest these three trading indicators.

1. Donchian Channel
2. Moving Average
3. Stochastic Oscillator

They are simple, easy to understand, and useful for day trading. No, they are not perfect. But they form a nice package to start with.

Best Day Trading Indicators

This chart shows how the three indicators add value to day trading.

4.1 Donchian Channel (Blue)

Richard Donchian, the pioneer of trend following, invented the Donchian Channel. The channel plots the highest high and lowest low of a specified time period. An average of the two values is also calculated and plotted as the mid-line.

Donchian Channel shows you where the market is now, compared to its past, in a direct and visual way.

The Donchian Channel is useful for day trading as you can use it to keep on eye on the larger time frame. Use a 100-period Donchian Channel to keep you with the longer term trend.

4.2 Moving Average (Orange)

A x-period moving average is the average of the past x number of price closes. As new price bars close, the moving average will move along, dropping the oldest close and including the newest close in its calculation.

The direction of the moving average highlights price trend, and the space between price and the moving average highlights momentum. This simple indicator packs a punch if you know how to use it.

While there are dozens of moving average flavors, start with the simple or exponential moving average with a 20-period setting for day trading.

4.3 Stochastic Oscillator (Lower Panel)

The stochastic oscillator is a popular day trading indicator.

Its working logic is like that of Donchian Channel, in the sense that it measures the current market position relative to the market's past

trading range. However, it assumes that the market is in a trading range and turns that measurement into an oscillator that moves between 0 to 100.

It is useful for finding day trade entries as it is sensitive and responsive. (Use %K-5, %D-3, Smooth-3 for your settings.)

For a multiple time-frame day trading method using stochastic, take a look at Kane's %K Hooks strategy.

4.4 Day Trading Indicators - A word of caution

You get three indicators. Now it's time for three warnings against them.

1. Indicators are not perfect, understand when and how to use them.
2. Don't neglect price action when trading with indicators. Consider using price action patterns to improve your analysis. (Like this simple failure pattern, or the Hikkake pattern.)
3. Do not overwhelm yourself with indicators. Consider the value of every single indicator you add to your chart. Does it add value? Remember to trade simply.

Finally, remember that even with powerful indicators, the most successful traders never forget to analyse price itself.

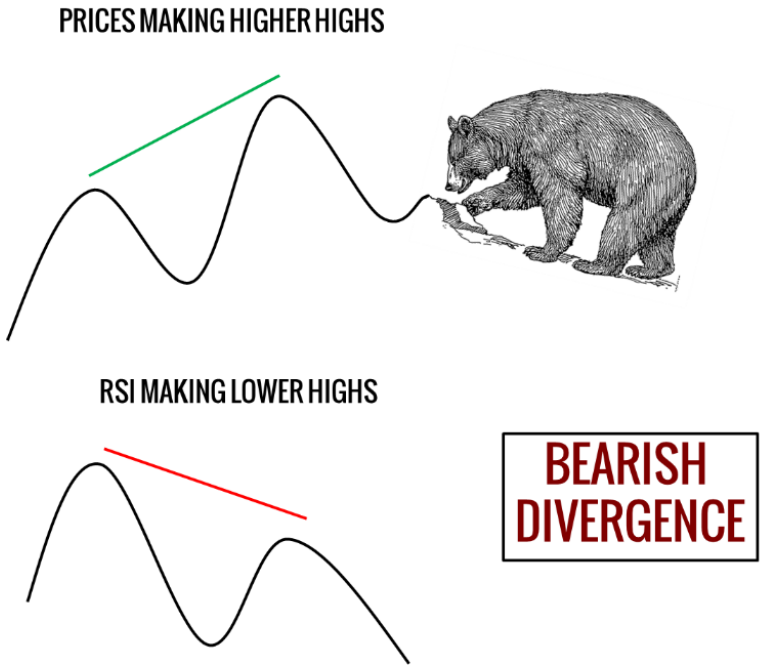
5. Trading Candlestick Patterns With Relative Strength Index (RSI)

In Japanese Candlestick Charting Techniques, Steve Nison included a section on using candlesticks with oscillators including stochastics, RSI, and moving average oscillator. According to Steve Nison, **oscillators are objective and augment the more subjective candlestick patterns**.

In our review, we will focus on using candlestick patterns with Welles Wilder's RSI. RSI measures the momentum of gains and losses.

The relative strength in the formula refers to the ratio of average gain to average loss. These averages are calculated in way similar to the exponential moving average, before turning the relative strength into an index that fluctuates between 0 and 100.

Other than candlestick patterns, we will also look out for **RSI divergences** in our trade setups. Divergences occur when RSI does not support prices. The diagram below illustrates a bearish RSI divergence.



Bearish RSI Divergence

5.1 Rules For Long

1. Bearish divergence between 14-period RSI and price
2. Sell with a bearish candlestick pattern

5.2 Rules For Short

1. Bearish RSI divergence between 14-period RSI and price
2. Buy with a bullish candlestick pattern

5.3 Winning Trade

This daily chart of IBM shows two consecutive bearish divergences (also called a three-point divergence). With a clear evening star candlestick pattern, we shorted at the red arrow for a quick and profitable trade.

1. As prices push higher, RSI made a lower high. This was the first **bearish divergence**. However, no candlestick reversal pattern was present so we sat on our hands.
2. Prices made another high after some sideways movement. However, RSI did not make a higher high and we got another bearish divergence. Although IBM tested a new high, it was **not able to close above the previous swing high**. This was a bearish sign. The next day completed the evening star candlestick pattern and we shorted.
3. The earlier gap (or window in candlestick-speak) was the perfect price target.

5.4 Losing Trade

This is a 10-minute chart of the futures on the DAX, Germany's blue chip stock index. It is very liquid and suited for active trading. Let's take a closer look at this failed trade setup.

1. Prices made a lower low not supported by the RSI, indicating a **bullish divergence**.
2. With the bullish divergence, a bullish engulfing candlestick pattern formed and we bought (as shown by the green arrow). The trade went sideways for around an hour and stopped us out. (Our stops are below the signal bar.)
3. However, after our losing trade, the bullish divergence continued. Finally, the hammer candlestick pattern nailed a profitable long trade.

5.5 Review - Candlestick Patterns With Relative Strength Index (RSI)

Essentially, this trading strategy of combining candlestick patterns and RSI divergence is a **reversal trade setup**. Reversal trade setups

have a low chance of success and a high reward-to-risk ratio. Using RSI divergences to find trends that have exhausted helps to improve the odds of a reversal trade.

However, the problem with divergences is that they merely hint at an impending reversal. The hints might keep coming, and coming, and coming, before the reversal actually takes place. While looking out for candlestick patterns help to pinpoint better entries, **whipsaws are inevitable** and consecutive losses might take place.

Hence, we must be nimble and try to scratch losing trades. **Pay attention to price action after entry**. The best reversals happen swiftly and you should see strong bars in your trade direction within two to three bars of your entry. If not, simply exit with a small loss or profit and wait for better opportunities.

Divergences are uncommon. To find trading opportunities efficiently, you can use a stock scanner to scan for RSI divergence in a basket of stocks, before looking a closer look to see if there is a trade setup.

Most stock scanners allow you to scan for RSI divergences easily. You can also save your screens and back test your strategies on them.

For learn more about candlestick patterns and how to combine them other oscillators like stochastics, you should refer to Steve Nison's book, Japanese Candlestick Charting Techniques. This book is a superb reference text that is part of in the Chartered Market Technician program.

6. Day Trading Forex With CCI Indicator

In this trading strategy, we use Donald Lambert's original article on the Commodity Channel Index (CCI) as a starting point to create a day trading strategy for forex markets.

6.1 Formulating our CCI Day Trading Strategy

Many traders use the CCI indicator to find oversold and overbought markets. Buy when it is below -100 and sell when it is above +100.

However, Donald Lambert did the complete opposite.

> If the CCI goes above the + 100 line, that's a signal to establish a long position. When the CCI drops below the + 100 line, the long position is closed out. The same techniques apply to short positions at the -100 line.

Following his words, we will look for long trades when CCI moves above 100 and short trades when CCI falls below -100.

Regarding the period of CCI, he mentioned that:

> … data base (look-back period) should be less than one third of the cycle length to produce a reasonable level of theoretical efficiency.

Instead of performing complex cycle analysis, we assume there are daily cycles in forex markets. Hence, the cycle length is 24 hours.

We trade with 30-minute bars. In 24 hours, we have 48 bars. One third of the cycle length is 16 bars.

Hence, the typical CCI setting of 14 period is adequate.

Donald Lambert also cautioned that:

> Too short a data base will produce whipsaws as the index interprets daily price fluctuations as being cycle tops or bottoms.

To avoid whipsaws, we will not enter immediately after a CCI signal. **We will wait for a retracement and a clear trend bar before entering.**

6.2 Trading Rules - Day Trading with CCI

Based on the above, we have come up with clear trading rules for day trading with CCI.

Long Trading Setup

1. 14-period CCI moves above 100
2. At least one bar closes down (retracement)
3. Enter one tick above bull trend bar

If CCI falls below -100 at any point, the trading setup is void.

Short Trading Setup

1. 14-period CCI moves below -100
2. At least one bar closes up (retracement)
3. Enter one tick below bear trend bar

If CCI rises above 100 at any point, the trading setup is void.

6.3 Day Trading with CCI Examples

Winning Trade - Short CCI Day Trade

This is a 30-minute chart of 6E futures contract.

1. CCI fell below -100 line and set the stage for short trades.
2. This bar closed up as the first sign of retracement. We went on high alert for a bear trend bar as a signal bar.
3. This small bar could have been our trigger but price did not go below it to trigger our sell stop order. Instead, we went short at bearish inside bar (red arrow).

Losing Trade - Long CCI Day Trade

This trade actually worked, if not for the outside bar that whipsawed us out of our position.

1. CCI went above 100.
2. Prices retraced down for two bars before giving us a bull trend bar for entry. However, right after we entered the long trade, an outside bar stopped us out by one tick. (As always, we placed our stop-loss a tick below the signal bar.)
3. Long trading setups that allow us to enter below the high of the CCI break-out bar tend to work better. The reverse is true for short trades.

6.4 Conclusion - Day Trading with CCI

This simple trading strategy uses CCI to find momentum before we trade along with it. Waiting for retracement before entering the trade works well to avoid whipsaws.

Add your own trade management rules to trail stops or set price targets, and you can trade with it reliably.

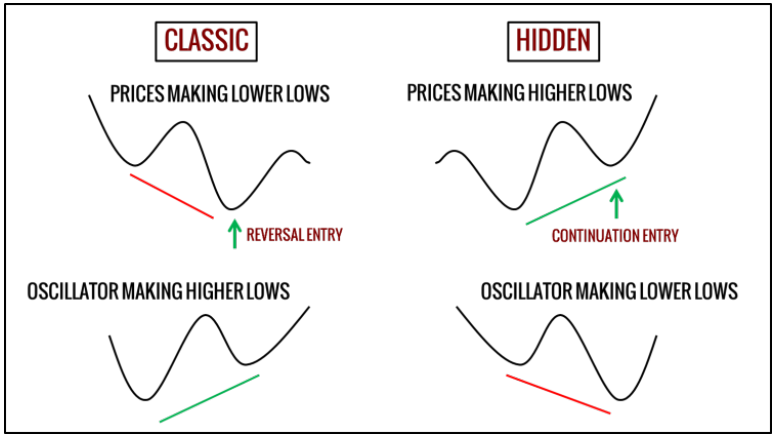
Observing price action after the break-out is the key to finding quality trades.

Source: Donald Lambert's original article in "Stocks & Commodities V. 1:5 (120-122): Commodity Channel Index: Tool for Trading Cyclic Trends"

7. MACD Hidden Divergence Trading Strategy

Oscillators like RSI, stochastics, and MACD are powerful tools if you know how to use them. Looking out for divergences is a part of using oscillators for trading. Divergence refers to the disagreement between price and the oscillator.

Classic divergences are part of a reversal trading strategy. Hidden divergences point to continuation trades. Take a look at the two types of bullish divergences illustrated below. (Bearish divergences are the reverse.)



Hidden Divergence

For our review, we will be using MACD, but the same trading strategy can work with any trading oscillator.

7.1 Trading Rules - MACD Hidden Divergence

Long Trading Strategy

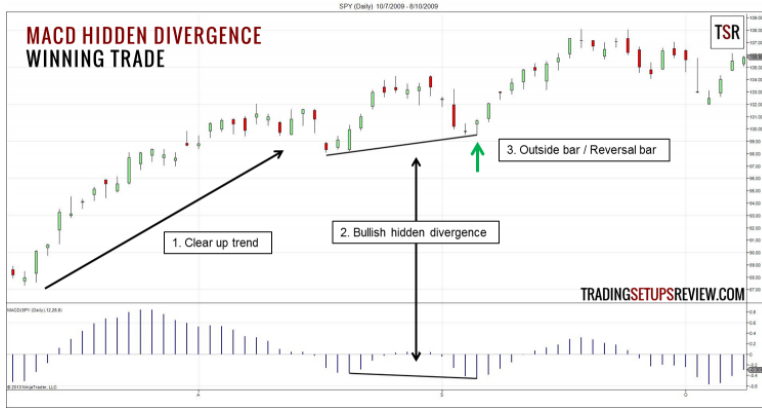
1. Bullish MACD hidden divergence
2. Buy one tick above any bullish reversal bar

Short Trading Strategy

1. Bearish MACD hidden divergence
2. Sell one tick above any bearish reversal bar

7.2 MACD Hidden Divergence Trade Examples

Winning Example - Bullish Hidden Divergence



This is a daily chart of the S&P exchange-traded fund, SPY, with the MACD histogram on the lower panel.

1. There was a clear up trend leading up to our trading setup, which is crucial for continuation trades.
2. To find hidden divergence, pay attention to the last low of MACD. Once MACD descends past it, you turn your attention to price. If price is above the last swing low, you have a hidden divergence. However, if price continues down below the last swing low, the hidden divergence becomes invalid.
3. After the hidden divergence, we had a reversal bar that showed its strength as it turned into an outside bar. We entered a tick above its high for a nice swing upwards.

Losing Example

This is a daily chart of Ross Stores. It shows a bullish MACD hidden divergence that failed.

1. Like the previous example, we had a clear up trend, without any significant pullback.
2. We got a bullish hidden divergence that set us looking for reversal patterns.

3. After entering a tick above the bullish inside bar, prices stalled with a couple of dojis. As prices attempted to move up again, the bears made their stand with the large bearish outside bar.

7.3 Review - MACD Hidden Divergence

Divergence trading strategy requires you to pay attention not just to the indicator, but also to price itself. This is why it is a better way to use oscillators. We should never use trading indicators without consulting price.

Another advantage of hidden divergences is the higher odds of success, given that it finds trades along the trend and not against it.

Bullish hidden divergences highlight oversold regions in an up trend. However, instead of using a fixed oscillator value to decide if prices are oversold, we use the previous low of the oscillator. (The reverse is true for bearish divergence.) This is definitely an improvement over the using fixed thresholds.

Despite having the help of the MACD histogram, we must emphasize that **finding divergences is an art**. The subjectivity lies with picking out significant lows and highs on both the oscillator and price. For better results, traders usually ignore minor swing lows and highs. However, in powerful trends, those minor swings could lead to explosive moves.

For those interested in MACD and divergences in general, here are some resources for further study.

- MACD Basic Trading Strategy from the inventor of MACD
- Trading strategy using Classic Divergence with RSI
- Hidden Divergence article in Stocks & Commodities V. 14:7 (285-289) by Barbara Star

8. Moving Momentum Trading Strategy

The Moving Momentum trading strategy comes from the ChartSchool at StockCharts.com, where you can find comprehensive information on most technical indicators. This strategy goes through a three-step process to find corrections in trends.

8.1 Trading Rules - Moving Momentum Strategy

Long Trading Strategy

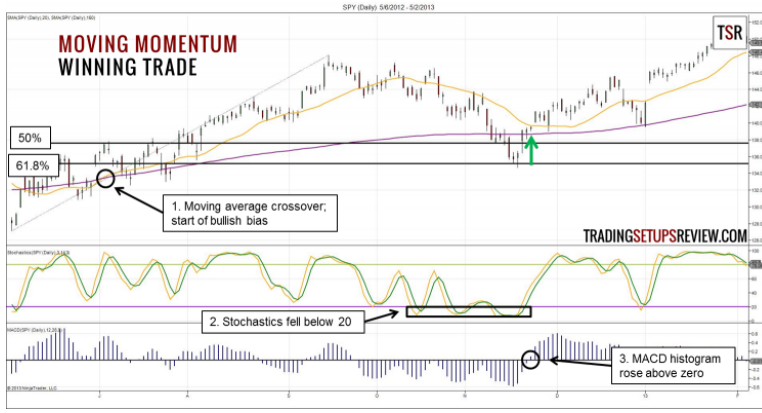
1. 20-period simple moving average (SMA) is above 150-period SMA
2. Slow Stochastic (14,3) falls below 20
3. MACD Histogram (12,26,9) moves above zero

Short Trading Strategy

1. 20-period SMA is below 150-period SMA
2. Slow Stochastic (14,3) rises above 80
3. MACD Histogram (12,26,9) moves below zero

8.2 Moving Momentum Trading Examples

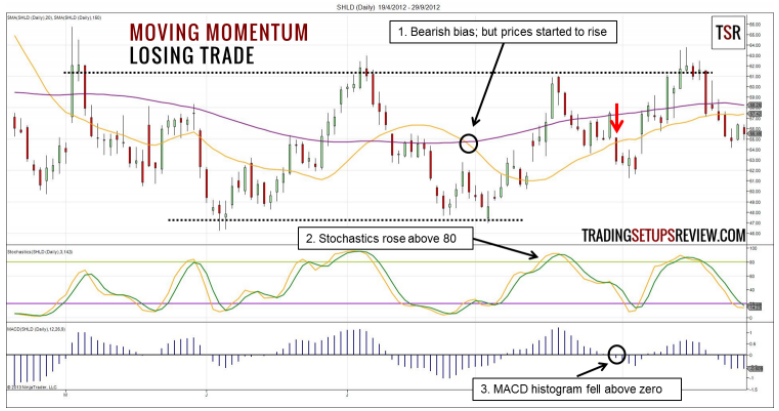
Winning Trade - Long Trading Signal



This is the daily chart of S&P 500 ETF (SPY). It shows how the Moving Momentum trading strategy found a profitable entry after a deep pullback in the index.

1. The 20-period SMA rose above the 150-period SMA to signify a bullish bias.
2. Slow stochastics fell below 20. It lingered around the lower values as price pulled back substantially.
3. Finally, the MACD histogram went above the zero line and gave us a long signal. This long signal came after price bounced off from a 61.8% retracement of the previous upswing.

Losing Trade - Short Trading Signal



This daily chart of Sears Holdings shows a short Moving Momentum trade which failed. Paying more attention to price itself might help you to avoid this losing trade.

1. The bearish SMA crossover defined a down trend according to the trading strategy. However, price started to rise immediately after the bearish crossover. Furthermore, a trading range (dotted lines) was forming.
2. Stochastics rose above 80 and highlighted the pullback. This pullback is deep and went beyond the 150-period SMA. The winning trade example had a deep pullback as well. However, in the winning case, the trend was firmly established. In this example, the trend was in its early stage when deep pullbacks are unusual. Hence, the bearish bias was in doubt.
3. We went short when the MACD histogram fell below zero. Price shot up and made a higher high shortly after.

8.3 Review - Moving Momentum Trading Strategy

This trading strategy's merit lies with its systematic approach to finding trading opportunities. The process and logic of this trading strategy is sound.

It uses moving averages to find the long-term trend before using stochastics to find pullbacks. Then, it uses MACD as a trade trigger.

MACD is a reliable trade trigger for complex pullbacks. However, for simple and shallow pullbacks, the lagging nature of MACD gives slow signals with bad reward-to-risk ratio.

(Learn more: MACD Basic Trade by Gerald Appel)

The Moving Momentum trading strategy is not a simple trading strategy. It uses four indicators. The orignal article at ChartSchool correctly pointed out that you will need to calibrate the settings of the indicators according to your trading instrument's volatility. Adjusting 4 different indicators is not an easy task.

(Read: Template For A Simple Trading Strategy)

Instead of optimizing the parameters and risk the dangers of curve-fitting, you can use this trading strategy to find trading opportunities before observing the price action to see if the trade is worth taking.

Remember that this trading strategy seeks to find corrective moves within a trend. Look at each chart and assess if there is a corrective move within a trend. (Compare the winning and losing examples.)

9. Trading The Impulse System by Elder

Alexander Elder is the author of two bestselling trading books, Trading for a Living and Come into my Trading Room. He is also known for many trading tactics including the Triple Screen Trading and the Impulse System.

I have come across many recommendations of his books for beginning traders once and again. And I would personally recommend them as well.

Being a trader with a background in psychology, he gives unique insights into the world of trading in a concise and readable way.

Without further ado, let's introduce the Impulse System by Alexander Elder. This system combines a relatively short EMA with the standard MACD to find market momentum. When the two indicators align, they show an impulse move.

Alexander Elder advised that we should use the Impulse System on a higher time-frame to enhance the trading setup.

9.1 Trading Rules - Impulse System

Long Trading Setup

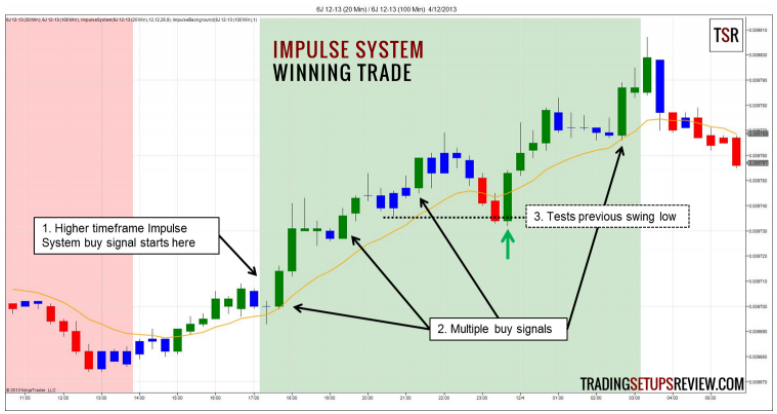
1. 13-period EMA rising
2. MACD(12,26,9) histogram rising

Short Trading Setup

1. 13-period EMA falling
2. MACD(12,26,9) histogram falling

9.2 Impulse System Example Trades

Winning Trade - Impulse System



This 6J chart is in need of explanation. Bars with positive impulse are green. Bars with negative impulse are red. Blue bars mean that EMA and MACD are disagreeing. (I must thank Wessel on Ninjatrader forum for sharing this indicator.)

I also coded a separate indicator for the background color to show the Impulse System on a higher time-frame. Our trading time-frame is 20-minute. Alexander Elder recommends a factor of five. So the background reflects the impulse on the 100-minute time-frame.

1. EMA and MACD on the higher time-frame were both rising.
2. There were multiple buy signals in our trading time-frame from the Impulse System.

3. For this example, we are focusing on the signal marked by the green arrow. That trading setup had a high chance of success because it tested the previous swing low, but did not affect the momentum on the higher time-frame.

Losing Trade - Impulse System

This is a daily chart of Hewlett-Packard. The higher time-frame uses weekly bars.

1. A bearish triple top foreshadowed this trade.
2. However, prices stalled at the last swing low. This might have contributed to the failure of the short signal from the Impulse System.
3. As shown by the blue bar, price lost momentum right after entry. Given that the Impulse System is a momentum trade, we should take that as a signal to exit earlier and limit our loss.

9.3 Review - Trading The Impulse System

Combining multiple time-frame analysis with the Impulse System produces a solid momentum trading strategy.

However, some trading platforms are not friendly to multiple time-frame analysis. In that case, you can pay attention to pullbacks that do not overlap with the EMA.

For instance, price bars are above the EMA and they start to retrace down. However, throughout the pullback, price bars stay above the EMA. It means that the bullish momentum is strong. Given that context, it is likely that the higher time-frame supports the bullish impulse.

To improve on this trading strategy, you can seek confirmation from support and resistance like our examples above.

You should definitely read Alexander Elder's explanation on the Impulse System in Come into my Trading Room, if you haven't already.

If momentum trading is your cup of tea, you should also take a look at the 5-minute Forex "Momo" trading setup, which also uses EMA and MACD. It will be an interesting exercise to compare the two trading strategies, but that's for another day.

10. 2-Period ADX Trend Trading Strategy

J. Welles Wilder pioneered an array of popular indicators (ADX, Parabolic SAR, RSI) in his book, New Concepts in Technical Trading Systems. The 2-period ADX is our tweak of Wilder's ADX indicator to enhance its prowess for day traders. In the 2-period ADX Trend Trading Strategy, we are using a 2-period ADX to catch low risk entries in a trending market.

The concept underlying the 2-period ADX is to find the perfect pause in the market. By using such a short look-back period for the ADX indicator, it becomes extremely sensitive. Hence, it rarely falls below 25. When it does, it is a signal that a break-out is imminent.

Learn: The Logic Of The 2-Period ADX

In this trading strategy, we will analyze the trend context to anticipate the break-out direction.

10.1 Trading Rules - 2-Period ADX Trend Trading

Bull Trends

1. From below the 20-period EMA, price makes a higher swing high above the 20-period EMA.
2. 2-period ADX falls below 25 but price is still above EMA. (signal bar)
3. Place buy order one tick above the high of the signal bar.
4. Cancel order if not triggered by the next bar.

Bear Trends

1. From above the 20-period EMA, price makes a lower swing low below the 20-period EMA.
2. 2-period ADX falls below 25 but price is still below EMA. (signal bar)
3. Place sell order one tick below the low of the signal bar.
4. Cancel order if not triggered by the next bar.

10.2 2-Period ADX Trend Trading Examples

Winning Trade - Bullish Entry

This is a 5-minute ES chart showing a nice bullish trending session. The purple line is the 20-period EMA, and the lower panel shows the 2-period ADX.

1. From below the moving average, price rose and broke above a swing high. That was our signal that a bull trend has begun.

2. After rising for several bars, price started to pullback. The pullback consisted of many narrow range bars which stayed above the EMA. The bullishness remained intact.
3. The 2-period ADX fell below 25. We bought as price broke above the high of the signal bar.

By placing our stop just below the low of the signal bar, our risk was small. Even with a conservative target price, we could obtain a high reward to risk ratio.

In addition, the 2-period ADX offered a second entry in the later part of the session. That entry was another low-risk entry into the bull trend.

Losing Trade - Bearish Entry

This is another 5-minute chart of ES futures. In this case, the first signal resulted in a loss.

1. Price fell below the EMA and broke a swing low, giving us the signal to look for shorts.

2. After pushing below the support, the bearish momentum waned. The bearish candlesticks had small bodies. Eventually, a strong bullish bar ended the fall. However, the bullish bar had no follow-through. Instead, price drifted horizontally along the earlier support which has flipped to become a resistance.
3. In the sideways trading range, we had two 2-period ADX signals. The first signal failed almost immediately.

However, the trade risk was low. Hence, the potential profits from the second ADX signal more than made up for it.

10.3 Review - 2-Period ADX Trend Trading Strategy

The 2-period ADX is an excellent way to find low-risk entries into market trends. Most signal bars are narrow range bars, and its extreme offers a reliable stop-loss level.

The main drawback of the 2-period ADX is that we might get caught in tight trading ranges. However, by combining the 2-period ADX signal with the market bias we identified with price action, we limit our entries to potential new trends. Not only does this method keep us with the trend, it also helps us to avoid false break-outs.

Another characteristic of the 2-period ADX signals is that they occur infrequently. It teaches the virtue of patience in trading. Instead of jumping into a trend as it's speeding away, exercise patience and join the train during its perfect pause.

Feel free to use your own trend filters. The key is to find potential new trends. The signals do not work as well in mature trends.

11. How I Trade With Only The 2-Period RSI

> "Even though we do not suggest using only one indicator, if one had to, the 2-period RSI would be the indicator."
>
> -Larry Connors in How Markets Really Work

Larry Connors is an experienced trader and publisher of trading research. Together with Linda Raschke, he wrote the book, Street Smarts, which is a solid collection of trading strategies including the Holy Grail.

What is so fantastic about the 2-period Relative Strength Index (RSI) that a well-regarded trader like Larry Connors would suggest it as "the one indicator"?

Let's find out.

11.1 Trading Rules - 2-Period RSI Strategy

Coupling an oscillator with a trend indicator is the usual approach. For instance, Connors recommended the 200-period moving average, and StockChart.com did just that in their RSI2 examples.

However, I added a twist to this fast oscillator. Let's do away with a separate trend indicator, and let the 2-period RSI clue us in on the trend. I always enjoy putting less on my charts.

The 2-period RSI (like our 2-period ADX covered earlier) is extremely sensitive. We expect the 2-period RSI will give many

overbought signals during an up trend. Of course, most of these overbought signals will fail because the 2-period RSI is not meant for locating major reversals.

So, when an overbought 2-period RSI actually succeeds in pushing the market down, we know that a down trend has begun.

Apply the same logic to oversold RSI signals in bear trends to alert us to the beginning of bull trends.

Long Setup

1. 2-period RSI falls below 5
2. Price breaks above the higher swing high that formed just before the RSI signal (confirmation of bull trend)
3. 2-period RSI falls below 5 again
4. Buy on break of high of a bullish bar

Short Setup

1. 2-period RSI goes above 95
2. Price breaks below the lower swing low that formed just before the RSI signal (confirmation of bear trend)
3. 2-period RSI rises above 95 again
4. Buy on break of low of a bearish bar

To sum up, we look for two RSI signals. The first one to show us the trend, and the next one to show us trade.

11.2 2-Period RSI Trading Examples

Winning Trade - RSI Oversold

This is a daily chart of FDX. The lower panel shows the 2-period RSI indicator with overbought and oversold levels set at 95 and 5 respectively.

1. The RSI dropped below 5. That was our signal to look for the last higher high. We marked it with the dotted line and watched it closely.
2. Price moved up and broke the resistance level. The 2-period RSI oversold signal was credible. **Although we did not take this oversold signal, its success confirmed that the market is now in an upwards trend**. Time to look for a tradeable signal.
3. The next 2-period RSI signal came quickly as it dropped below 5 again. We bought as price gapped above the bullish bar marked with a green arrow. It was an excellent long trade.

To clarify how we figure out trend changes in this strategy, I've marked out the RSI overbought signals that failed to push the market down in red. These failures are common in a bull trend.

However, the last overbought signal circled in black sent the market down below the last lower swing low. The market bias has changed from bullish to bearish.

Losing Trade - RSI Overbought

This chart shows the 6J futures with 20-minute bars and a less rosy picture.

1. The 2-period RSI rose above 95, and we started paying attention to the last major pivot low.
2. 6J fell below the support level and confirmed a change of trend. We started looking for overbought signals for short trades.
3. The RSI overbought signal came, and we shorted below the bearish inside bar. Price stopped out our position within an hour.

Compare the price action surrounding the first RSI signal in both examples. **The quality of the first RSI signal shows us if the impending trend change is genuine**.

In the winning trade, the first oversold signal was solid, and price rose up to break the resistance without hesitation. It showed great bullish momentum which supported our trade.

However, in the losing example, the first overbought signal did not reverse the price immediately. Instead, it rose up further to make a higher high before falling down through the support level. This RSI signal is inferior. Hence, the trend change it signaled is less reliable.

11.3 Review - 2-Period RSI Trading Strategy

I had fun with the 2-periood RSI. It is a very useful version of RSI that you can add to your trading toolbox.

I find value in this trading tool as it highlights where price action gets interesting.

The 2-period RSI finds potential short-term tipping points of the market. And according to whether the market tips or not, we form our market bias and get our trading signals.

According to our trading rules, we are looking for one successful oversold signal to confirm the up trend, before we buy the next oversold signal. What this approach implies is that one good trade is more likely to be followed by another good trade. Statistically speaking, we are depending on the serial correlation of successful signals, a useful concept in trending markets.

Our method of using the 2-period RSI to find trend changes works best when you are trying to catch the end of a well-established trend.

Larry Connors' research comes with performance statistics. And the statistics of the RSI2 back-testing in his book looks excellent. If you feel tempted to trade it mechanically, think again because the results are historical.

However, his book, How Markets Really Work, is definitely a great read. It has back-test results of trading strategies and price action behavior, including highs/lows, VIX, put/call ratio and more. It presents the results clearly in nice tables to show you how markets really work.

Read it for the complete answer to why Connors recommends the 2-period RSI.

(Connors has recently came up with ConnorsRSI. If you want to move ahead, you can get more information here.)