<u>DIP OR TREND REVERSAL?</u>

By Leon Wilson

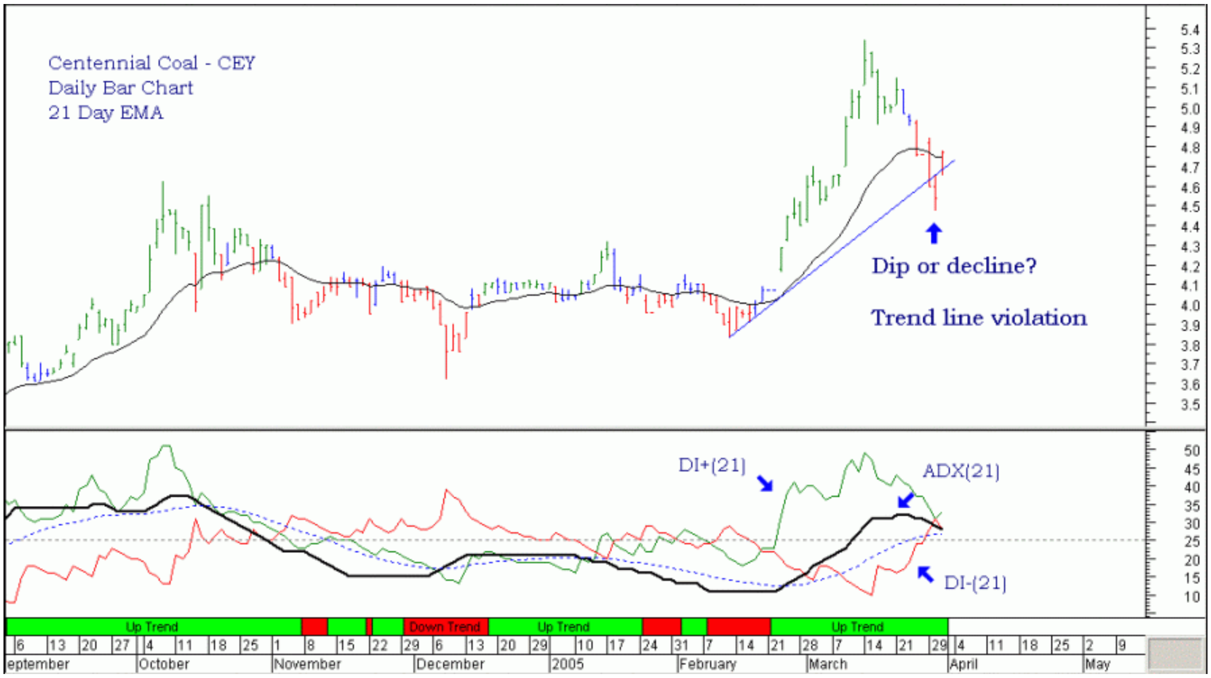
These analysis notes show how the ADX indicator is applied to distinguish between a temporary dip in the trend and a collapse in the trend. The chart examples are historical, but the analysis methods are applied to the current market conditions. ED.

The market appears to be changing as the fluctuations in price action steadily increase. The swings are yet to become severe, however, the thought of changing conditions has the alert trader keeping a very close eye on management techniques and the market. Increased swings are usually associated with mature markets, therefore, consideration must be given to the fact that a higher percentage of these moves will ultimately fail, taking on a more permanent downward spiral then previously experienced during the recent bull run.

Managing minor declines and swings in price action depends to a large degree on market maturity. If the market is bullish, but far from mature, then the tendency is to apply a fairly low stop, such as 3 or even 4xATR. This will often absorb many of the minor swings without closing the position prematurely. Once the market enters into a mature phase of development, then the approach to position management reverses whereby the trader considers closer trailing stop application. Two problems with dips in mature markets is the higher probability of continued decline and the difficulty in differentiating between a dip and a more permanent decline as they develop. If we had the ability of separating mature price action from immature, then we are in a position of being able to determine trailing stop application.

Centennial Coal has penetrated our tentative trend line of support with a closing price of $4.60. Things get worse when intra day trading drops to a low of $4.47. Our initial impression is that we may have more than just a dip in progress. I apply directional movement for identifying trend maturity. Wilder puts forward the idea that trend maturity is identified when the ADX moves above both DI indicators. I have found that the ADX simply being above both DI indicators does not always imply trend exhaustion. I have taken this process further requiring the ADX to plateau at a relatively high value once becoming the dominant indicator then to experience the bearish penetration of a moving average.

I plot a 13 day moving average below the ADX, not so much as a trigger line, but as a barrier between increasing and decreasing strength, which is primarily intended for the identification of trend maturity. The ensuing down turn with the ADX will usually coincide with the reversal in price action. Ideally, the strongest signal of trend maturity is when the ADX is positioned well above both DI indicators on both daily and weekly time frames. If we have an ADX that is declining from a relatively high value, having been positioned well above both DI indicators on a daily chart while the ADX is also clearly dominant on weekly time fame and has now plateaued, then we have the high probability of a more permanent decline about to develop rather than a temporary dip.



Analysing Centennial Coal and the first observation we make is that the DI+ indicator continues to dominate price action. The DI indicators have touched, but not crossed, while the ADX remains above its moving average. While the ADX has briefly plateaued, the pause has not occurred above both DI indicators, therefore, we do not have the classic signs of trend maturity. Trend line penetration has generated an exit signal, however, when we combine the exit signal with directional movement, we potentially have an exit signal generated by a dip in price action on temporary weakness and not a more permanent decline. The ADX is a reflection of trend strength and while the ADX has recently paused, the general direction is upward while remaining above its moving average.

Lion Selection Group does not appear as severe as Centennial Coal on the surface and has managed to close above our trend line of support at $2.10. We would accept that an exit signal has not been received based on trend line placement. The closing price is consistently developing near the high, therefore we would also accept the rejection of significantly lower trading prices intra day as occurred as bullish behaviour. Price action has the typical signs of a dip in price action due to the strong rejection of lower prices and the ability of LSG to consistently close near the high.

When we add directional movement into the equation, we have the classic signs normally associated with trend maturity. Both DI indicators have converged while the ADX is clearly the dominant indicator by remaining well above both the DI+ and DI- while also producing extreme values. Generally speaking, there is only one direction that the ADX can take from this point and that is downward. Seldom will you see the ADX plateau at an extreme value only to push on to make new highs. Any upside move is usually minimal at best and very short lived. In relation to LSG, the ADX on daily is now showing the first signs of declining while being in the process of crossing its moving average. If we combine the dip in price action with directional movement, we have the first signs of weakness in a mature trend.

On the surface we have a dip in a strong trend, but combine this with directional movement, we have a dip in a weakening trend. Price action does not always reveal all, therefore we can never assume that simply because price action may appear bullish on the surface, that this must be the case.

So how does the ability of being able to differentiate between dips and declines impact on trailing stop application? Naturally the question from here is whether we should adjust our trailing stops in order to accommodate the dip when a stock does not display the classic signs of trend maturity. Technical analysis is not an exact science, therefore we will never know with any certainty just how price action will develop. The inability to quantify the expected downside with a dip in price action leads us to further question the validity of such an approach. While we may feel confident that a dip is developing, the severity and duration is unknown at the time. The urge is to lower the trailing stop in order to absorb the dip, however, as we do not know the severity of the dip, trailing stop placement becomes nothing more than guesswork. Disciplined trading does not involve random acts based on assumptions, it involves trading on the evidence before us. My personal approach is to apply the opposite technique, whereby my trailing stops hug price action. If your preference is for count back and trend line placement, then plotting trend lines relative to rallies and shorter term price action will lift the probability of receiving a confirmed count back exit signal relatively early. If 3xATR trailing stops are normally applied, then switching to 2xATR will see the exit point shift nearer to current price action.

The natural tendency of many is to lower their trailing stops in order to absorb the dip. Adjusting our trailing stop involves the trader making an assumption that what we have is a dip in progress and that price action must rebound in the short term. There is no guarantee that a rebound will develop as expected, especially in mature markets or stocks, therefore I treat all bearish activity with equal respect regardless of market or stock maturity. If we are experiencing increased swings in price action and find that we are being whip-sawed, then the time has come to apply short term trading techniques relevant to the current conditions. Adjusting the trailing stop in order to accommodate changing conditions with an inappropriate technique is seldom the answer, it’s the technique as a whole that needs to be reviewed.