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Magic trend indicator - a combination of CCI and ATR to identify the market trend

By **TRADERS' Magazine**, 05 Nov 2015

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Technical analysis provides us with many tools that may help to identify the trend of an asset. These tools go from the simplest moving averages´ method to more complex methods such as the Parabolic Stop And Reversal.

One of these methods is known as the Magic Trend Indicator, and we will explain it in this article.

Basis of the Magic Trend Indicator

The Magic Trend indicator tries to identify the prevailing trend at any stage. To do so, it uses the CCI indicator (Commodity Channel Index) as a measure of the direction and ATR (Average True Range) as a volatility factor used to project the trend breakout lines.

The CCI measures the financial asset's price deviation in relation to its statistical average price.

High values of the index indicate that price is extremely high in relation to its average, and low values indicate that price is extremely low in relation to its average.

Despite its name, the CCI can be applied to any financial instrument and not only to commodities.

The CCI should be used in the same way as other indicators such as Relative Strength Index and Stochastic, looking for divergences with the underlying asset or detecting overbuying and overselling areas. In the case of the Magic Trend indicator, the CCI is used to determine the direction of the asset's chart (as we already mentioned).

This is the rule that we will establish:

1)   When the CCI value is above zero, it is indicating prices above the average. In those cases the Magic Trend indicator appoints a prevailing bullish trend and calculates the corresponding support

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levels.

2)   When the CCI value is below zero, it is indicating prices below the average. In those cases, the Magic Trend indicator appoints a prevailing bearish trend and calculates the corresponding resistances levels.

F1) Magic Trend in AEX-25 Futures, 10-Minute Chart

We see the breakout levels drawn by the indicator. Point A shows a strong bearish trend as the resistance level is far away from price. Something similar happens at point C with the bullish trend. The points B and E have higher uncertainty, as in both cases the indicator is being crossed by price, generating some doubts about a possible trend continuation.

Source: Visual Chart

The technical indicator ATR (Average True Range) represents the market volatility.

It was developed by J. Welles Wilder and presented in his book "New concepts in Technical Trading Systems" (1998), and since then has been used as a component in numerous indicators and trading systems.

The Average True Range indicator has high values after a strong fall, caused by the panic of long position holders.

Low values of the indicator normally correspond to long lasting periods of horizontal movements that can be observed in market peaks and consolidation areas.

We also need to mention that the value of the indicator is independent of the direction of the trend and the amplitude that this trend can take.

Here, the ATR is used as a dynamic volatility factor to establish the positions of support and resistance levels: the higher the volatility level, the higher the difference between the support and resistance lines and the current price.

Instead, in phases with low volatility, the breakout points will be more adjusted to the market current price.

Study of the Magic Trend

The Magic Trend indicator has a simple structure that updates the breakout levels according to the price evolution:

F2) Magic Trend With Smoothed Average

In the EUR/USD Future 20-minutes chart, we see how the use of a moving average filters the signal given by the Magic Trend. A bullish swing starts up at point A where we can find several price levels where the Magic Trend detects a change of the trend. However, the average indicator filters these signals and extends the bullish trend to point B. The cross of the indicator with its average will indicate the end of the bullish trend in A and C and the end of the bearish trend in B and D. The worst results are obtained during the movement at Point E as the lack of the trend generates false signals.

Source: Visual Chart

1)   Increasing phase: When the CCI detects a bullish trend, the minimum value of each bar is calculated

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subtracting the current ATR (in a way that this value will depend on the volatility). The Magic Trend calculates the support level according to this result, and updates this level if new higher lows appear.

2)   Decreasing phase: When the CCI detects a bearish trend, the maximum value of each bar is calculated adding the current ATR factor (so this value will depend on the volatility). The Magic Trend calculates the resistance level according to this result and updates this level if new lower highs appear.

On the chart in Figure 1, we can see an example of the Magic Trend Indicator. The chart shows a bearish trend starting at point A and how the resistance level is updated while prices are falling.

At the beginning of the trend, the indicator is far away from price due to the high volatility moment. When the exhaustion phase starts, the indicator moves horizontally, as shown in point B.

In fact a lateral move of the indicator can be an indication of a trend exhaustion point. Even though the resistance point is broken, the indicator will still appoint bearish direction such as the CCI does not indicate the opposite.

This situation is repeated in the points D and E, each of them with their corresponding point.

Signals' Interpretation of the Magic Trend Indicator

Despite the simplicity of the indicator, there are several ways to interpret the study of its signals. Let us see some examples:

1.   Slope Analysis

For markets with huge price swings, the Magic Trend accompanies such impulses with very pronounced changes of slope.

However, for markets with congestion or exhaustion situations, the indicator stops abruptly its trending movement and starts a horizontal phase.

Those changes of slope can be used as trading signals:

- We buy if the indicator slope turns positive.

- We close long positions if the indicator slope turns from positive into neutral.

- We sell if the indicator slope turns negative.

This type of strategy can be very aggressive in uncertainty areas as, the indicator may continuously change its slope and produce many false signals. In those cases our recommendation is to use other technical indicators as filters.

Programming Code

Link to the programming code: www.tradersonline-mag.com/ download/e_tra10_basics_cuevas_programmingcode.txt

2.   The Use of the Magic Trend As a Moving Average

The Magic Trend can be used in the same way as any moving average applied to price. In those cases, buy and sell signals will be determined by the position of the price in relation to the indicator.

Another option is to apply a moving average to the indicator in order to smooth its signals. This option will be especially useful in the long trend swings, but not during lateral movements.
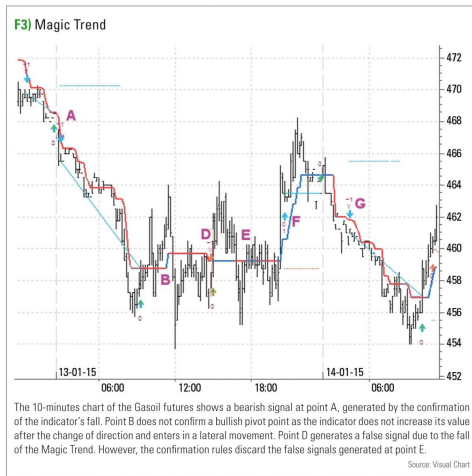
A clear example of this can be observed in Figure 2. In this case, the bullish phase that starts on 9th January will be perfectly drawn by the average applied on the Magic Trend.

3. Trend Confirmation

A conservative strategy should follow the bearish or bullish direction given by the CCI and apply a confirmation filter.

The confirmation filter will be as follows: when the trend changes its direction, we must wait until the indicator climbs a second step, confirming the new swing.

The idea we follow with this rule is to avoid exhaustion areas, periods where the Magic Trend normally keeps a constant value.

F3) Magic Trend

The 10-minutes chart of the Gasoil futures shows a bearish signal at point A, generated by the confirmation of the indicator's fall. Point B does not confirm a bullish pivot point as the indicator does not increase its value after the change of direction and enters in a lateral movement. Point D generates a false signal due to the fall of the Magic Trend. However, the confirmation rules discard the false signals generated at point E.

Source: Visual Chart

In Figure 3 we can find an example on the Gasoil Futures 10-minutes chart. In this example four trades are made.

The short trade at the point A is generated as the Magic Trend is continuously falling. The short trade at the point D is generated because the Magic Trend returns a bearish signal and falls down a step.

The trade at the point F is generated by a bullish pivot point confirmed by a rise in the indicator; similar situation to the short trade at the point G.

Points B and E indicate areas where the confirmation rule is filtering some false signals, as there are no strong swings confirming the change of the trend.

Those are some of the interpretations of the indicator, but it has some other utilities as, for example, its use as an exit point.

We will conclude that the indicator´s main strength resides in the combination of the two main technical analysis' elements, the study of price direction (represented by the CCI) and the study of volatility (represented by the ATR).

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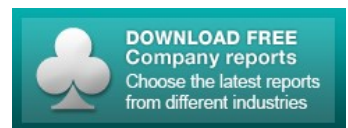
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