

Introduction

Thank you for making the effort to obtain and read my new e-book on intermarket analysis. I know you will learn and benefit from this e-book because I try to do all of my writing in "plain English"so it is easy to understand, no matter what your trading experience level.

I have been involved in markets and trading for nearly a quarter century. Starting out as a journalist on the trading floors of the futures exchanges in Chicago and New York was an excellent way for me to begin to learn about "the ways of the markets." Being able to walk right up to floor traders in the trading pits, on a daily basis, and ask them all kinds of questions about markets and price action was an excellent – and rare – opportunity to learn. I took full advantage of that opportunity as a floor reporter on the exchanges, including attending as many trading seminars and workshops as my editors would allow.

Not long after beginning my career on the rough-and-tumble futures trading floors, I realized that floor traders did have an edge over most retail traders in the futures markets because they tended to rely mainly on technical analysis to provide them with early clues about imminent trending price moves. Indeed, I came to learn that technical analysis takes into account all of the fundamental news that has or is expected to occur in a market, reflected by the most recent price activity. Price patterns and movement provided these traders with a roadmap for trading profits. To put it another way, if a trader decided to rely only on fundamental factors to analyze and trade markets, he or she could spend nearly all day studying past and present news events and supply and demand statistics, only to have all of that information already digested by and factored into the market price structure. Respected veteran trader and market analyst Louis Mendelsohn has taken technical analysis one step further – maybe even two or three steps. For more than 25 years he has advocated and developed an "intermarket" approach to market analysis and trading.

Intermarket analysis theory (actually, trading professionals know it as fact) suggests that markets are interrelated and behave in ways and patterns that are based upon other markets' price behavior. Two of my own experiences confirmed the validity of intermarket analysis as fact for me. The first example occurred very early in my career as a financial market journalist when I covered several markets each day while reporting from the trading floor. One of the

market areas I covered was stock index futures. In doing my preopening market call for stock indexes, I would ask floor traders about the likely price direction for the day. Nearly every day the response I got would be something like, "Well, based upon what the bonds are doing in early trading, we expect the stock indexes to" And when I covered the grains, the preopening calls would be based partly upon what the U.S. dollar, stock indexes and precious metals had done in overnight trading. And when I covered the precious metals, those traders looked to the value of the U.S. dollar for direction.

More recently, what I call the "axis" markets – crude oil, gold and the value of the U.S. dollar versus other major currencies – have been a defining example of the reality of intermarket behavior. These three market areas combine to produce a powerful influence on daily price activity in many other commodity markets. In fact, for a while the axis markets were the main factor driving prices. Imagine the trading advantage you could enjoy if you could employ intermarket analysis in the markets you trade. Mendelsohn, a pioneer since the 1980s in developing trading software for the personal computer based on intermarket analysis, has made that possible with VantagePoint Intermarket Analysis Software. His son, Lane, has led the effort to enhance the software to cover more markets with more indicators and more parameters to make this intermarket analysis trading tool even more powerful. I think you will enjoy the format of this book: short chapters that are easy to comprehend. Too many times in this industry, books on trading have been so technical and complicated that traders find themselves swimming in a sea of market statistics, computer code or mathematical formulas. You will find none of that in this book. What you will find are important lessons and anecdotes that will move you up the ladder of trading success.

Summary

Want Trading Secrets From the Pros?

The Trading Pro's Secret: Intermarket Analysis can help you better understand what it takes to be successful with VantagePoint. The easy to read book covers:

- Factoring in fundamentals.
- Understanding historical market correlations.
- Spotting intermarket relationships.
- Intermarket indicators for intraday or long-term positions.
- Using predictive indicators.

Bio

Jim Wyckoff, a senior market analyst at <u>TraderPlanet.com</u> and the proprietor of an analytical, educational, and trading advisory service, "Jim Wyckoff on the Markets," is into his third decade of involvement with the stock, financial and commodity futures markets. As a financial journalist with *Futures World News* for many years, he spent day after day reporting from the futures trading floors in Chicago, New York and abroad. At one time or another, Jim has covered every futures market traded in the United States and several overseas.

Born, raised, and still residing in Iowa, Jim loves adventures, from driving a Jeep across the highest mountain pass in the continental U.S. to extreme winter camping in the Boundary Waters Wilderness in Minnesota to hiking the jungles of South America.

Examine Fundamentals Even As a Technical Trader

Those who have read my features know I base the majority of my trading decisions on technical indicators and chart analysis – and also on market psychology. However, I do not ignore certain fundamentals that could impact the markets I'm trading. Neither should you.

When I was a reporter and editor for a wire service, I was forced to learn about the fundamentals impacting all the markets I covered. (At one time or another, I covered every U.S. futures market and also many overseas futures markets.) I had to talk to traders and analysts every day, and often the comments related to the fundamentals that impacted the particular market on which I was reporting.

Here are some useful nuggets about market fundamentals that I picked up from the professionals:

- Know the contracts you are trading price increments, contract size, physically delivered or cash settled or both, first notice day, last trading day, etc. Some traders know they want to trade, say, soybean futures without realizing what the value and risk of the contract entails. Contract information is all free and available on the websites of the exchanges on which the markets trade. For example, if you trade U.S. T-bond futures, you should know that the minimum tick size was changed recently from 1/32nd of a point (\$31.25) to ½ of 1/32nd of a point (\$15.625), based on a yield of 6%. You don't have to become an expert on yields, deliveries or notices, but you should be aware of the concepts.
- **Know your market.** Reading what the exchanges have to say about their markets is a great way to start out learning fundamentals. The Internet is indeed a wonderful tool to help you learn additional market fundamentals for free. Use your favorite search engine and do a search on your market. However, make sure you include "futures" in the search words, as this will narrow the focus of the search engine.

- Know how professional traders think. Professional traders anticipate market fundamentals and often factor the fundamentals into prices even before the fundamentals occur. In fact, this happens quite often in futures markets. For example, it stands to reason that heating oil demand will increase in late fall and winter and that heating oil futures prices should rise in that time frame compared to summertime prices. A novice trader may think it's a nobrainer to go long the December heating oil contract in September. However, keep in mind that all the professional and commercial traders know this, and they have likely already factored this seasonal fundamental into the price of the December contract.
- Be aware of U.S. government economic reports. These reports can sometimes have a significant impact on markets. Associations also release reports that impact futures markets. Even private analysts' estimates can move markets. Try to learn about the reports or estimates that have the potential to affect the market you wish to trade. You should make it a priority to know, in advance, the release date and time of any scheduled report or forecast that has the potential to move a market. For example, if you are thinking about establishing a position in the T-bond market a day before a U.S. employment report is due, you may want to wait until the report is released before entering your position. The employment report can whipsaw the bond market in the minutes after it's released, which could stop you out of your position.
- Follow media coverage. If you like to trade financial futures, newspapers like the Wall Street Journal and Investors Business Daily have sections that follow bonds, stock indexes and currencies can influence traders' decisions. Reading about how fundamental events impact these markets allows you to get up to speed on fundamentals and gives you insights into information available to other traders. If you trade commodities such as cotton, coffee or cocoa, it's a little more difficult to find fundamental news sources unless you subscribe to a specialized news service. The U.S. Department of Agriculture website does have reports on many commodities that trade in futures markets, including not only major U.S. crops but also world markets such as coffee and sugar.

Realize that markets are interrelated and influence each other. That's especially true for major markets such as crude oil, gold and the U.S. dollar, which have an effect on many other markets. This "intermarket analysis" should never be ignored. "Intermarket analysis empowers traders to make more effective trading decisions based upon the linkages between related financial markets," says Louis Mendelsohn, developer of VantagePoint Intermarket SoftwareTM. "Bv Analysis Trading incorporating intermarket analysis into your trading strategies, rather than limiting your scope to each individual market, these relationships and interconnections between markets will work for you rather than against you."

Make a 'Checklist' To Help You Execute Trades

One of the questions my readers frequently ask me is how to improve "pulling the trigger" to enter a trade. How many traders have ever pondered a potential trade for so long that, once they actually got ready to execute it, they then got cold feet and missed the move?

Some traders are reluctant to put on a position because they are torn between what they perceive as conflicting market factors. One indicator suggests one thing, another says the opposite. "What should I do?" they wonder.

Making a "trading checklist" to prioritize your criteria not only will help you decide when to execute a trade but will also help you identify potential winning trades. You'd be surprised how a visual checklist can resolve uncertainty in your mind.

So what should a trader put on a trading checklist? That depends on the individual trader. Each trader should have his or her own set of criteria that helps to determine a market to trade and the direction to trade it – including a point at which to enter a position.

I like to compare my trading criteria to a bunch of tools in a toolbox. The more tools I have at my disposal, the better. Different tasks require different tools. However, I think some basic tools are more important than the others and are a must for any toolbox. In trading terms, you know them as chart patterns, technical indicators, fundamental factors, etc.

Put your most important trading tools on the checklist in the order of their importance to you.

At the top of my trading checklist is, "Are daily charts in agreement with longer-term trends?" A very important tenet for me to take a position is that charts for shorter-term and longer-term periods should agree on the trend of the market. If the daily and weekly charts are bullish but the monthly is bearish, there's a good chance I'll pass on the trading opportunity.

The following three close-only charts of continuous soybean futures illustrate the importance of looking at different time frames to put current price action into its proper historical context.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

Soybean prices are clearly in a downtrend on the chart above and appear to be just breaking the trendline to move into a potential uptrend. But this is only a one-month chart. Is this a true picture of soybean price direction?



This one-year chart paints quite a different picture, as soybeans have clearly been in an extended uptrend for more than six months. The "downtrend" in the one-month chart has penetrated the uptrend line but hasn't confirmed a downtrend and may be just a large correction of the upmove.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

The five-year chart shows that while the steep trendline of the last year has been breached, soybean prices are still well above the longer-term trendline to the upside. The chart also shows the previous high around \$10.50 (red dashed line) from several years earlier that was surpassed on the runup to new highs. Once prices moved above that point, traders looked to the all-time high in soybean futures of \$12.90 established way back in the 1973 as a price target.

It's like looking at a roadmap to see where you are now and where you might be going in relation to where you have come from in the past. If you don't look at the bigger picture, you could be lost in the wilderness of prices without a good idea of where the value of the current market really is.

With both the major trendline and a previous high that now serves as potential support crossing in the \$10-\$10.50 area on this chart, that area now becomes a focal point for soybean price action and could become a key battleground if soybean prices sink to that level. At this point on the right edge of the chart, the longer-term trend is still up until proven differently.

If the trends for different time periods do not agree and the very first (and most important) objective on my trading checklist is not met, then I really don't need to go any farther down the list. I'll look for another trading opportunity.

However, if the last item (least important) on your trading checklist does not meet your objective but the big majority of the other objectives on your list are met, then you may make the trade anyway. It's entirely possible that all of your trading tools on the list may not give you the proper signal to trade the market, but it's still a good trading opportunity.

Also keep in mind that the times you are looking at may not be days, weeks and months but could be minutes, hours and days if you are a more active trader and can watch the market more closely. It all depends on your trading plan, which we'll discuss in the next chapter.

Another valuable trading tool on my checklist is how the markets are relating with and reacting to each other, also called intermarket analysis. Veteran trading professionals know that most markets are like a big spider web – they are all connected by varying degrees and dependent on each other. Realizing that no market operates in isolation can give you an edge in trading the markets. The main value of intermarket analysis comes from improving your ability to identify market turns and new trends ahead of other traders.

You may have a favorite technical indicator or some other tool you would put on your own checklist. Every trader should have at least a few trading tools to help them determine a trading opportunity and how to capitalize on it. Listing those tools on paper, in order of importance, and then examining that list when deciding each trade should make the sometimes difficult task of pulling the trigger a little easier.

Refining Your Own Specific Trading Plan of Action

Some of my readers are quite interested in what I think about their trading systems or trading plans, which they explain in great detail. I don't try to duck their questions, but my answer to this question is usually the same: "If your trading system or plan works for you, then stick with it and don't make major changes to it."

The old expressions, "There's more than one way to skin a rabbit" or "If it isn't broken, don't try to fix it" come to mind and certainly ring true in successful futures or stock trading methods. Just because one trading method or plan works well for a particular trader does not mean the same plan will work well for another trader. Trading plans should be customized to fit each person.

Of course, all trading plans should address certain basic trading tenets, such as minimizing risk and proper money management. But again, guidelines that are appropriate for one trader may not fit another.

Below are a few general questions that may help you define or refine your own trading plan or that may help you reaffirm that your trading plan is right on the mark for you:

- 1. Are you a trend trader? Most successful traders are trend-followers, in some form or another. But there are a few successful traders who do "buck the trend" and are not trend-followers. If you are a trend-following trader, then your trading plan should include technical tools that focus on the trend of the market such as moving. If you do not consider yourself a trend-following trader, then you probably should not use trading tools whose main focus is price trend. Instead, you might want to focus on momentum oscillators.
- 2. What is your trading "time frame?" If you are mostly a "day trader," then your trading plan needs to include trading tools that attempt to define shorter-term trends or recognize shorter-term market turns. A day trader is likely to be less interested in a 40-day moving average than a 15-minute moving average. A longer-term "position trader" is likely to focus on longer-term trend lines or fundamental factors such as economic reports or weather patterns. There are successful day traders and successful position traders,

but the point here is that some different trading tools should be employed for each type of trader.

- 3. Are you an aggressive or conservative trader? There is no right or wrong answer here. There are successful aggressive traders and successful conservative traders, but they very likely have significantly different trading plans or methods. The aggressive trader should realize that he or she will likely experience some bigger trading losses at some point as they attempt to take bigger profits off the table. The aggressive trader's trading plan should take into account that trading account drawdowns are likely to be larger during any losing streak. Although the conservative trader's trading plan will likely not place as much emphasis on big drawdowns, neither should that more conservative trading plan expect to see bigger trading profits accrue in short periods of time.
- **4. What is your benchmark for trading success?** This question does not have a single right answer either. However, your trading plan needs to take into account what you deem to be successful trading. Are you satisfied to be a part-time trader who is not in the market with positions at all times. Or are you determined to be a full-time trader who has a position or positions most of the time. There is no doubt that there is much more pressure on the person who tries to be a full-time trader. Any trading plan for the full-time trader needs to be that much more concise, including contingency plans for losing streaks and bigger account drawdowns.
- **5. Do you keep track of other markets in addition to the one you are trading?** If not, you should. Remember that all markets are interrelated, and many markets are affected by the same fundamental events. Intermarket analysis has a bearing on every market.

Establishing Your Own Favorite Trading 'Setup'

My readers are always asking me about trading secrets to get into and out of positions. Well, here is my secret: I don't have any trading "secrets."

What I do have is many years of market experience, including studying the markets and technical and intermarket analysis . . . and listening carefully to the best and brightest traders sharing their philosophies on successful trading. You should be suspicious if anyone tries to tell (or sell) you any trading "secrets."

The first step to get better entry and exit points for your trades is a trading plan – before you enter the trade. Then you need to stick to it. Your trading plan can have different scenarios and options once you're into the trade, but the key here is don't "fly by the seat of your pants" when you're in a trade. You don't want to let emotions dictate your strategies while you're actively trading a market.

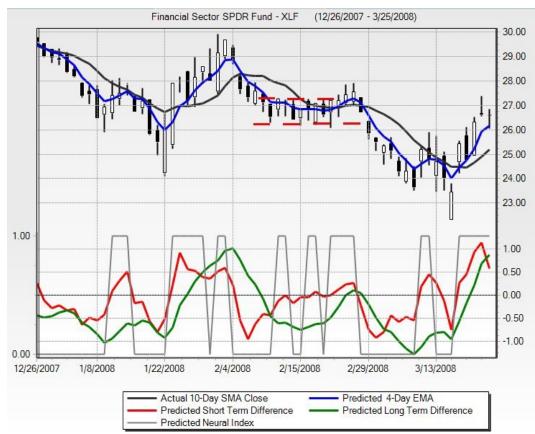
As you are developing your trading plan, realize that the amount of money you have to trade can dictate the markets you can trade and how you can trade them. Know how much money you can stand to lose and then place protective buy or sell stops accordingly. You can tighten your stops, depending on how price action unfolds, but don't change your mind and pull your stops when you're in the middle of the trade.

If you've got a winner going, you should also have a plan in place about when and where to take your profits. Again, your trading plan can allow for some flexibility once you are in the trade.

More specifically, I like to "buy into strength" and "sell into weakness." This trading method abides by the old trading adage, "The trend is your friend." Conversely, traders who try to "fight the tape" and be a bottom-picker or top-picker usually wind up getting their fingers burned.

One of my favorite trading setups is what I call a "collapse of volatility." Prices that had been making wide daily ranges move into a period of smaller daily ranges and form a trading range or congestion area on the chart, staying between key support and resistance levels for an extended period of time – the longer, the better. Then, if the price "breaks out" of the range (above key

resistance or below key support), I like to enter the market long on an upside breakout or short on a downside breakout. The red dashed lines on the financial sector SPDR exchange-traded fund below illustrate the boundaries of a tighter range after a period of volatility. (We'll discuss the signals provided by the other indicators on this chart in a later chapter.)



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

A safer method would be to make sure there is follow-through strength or weakness during the next trading session or two to avoid a false breakout, which would have been good advice if you were trading the upside breakout on this chart. The tradeoff is that you could be missing out on some of the price move by waiting an extra trading session.

If you are long the market, set your sell stop just below a technical support level that's within your tolerance for a drawdown. If you're short, set your buy stop just above a technical resistance level that's within your tolerance for a drawdown. Don't set your stops right at support or resistance levels, because there's a decent chance that those levels will check and possibly reverse the price move. That

may prevent you from getting stopped out and then watching as the market resumes its directional march.

If you've got a winner and decide to let your profits run (per your initial trading plan), use trailing stops that utilize technical support and resistance levels, moving your stops as the market moves in your direction.

When the direction of prices is not so clear and you are in the middle of a trade, it's also important to employ intermarket analysis techniques so you know how your particular market is reacting with other key markets. Some markets can and do lead other markets on trending price moves. Although it hardly qualifies as a "secret" to many traders, intermarket analysis is a key in trading a number of markets.

"With today's advances in communications technology and a global marketplace, single-market technical analysis is less effective because it relies on lagging indicators that view a market retrospectively to identify re-occurring patterns that then form trends," comments Louis Mendelsohn, developer of VantagePoint Intermarket Analysis Software. "To be clear, single-market analysis is not wrong nor is it irrelevant for identifying trends; alone, it is simply insufficient. Intermarket analysis tools comprised of leading indicators forewarn whether an existing trend is likely to continue or is about to change direction."

Understanding Historical Market Correlations

In nearly a quarter century of active involvement with trading and the markets, rarely, if ever, have I seen the type of market activity like the events that have unfolded in recent years. A powerful axis of three markets – the U.S. dollar, crude oil and gold – has combined to impact most other markets significantly.

Intermarket relationships are certainly not a new phenomenon. In fact, Louis Mendelsohn has been developing and enhancing software and trading strategies that incorporate intermarket analysis for decades. (See the next section for more details.)

What has been different and unique recently is the degree to which the axis influences most other markets. Arguably, the axis of the dollar, crude oil and gold – sometimes referred to as the "outside markets" that influence other markets – often seem to be exerting more influence over near-term price direction in many markets than those markets' own fundamentals. This is an important factor for traders to keep in mind.

The combination of a weaker U.S. dollar versus the other major currencies, record-high triple digit crude oil prices, and record-high gold prices have had a significant bullish influence on most raw commodity futures markets. And the axis also has had a bearish influence on the U.S. stock market, which was in turn bullish for U.S. Treasuries. If nothing else, these "outside markets" have limited selling pressure in commodity markets at times. See what I mean about the reality of intermarket analysis!

Arguably, the value of the U.S. dollar is the most important component of the axis, followed by crude oil and then gold. The currency debacle of the early 1990s, when the dollar was under severe attack from speculators, reached a peak only when daily price moves in the currencies became significantly larger. As a result of longer-lasting economic and political policies, price trends in the currency markets tend to be stronger and longer-lasting than price trends in other markets.

Experienced futures traders realize there are many other correlations among futures markets, some of which are valuable guides in helping to determine specific market trends and some of which are fickle. Below is a review of some correlations that have

been trader favorites over the years and that today's traders might want to watch, keeping in mind that these basic correlations among futures markets may have weakened or strengthened over time:

U.S. dollar-gold: The gold market and the dollar usually trade in an inverse relationship – when the value of one goes down, the value of the other goes up. This has been the case for many years. During times of U.S. economic prosperity and lower inflation, the dollar will usually benefit as money flows into U.S. paper assets (stocks and bonds), while physical assets (gold) are usually less attractive. Conversely, during times of weaker U.S. economic growth, higher inflation or heightened world economic or political uncertainty, traders and investors tend to flock out of "paper" assets and into "hard" assets such as gold. Inflation is a bullish phenomenon for gold.

U.S. dollar-U.S. Treasury bonds: Usually, a stronger dollar means a stronger bond market because of good demand for U.S. dollars (from overseas investors) to buy U.S. T-bonds. T-bonds are also seen as a "flight-to-quality" asset during times of economic or political instability. In the past, the U.S. dollar has also benefited from flight-to-quality asset moves. However, since the United States has become more vulnerable to major terrorist attacks, the safe-haven status of the greenback has been much less pronounced.

Crude oil-U.S. Treasury bonds: If crude oil prices rally strongly, that is a negative for U.S. T-bond prices due to notions that inflationary pressures could reignite and become problematic for the economy. Inflation is the arch enemy of the bond market. Rising crude oil prices are also bullish for the gold market.

Commodity indexes-U.S. Treasury bonds: Commodity indexes are baskets of commodities melded into one composite price. There are several different types of commodity indexes, weighted to different sectors. A rising commodity index means generally rising commodities prices and increasing chances of inflation. Thus, a rising commodity index is negative for U.S. Treasury bond prices.

U.S. stock indexes-U.S. Treasury bonds: Stock index and U.S. Treasury bond futures prices tend to trade in an inverse relationship historically – that is, when stock prices are up, bond prices are usually down. However, during the long bull market run a few years ago, stock and bond prices traded in tandem. In fact, years ago, before all the electronic overnight futures trading began, the best way to get a good read on how the stock indexes would

open was to look at early trading in the T-bond market (pit trading in T-bond futures trading opened 70 minutes before the stock indexes).

Silver-soybeans: This corollary may be more fiction than fact, at least nowadays. But during the "go-go" days of soaring precious metals and soybean prices, it was said that if soybean futures locked limit up, bean traders would turn to buying silver futures.

Cattle-hogs: The point to mention here is that if strong price gains or losses occur in one meat futures complex, there is likely to be somewhat of a spillover effect in the other meat complex. For example, sharp losses in cattle or feeder cattle futures will likely weigh on the prices of hogs and pork bellies. On the other hand, if the price for, say, beef gets too high, consumers are likely to turn away from beef at the meat counter and look for pork or chicken substitutes, eventually bringing the price of beef (and cattle) back into line with other meats.

Currency futures-U.S. Dollar Index: Most major currency futures contracts are "crossed" against the U.S. dollar. Thus, when the majority of the currencies are trading higher, it's very likely that the U.S. Dollar Index will be trading lower. It's a good idea for currency traders to keep a watchful eye on the U.S. Dollar Index because it is the best barometer for the overall health of the U.S. dollar versus major foreign currencies.

U.S. stock indexes-lumber: Lumber is a very important commodity for the U.S. economy, literally a building block for the nation. If the stock market is sharply higher, lumber futures prices will be supported, reflecting a strong economy and building demand. A big selloff in the stock market will likely find selling pressure on lumber futures.

New York cocoa-British pound: London cocoa futures trading is as important as New York cocoa futures trading, perhaps even more so on a worldwide basis. London cocoa futures trading is conducted in the British pound currency. Thus, big fluctuations in the pound sterling will impact the price of U.S. cocoa futures due to the cross-currency fluctuations of the British pound and the U.S. dollar. Keep in mind that arbitrage trading is taking place constantly between the New York and London cocoa markets so the currency cross-rates between the pound and the dollar are very important.

Grains-U.S. Dollar Index: A weaker U.S. dollar will be an underlying positive for the U.S. grain futures markets because it makes U.S. grain exports more competitive (cheaper prices) on the world market. Larger-degree trends in the U.S. dollar will have a larger-degree impact on the grains.

Laying the Base For Intermarket Analysis

Intuitively, traders have no problem seeing the correlations mentioned in the previous chapter and understanding how developments in other markets can have an impact on the market they are trading. They realize markets do not function in a vacuum, and it seems quite logical to assume that single-market analysis will not be sufficient in today's global marketplace where trades are taking place 24 hours a day.

Accepting the importance of intermarket relationships is one thing, but implementing the effects of these relationships into a trading strategy is a little more challenging. First, you have to identify which markets have the most effect on the market you are trading and then you have to quantify the degree of influence that these related markets have on each other.

The most helpful tool I have found that accomplishes this task is VantagePoint Intermarket Analysis Software, developed by respected trader/analyst Louis Mendelsohn, whom I have mentioned several times already in this e-book.

"There are no 'silver bullets' when it comes to trading," cautions Mendelsohn. "Trading is work, and it takes time and effort to understand a particular market, establish a strategy to trade within that market, and apply the necessary discipline to stick to the strategy. Then, and only then, will VantagePoint provide the edge needed to trade successfully."

What VantagePoint does first is identify the markets that have the most influence on a target market. Instead of correlations involving several markets, as described in the previous chapter, the software takes price, volume, open interest and other data through a neural network process to find as many as 25 markets that have the most influence on a target market. Then VantagePoint evaluates the degree of influence that each market has on a target market. The result is a set of intermarket data that can be used as the price input for technical indicators such as moving averages, stochastics and Relative Strength Index.

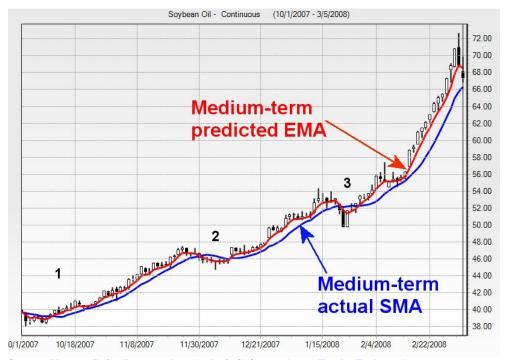
In traditional technical analysis, these indicators lag the market because they are based on prices that have already occurred – prices that are history and may not in tune with current price activity. With intermarket data, extensive studies have shown that VantagePoint is able to produce predictive indicators that can forecast market trends with about 80% accuracy across a broad range of markets and time spans.

I am a market analyst and trader and not a computer programmer. My job is analyzing data output so I do not attempt to get into all the details that explain exactly how VantagePoint arrives at its predictive indicators other than to say that the process involves extensive computer tests of intermarket relationships using neural networks that run the data through numerous iterations to come up with the best results. Sort of like a trial-and-error method to discover the best parameters that produced a desired result. This is perfect work for a computer.

(If you are interested in understanding more about the underlying formulations of intermarket analysis, read Mendelsohn's book, *Trend Forecasting with Technical Analysis*, which explains his trend forecasting philosophy and its significance for traders in today's global markets, or go to www.TraderTech.com)

Applying Intermarket Analysis to Trading

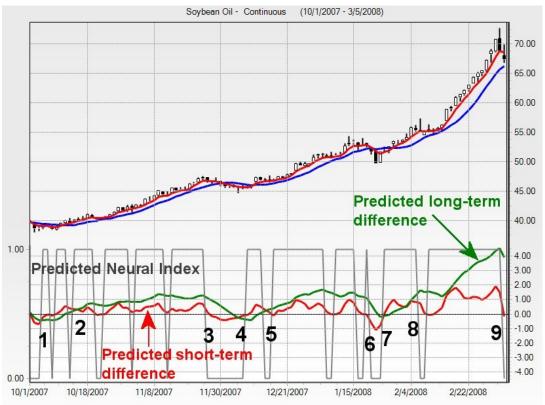
Rather than studying all the nuances of how the neural networks are structured and how they evaluate the data input, I am more interested in examining how VantagePoint's predictive capabilities can help me develop trading strategies that can give me an edge as I compete with the market crowd for the best trading positions. There are many possible tactics that can be developed with VantagePoint's predictive indicators, but I will illustrate only a few of the basic techniques that traders use to take advantage of VantagePoint's forecasting capabilities.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

The first is essentially just a basic moving average crossover strategy – when a shorter-term moving average crosses above a longer-term moving average, buy; when the shorter-term moving average crosses below the longer-term moving average, sell. The edge that VantagePoint provides is that the turns of its predicted exponential moving averages tend to occur before the turns in the actual simple moving averages, providing an early alert that gives VantagePoint traders an opportunity to get into a position before other traders see the turn.

Using the predicted and actual medium-term moving averages in VantagePoint, the soy oil chart above illustrates three potential crossover locations that could have been used to enter positions to ride the long uptrend in late 2007 and early 2008. Depending on your risk tolerance, patience and discipline, you could have gotten long when the crossover itself occurred or you might have used traditional chart analysis techniques and waited until the market broke above the previous high before establishing a position, keeping a trailing stop below the actual moving average.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

VantagePoint has several other predictive indicators that can be used with the predicted moving averages to provide confirmation for a trade and give you more confidence to "pull the trigger" (see the section below for more comments on this topic).

The first predictive indicator is the Predicted Neural Index, a proprietary indicator that predicts whether or not a three-day simple moving average of the typical price (the average of the high, low, close) will be higher or lower in two days than it is today. If the reading for the Predicted Neural Index is 1.00, the market is expected to be higher in two days; if the Predicted Neural Index is 0.00, the market is expected to be lower. Those are the

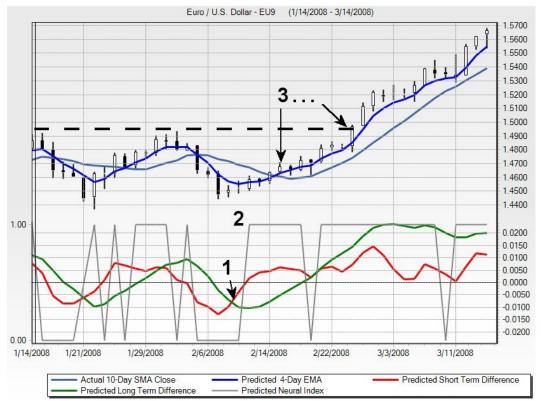
only two choices so it is either right or wrong. Extensive tests have shown a predictive accuracy rate of about 80 percent over a broad range of markets and time spans, so it is definitely an indicator worth watching and having positions in line with its forecasts.

The second indicators are the predicted differences for three different time frames. In addition to the moving average crossovers, VantagePoint also compares the predicted and actual moving averages to each other to indicate the market's weakness or strength and whether this strength or weakness is increasing or diminishing. A common combination involves using the predicted short-term moving average difference with the predicted long-term moving average difference, using crossovers of these lines and their positions relative to the zero line to act as an indication to be long or short.

I'll work through the numbers on the soy oil chart above to illustrate how a moving average crossover and the predicted Neural Index and predicted difference indicators might be used together in a typical trading strategy:

- 1 The predicted short-term difference moves above the predicted long-term difference and the Predicted Neural Index is at 1.00, which are the first two steps for being long. But the predicted short-term difference is still below zero and the predicted medium-term moving average has not crossed above the actual medium-term moving average. Those three conditions do come together a few days later to put you into a long position.
- 2 The predicted short-term difference has crossed below the predicted long-term difference, suggesting a possible change in trend direction, but it is still above zero and the predicted medium-term average remains above the actual medium-term moving average so you would retain the long position.
- 3 After a price runup, the predicted differences both point down, the predicted Neural Index is at 0.00 and the predicted medium-term moving average has turned down, all suggesting getting out of the long position.
- 4 The predicted short-term difference moves back above the predicted long-term difference, the predicted Neural Index is at 1.00 and the predicted medium-term moving average starts to turn higher, setting up a return to a long position.

- 5 With the predicted Neural Index at 1.00, the predicted medium-term moving average crossing above the actual medium-term moving average, the predicted short-term difference above zero and prices moving above the previous high, VantagePoint indicates another long position. With the predicted long-term difference moving above the predicted short-term moving average and above the zero line, the crossover could be interpreted as an acceleration as the long-term trend gains strength and provides an add-on opportunity.
- 6 This two-day bump in the uptrend provided a challenge for a bullish trader. The decline of the predicted short-term difference below the zero line, the predicted Neural Index at 0.00 and a crossover of the predicted medium-term moving average below the actual medium-term moving average all indicate getting out of the long position.
- 7 All those indications in 6 get reversed a couple of days later, and you're right back in a long position with the predicted short-term difference, predicted Neural Index and the moving average crossover providing confirmation.
- 8 With the predicted long-term difference crossing above the predicted short-term difference and prices moving above an earlier high, you have another acceleration in trend strength that could be another good add-on opportunity ahead of the steepest part of the uptrend.
- 9 The uptrend begins to deteriorate with a big black candle looking like an ominous top signal. The predicted differences have both turned down and the predicted Neural Index has changed to 0.00. After an extended rally and with prices at these levels, that would probably be enough to cause a trader to close out the long position or to at least tighten stops close to the market. All that is necessary for a shift to a short position is for the predicted medium-term moving average to cross below the actual medium-term moving average.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

Here is another example of putting these three indicators together on a EUR/USD chart in what is known as a basic 1-2-3 strategy with VantagePoint.

- 1 The predicted short-term difference crosses above the predicted long-term difference.
- 2 The predicted Neural Index changes from 0.00 to 1.00.
- 3 The predicted medium-term moving average crosses above the actual medium-term moving average, where the long trade could be made. A more conservative trader might wait for the breakout of a previous high (dashed line) as the point to enter a long position, or a trader trying to build a larger position might use this breakout as an add-on opportunity.

Getting into Intraday Trading

Although VantagePoint is generally regarded as an end-of-day program for daily analysis, it also offers predictive indicators for traders who are interested in getting involved in intraday price movements. This strategy requires you to monitor prices more closely and may not fit your style, but if you like to follow the pace of a market and have access to intraday data, it can be a rewarding way to trade without having the risks of holding positions overnight or over a weekend or holiday period.

Using data provided by intermarket analysis, VantagePoint produces predicted next day's high and low prices. As the chart below shows, the predicted highs and lows provide a trading range within which the next day's trading activity is expected to take place. The ranges form a channel that is useful not only for intraday traders but for position traders as well.

Before getting into the strategy itself, I should mention several caveats:

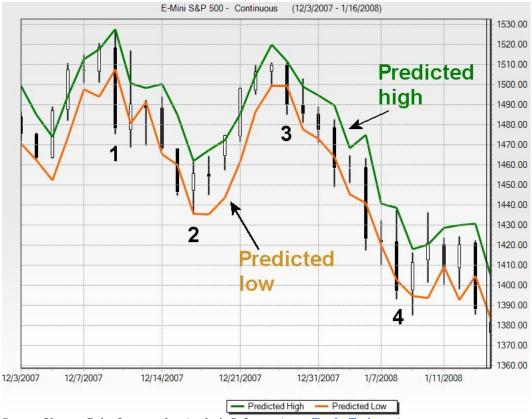
- The market should have sufficient intraday trading ranges to make trading them worthwhile.
- The market should have plenty of liquidity. For that reason, many traders prefer to limit their "day" and their trading to "regular" trading session hours for example, 8:30 a.m. to 3 p.m. Central time for U.S. stock indexes even though electronic trading is available around the clock.
- You will place orders every day but you will not have trades every day in fact, it is likely there will be more days when you do not trade than days where the setup is available. In some cases, activity in overnight trading or extremely volatile conditions will negate the possibility of using this strategy.
- You will need to experiment to find the time frame, parameters and other setup criteria that works best for you.
 In other words, more research is needed to find out how viable this strategy is over a longer time.

The basic strategy involves placing four orders early in the regular trading session when the open is within the predicted daily range – that is, between the predicted high and predicted low. If the open is beyond the daily range (or if overnight price activity has been

outside the range and very volatile), take a pass on this strategy and come back another day.

- 1. Limit order to buy at the next day's predicted low plus a set amount (X points, X percent of the recent daily range or some other criteria).
- 2. Limit order to sell at the next day's predicted high minus a set amount (X points, X percent of the recent daily range or some other criteria).
- 3. Protective sell stop at the next day's predicted low minus a set amount (X points, X percent of the recent daily range or some other criteria).
- 4. Protective buy stop at the next day's predicted high plus a set amount (X points, X percent of the recent daily range or some other criteria).

Set a time limit for these orders (two hours?). If your entry order is not activated within that time limit, pull the orders. **Do not try to use this strategy late in the day.** If the market moves up and reaches your limit sell order with five minutes left in the regular trading session, it could leave you with an unwanted short position overnight. (On the other hand, of course, if you are a longer-term trader, this could be an entry tactic, depending on the flow of the market).



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

The E-mini chart above shows four days when this strategy would have worked well during the time period shown. On other days, the market generally (1) never reached your entry order points, (2) opened outside the predicted daily range, (3) reached your entry point too late in the day (opened in the middle of the predicted daily range but closed near the predicted high and your limit sell order, for example), or (4) stopped you out with a loss.

In effect, you are fading the day's predicted high and low and attempting to take a piece out of the middle of the predicted daily range with this strategy, not a long-term position. We'll use 2 points as our "fade" criteria – that is, 2 points below the predicted high and 2 points above the predicted low, rounded to the nearest quarter point, as the place to set our limit orders. Stops will be placed 2 points above the predicted high and 2 points below the predicted low so that, assuming you are filled at the prices indicated, you have a risk of 4 points or \$200 on each trade.

Let's take a quick look at each of the four example trades highlighted:

1. The predicted high was 1527.83, the actual high was 1527.00 The predicted low was 1507.83, the actual low was 1475.50. You would have been short on a limit sell order at 1525.75; the stop order at 1529.75 was not reached. You would have ridden the market down to your limit buy order at 1509.75 to exit the short trade. Result: 16 points or \$800 profit for the day.

In this case, you gave up a lot of potential profit by exiting as prescribed by this trading strategy, but that's the way trading plans sometimes work. Depending on how you assessed the price action and the momentum of the market, you might have used a trailing stop and stayed with your short order until the close, which could have meant more than \$1,500 additional profit. But . . .

- 2. The predicted high was 1462.18, the actual high was 1461.75. The predicted low was 1435.88, the actual low was 1485.00. The chart and table below provide a more detailed explanation of the results from this example.
- 3. The predicted high was 1511.73, the actual high was 1527.00. The predicted low was 1507.83, the actual low was 1475.50. This bar is similar to Example 1 but not as extreme. The main question might be whether you entered a short trade at all because the open was at 1509.75 and the predicted high for the day was 1511.75, right on the 2-point criteria for the strategy. Assuming you did have a limit sell order in place and got into a short position at 1509.75, you would have exited at the limit buy stop at 1501.25. Result: 8.5 points or \$425 profit.
- 4. The predicted high was 1438.89, the actual high was 1437.75. The predicted low was 1402.89, the actual low was 1393.00. The market again opened in the middle of the predicted price range and, as before, we don't know whether the high or low of the day came first. By looking at the long black bearish candle, we'll assume the market moved to its high first and then sank to its low for the day. With a limit sell order at 1437.00, you sold near the high of the day, pulled the sell stop order and closed out the short trade at the limit buy order placed at 1405.00. Result: 32 points or \$1,600 profit for the day. Again, you could have made more money on this day, but that's not part of the trading plan.

Below is a more detailed look at Example 2 that should provide a clearer explanation of how this intraday strategy works on three

different types of days – one a small loss, the second a nice profit and the third a no-trade day.



Source: VantagePoint Intermarket Analysis Software (www.TraderTech.com)

	Predicted high	Actual high	Limit sell order	Buy stop	Predicted low	Actual low	Limit buy order	Sell stop
Bar 1	1485.21	1468.00	1483.25	1487.25	1460.19	1444.75	1462.25	1458.25
Bar 2	1462.18	1461.75	1460.25	1464.25	1435.88	1435.50	1438.00	1434.00
Bar 3	1467.48	1464.50	1465.50	1469.50	1435.28	1445.00	1437.25	1433.25

Bar 1 – The market opened in mid-range and the predicted high was never in the picture as prices slid to the limit buy order at 1462.25. Instead of bouncing off the predicted low to stay within

the predicted range, the market kept sliding, hitting the sell stop order at 1458.25. Result: Loss of 4 points or \$200.

Bar 2 – The market again opened in the middle of the predicted range. It's hard to say from the position of the open on this candle whether the high or low came first, and it really doesn't matter because prices hit both edges of the predicted daily range. Because the market closed higher than the open, we'll assume the market dipped first to hit your limit buy order at 1438.00 but never got as low as your protective sell stop at 1434.00. The sell stop remained in place but once you were long, you pulled the buy stop order. The market advanced to hit the limit sell order at 1460.25, where you exit the trade, assuming no slippage. Result: 22.25 points or \$1,112.50 profit for the day.

Bar 3 – The market opens within the predicted price range but falls short of reaching the limit sell order by a point and the actual low stays about 8 points above the limit buy order in a narrower range day. Result: No trade.

Although VantagePoint's predicted highs and lows for the next day might seem to be most useful for an intraday trading strategy, they can also be used by a position trader in several different ways. For example, assume VantagePoint's predictive indicators have forecast an uptrend. You could place a buy stop a few points above the predicted high as a good spot to jump on board the pending move.

Or if you are wondering about the strength of a trend, look at where the actual price range and high or low are relative to VantagePoint's predicted daily range. If the closes are above the predicted high and the candle shows that closes are above the opens, you have additional confirmation for a strong uptrend that can give you confidence to enter or add to a long position. The same concept applies on the downside although the downdrafts tend to be much sharper than the gains in a rising market.

In any case, the predicted highs or lows can be excellent tools to help you place stops with any strategy because those prices will usually be at a point that is different than what most traditional traders are using with traditional chart analysis.

Sharpening Your Trading Skills During Market 'Noise'

When I was a futures market reporter with a wire service, I spent time working right on the futures trading floors in Chicago and New York. Most of the time my daily reporting "beat" involved interviewing traders and analysts and then writing three daily market reports. For months at a time I would cover the same markets, day in and day out. It was a fantastic learning experience and an opportunity that very few get.

One thing I eventually discovered from covering the same markets day after day, month after month, was that most of the time the vast majority of the markets' overall fundamental and technical situations did not change on a day-to-day basis. Yet, as a market reporter, I was conditioned to write about why the market went up one day and why the market went down the next day, or vise versa. Even though a market may have been in a very narrow trading range for days or weeks, I had to ask the traders and analysts every day to come up with some fresh fundamental and\or technical reasons why that market moved only a fraction.

Reporting on the New York "soft" futures markets (coffee, cocoa, sugar, cotton and orange juice) was especially difficult for a reporter in the floor trading days and is probably more difficult now that those futures markets trade electronically and no longer on the floor. A reporter in these markets needs to dig up and write about some fresh-sounding news every day. Quite often, the soft markets just do not have much fresh fundamental news on a daily basis – or sometimes even on a weekly basis, for that matter.

Conversely, it was easier covering the financial and currency markets because there was usually at least one government economic report that came out every day that would make those markets wiggle a bit. Or some government official (like Fed Chairman Alan Greenspan at the time) would make comments that made those markets take notice.

As time went on and I came to better understand markets and market behavior and as I studied specific trading strategies, I realized that the day-to-day market "noise" is not much use to most traders. Here's a specific example of market noise: The live cattle futures market was up a bit on a Monday due to talk that the cash cattle trade would be at higher money later in the week. On

Tuesday the futures market dropped a bit because of ideas the cash cattle trade later in the week might not be at firmer money but steady at best. Nobody was trying to manipulate live cattle futures prices that week. It was just a case of differing opinions getting center stage when the market closed on different sides of unchanged.

For a trader who tries to follow the near-term fundamentals in a market too closely, hearing that kind of conflicting news can be a nuisance at least or, at most, a factor that prevents successful trading results. It's not easy for less-experienced traders to ignore the differing daily drumbeat of fundamental news that is reportedly impacting a market.

The lesson here is that prudent traders should not become overly sensitive or reactive to most of the day-to-day fundamental news events that are reported to be moving the market on any given day. What is important for traders is that they recognize and understand the overall trend of the market. Daily market "noise" is usually an insignificant part of the overall process of trading and of market behavior itself.

Intermarket analysis tools that can identify reoccurring patterns within financial markets and between related global markets afford traders a broadened trading perspective and a competitive edge in today's trading environment, which has been transformed by the globalization and integration of the world's financial markets. Identifying trend direction and not trying to respond to each little bit of information is critical to successful trading, especially if you can rely on leading indicators provided by intermarket analysis and not lagging information.

Trading 'Nuggets' That May Be Helpful

After studying the markets and discussing them with my readers and peers for so many years, I have gleaned a number of tidbits that don't fit any particular category. Here are just a few of my conclusions/opinions or trading "nuggets" to pass on to you.

Trading is indeed a 'head game'

I have written extensively about the all-important psychological aspect of trading futures. My conversations with traders continually reinforce the truism that trading is much more about personal discipline and controlling emotions than it is about discovering some great trading method.

The one truth about futures trading that "psyches out" many traders is that losing is part of the overall process of trading. If a trader cannot accept the fact that during most years he or she will likely have a higher percentage of losing trades than winning trades, then odds for his or her ultimate trading success are very low. Most professional traders will "cut their losses short" on the more numerous losing trades and "let their profits ride" on the fewer winning trades – that's why they are profitable traders.

Remember, it's more important to be profitable in futures trading than to be "right." Being right is an ego thing that will cause traders to pull protective stops, try to "average down" losing positions, and do other things that are not conducive to successful trading.

Protective buy/sell stops are a must for most traders

The advantage of using protective buy and sell stops when initiating a trading position is that you have an exit strategy in place when you enter the trade. The intraday trading strategy using VantagePoint's predicted high and predicted low prices described in an earlier chapter provide a good example of a trading plan that incorporates stop orders right with the entry orders.

It is much more difficult to try and figure out where you are going to exit a trade when you are in the heat of battle in the middle of a trade. Most veteran trading professionals agree that "any fool" can enter a trading position, but it's the astute and successful traders who know when to exit a trade. Having an exit strategy, via protective buy or sell stops, in your initial trading plan will take you a long way toward the goal of trading success.

Why economists don't make good traders

Before my very first trip onto the trading floor as a reporter for a wire service, I suspected I'd find that floor traders were a bunch of academics (or economists) in pinstripe suits, conducting business quietly with their noses stuck into a notebook full of trading statistics and charts. **Wrong!** Instead, I found that floor traders were more like construction workers than academics. They were "regular" guys or gals, many of whom did not conduct business quietly and read the sports page first . . . and even told a salty joke here and there

Actually, I found that a bit refreshing because my background is rooted in a blue-collar-type work ethic. (I was also a construction worker before and during my college days.) My point is that successful floor traders (and other traders) are good at what they do because of their trading experience and their realization that markets are a reflection of human nature, which tends to repeat itself, not because of their extensive studies of economics or business principles or related text books. Veteran traders also understand that markets are all interrelated and often trade intermarket spreads.

Let me provide an analogy with the famous "Old Faithful" geyser at Yellowstone Park. An academic (economist) may study what makes the geyser work and all the physical elements involved in producing the big shot of water and steam. However, all the trader really cares about is one important thing: When the geyser will produce its next big plume of steam. Most economists tend to be "behind the curve" when it comes to pegging economic conditions and market moves. Traders are forced to be right out there on the cutting edge of market trends and trend changes – and, yes, that "edge" can be very sharp!

Baseball and futures trading: Both are big boy games

Trading futures is not a game for the faint of heart. Compare trading with major league baseball, where "failure" is accepted as part of the game. The greatest baseball hitters in the world do not

even bat .400. In fact, the best baseball sluggers may be successful only about 3 out of every 10 times they step up to the plate.

The same is true with futures trading. The very best traders in the world may lose on well over half of all the trades they make. The key is limiting losses on the more numerous losing trades and maximizing profits on the fewer winning traders. Some egos cannot accept the fact that they may have more losing trades than winning trades, but that's part of the futures trading game.

Examine the feats of some of the biggest sluggers in baseball history – Barry Bonds, Hank Aaron, Willie Mays, Mark McGwire – and you will find that they all suffered hitting slumps. I'm sure they didn't like those slumps, but they persevered and eventually broke out of them. Futures and stock traders will also almost certainly experience periods of poorer trading performance.

And, of course, many men once had a dream to make it to "the show" in the major leagues but did not have the skills required. Those who did not make it to "the bigs" were not "losers." They probably at least gave their dreams their best shot but then went on to pursue other things where they found their successful niche in life. I believe the same is true in the very challenging fields of trading futures and stocks.

Some people never learn

I am going to describe a CNBC-TV interview that I saw, and then I want you to figure out what's wrong with the analyst's approach.

This stock analyst/advisor was asked by the CNBC reporter to provide his stock picks that he saw as good bets to perform well in the next year or two, a common interview technique. The analyst described several stocks, going into detail about how one stock had been beaten down too far in the last few months and explaining that another stock was a bargain at its current low price level because it was sure to rise from the depths. Still another stock had been "underperforming" but was likely to kick into higher gear once some kinks were worked out and the economy picked back up. He described a couple more stocks that were also "due for rebounds."

What's wrong with this investment approach? The stock analyst is a bottom-picker! So-called bargain hunters for beaten-down or cheap stocks only have slightly better odds for success than

bottom-fishers in futures markets. When a stock or futures market price is low, there is usually a good reason why it is so low: The collective marketplace has determined the price to be a fair price at that given moment.

A Never-Ending Quest For Trading Knowledge

After my first few weeks of working as a wire service reporter on a futures trading floor, I went home one night and made this bold statement to my wife: "All I need to do is spend a few months studying markets and technical analysis, and then I will begin trading successfully for a living and soon we'll be rich!" (Now you see why I was a naïve young reporter!)

Not too long after that bold statement, I began to realize that trading and analyzing markets is a lot like playing the game of golf. The beginners don't have any idea how bad they really are! Then, once a few basic skills are understood and mastered, the beginners suddenly realize how difficult the task is and how much work lies ahead on the road to success.

My bold statement was made nearly 25 years ago. After 25 years of being involved in markets, trading and analysis on a full-time basis – including reading stacks of educational books and other materials at night – my hunger for market and trading knowledge is still insatiable. Every day, I am still learning valuable lessons regarding markets and trading.

Futures traders should never abandon their quest for more knowledge about markets and trading. Below are some tips about "continuing education" in futures trading.

DO: Read books on trading and markets. Books are a great (and inexpensive) way to continue to learn about this challenging field. Many good futures trading books are readily available – many more than when I first got into the trading world. Check out the www.amazon.com website and type in the search words "futures trading" or go to www.traderslibrary.com, and you will find many good books and other trading resources available.

DO: Search the Internet for websites that offer free research and educational material on trading and markets. Start with www.TraderEducation.com where you can find my daily and weekly commentary as well as other experts comments, trading tutorials, etc. – all free! It's surprising and refreshing to see how much free educational material on markets and trading is available

on the Internet. Exchanges also have major sections of their websites devoted to educational material that is of high quality.

DON'T: Head down a narrow alley of market analysis or a specific trading method without first examining a wide variety of trading methods or market analysis. For example, Elliott Wave theory is a respected field of study. But for beginners to focus only on Elliott Wave without having studied other methods of market analysis and trading limits their scope.

DO: Keep in mind that all markets are related and react to each other. Don't think that you can just follow one market closely and forget about what other markets are doing. The intermarket analysis approach is a valuable concept that no trader can ignore.

DO: Invest in the best software and other resources that can help you learn trading skills or give you an edge in today's volatile trading environment. One such tool is VantagePoint Intermarket Analysis Software, a product of years of computer research that provides forecasts of short-term market trends that you would not be likely to spot with traditional chart analysis.

DO: Make the effort and commitment to give yourself a chance to be successful trader if you really want to be a trader. "The issue is not the value of the software; rather, it is the effort it takes to fully grasp that value and then to understand how to fully utilize the value in developing a trading strategy based on the software," says Louis Mendelsohn, developer of VantagePoint. "In my experience, the two keys that unlock the value of the software are confirmation and timing. VantagePoint is not magic. It took me some time to understand that the best trades are found when all relative leading indicators are analyzed, the most profitable entry and exit points are established, and the predicted highs and lows are utilized in accordance with the indicators analyzed."