Dynamic Trading and Indicator Trade Strategies

Objective Trade Entry and Protective Stop Strategies

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A Special Tutorial Series for Subscribers to the DT Reports

www.DynamicTraders.com

Lesson One

Indicators, Trend Direction and Trend Reversals

This lesson begins a comprehensive tutorial series how to use an indicator as an integral part of your trading plan for *objective* trade entry and protective stops. The strategies taught in this series may be applied to any market and any time frame. Here is a general outline of what will be covered in the lessons ahead.

Trend Filters

Indicator Settings

Indicator Buy/Sell Zones

Indicator Stop Zones

Initial and Trailing Protective Stop

Indicator Trend Reversal and Trend Continuation Strategies

Objective Entry/Exit Rules

Momentum Cycles, Price Cycles and Stops

Daily and Intraday Data Strategies

Multiple Time Frame Strategies

Each lesson in the series will focus on one aspect of the complete strategy beginning with the basic principles and building up to a specific trading approach. Each trader may integrate all or part of the strategy into his or her own trading plan.

Indicators and Trend

Indicator entry strategies may be used as trend-reversal and trend continuation set-ups.

The term indicators and oscillators are generally used interchangeably. I prefer the term indicator. This tutorial series will only include trading strategies using the StoRSI indicator that is in Dynamic Trader. The exact StoRSI formula is proprietary to Dynamic Trader. I use this indicator because it generally has fewer "false signals" than any other indicator I have found.

However, most indicators provide about the same information. You may have had a positive experience using another indicator that you will find just as valuable for these trading strategies. The concepts are what are most important. Once you learn the concepts, the trading strategies may incorporate any indicator you wish to use.

Most trading "systems" are based on some sort of "momentum" indicator. The traditional use is to buy a market if an indicator turns up while in an "oversold" zone such as below 25% or sell the market if the indicator turns down while in an "overbought" zone such as above 75%. Of course, most trading systems consistently lose money. This is a ridiculous approach to indicator use because many of the trades will be against the direction of the trend and, as we will see, indicator extremes do not always coincide with price extremes.

Trade Entry Strategies and Stop-Loss or Exit Strategies

Indicators may be used with the Dynamic Trading approach for entry strategies, trailing stop-loss or exit strategies. However, their best use is as part of a trading plan that also considers the time, price and pattern position of the market.

Trend-Direction and Entry Strategies

The chart below is the June 1999 S&P daily data with the StoRSI 13-8-5-3 indicator. In mid-March the indicator was in the "overbought" or extreme high zone and turned down. Four days later, the indicator crossed below the 75% line. The next day the S&P made a short-term top followed by just a two-day decline. Would you have wanted to go short on these

indicator signals from the "overbought" zone – either when the indicator turned down or crossed below the 75% line?
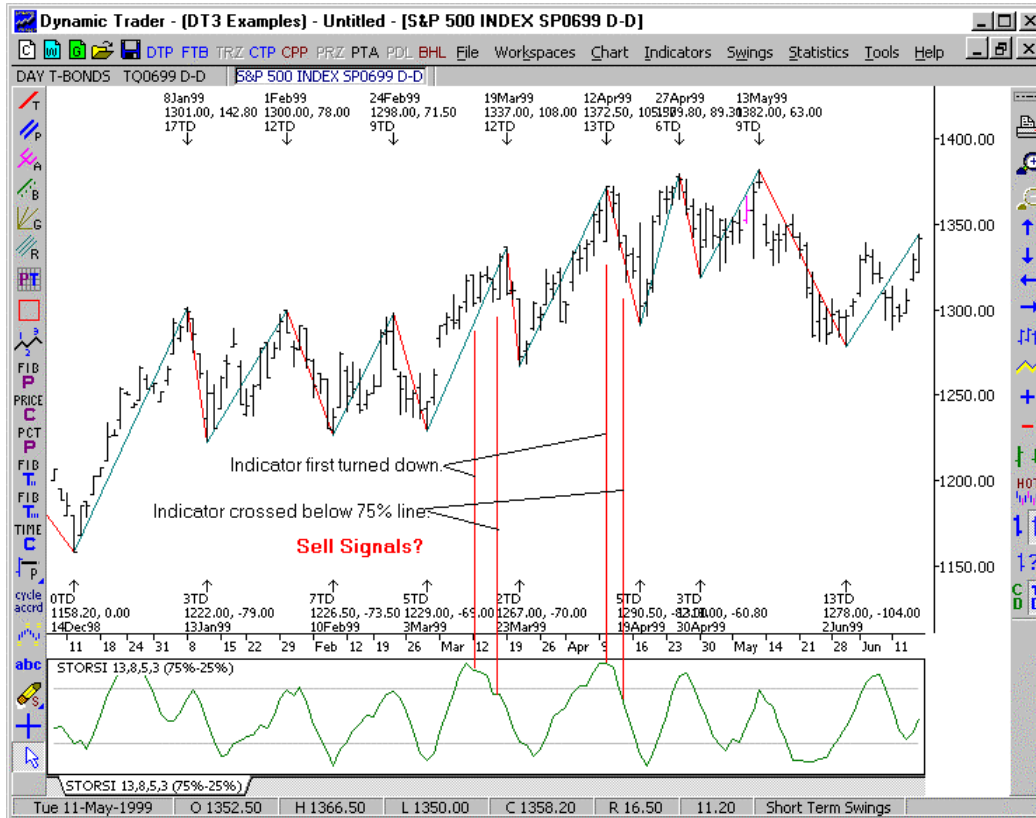
Later in mid-April, the indicator turned down the day after the April 12 short-term high. Two days later, the indicator crossed below the 75% line. Would you have wanted to sell on either of these two signals when the indicator turned down or when it crossed below the 75% line?

After-the-fact we can see that going short on these signals may have been costly as the S&P made a low within 2 or 3 bars of the go-short indicator signals. With both of these set-ups, the indicator was in the "overbought" zone or relatively high indicator level *within a bull trend*.

Most Indicators Measure Rate-of-Change, Not Price Highs and Lows

Most indicators measure a rate-of-change one way or the other. An indicator may turn down long before a price top is complete if the rate of advance slows down. If the rate-of-change continues into the price top, the indicator may not turn down until several bars after the price high has been made. In either case, an indicator signal alone will usually be either too early or too late a signal to initiate a trade with acceptable capital exposure.

The chart below is June 1999 daily Bonds with the 13-8-5-3 StoRSI indicator. In late Dec., the indicator turned up one day after a short-term low and crossed the 25% line two days later which happened to be just two days and only one or two points prior to the next short-term high. In early Feb., the indicator turned up one day after a short-term low. The indicator continued to advance even while bonds continued to a new short-term low a few days later.

Why did the indicator continue to advance while price declined to a new low? Every indicator based on some sort of rate-of-change may lag the market depending on the recent rate-of-change and the look-back period of the indicator.

The lesson with these few examples is it should be obvious that an indicator signal alone does not provide high probability trade entry signals with acceptable capital exposure.

Indicator and Trend Direction

What would be the first improvement to an indicator trading strategy?

Only take signals in the direction of the trend.

In the case of the S&P data, the trend was sideways to up. Using the indicator position alone for buy-signals probably would have resulted in a number of profitable trades depending on how the protective sell-stop was adjusted as the market advanced.

In the case of the bond data, the trend was decidedly down. Indicator sell signals would probably have resulted in fairly consistent profits, depending on protective stop-loss strategies.

In each case, an indicator sell-signal in a bull market or buy-signal in a bear market is very unlikely to result in profitable trades.

The first question that must be answered if using any indicator as part of your trading strategy is - *What is the direction of the trend?*

You may use an objective trend filter such as the Dynamic Trend Filter in the Dynamic Trader software or moving averages or other trend direction filter. You may also use the Dynamic Trading approach to trend position which includes Elliott wave pattern analysis to provide the answer to the trend direction question. The time, price and pattern position will help to identify trend reversal targets, minimum and maximum time and price targets for trends of any degree and the pattern position that often signals a trend may be terminating.

Once we have identified the trend direction, we know trading strategies should only be oriented to trades in the direction of the trend.

Using an indicator alone for a trade-entry strategy, even in the trend direction, will often result in entering either too early or too late with unacceptable capital exposure. So we must ask ourselves, what is the

unique characteristic of the indicator that can be useful for making trading decisions and be incorporated into a trade-entry and protective stop-loss strategy?

   The answer - *The indicator position is a very reliable signal that a market is at or near the end of a correction against the main trend.* The indicator position can help us to identify when minor corrections against the trend are near completion as a signal to prepare to enter a trade in the direction of the main trend.

Lessons Learned So Far

1. An indicator should only be used to signal a trade entry in the direction of the trend.

2. An indicator is usually some measurement of rate-of-change. An indicator high or low will usually not coincide with the actual price high or low.
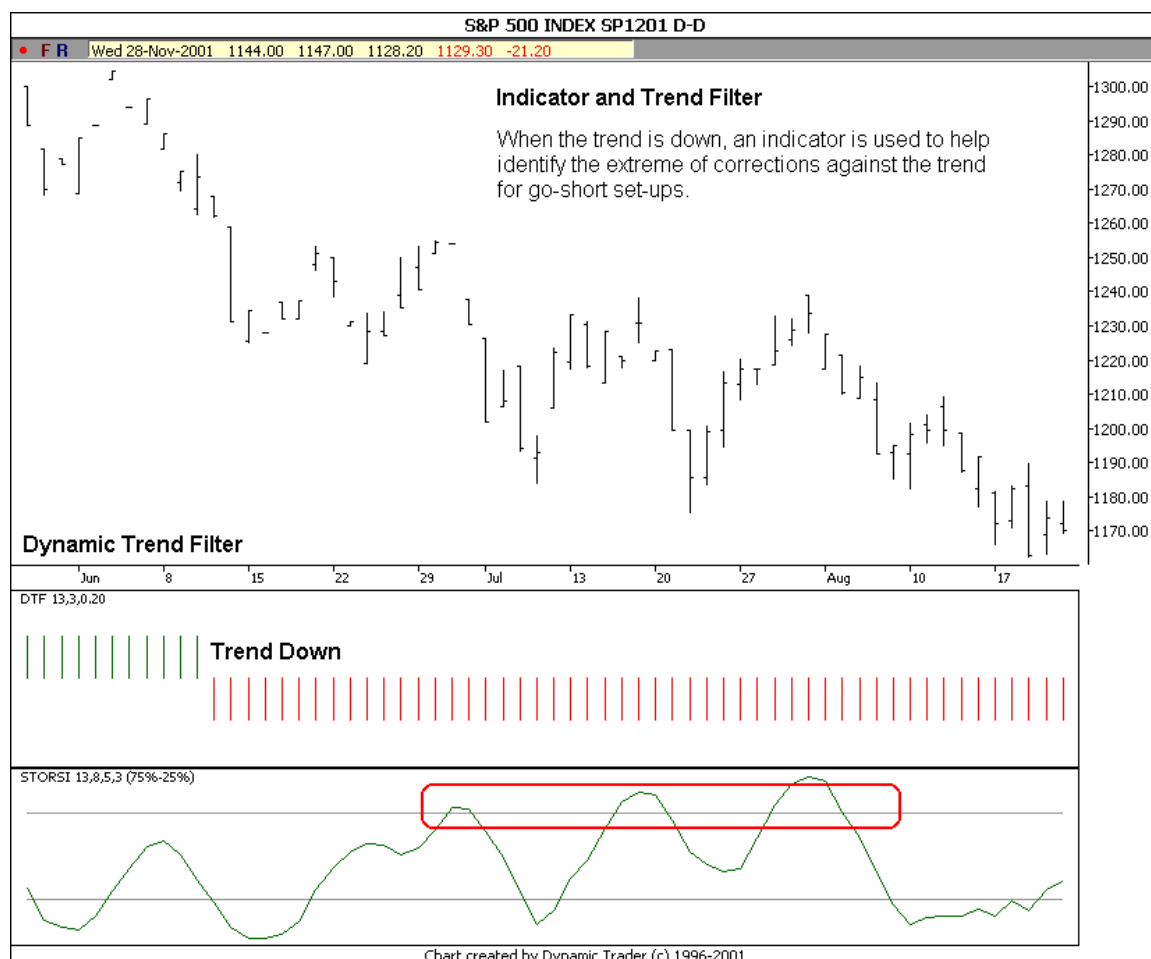
A Few More Examples

In the examples below, Dynamic Trader's Dynamic Trend Filter (DTF) gives the trend direction. Indicator extremes will only be used as trade entry set-ups to help identify the extreme of a minor correction against the main trend.

The indicator reached the extreme high zone three times during the bear trend shown below.


Chart created by Dynamic Trader (c) 1996-2001

In late June, the indicator reached the extreme low zone but the trend was down as represented by the Dynamic Trend Filter. If the DTF was used as the trend direction filter, a long trade would not have been considered.

In early Aug. and mid-Oct., the DTF was bullish and the indicator reached the extreme low zone for potential long trade set-ups.
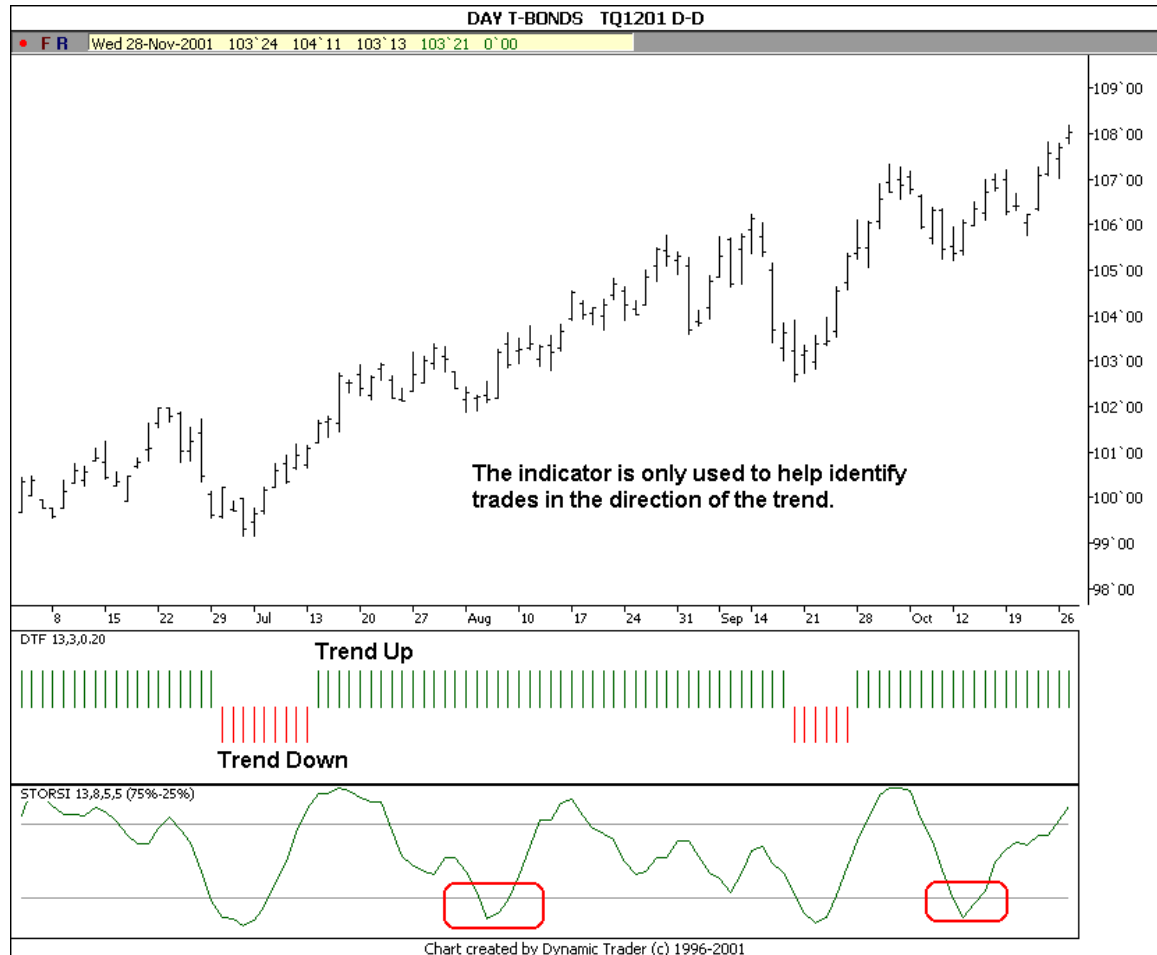

There are many trend filters in most software packages that may be used to signal the trend direction. All trend filters lag the market. The Dynamic Trend Filter tends to lag the market less because it has a component that measures the short term volatility and adjusts the look back period as each new bar is added.

How much a trend filter lags the market will also depend on the settings chosen including the look back period.

The trend filter turned down in mid-Aug. Using the settings below, the indicator did not reach the extreme high zone during the Aug.-Oct. bear trend. We will discuss how to choose the settings for any indicator later in this tutorial series.
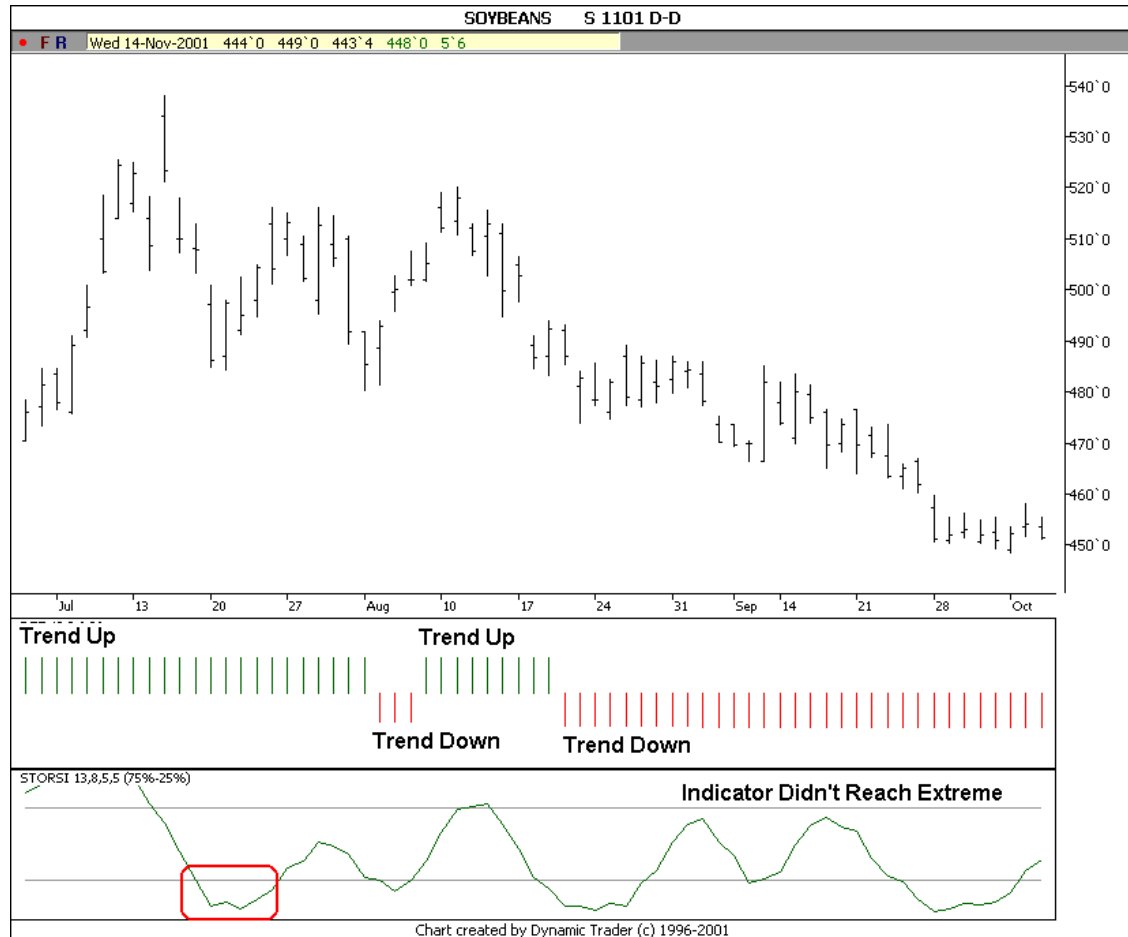
These examples have shown an objective trend filter to signal the trend direction and potential trade direction. Most traders who use the Dynamic Trading approach to technical analysis will incorporate some aspect of the time, price and pattern position into the trend direction decision and may not use an objective trend filter at all.

Lesson Two

Buy and Sell Zones

In Lesson 1 of this tutorial series we learned –

1. An indicator is usually some measurement of rate-of-change. An indicator may be "overbought" or "oversold" but this does not mean it will coincide with an actual price high or low. The change in direction of an indicator may only represent the slowing down or the speeding up of the rate-of-change of the price data.

2. The best use of an indicator as part of a trade entry plan is to help identify the end of a correction so a trade may be entered in the direction of the trend.

   Now, let's learn about Buy and Sell-Zones.

Buy-Zone In a Bull Trend and Sell-Zone in a Bear Trend

The chart below is daily data for the S&P. For the period shown, the trend is sideways to up. We will assume during this period, the Dynamic Trading analysis indicated the trend should be up into mid-May or later. If this is the case, we should only consider taking long trade set-ups during this period.

The indicator declined below the 25% line just one or two bars before the price low on each of the minor corrections and turned up within two bars of the price low.

For this period of the S&P, each time the indicator dipped below the 25% line, a minor corrective low was at or near completion. The relatively low indicator level in a bull trend is called the "Buy-Zone" because the indicator is in the position from where corrective lows are typically made.

The relatively low indicator level in a bear trend is not a buy-zone, because it is not a position from where a correction is complete. Since we use the indicator to identify the end of a correction against the larger degree trend, we would use an indicator to help identify a corrective high in a bear trend.

The "Sell-Zone" in a bear trend is a relatively high indicator level from where corrections to the bear trend usually terminate.
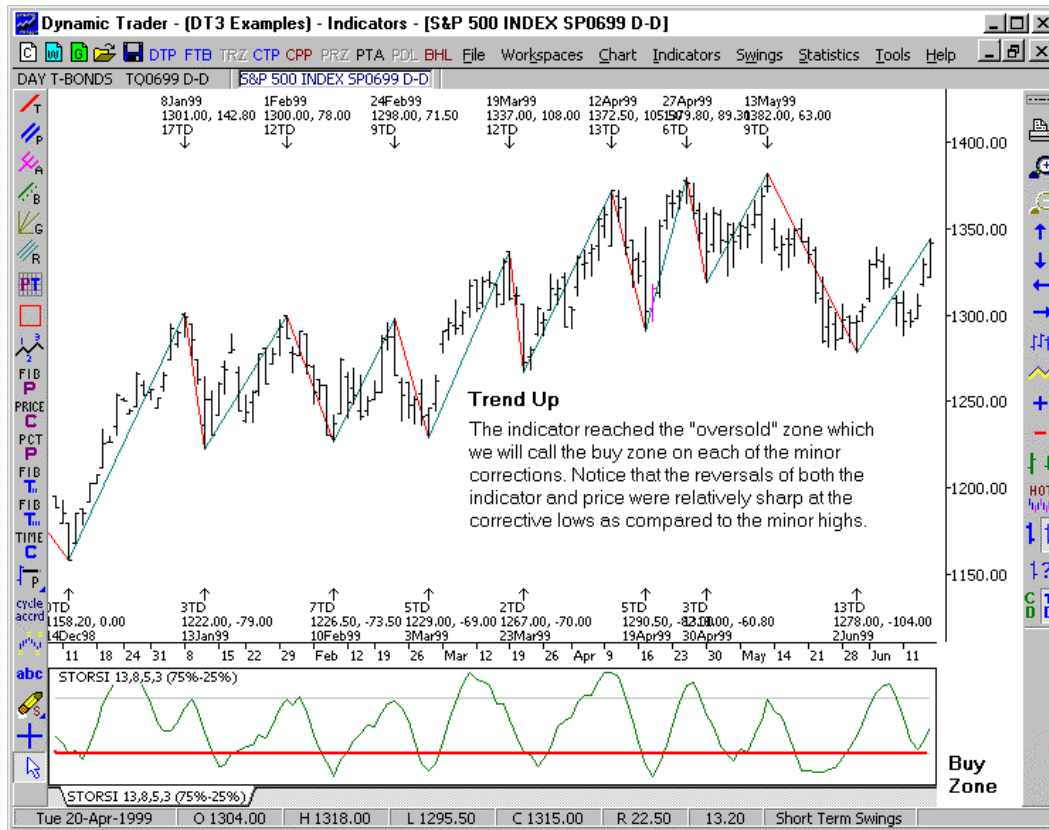
The chart example above is what we call in the trading education business a "well-chosen example." The S&P made very regular short-term swings during this period and the indicator flawlessly signaled the end of each correction. I used this example to clearly illustrate the first and most important concept of using indicators as part of your entry plan.

> ### *The indicator is used to help identify the end of a correction in order to enter a trade in the direction of the major trend.*

While the larger degree S&P trend was up in this example, this period was essentially a trading range with a bullish bias. We never know in advance if a market is going to be in a trading range and make consistent, symmetrical swings. As we will see with other less perfect examples, that does not effect how we may use an indicator as part of a trading strategy.

During the period shown below for bonds, the trend was decidedly down. We will assume the Dynamic Trading analysis suggested the trend would be down for this period and we would only want to consider short trades.

The indicator reached the "Sell-Zone" <u>In A Bear Trend</u> at all but two minor corrective highs. In two of the instances, the indicator remained in the sell zone for several bars but the indicator turned down within one or two bars of the price high.

Remember, we can only have a Sell-Zone in a bear trend just as we can only have a Buy-Zone in a bull trend. The sell-zone is where the indicator is in a position from where corrective highs have been made in the past during the bear trend.

**What have we learned so far about indicators and price trends?**

1. If we have the correct choices for the indicator settings, the indicator usually reaches a buy or sell zone within a few bars of the extreme price high or low of a minor correction. A future part of this series will teach you how to determine the correct indicator settings.

2. The indicator represents the rate-of-change and will usually reverse direction one to three bars before or after the price extreme of the correction. The high or low of the indicator will usually not coincide exactly with the high or low of the price reversal.

3. The indicator may be an excellent signal that a market is at or near the completion of a minor correction against the main trend.

4. The indicator may be used as the *initial condition* to consider a trading strategy to enter a trade in the direction of the main trend.

5. The indicator itself should not provide the buy or sell signal because the change in the indicator direction usually leads or lags the price direction change by a few bars.

A Few More Examples – Bonds 60M

This chart of 60-minute data for bonds shows the recent sharp decline. The red columns encompass the price data for the period the indicator was in the "Sell-Zone" in a bear trend or the extreme high level.

At the Wave-2, Nov. 8 high, the indicator reached the Sell-Zone several bars before the price peak and flattened out before reversing to below the sell-zone. Just because an indicator reaches an extreme does not mean price will immediately peak. The price should not peak until the indicator has peaked <u>and</u> turned down. Subscribers may recall that the recent short sale for bonds was made on the outside-reversal day on Nov. 8 when the indicator was in the sell-zone in a bear trend.

The indicator and price peaked together at the W.4, Nov. 20 high.
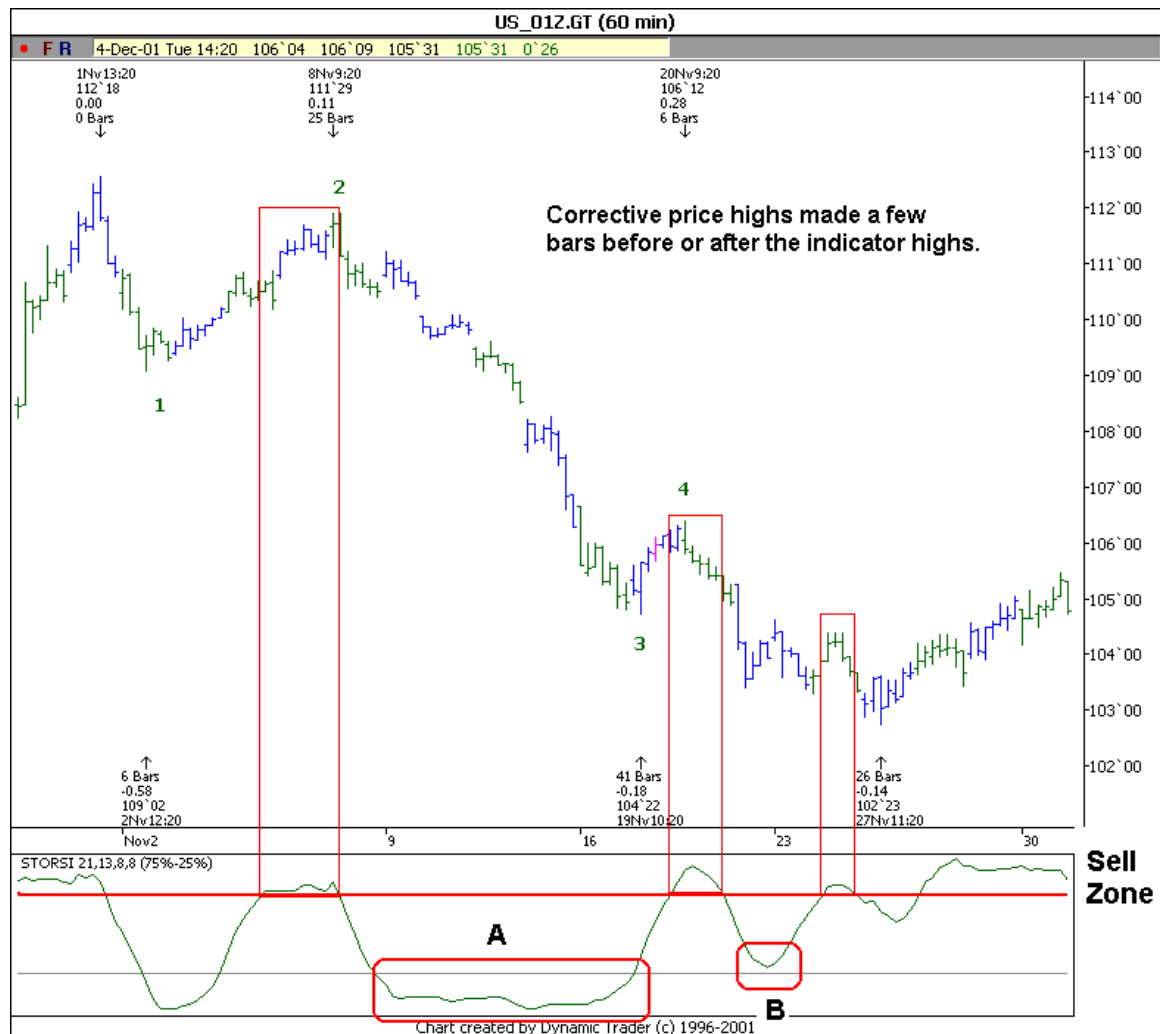
A. Shows how an indicator may remain at an extreme position during a strong trend. The indicator turned up when the rate-of-change in the decline changed.

B. Following the W.4 indicator and price high, price declined to a new low but the indicator not only did not make a new low but did not reach the extreme low zone before returning to the Sell-Zone. This is an indicator pattern that signals the trend may be at or near completion and is often seen at the Wave-5 extreme. We will discuss indicator patterns in a future tutorial.

Lessons Learned

An indicator reversal and decline from a Sell-Zone (low in a Buy-Zone) does not provide any information how long or far the next trend swing will last. Traders must consider the time, price and pattern position of the price data to help with the trend objectives.

Indicator/price divergences may signal a trend is terminating. We will look at indicator patterns in a future tutorial in this series.

S&P – 60M

If a particular choice of settings for an indicator catches each correction perfectly, it will usually not catch corrections of similar degree in a faster trend.

The period shown below for the S&P, 60M data includes two distinct bull trends. The first is a much greater rate-of-change than the second. The indicator did not reach the Buy-Zone during the minor corrections during the first, fast trend phase represented by the letter "A".
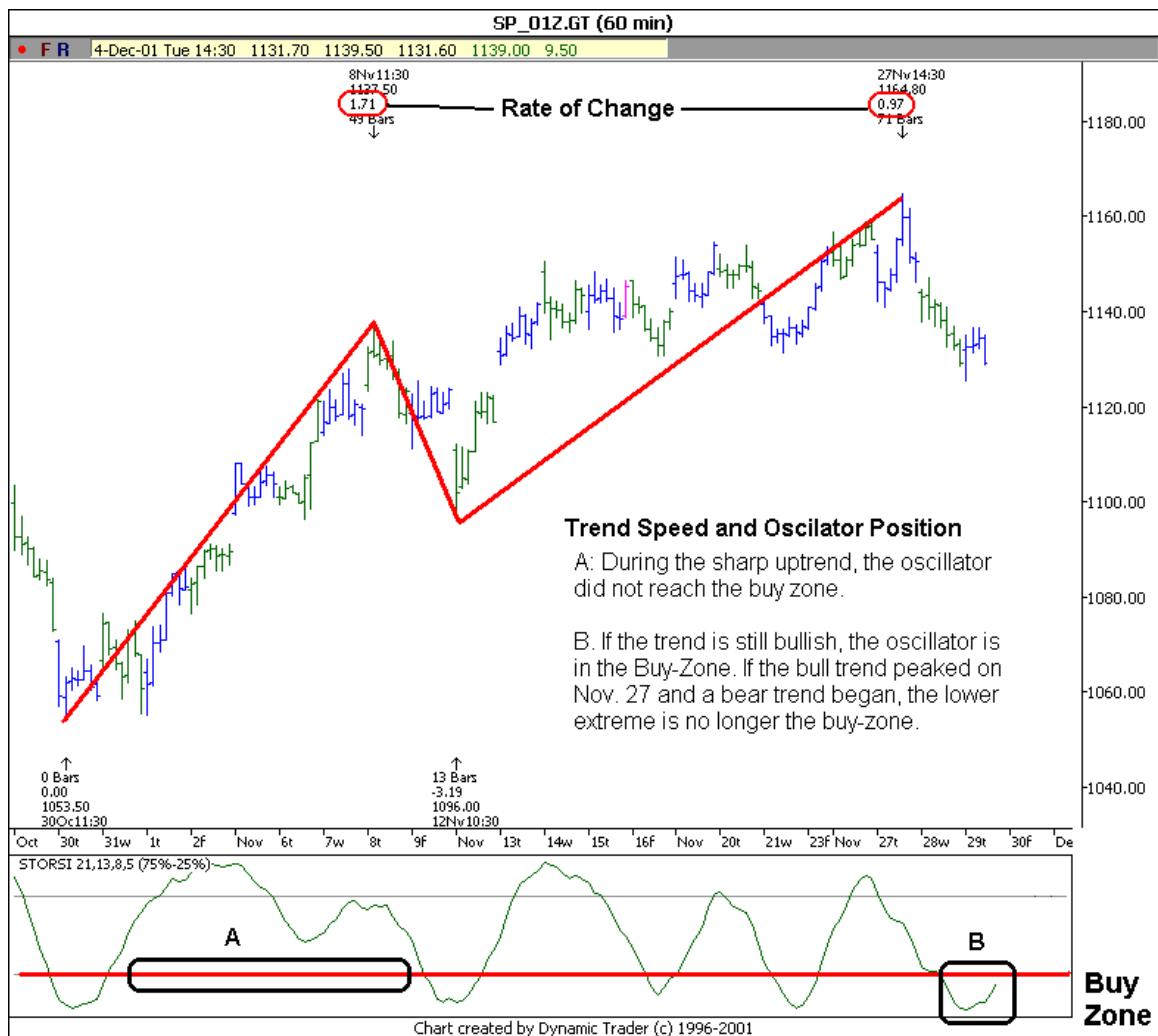
During the second bull phase, each of the minor price corrections coincided with the indicator in the Buy-Zone. This phase of the bull trend

was essentially a trading range with a bullish bias, also know as indicator heaven because an indicator usually identifies every minor correction perfectly. Unfortunately, we do not know *in advance* if a market is going to be making a trading range. We only know well after the trading range is established.

At "B", the indicator is in the Buy-Zone *if the trend is still bullish.* If our pattern or trend analysis indicated a top was complete on Nov. 27 and a bear trend had begun, the extreme low zone would no longer be considered a Buy-Zone.

Lessons Learned

No single indicator setting will identify corrections in all types of trends. The faster the trend, the less likely an indicator will reach the buy or sell-zones on minor corrections. A very slow, choppy trend will often have very early indicator signals.

We never know in advance what type of market is about to unfold. Our indicator-trading strategies much be developed for the most frequent type of trends knowing that the indicator will either not give signals during faster than typical trends or give pre-mature or false signals during much slower than typical trends.

Soybeans – 60M

Here is another example of how the indicator may be in the position from where corrective highs are made, but that doesn't mean the price high is complete.

In "A" below, the indicator remained in the Sell-Zone while price traded sideways making a contracting triangle correction. The indicator oscillated above and below the 75% line during the correction. "B" below is the same situation. Both price and indicator moved sideways during the trading range correction.
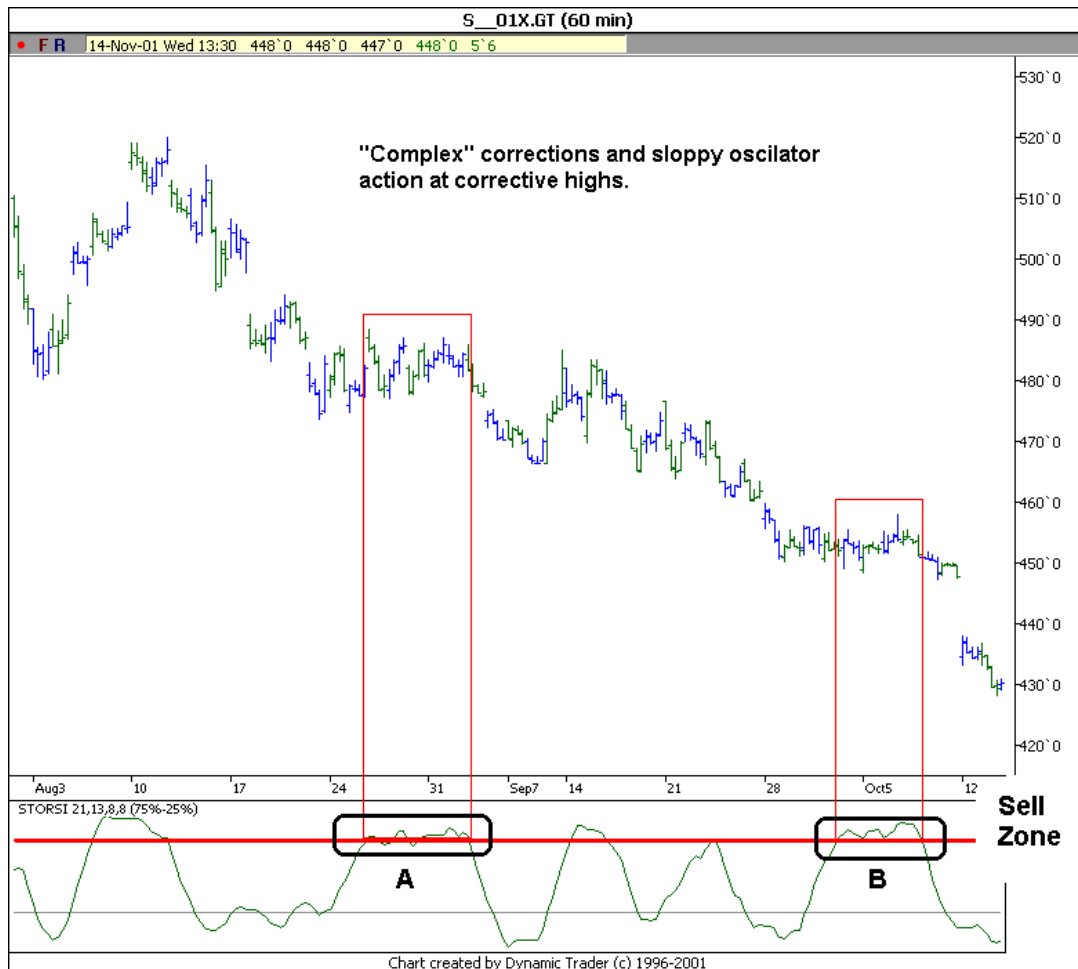
Lessons Learned

Even if an indicator reaches the Sell-Zone in a bear trend (or Buy-Zone in a bull trend), it is not a signal a corrective price peak is complete. Trading strategies must recognize that *the indicator in the Buy or Sell Zone is only the initial condition* for a trading strategy to enter a trade in the direction of the larger degree trend.

Lesson Three

Objective Trade Entry and Initial Protective Stop Strategy

The first two lessons of this series have shown that an indicator may help us to identify the end of a correction so we may take a trade near the extreme of the correction in the direction of the main trend. We have seen many examples of different time frames and markets how an indicator acts at corrections. We have learned that an indicator reversal does not necessarily coincide with a price reversal.

Now lets see how we can use what we have learned so far to develop a logical and objective trade entry strategy method.

1. The indicator is used to help identify the extreme of a correction against the main trend so a trade may be taken in the direction of the main trend. The indicator is used to identify buy set-ups in a bull trend and sell-set-ups in a bear trend.

2. The indicator in a Buy or Sell Zone will not necessarily coincide with the price low or high. The indicator in the buy or sell zone only indicates price may be at or near the end of a correction.

Indicator and Trade-Entry and Initial Protective Stop-Loss Strategy

If the indicator only warns us that a market is near the extreme of a correction but does not signal the price reversal itself - *What is an objective signal to enter the trade and where exactly is the initial protective stop-loss placed if the trade is elected?*

A trade entry and initial protective stop strategy must be completely objective. The initial capital exposure must be identifiable and acceptable to an individual's trading plan. Trade set-ups that require a greater capital exposure than is acceptable according to your trading plan are not taken.

To overcome the lead or lag characteristic of all indicators, we use the indicator to signal the initial condition from where a price trend reversal is probable near the end of a correction but require the market itself to signal the correction is complete and trigger the actual trade entry.

Indicator Trade Entry Rules (Buy in a Bull Trend)

1. Only take a trade in the direction of the trend. You must have an opinion of the trend direction whether you use an objective trend filter such as the Dynamic Trend Filter or your DT analysis of the time, price and pattern position.

2. The indicator must reach the Buy Zone in a bull trend or the Sell Zone in a bear trend. In other words, the indicator must have reached the position from where corrective highs and lows have been completed in the past.

3. If the trend is up and the indicator reaches the Buy Zone (relatively low indicator reading), trail a stop one tick above the high of the prior bar. The market itself must provide some action that signals the correction is complete by making at least a minor reversal in trend direction by taking out the extreme of the previous bar.

4. Place the initial protective sell-stop one tick below the recent low. If the purpose of this set-up is to identify the end of a correction and a return to the main trend direction, there is no reason to place the stop more than one tick beyond the extreme made just prior to the trade entry.

5. Trade set-ups should not be taken if the market is at or near a time, price and pattern objective to complete the trend. An example would be if the market is near the price target for a Wave-5 high to complete the trend but makes an indicator buy set-up, don't take the trade. There is some judgment that must be exercised here, but it will usually be quite obvious.

This is a very simple but logical strategy that can be summed up –

Once the indicator declines into the buy-zone in a bull trend, trail a buy-stop one tick above the high of the prior bar. If the buy-stop to go long is elected, place the initial protective sell-stop one tick below the recent low.

The S&P chart below shows all of the set-ups that met the indicator-trailing-stop entry strategy. The fourth and last set-up for this data required a relatively large capital exposure and probably would not have been an acceptable risk.
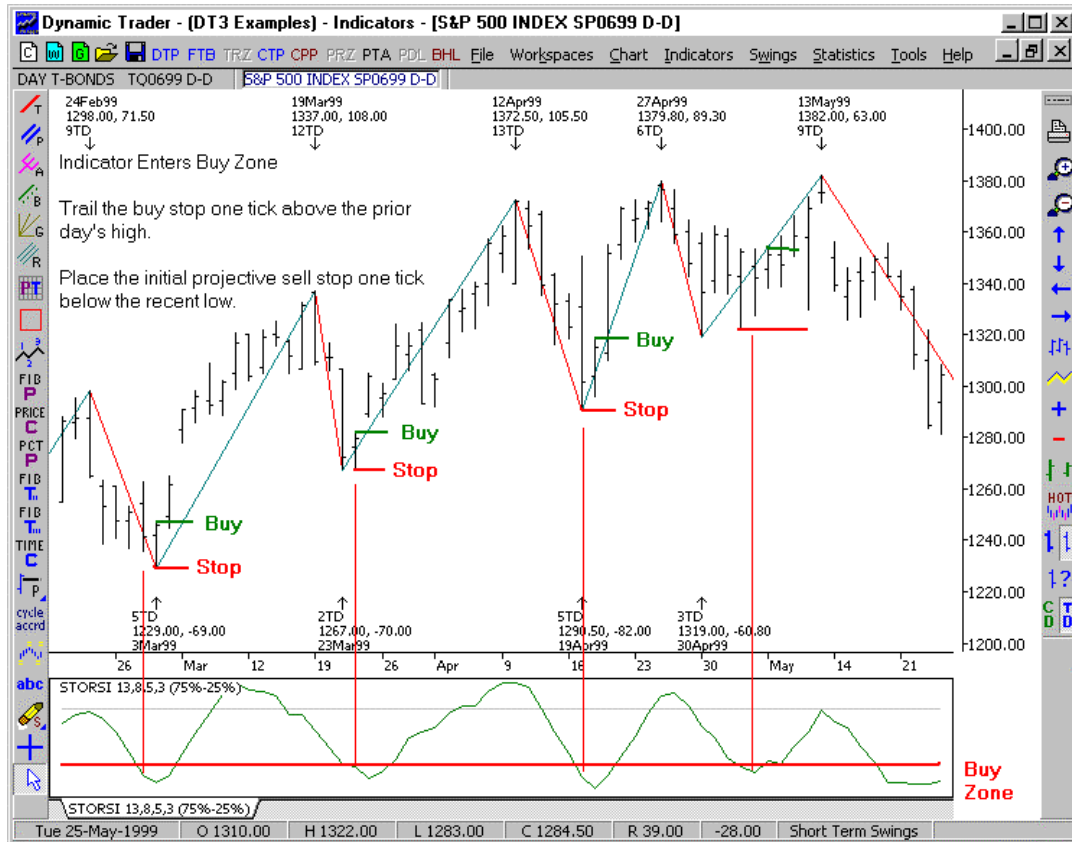
This entry strategy only resulted in high-probability, low-capital exposure trade set-ups and high profit potential trades. Keep in mind this is the well-chosen-example but it clearly illustrates the conditions of the indicator entry strategy.

A Logical and Objective Entry Strategy

The market must be in a position similar to recent minor lows in a bull trend. The market must provide at least a minor reversal signal to enter by taking out the high of the previous bar. The buy-stop to go long is trailed one tick above the high of the previous bar. The initial capital exposure will usually be relatively small, about the range of just one bar or so.

Sell Set-Ups In A Bear Trend

The bond chart below shows a more typical period than the S&P example above. The trend is down and only sell set-ups are considered. The indicator reached the sell-zone in a bear trend (relatively high indicator reading) on four occasions during this period. The trailing sell-stop to go short was hit six times. Once the indicator reaches the Sell-Zone in a bear trend, all trade set-ups are taken even if the first one is stopped out. I have numbered the set-ups 1-6.

1. The first short trade is stopped out for a small loss as bonds continued the corrective rally and made a new price high. We would continue to trail a go-short sell-stop one tick below the low of the prior bar since the indicator has reached the Sell-Zone.

2. The second sell signal is made two days after the price high. The capital exposure is very minimal. The main bear trend continued.
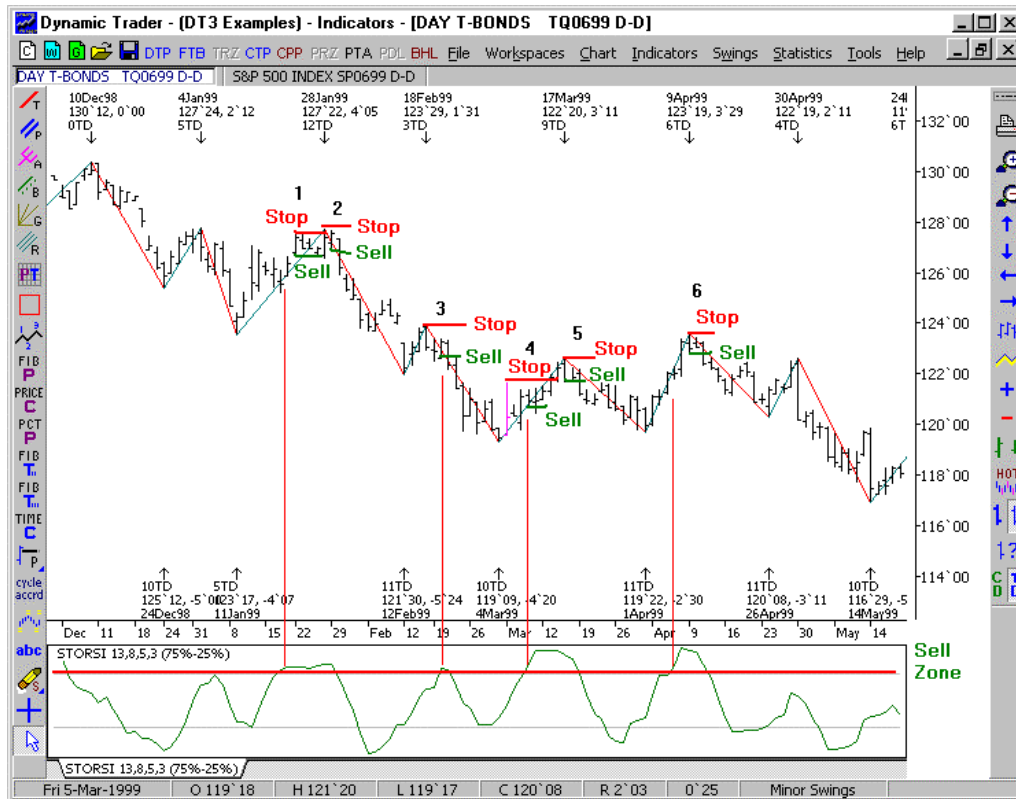
3. Another sell signal with minimal capital exposure.

4. Short trade is stopped out at the initial protective buy-stop with a minimum loss.

5. Another short trade with minimum capital exposure. Note that price continued to advance for several bars after the indicator reached the Sell Zone. The trailing entry strategy kept the trader out of the market until after the price peaked.

6.   Another sell set-up with minimal capital exposure.

Lessons Learned

An indicator may be used to help identify if a market is at or near the completion of a correction against the main trend. The indicator position becomes part of a completely objective entry and initial protective stop-loss strategy.

   If we have an opinion of the trend direction and trend objectives, we know which side of the market to trade. The indicator must be in the position where minor corrections have usually ended in the past to signal a correction is at or near completion. The trailing entry strategy requires the market to make some indication the correction may be over. The initial protective stop-loss is usually very close to the entry price.

   What about adjusting the protective stop-loss if the trade is successfully entered and the market resumes the trend? Stop-loss strategies depend on your trading plan and objectives.

   In the next tutorial, we will see how we can use the indicator as part of an objective strategy to trail the protective stop-loss to protect profits as the market progresses.

Step-By-Step Example

Let's go through a step-by-step example of a trade set-up and initial protective stop using Dec. S&P 60-minute data. We will assume our analysis shows the trend is bullish and should remain up for some time. I have not marked off the dates for these examples because I want you to concentrate on the method and objective rules.

On the chart below, the indicator has reached the Buy-Zone in a bull trend. A buy-stop to go long is trailed one tick above the high of the prior bar once the indicator is in the Buy-Zone.

For those subscribers with the Dynamic Trader program, use the BHL (Bar-High-Low) function which will automatically trail the stop and give you an alert when the bar extreme is taken out.

The buy-stop to enter a long position was trailed and a long position was elected three bars after the indicator first declined into the Buy-Zone. The long position was taken at 1122.90, one tick above the high of the previous bar and the initial protective sell-stop was placed at 1110.90, one tick below the recent low.
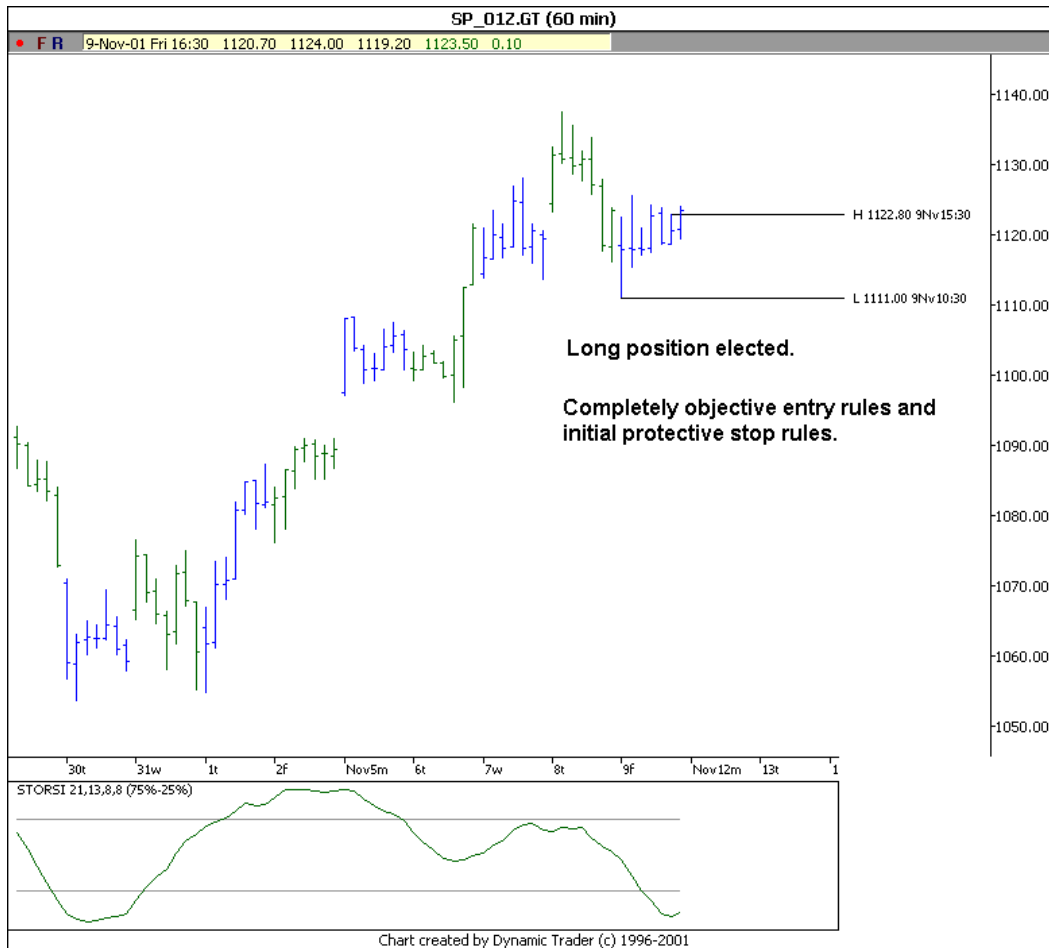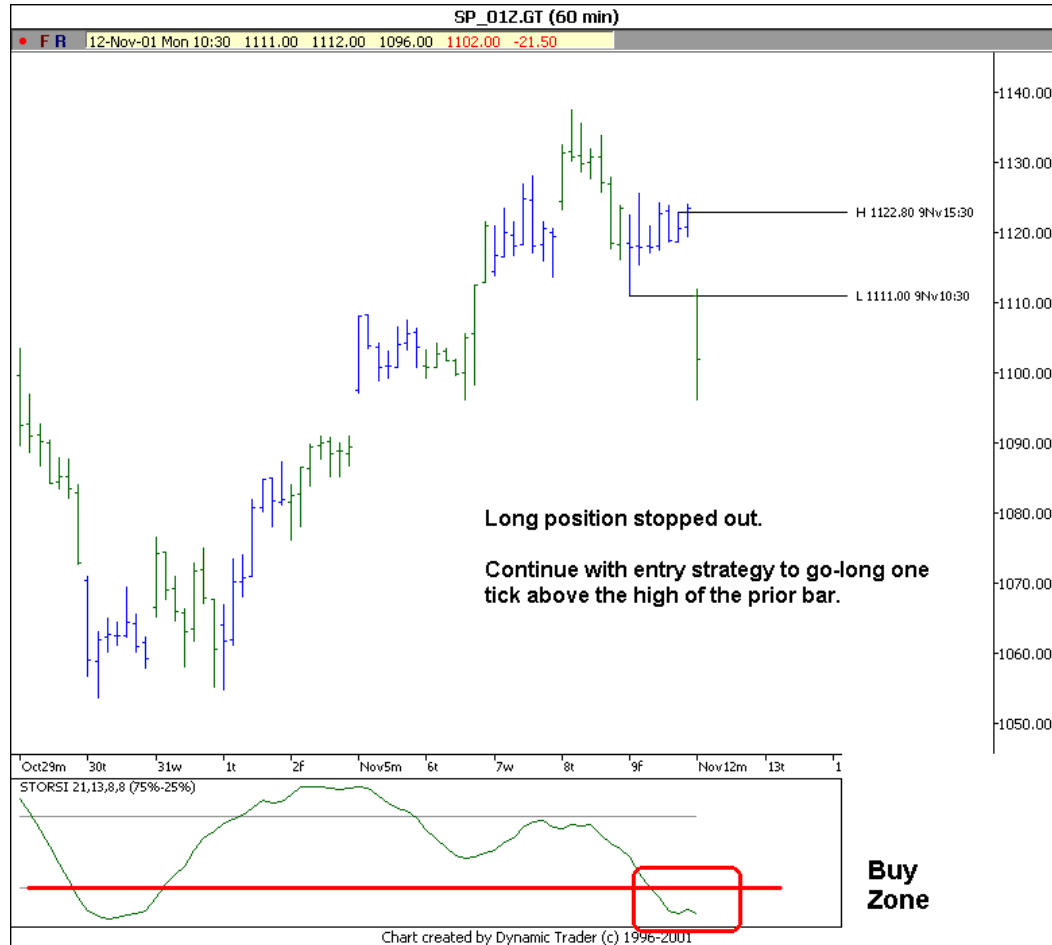

Long position elected.

Completely objective entry rules and initial protective stop rules.

The very next bar, the S&P gapped down and hit the protective sell-stop to exit the trade.

If there is nothing that has changed the outlook for a continued bull trend, a long position should still be taken if the trade-entry rules are met.
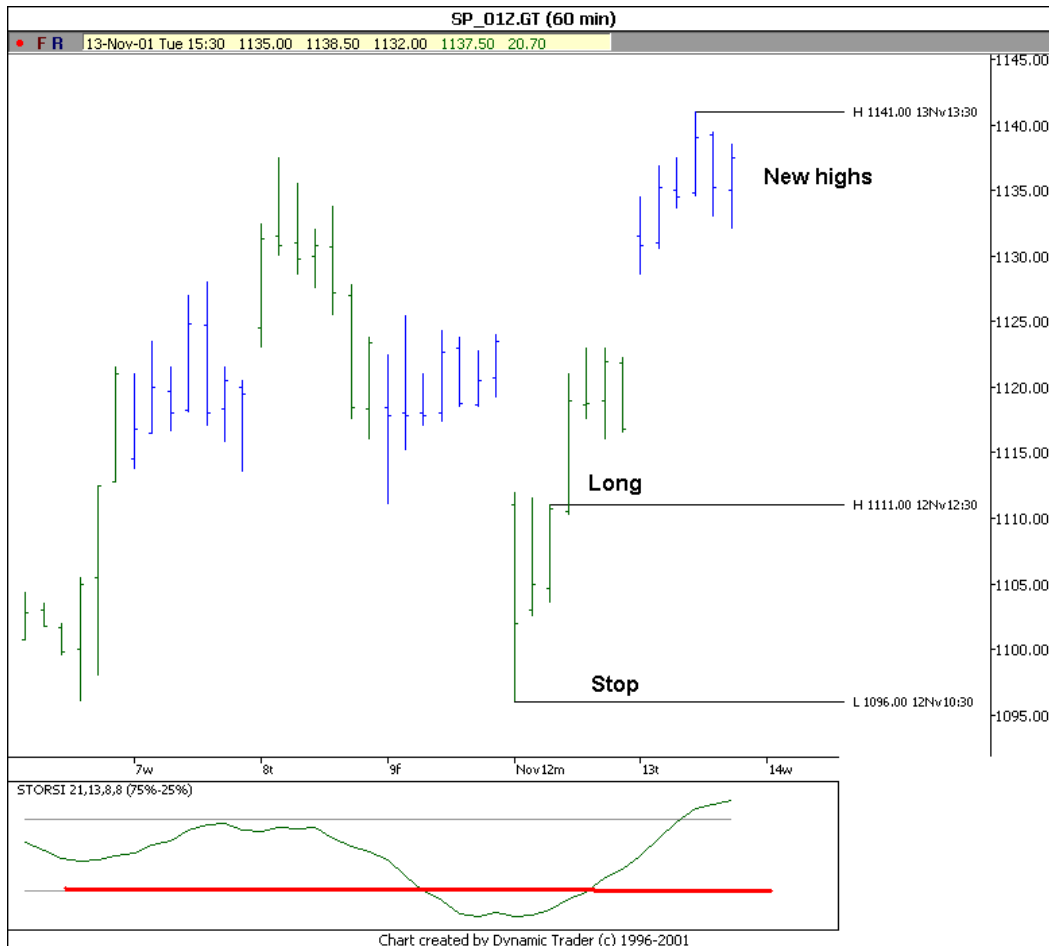
A trailing buy-stop to enter a long position continues to be trailed one tick above the high of the prior bar. Three bars after the gap down day, a long trade is elected at 1111.10 with an initial protective sell-stop at 1095.90.

Within the next few bars, the S&P has continued to advance to a new high.

A few days later, the indicator once again declines into the buy-zone. A long trade is elected at 1136.60, just one bar after the price low, with the initial protective sell stop at 1130.40, one tick below the recent low.

You would continue to take all buy set-ups as long as you feel the trend is bullish. If your trend indicator turns down or your DT time, price and/or pattern analysis indicates the trend is at or near completion, the buy setup would not be taken as a trade entry.

Indicator Entry Strategy Review

You must have an opinion of the trend direction in order to use this strategy. You may use a completely objective trend direction signal such as the Dynamic Trend Filter, Moving Average Cross-overs or such. Or, you may use your DT analysis of the time, price and/or pattern position of the market as a signal of the trend direction and targets.

These examples illustrate an objective entry strategy which requires a market to be at a position from where corrections are typically terminated and, very importantly, the market must provide a signal a high or low may be complete by taking out the high or low of the previous bar. If the trade is entered, the initial protective stop is placed *no further* than one tick beyond the extreme made prior to the trade entry. The initial capital exposure is controlled and relatively small.

The next tutorial in this series will teach you how to use the indicator position to trail the protective stop on a position in a logical manner.

Lesson Four
Indicators and Trailing Stops

The first three parts of this series have shown that an indicator may help us to identify the end of a correction so we may take a trade near the extreme of the correction in the direction of the main trend. We have seen many examples of different time frames and markets how an indicator acts at corrections. We have learned that an indicator reversal does not necessarily coincide with a price reversal.

Now lets see how we can use what we have learned so far to develop a logical and objective *trailing-stop strategy*.

1. The indicator is first used to help identify the extreme of a correction against the main trend so a trade may be taken in the direction of the main trend. The indicator is used to identify buy set-ups in a bull trend and sell-set-ups in a bear trend.
2. The indicator in a Buy or Sell Zone will not necessarily coincide with the price low or high. The indicator in the buy or sell zone only indicates price may be at or near the end of a correction.
3. In this lesson, we will learn how to use the indicator and the *Stop-Zone* to trail a stop in a completely objective way on an existing position.

Indicators and Trailing Stop Loss

So far we have learned how to use an indicator and a trailing stop to enter a trade in the direction of the trend with objective and minimal capital exposure. Now let's see how we may use an indicator to adjust the protective stop-loss. First, let's quickly review what an indicator is telling us if it reaches an extreme position in the *trend direction* such as near an extreme high in a bull trend.

The S&P daily chart below is for the same period during Feb. – April 1999 that we looked at previously for indicator entry signals at the end of corrections. Now we are interested in the indicator/price position when an indicator reaches near an extreme high and turns down in a bull trend. Three of these conditions are labeled.
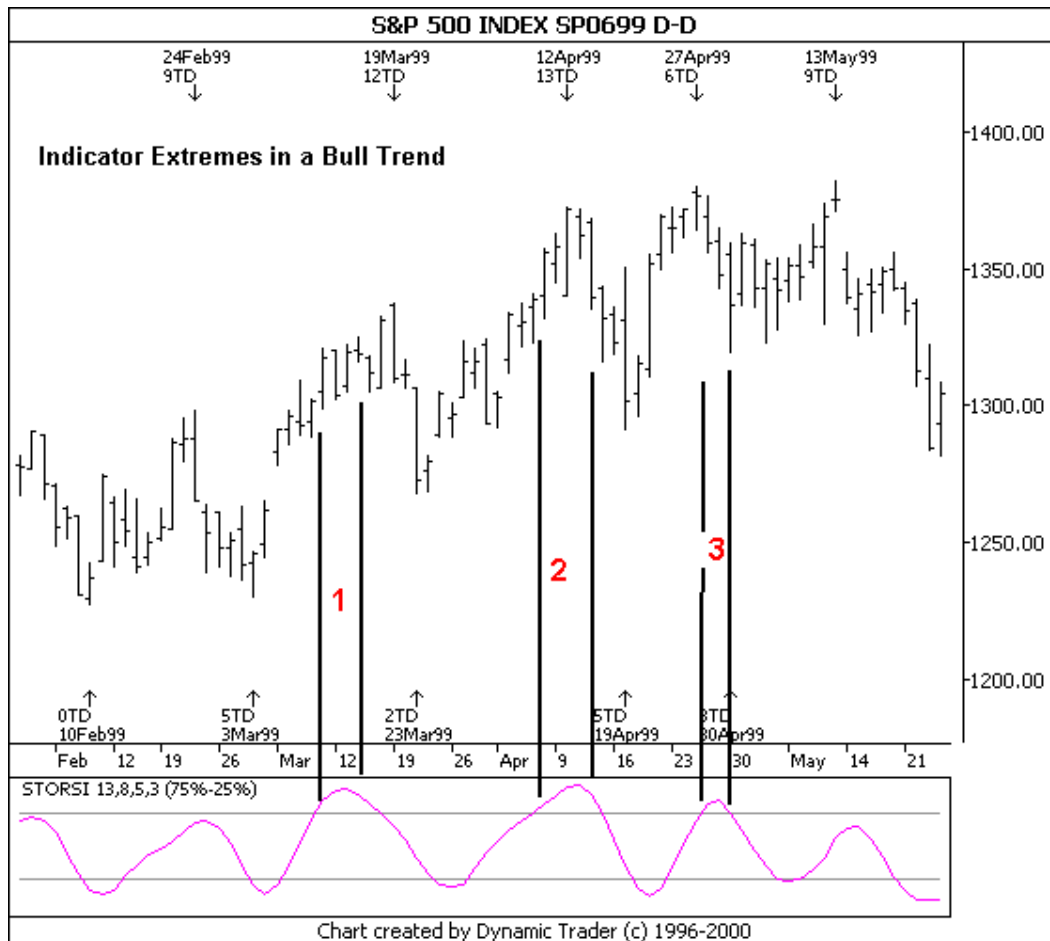
1. The indicator reaches above 75% and turns down several bars before a short-term top is complete. The correction lasted only two bars.

2. The indicator reaches above 75% several bars before the short-term high and turns down within two bars of the top. The corrective decline only lasts three bars following the downturn in the indicator.

3. The indicator reaches above 75% one bar after the price high and actually turns down on the last bar of the corrective decline.

What have we learned from just these few examples?

1. We would not want to go short in a bull trend on an indicator signal from an extreme high position! The indicator often turned down well before the price high or enough after the price high that the correction was almost over before the indicator turned down.

2. We may want to begin to trail the stop very close to the market on all or a portion of a position once an indicator reaches an extreme position in the direction of the trend. The indicator at an extreme high level in a bull trend often preceded a slowing down in the rate of advance if not at least a short-term top.
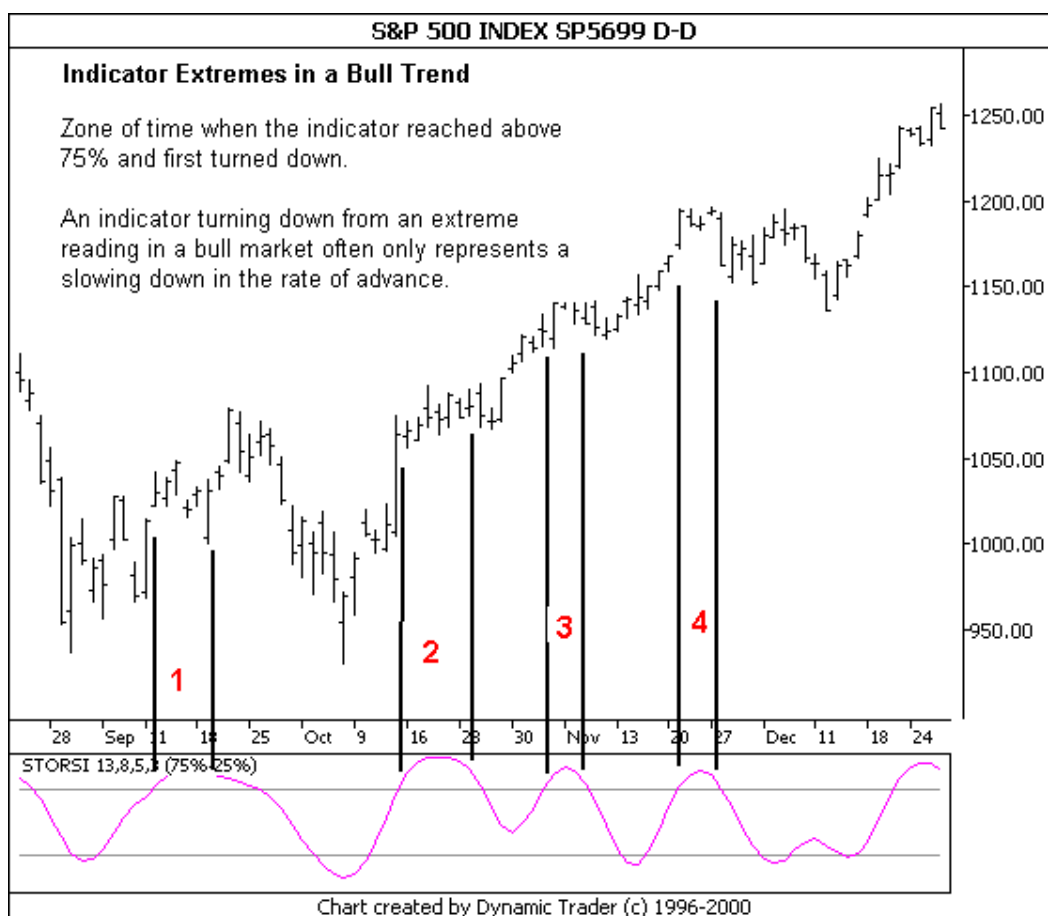
   The period for the S&P shown above was a very symmetrical trading range with a bullish bias. Let's take a look at another example of a more consistent trend.

   The chart on the next page shows a much stronger bull trend. The periods when the indicator reached an extreme level and turned down are labeled 1-4.

Continued on the next page.

S&P 500 INDEX SP5699 D-D

Indicator Extremes in a Bull Trend

Zone of time when the indicator reached above 75% and first turned down.

An indicator turning down from an extreme reading in a bull market often only represents a slowing down in the rate of advance.

Chart created by Dynamic Trader (c) 1996-2000

1. The indicator reached the extreme and turned down several bars before a temporary price high.

2. The indicator reached an extreme and turned down but no corrective decline was made. The bull trend continued but the advance only slowed down temporarily. The indicator high and decline only represented a slowing down in the rate of advance.

3. The indicator reached a high and turned down at a minor price high. Essentially price moved sideways for several bars while the indicator declined. Again, the indicator position only represented a temporary slowing down in the rate of advance of the bull trend.

4. The indicator reached an extreme and turned down at the same time price made a temporary high. If all indicator/price action were like this, the indicator would be the perfect signal of a price top.

This period of a strong bull trend shows us even more clearly that an extreme high indicator reading in a bull trend is never a signal that the price is at or near a top, only that the rate of the price advance may temporarily slow down.

If we could know in advance whether a market was about to make a strong, consistent trend or begin a trading range or choppy period with a trend direction bias, we would know how to use the indicator position for each type of trend for a trading strategy. We can *never* know in advance if a market will trend strongly or make a trading range. I always get a kick out of books, articles or workshops that describe a trading range strategy and a trend strategy. As if they know in advance how the market will trend. Give me a break!

While these have been only a few examples, they are representative of indicator/price relationships at extreme levels in the direction of the trend – high indicator levels in a bull trend or low indicator levels in a bear trend.

We have already shown how we can use an indicator at an extreme level to identify when a market is in a position to complete a counter-trend high or low. Can we use an indicator in our trading plan when the indicator reaches an extreme level in the trend direction?

We can use the indicator position as a disciplined and <u>objective</u> method to trail stops on part of an open position.

Let's see how we might do this and return to our S&P example.

The assumption in the examples below is we have successfully entered a trade near the corrective lows using the indicator/trailing-buy-stop entry set-up and the market is trending up. The assumption for a bull trend is that that an indicator will almost always reach the upper extreme before a short-term top is complete. The trading objective is not to sell at a price high, but to sell when the upward momentum declines. This may or may not coincide with an actual price high. It may only coincide with a slowing down in the rate of advance or a temporary sideways trend.

Here are the conditions for trailing the protective stop using the indicator.

Stop Zones

The Stop Zone is the relatively high indicator level in a bull trend and the relatively low indicator level in a bear trend. In other words, they are the extreme indicator levels in the trend direction.

Indicator Trailing Stop Rules

1. The indicator reaches the Stop-Zone and turns down (lower value).

2. Trail the stop one tick below the prior bar's low.

The chart on the next page shows the same go-long buy set-ups that were demonstrated earlier on indicators and buy set-ups.

The three horizontal lines show where the indicator first turned down from the Stop-Zone. When the indicator turns down from the Stop-Zone, the protective sell-stop on the long position is trailed one tick below the low of the prior bar.

Continued on the next page.

S&P 500 INDEX SP0699 D-D
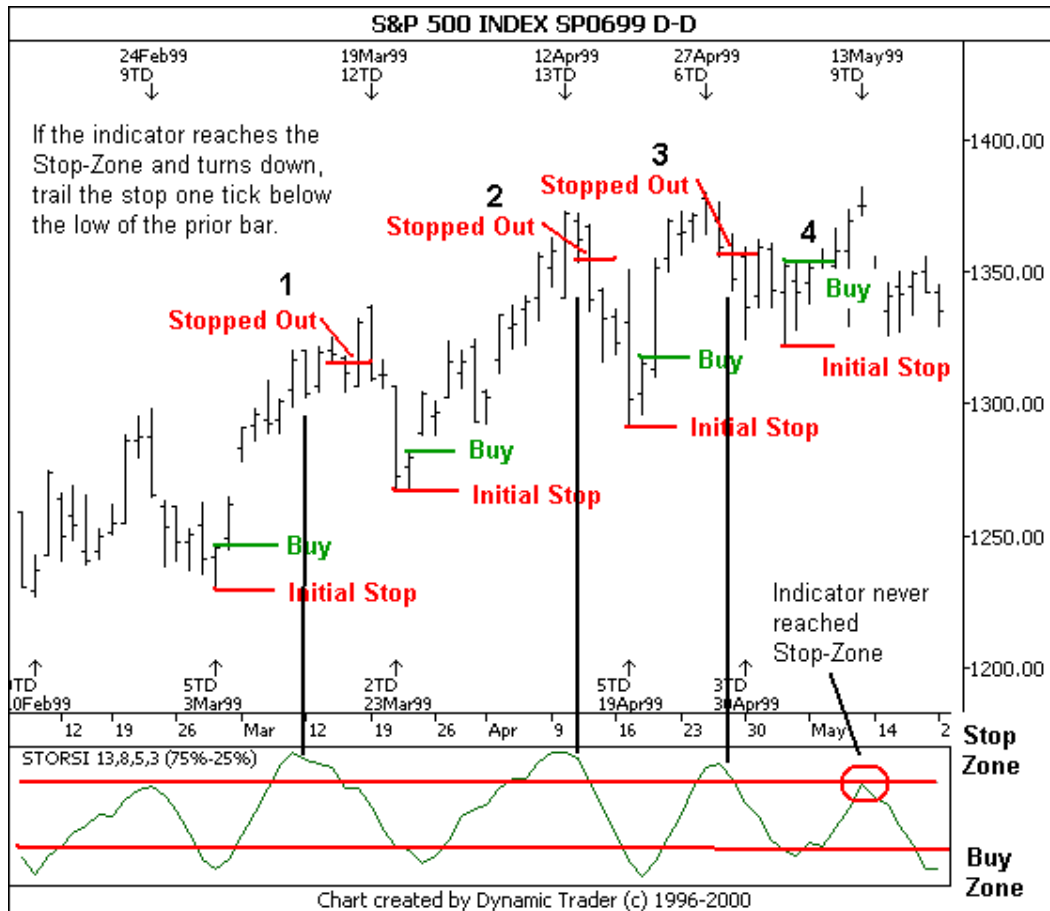
The trend is up. Trades 1-4 were long trade entries in the direction of the bull trend. Trades 1-3 were each stopped out with a substantial profit. The indicator never reached the Stop-Zone on trade #4. If trade #4 had been taken and we only considered the indicator-trailing stop strategy, the long position would still be open as the S&P had not yet declined below the initial protective sell-stop.

This is again the "well-chosen-example" where the S&P made very symmetric swings and the buys and sells worked out almost perfect profits every time. Now that we know the logic behind the indicator entry and trailing stop approach, let's take a look at less ideal examples.

Key Points: A key to this strategy is the assumption that the indicator will usually reach the extreme level in a trend before a price high is made. The stop is not trailed close to the market until the indicator reaches the extreme level ("stop-zone") and the "momentum" or rate-of-change of the

trend reverses which is signaled by the reversal in the indicator. The indicator reversal at the stop-zone may or may not coincide with a price reversal but it will usually coincide with at least a temporary halt in the trend.

Stop-Zone

Note on the chart above I have labeled the indicator Buy-Zone and Stop-Zone. The Buy-Zone in a bull trend is always the relatively low indicator readings from where a correction typically ends. The indicator Stop-Zone in a bull trend is the relatively high indicator readings from where we begin to adjust the protective sell-stop. The indicator Stop-Zone in a bear trend would be the relatively low readings.

More Indicator and Trailing-Stop Examples

The bond chart on the next page shows the four successful trade entries that were shown on the earlier bond chart which illustrated the indicator trade-entry strategy (see Part 3 of this tutorial series). Two entries on the earlier chart were stopped out with small losses and are not shown below.

At least three of the four short trades resulted in a profit using only the indicator-entry and trailing-stop strategy. Trades # 3 and 4 were relatively small profits but were still larger than the two losses shown on the earlier bond chart!

Note that the indicator never reached the Stop-Zone following trade entry # 2. Bonds had made a substantial decline from the trade entry and certainly the stop would have been moved to break even or better. This does illustrate that the trader shouldn't rely solely on the indicator stop-strategy and should consider other logical stop strategies in a fast moving market.
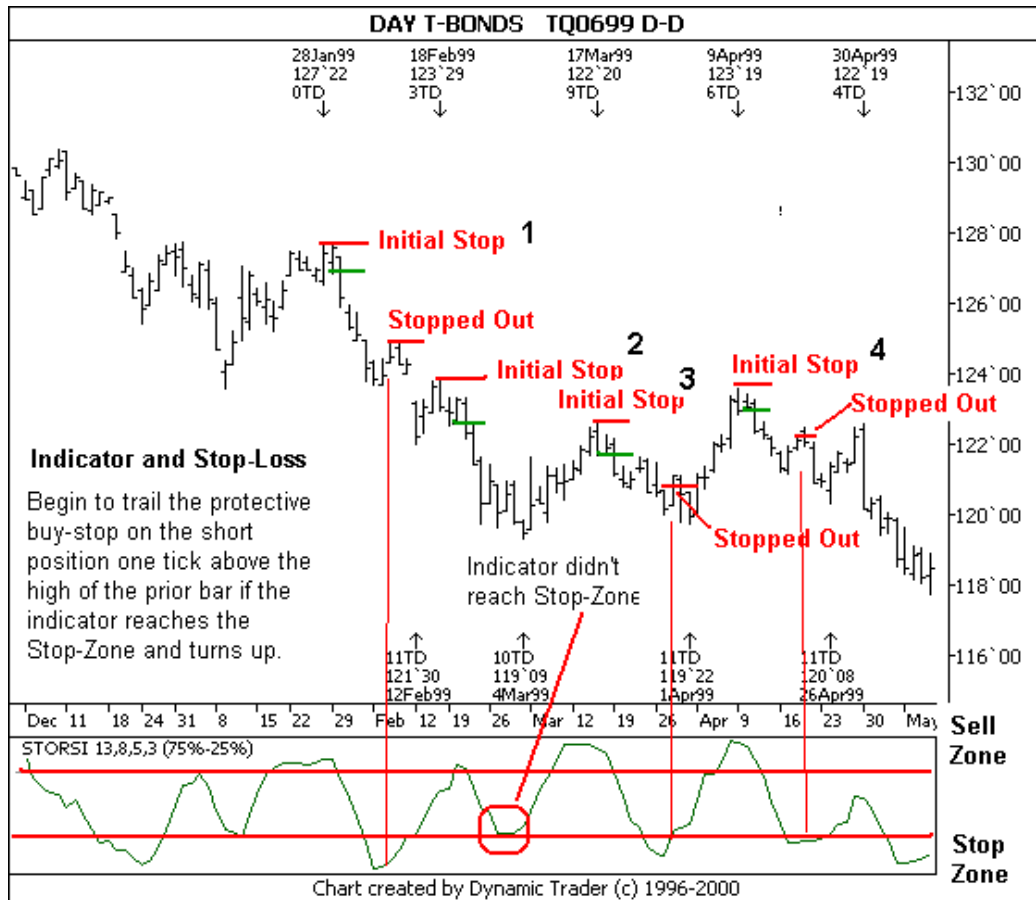
Some of these trades were stopped out at only very minor corrections and the main bear trend resumed much lower. Keep in mind that the objective using the indicator as part of the trailing stop-loss strategy is <u>not</u> to remain in the trade for the larger degree trend. This trailing stop strategy is meant to take profits on at least part of a position once the rate of change of the trend begins to slow down.
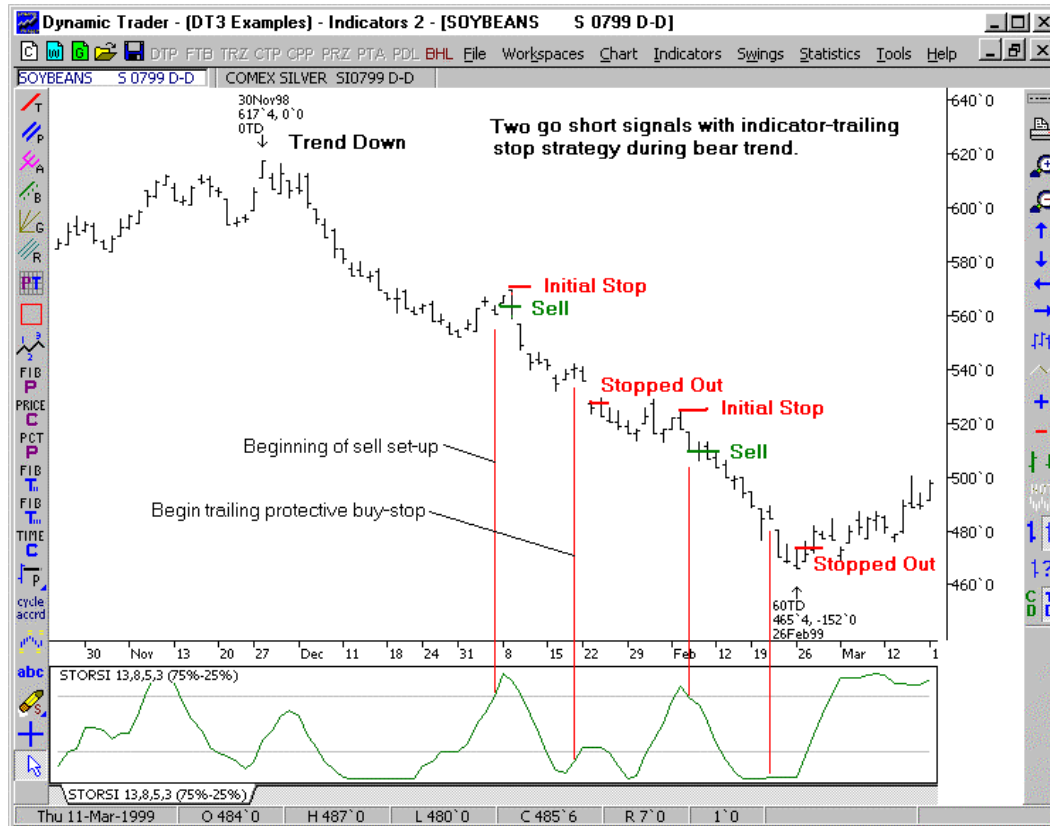
The Indicator Trailing-Stop Strategy is Completely Objective

Most of the Dynamic Trading stop strategies, while logical and systematic, are to some degree subjective meaning the trader must make a decision when and what strategy to implement within the context of the traders opinion of the time, price and pattern position of the market. *The indicator trailing-stop strategy is completely objective*. It is rule based and automatically implemented once the initial, objective conditions are met.

More Examples of Indicator Entry and Trail Stop Strategies

The next chart shows a period of a consistent bear trend with only minor corrections in July Soybeans from Nov. to Feb. Let's assume that we had identified the Nov. high as a trend reversal and anticipated a bear trend for at least several weeks. We would want to take any go-short, trend-continuation sell signals.

During this three-month period, the conditions for a short-sell were met just two times using the indicator trade-entry strategy to enter a short position and the indicator trailing-stop strategy to take profits on at least part of the position. Both trades had fairly significant profits. Once the indicator turned up from the Stop-Zone, the protective buy-stop was trailed one tick above the prior day's high.

In a strong trend with only very minor reactions, the indicator may not reach the buy/sell zone to meet the trade-entry conditions. However, when the conditions are met, the set-ups provide a high-probability of a

successful trade with minimum capital exposure. Do you have the patience to wait for the high-probability trade opportunities? If you don't, you shouldn't be trading.

   Other trend continuation trade set-ups such as the inside and outside-day strategies were made during this period. The indicator entry and trailing stop strategies I have taught so far are one type of trend-continuation trade strategy. A trader should consider using any of the trend continuation strategies once a trend is established.

Indicator Entry and Stop Strategies Good For All Market Conditions

We never know in advance what market condition or structure will unfold. We do not know if a consistent trend will develop or a choppy trading range. However, the indicator entry and stop strategy is applicable to any market condition. The key to its success is identifying the major trend direction and not taking any trades against the trend.

   The trend direction may be identified by a completely objective indicator such as a moving average or the Dynamic Trend Filter, or it may be identified by the application of the DT approach to time, price and pattern analysis. The DT approach provides a giant edge to the trader because it will usually identify in advance the high-probability targets for the trend of any degree.

More examples on the next page.

More Examples

On page 9 of the Part 3 tutorial, I used the S&P 60-minute data to illustrate the indicator strategy for trade entry. I will pick up on that same example to show how we use the indicator strategy for the trailing stop.

The morning of Nov. 14, the indicator had reached above the Stop-Zone and turned down setting up the conditions to begin to trail the stop one tick below the low of the previous bar.

Just two bars after the stop began to be trailed one tick below the 1BL (one-bar-low), the long position was stopped out.

The long trade was taken at 1111.10 and stopped out at 1138.40 for a 27.3 point gain.

The entry and exit rules were completely objective.

The trend is bullish so we would not consider a short position with the indicator at the extreme high level. We will consider a long position if the indicator reaches the Buy-Zone or extreme low level and turns up.

The chart below is the same data that I used for the buy example on page 10 of Part 3 of the tutorial series.

A long position was elected the afternoon of Nov. 16 at 1136.60, one tick above the high of the previous bar.

On the afternoon of Nov. 19, the indicator has reached the Stop-Zone and the stop was trailed one tick below the low of the previous bar.
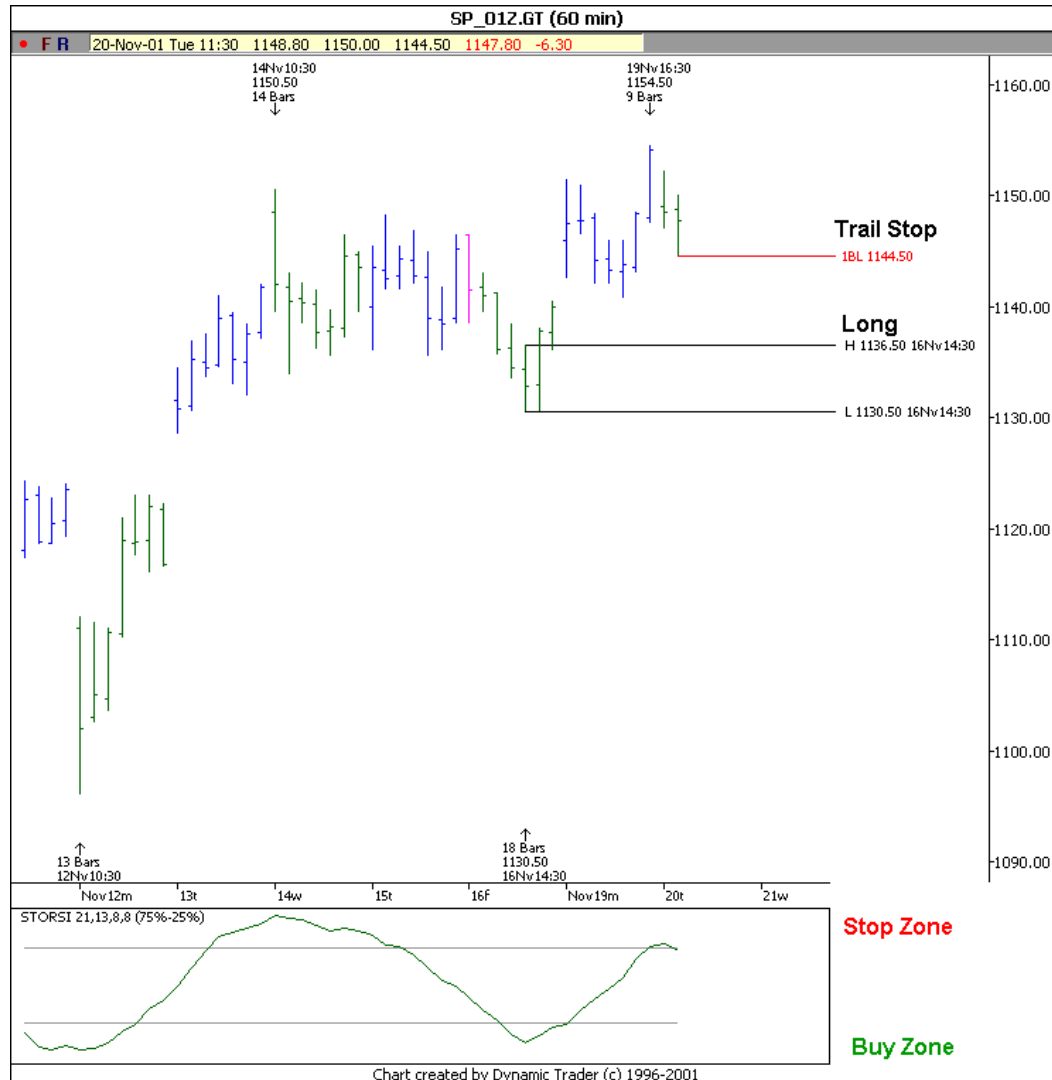
Four bars later, the long position was stopped out as the S&P declined below the low of the previous bar. In this case, the S&P traded marginally higher before taking out the 1BL.

The long trade was taken at 1136.60 and stopped out at 1147.90 for a 11.30 point gain.
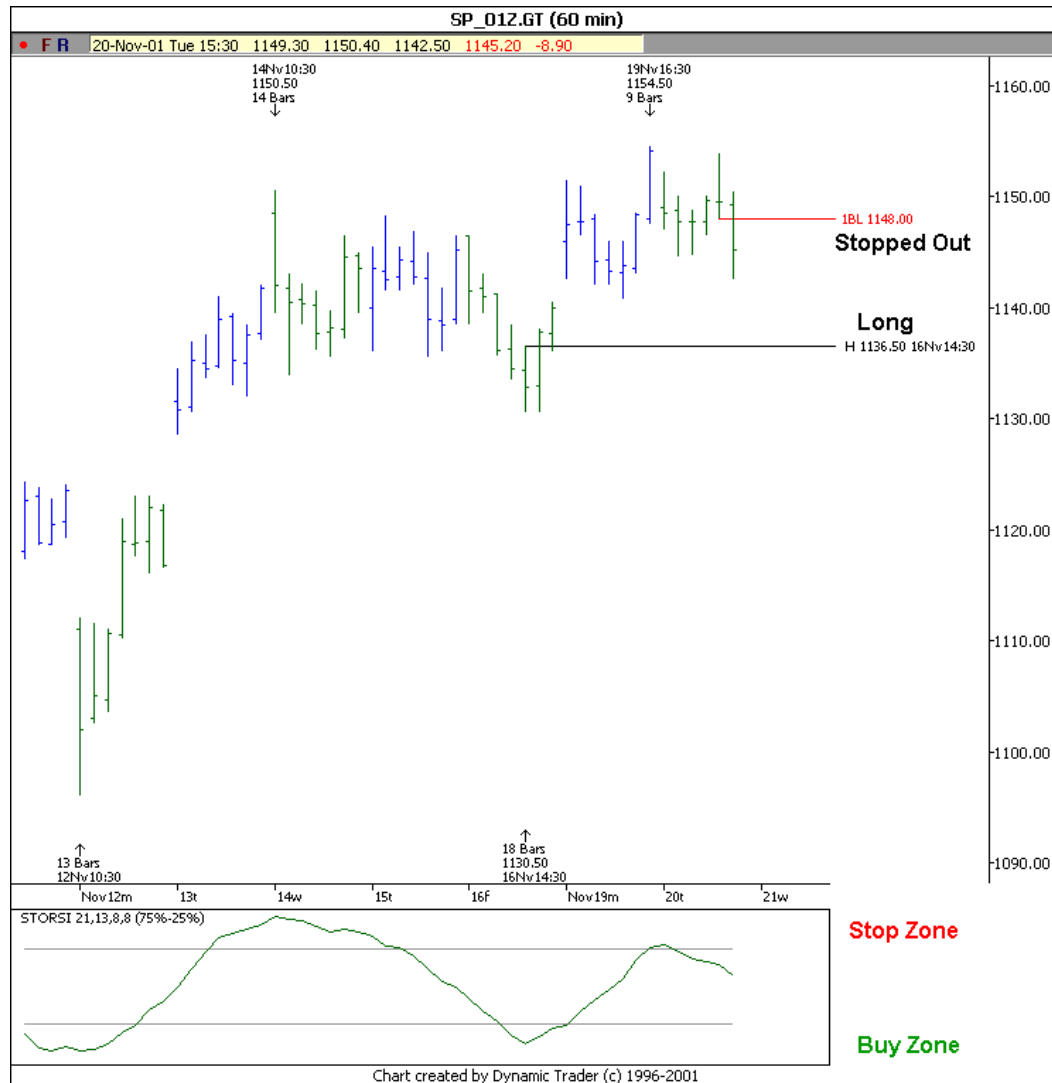
If our trend indicator or DT analysis is still bullish, we would not consider a short position but wait for the indicator to reach the Buy-Zone to consider a long position.

Indicator Exit Strategy Review

These examples have shown you an objective exit strategy for any market and any time frame. The objective of the indicator exit strategy is not to pick the top or bottom of a trend to exit. As you have seen, the indicator reversal is only a signal that the rate-of-change of the trend is slowing down. The objective is to lock in profits on all or part of a position after the initial trend thrust following a minor correction. Other Dynamic Trading strategies are used to identify the trend targets for longer term trades.

Continued on the next page.

Lesson Five

How To Choose The Best Indicator Settings

The first three parts of this series have shown that an indicator may help us to identify the end of a correction so we may take a trade near the extreme of the correction in the direction of the main trend. We have seen many examples of different time frames and markets how an indicator acts at corrections. We have learned that an indicator reversal does not necessarily coincide with a price reversal. Part 4 described how to use the indicator to trail a stop once a market reaches a "momentum" high or low.

This tutorial will describe how to choose the indicator settings.

What Indicator Settings To Use

Is there just one indicator setting that is best to use for a specific time period for all markets all of the time? Unfortunately, the answer is no. However, it is easy to determine which setting is best for the current data of any particular market for any particular time period of data.

Simply bring up data for a similar trend and test several settings to see which settings resulted in the indicator in the buy or sell zone at the end of most of the corrections.

I will continue to use the StoRSI indicator in Dynamic Trader for the examples. However, the same approach is used for all indicators. Dynamic Trader has several preprogrammed settings in the StoRSI and also allows the user to include any settings he or she chooses.

The chart below shows bonds in a bear trend. The indicator windows show three different settings with just the MA-1 displayed which is a green line. For this period of data, bonds were in a bear market. We would be concerned with which settings reached the upper extreme (sell zone in a bear trend) to help identify the end of a corrective rally in the bear trend. Of the three indicators shown below the chart, which setting appears to reach the upper extreme which is the Sell-Zone in a bear trend at most of the corrective highs?
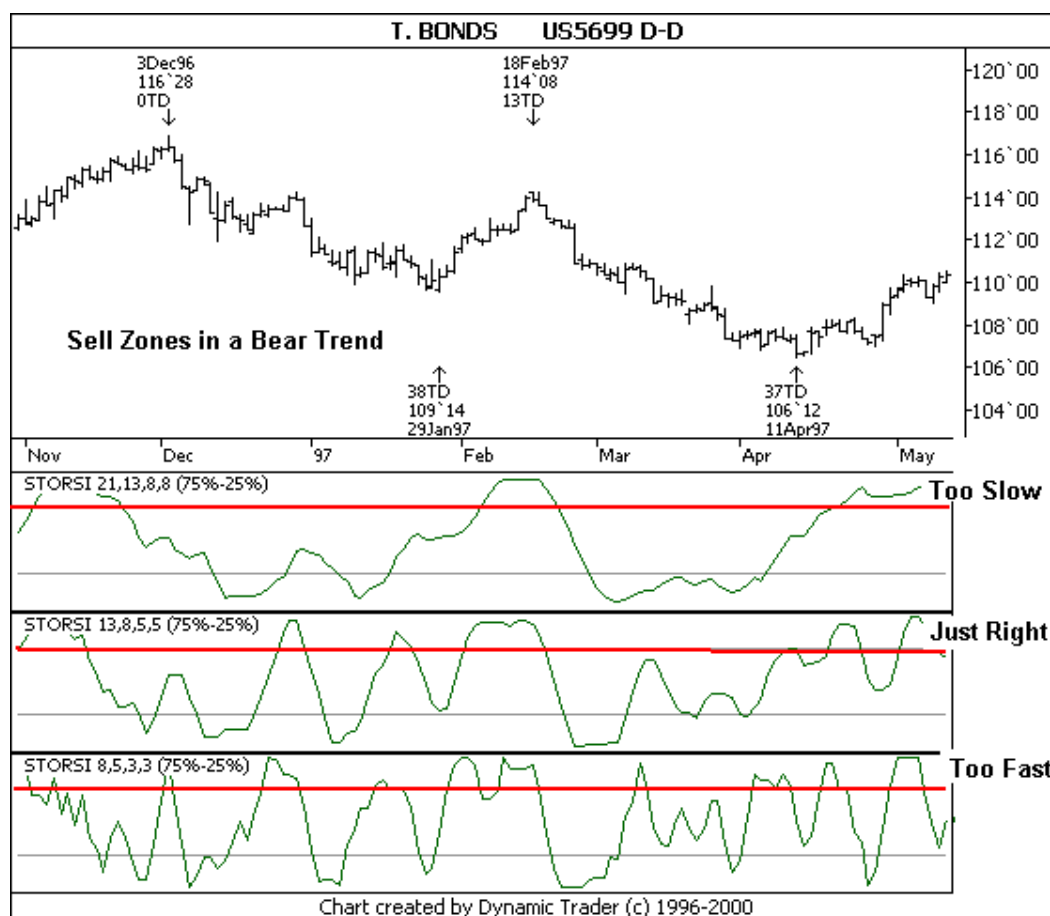
The 21…. setting only reaches the upper limits during the major correction during this six month period. If you are a long-term position trader and only interested identifying major trend changes, you would consider these "slow" settings. Most traders are looking for more than one trade each few months.

The bottom indicator, which is the setting that begins with 8, is too responsive and reaches the upper limits with just a mild slow down in the bear trend. There would be a lot of false signals with these settings.

The middle indicator window shows the group of settings that begin with 13….The indicator reaches the upper extremes during most of the minor corrections in the first section of the bear trend but does not reach the Sell-Zone during the second half. Of the three settings, it is still the best. While we might like to look at a couple more bear trends to see if the 13…. group of settings remains the best to identify Sell-Zones in a bear trend, it appears the 13,8,5,5 group is the best overall.

Keep in mind that most indicators will not reach a Buy or Sell Zone if a market is making a strong, consistent trend with only very short term corrections (2-4 bars) like the second section of the bear trend shown above.

StoRSI Settings Menu
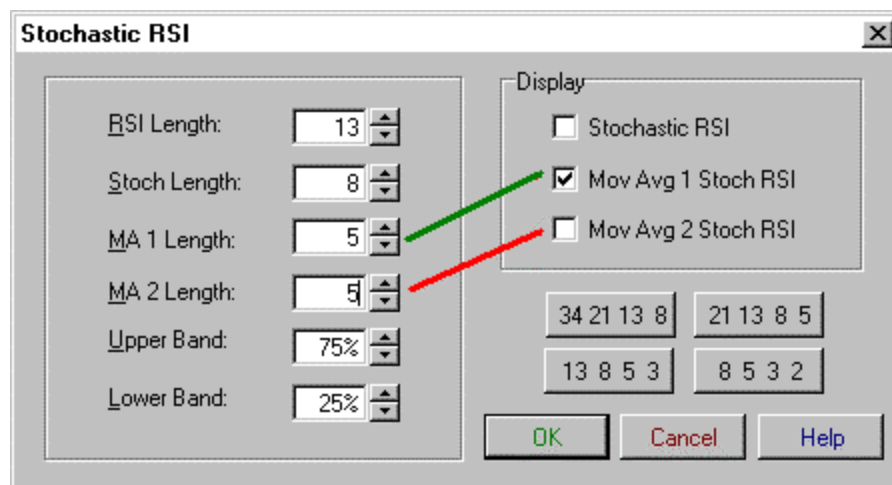
The MA-1 (moving average of the raw Stochastic-RSI) is the green line in the indicator menu. The MA-2 is a moving average of the MA-1 and is a pink line in the indicator window. When you take a moving average of a moving average, it is often called a "double smoothed" indicator. Either or both of the moving averages may be displayed in the indicator window. In the bond chart above, only the MA-1 was displayed.

In a later tutorial, I will show how we may use the crossover of the two moving averages as part of our trading strategies.

Suggested StoRSI Indicator Setting For Daily Data

The indicators shown in the charts so far have only included the Mov-Ave-1. The range of indicator settings that work best for *daily* data for most markets most of the time are:

Bands: Lower: 20%-30%; Upper: 70%-80%

Settings: 13-8-5-5 or 8-5-3-3

How do you know which of these limited ranges should work best for any particular market and any particular time frame? Simple. Just bring up the

recent data for a similar trend and display the various settings as we did above and discover which settings seem to give the most consistently reliable signals.

Don't be over anxious to use more sensitive settings just so more trade set-ups are made. *It is more important to have fewer but higher-probability, higher-profit and smaller-loss trades* than more frequent trades.

There are four default settings in the StoRSI menu using the Fib series of numbers. While these settings work very well for most markets most of the time, you may find other settings that work better for some markets. Take the time to test out other settings.

Let's take a look at a number of charts with various indicator settings to see which may be the most useful for different markets and time periods.

The first chart is the daily data for the S&P which was in a bear trend for this period. Which setting would have been most useful for this bear period to help identify if the market was at or near a corrective high?
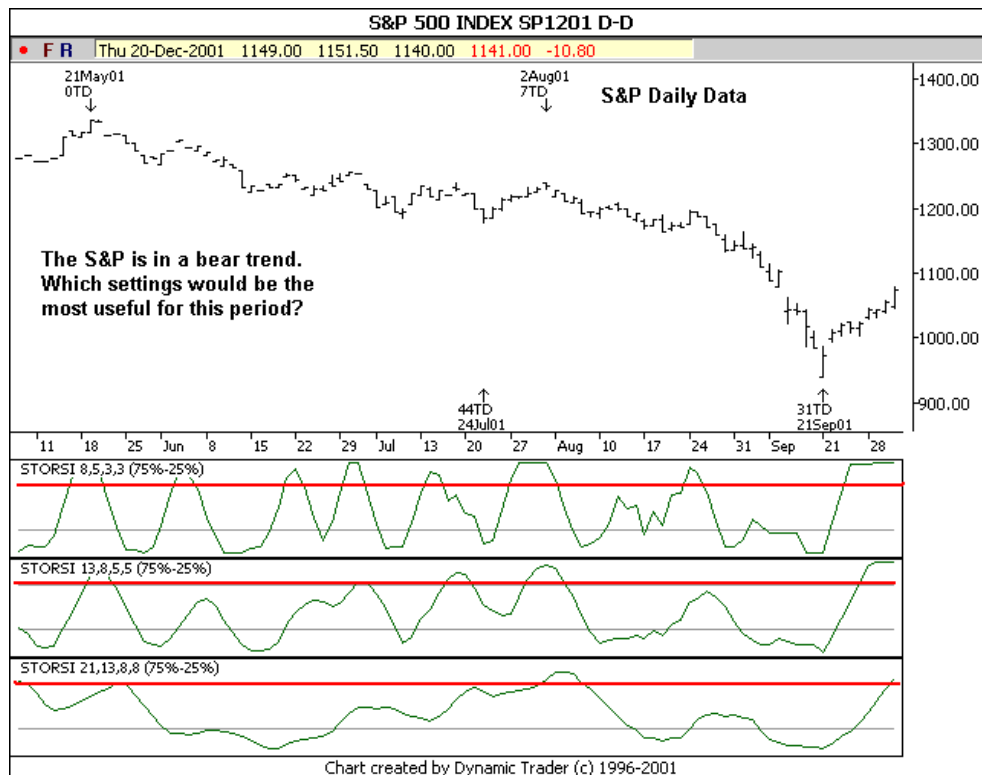
The top indicator window includes the settings that begin with 8…. The indicator reached the Sell-Zone at each of the minor corrections in the early part of the trend. The middle indicator window includes the settings that begin with 13… The indicator reached the Sell-Zone during most of the corrective highs in the first part of the trend.

In retrospect, the shorter term setting in the top window that begin with 8… would have worked best. The early part of this bear trend was very rhythmic making a regular series of 4-6 bar corrections in a choppy type pattern with a bearish bias. We will never know in advance the nature of a trend or counter-trend although a clearly defined Elliott wave structure may provide us with a possibility.

If we have found from studying other periods of data that the 13…. setting were usually the most helpful, we would want to use them as the shorter term settings beginning with 8…. only seem useful under a limited type of market – one that is relatively choppy and symmetrical.

The next chart is also S&P daily data during a bull trend.
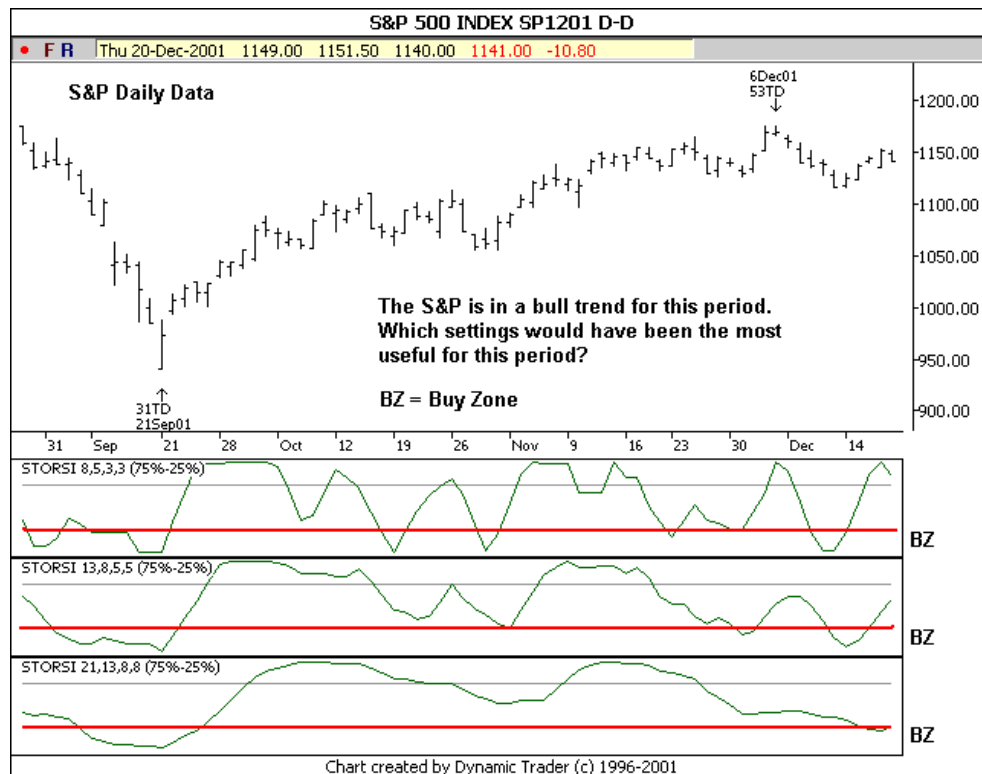
The next chart is also S&P daily data during a bull trend.

This bull trend period for the S&P was also relatively choppy. The short term settings that begin with 8… in the top window identified a few of the short term corrective lows. The indicator in the middle window with settings that begin with 13… only reached the Buy-Zone (BZ) at the larger degree correction in late Oct. in the middle of this trend.

In retrospect, the shorter term settings in the upper indicator window would have been a bit more useful. Although once again, we would not know in advance if the market was going to be a relatively choppy period with a bullish bias.

I've chosen these two examples to help illustrate that no indicator or particular setting is going to provide the trader with a set-up at every minor correction because we never know in advance what will be the character of the market. It is usually better to default to a longer period of settings that have a consistent history of reliability than to use settings that are too short and may give too many pre-mature signals. If you are looking to trade the short term swings that typically last just a few days, it is usually better to use the intraday data with an indicator for the trade set-ups.

The next chart is daily bond data during a bull trend. Which setting would have been the most useful to help identify the obvious corrections during this trend?

Continued on the next page.
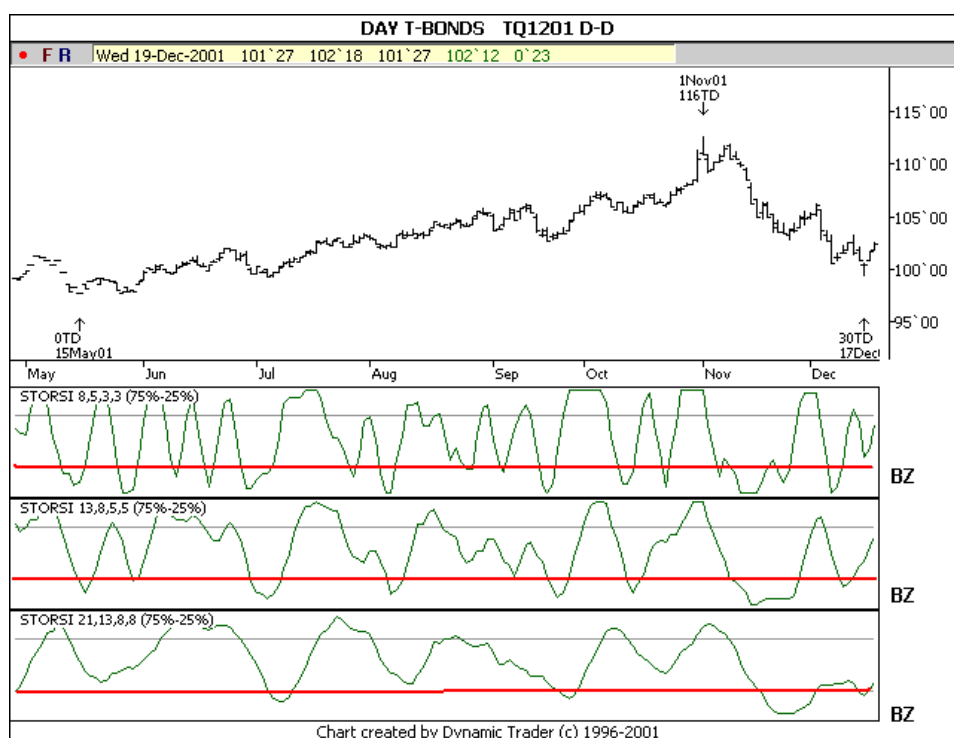
The middle indicator with settings that begin with 13…. consistently signaled when bonds were at or near the corrective lows. The upper indicator window with settings that begin with 8… often signaled a short term low but the short term signals would probably be more reliable from intraday data and an indicator. The next chart is bond 60-minute data for part of the bull trend period shown on the daily chart above.
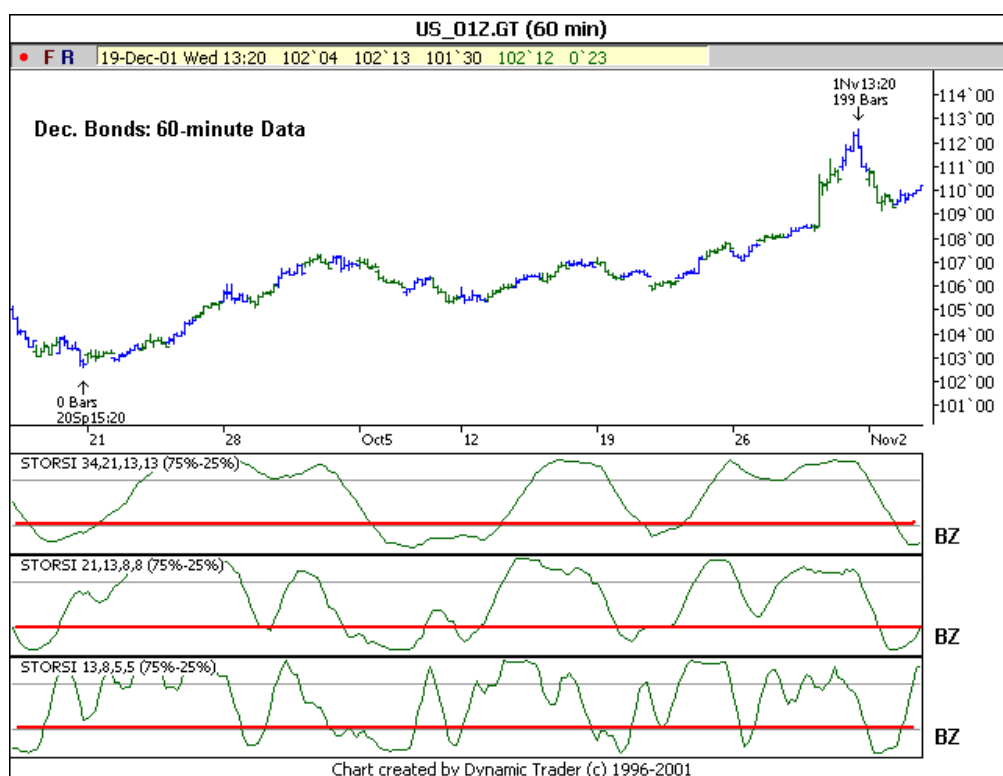
Which indicator is best depends on the time frame you intend to trade. The upper window with the longer term indicator reached the Buy-Zone at the major corrections that were followed by a 3-7 day advance. The lower indicator identified the short term lows although it often lead the market and reached the Buy-Zone well ahead of the actual price low.

Which indicator of the three would be most useful? What time frame are you intending to trade? From my point of view, either of the top two would be the most useful for relatively short term trade set-ups with the fewest false signals. If I wanted to trade the shorter term swings that only last 1-3 days, it would be better to go down to even shorter term data.

The next chart is bond 30-minute data with three indicator settings. The upturns from the Buy-Zone in the lower indicator window are marked with the vertical lines to the price data.

Chart created by Dynamic Trader (c) 1996-2001
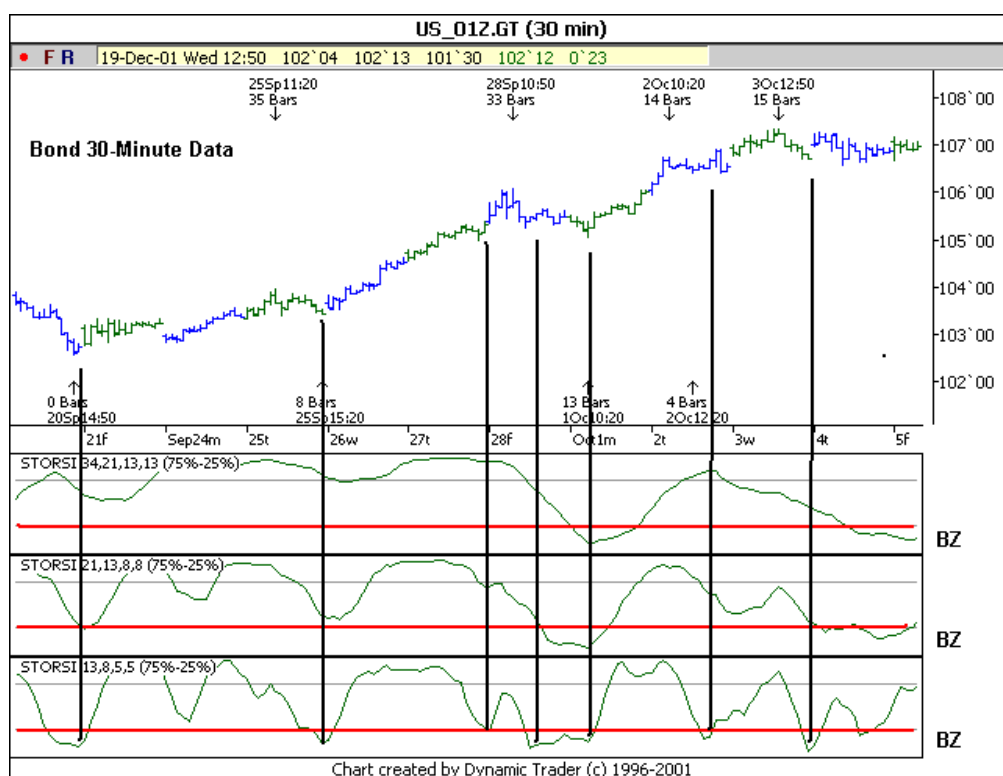
The lower indicator window with the settings that begin with 13… identified most of the short term corrective lows which were followed by a 1-3 day advance before the next short term low.

Let's go down to an even shorter time frame with 15-minute data for a part of the bull trend period.

The indicator settings beginning with 13…. Identified most of the lows that were followed by a 1-2 day rally.
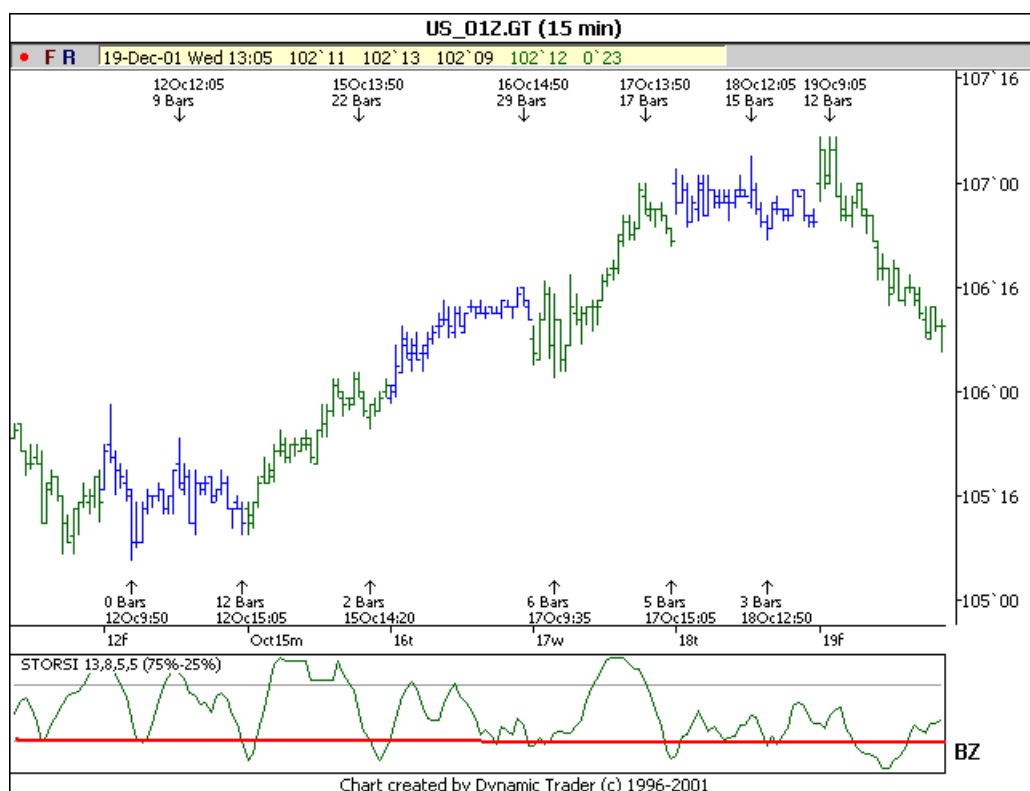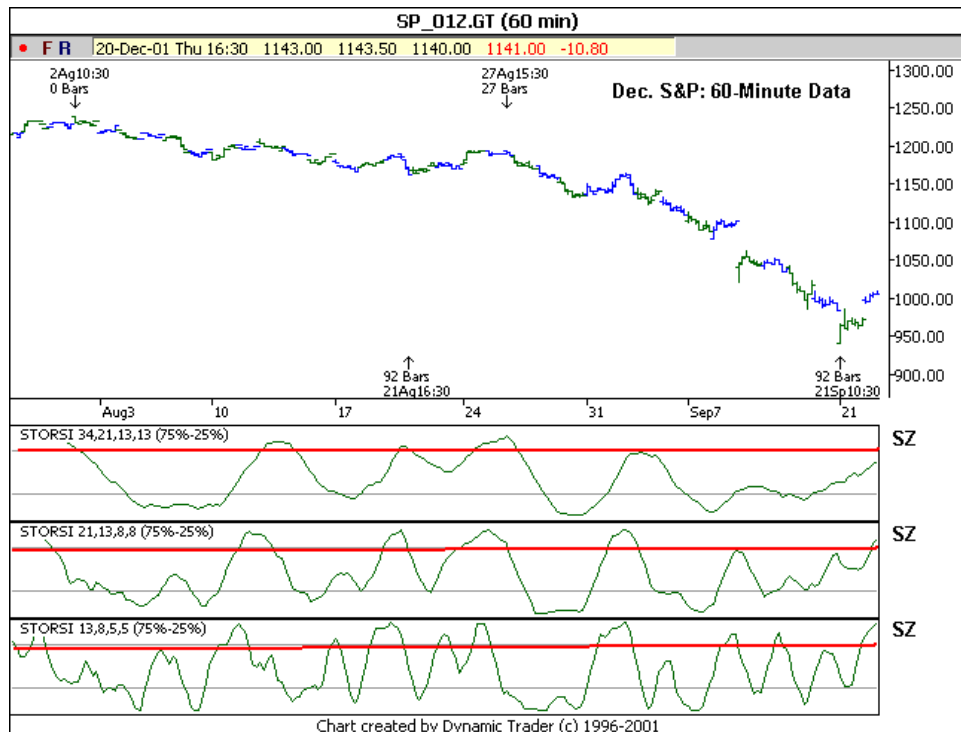
Keep in mind with all of these examples, the purpose of the indicator is to help identify corrective lows in order to take a position in the direction of the main trend.

Below are two more examples of S&P 60-minute data in a bull and bear trend with various indicator settings. Which would be most useful? Depends on your trading time frame.

Suggested StoRSI Indicator Setting For <u>Intraday</u> Data

The indicators shown in the charts so far have only included the Mov-Ave-1. The range of indicator settings that work best for *intraday* data for most markets most of the time are:

Bands: Lower: 20%-30%; Upper: 70%-80%

Settings: 21-13-8-8, 13-8-5-5

Note that these intraday setting suggestions are for a longer time period than the daily settings.

If you use an indicator other than DT's StoRSI, use the same process described above to discover what are the most consistently reliable settings for that particular indicator.

Indicator Setting Summary

There is no one indicator setting that is appropriate for all markets and all time frames.

If would be nice if there was some automatic, non-judgmental way to identify the ideal indicator setting for any market. There is not. Like all aspects of trading, it takes at least some work and judgment to identify the most useful indicator settings. Fortunately, it is not difficult and is relatively quick and logical.

Bring up a chart and place two or three indicators below the chart with different settings. Which setting most often reaches the Buy or Sell Zone at or near the end of corrections and turns near the price high or low?

In other words, which setting does not cause the indicator reversal to lead or lag the price reversal by more than a few bars. Which setting is most appropriate for your trading strategy will partially depend on the time frame of your typical trade.

Remember, the Buy-Zone is a low indicator reading in a bull trend and is used to help identify corrective lows. The Sell-Zone is a high indicator reading in a bear trend and is used to help identify corrective highs.

Don't try to use indicator settings on the data that is not appropriate for very short term trades. Go to a lower time frame of data. For instance, no indicator setting on daily data is likely to be reliable to identify 2-3 day trend swings. You will need to go to a smaller time frame of data, such as the 60 or 30 minute data.

Also, determine if the same settings for the same market and time frame are appropriate for both bull and bear trends.

Don't get indicator paralysis of analysis. If it is not fairly obvious it is usually not useful. I know of traders who insist that multiple indictors must all be in a certain position before a trade is considered. The main purpose of the indicator is to help identify the end of a correction so the trader can position a trade in the direction of the trend. Don't expect more of the indicator than it is able to give.

The next lesson will teach you how to use a double-smoothed indicator cross over as the set-up signal instead of a reversal in a signal indicator.

Lesson Six

Indicator Crossover Trend Reversal and Continuation Trade Set-ups

The indicator strategies described so-far have used just one indicator line – the MA-1 of the StoRSI with the Buy, Sell and Stop Zones. The strategy described below uses a crossover of the two Moving Averages as the set-up condition to begin to trail the buy or sell stop to enter the position and trail the protective stop as the trend progresses.

The principle for this entry and trailing stop strategy is the same as has already been described except we are using the crossover of the two moving averages to signal the change of momentum or rate of change rather than a simple reversal of a single indicator.

DT's StoRSI has two Moving Averages that may be used. The first MA is of the raw StoRSI data. The second MA is a MA of the first MA. This is also called "double smoothing" the raw data. In Dynamic Trader, MA-1 is a green line and MA-2 is a pink line. Since MA-2 is a MA of MA-1, it will lag the reversals of MA-1. How much it lags depends on the value chosen.
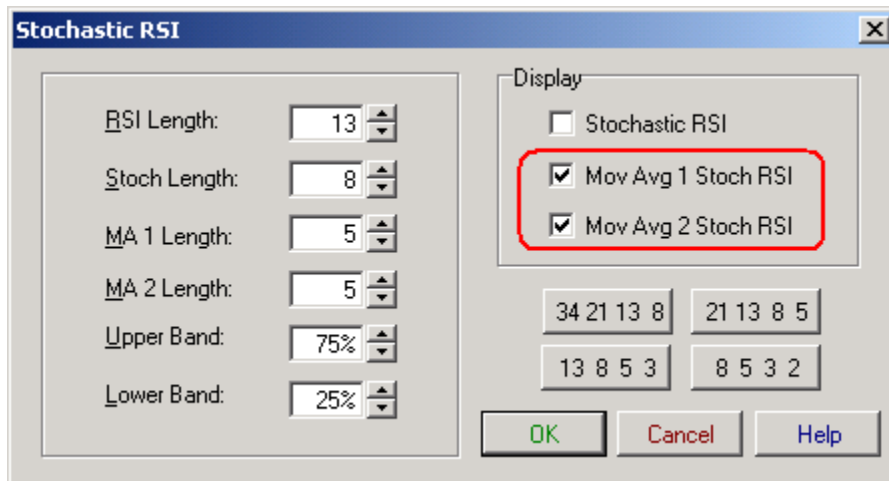
StoRSI Crossover Entry/Exit Strategy Rules

Set-Up To Enter The Trade (Buy to Go-Long Set-Up)

1. Only take a trade in the direction of the trend. For these rules, the assumption is the trend is bullish.

2. The MA1 (green line) must first reach the Buy-Zone (lower extreme).

3. The MA1 turns up above the MA2 (pink line). The MA1 is a higher value than the MA2.

4. Begin trailing the buy-stop to go long one tick above the one-bar-high (1BH).

5. If the long trade is elected, place the initial protective sell-stop one tick below the recent low.

Set-Up To Exit The Trade (Exit a Long Position)

1.   The MA1 (green line) moves into the Stop Zone (upper extreme).

2.   The MA1 turns down below the MA2. MA 1 is a lower value than the MA2.

3.   Begin trailing the stop one tick below the one-bar-low (1BL).

The rules are reversed to go-short from the Sell-Zone in a bear trend and exit the position in the Stop Zone..

Let's take a look at a series of set-ups using 15-minute S&P-mini data. The same rules or used for any market and any time frame.

Indicator set-ups should always be a part of a complete trading plan that includes time, price and pattern position. In the example so far in the prior tutorials, I have only considered the indicator position. These examples will show how the indicator strategy is complemented with the time, price and pattern position.

S&P-mini, 15-Minute Data

In these examples, we are using short-term data and looking to make relatively short-term trades that may last from a few hours to a few days. This same strategy may be used on any time frame and any actively traded market.

On the chart below, the S&P has declined to the 78.6% retracement. Let's assume our analysis indicates this is an important support zone from where a correction to at least the 50% retracement will be made. While the larger degree trend is down, the short-term trend should be up for 10-30 points. Remember, trend is relative to the time frame.

Our objective is to make a long trade for the corrective trend to capture 10 or so points.

Continued on the next page.

1. As of the last bar on the chart, the MA1 has reached the Buy Zone and has just crossed above the MA2. We trail a buy-stop to go long one tick above the 1BH. We can use the 1BH function in DT to alert us if the S&P trades above the 1BH.

2. The minimum objective is the 50% retracement because the assumption is usually that a market will correct to the 50%-78.6% retracement zone.

3. If the long trade is elected, the initial protective sell-stop is one tick below the recent low.

Chart created by Dynamic Trader (c) 1996-2000
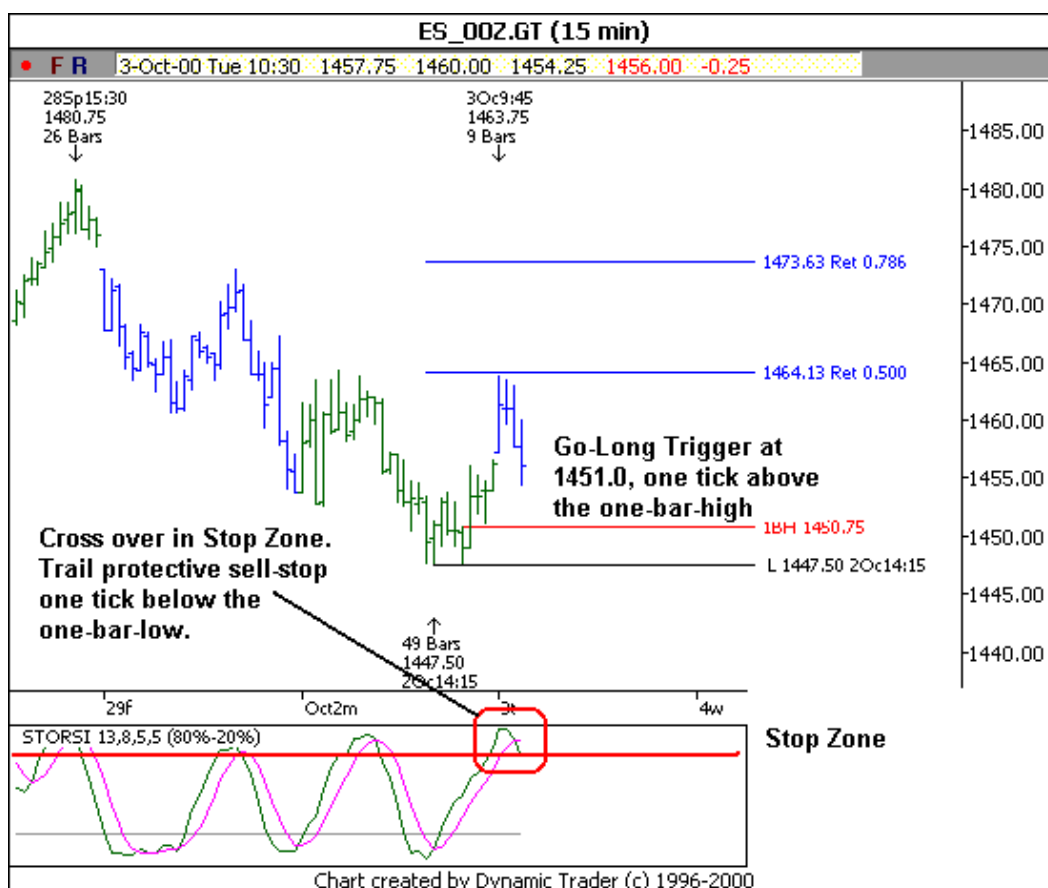
1. Three bars after the cross up from the Buy Zone, the S&P takes out the 1BH and triggers the long trade at 1451.0. Be aware that the trailing 1BH may actually decline if the bars after the crossover set-up have lower highs.

2. As of the last bar shown on the chart above, the MA1 has reached the Stop Zone and turned down and crossed below the MA2. The protective sell-stop for the long position is now trailed one tick below the one-bar-low (1BL). If the market continues to advance with the bars making higher lows, the 1BL stop will advance along with the market keeping the trade open as long as the market continues to trend higher.

Two bars with higher lows are made. The 1BL advances and three bars later the long position is stopped out at 1457.50, one tick below the trailing 1BL.

Trade Results: 1451.0 (Long) – 1457.50 (Out) = **$325 (Profit)**.

Should we have stopped out and reversed to a short trade on the cross over set-up in the Stop Zone? The better question - Is the corrective trend over and should the larger degree bear trend continue?

If we believe the Oct. 3 high completed the correction, we should reverse to short. If not, we only want to consider long trades until the market has either reached the corrective trend targets or makes a signal the corrective top is complete. This is where some judgment is required. The analysis of the trend position should be logical and meet guidelines.

The corrective rally is only nine bars so far which is only a 19% time retracement of the prior 49-bar decline (9/49=19%). The initial assumption is usually that a correction should be a 38.2% or more time retracement.

The Oct. 3 high fell two ticks short of a 50% price retracement. Since the corrective rally did not reach the minimum anticipated time and price targets for correction, the assumption is the correction is not complete. We should not initiate a short position and only consider a long position until this trend reaches the minimum objectives or the market continues the larger degree bear trend to a new low.
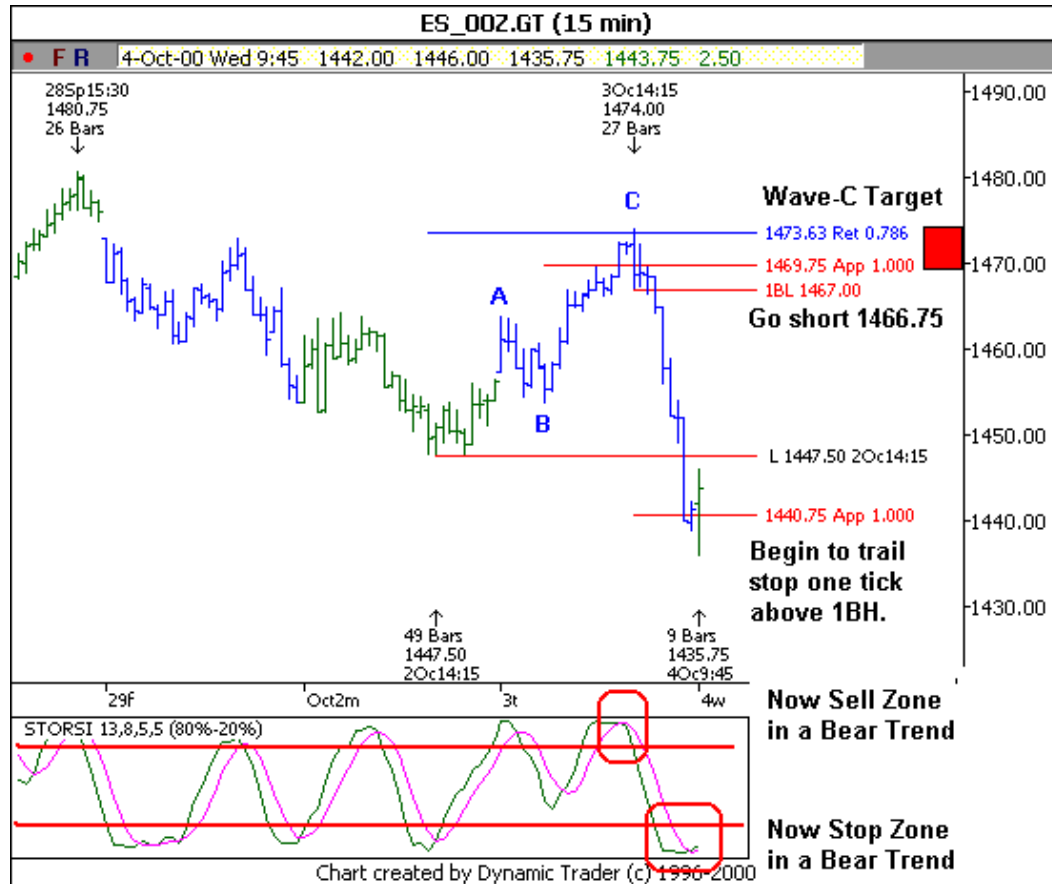

1. The S&P continued to advance from where we have labeled a Wave-B low without making a crossover in the Buy Zone (lower extreme). There was not another long trade set-up.

2. Later on Oct. 3, the S&P reached the 78.6% retracement, the maximum retracement anticipated for a corrective trend. Just below the 78.6% retracement is the 100% Alternate Price Projection where W.C = W.A, the typical target for a W.C high. The S&P had advanced 27 bars which was a 55% time retracement (27/49=55%). The S&P was in

a position to complete a corrective high if the larger degree trend is down as anticipated.

3. One bar after the Oct. 3 high, the MA1 crossed below the MA2 from the Sell Zone making the set-up to begin to trail a sell-stop to go short one tick below the 1BL. Note that what was the Stop Zone in a bull trend (upper extreme) is now the Sell Zone in a bear trend because we believe the correction is over and the trend is now down.

4. The short trade is elected at 1466.75, one tick below the 1BL.

5. Early the following day, the MA1 reaches the Stop Zone and crosses above the MA2. The protective buy-stop is now trailed one tick above the 1BH.

Continued on the next page.

Chart created by Dynamic Trader (c) 1996-2000
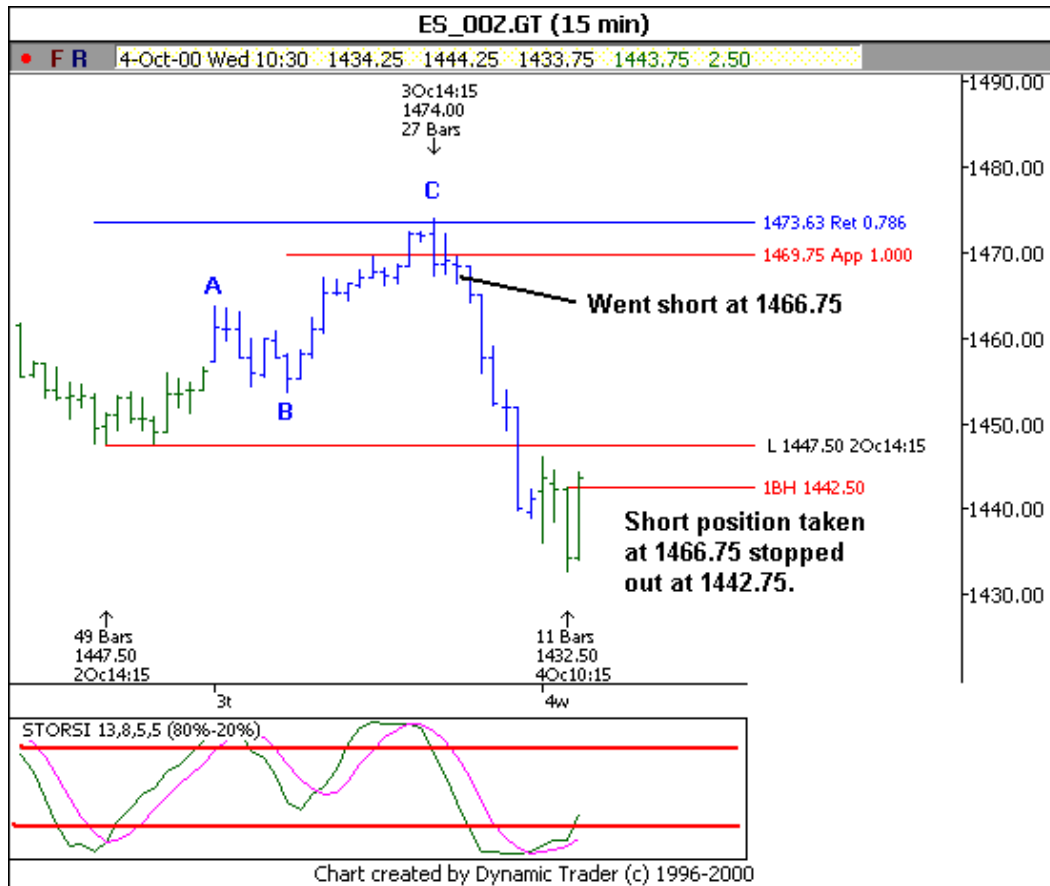
1. From the time of the initial crossover in the Stop Zone, the S&P continued to decline a few more bars making lower highs. The 1BH is trailed one tick above the 1BH.

2. The short position is stopped out two bars later when the S&P traded above the 1BH.

Trade Results: 1466.75 (Short)– 1442.75 (Out) = **$1200 (Profit)**

Should we stop and reverse to a long position? Let's assume the larger degree trend is down and the S&P has not reached a time or price support target. We want to continue to only take set-ups for a short position.

So far this looks like a can't-lose winning strategy. Let's find out if this is the case by adding more bars to the chart and looking for a set-up for another short trade.
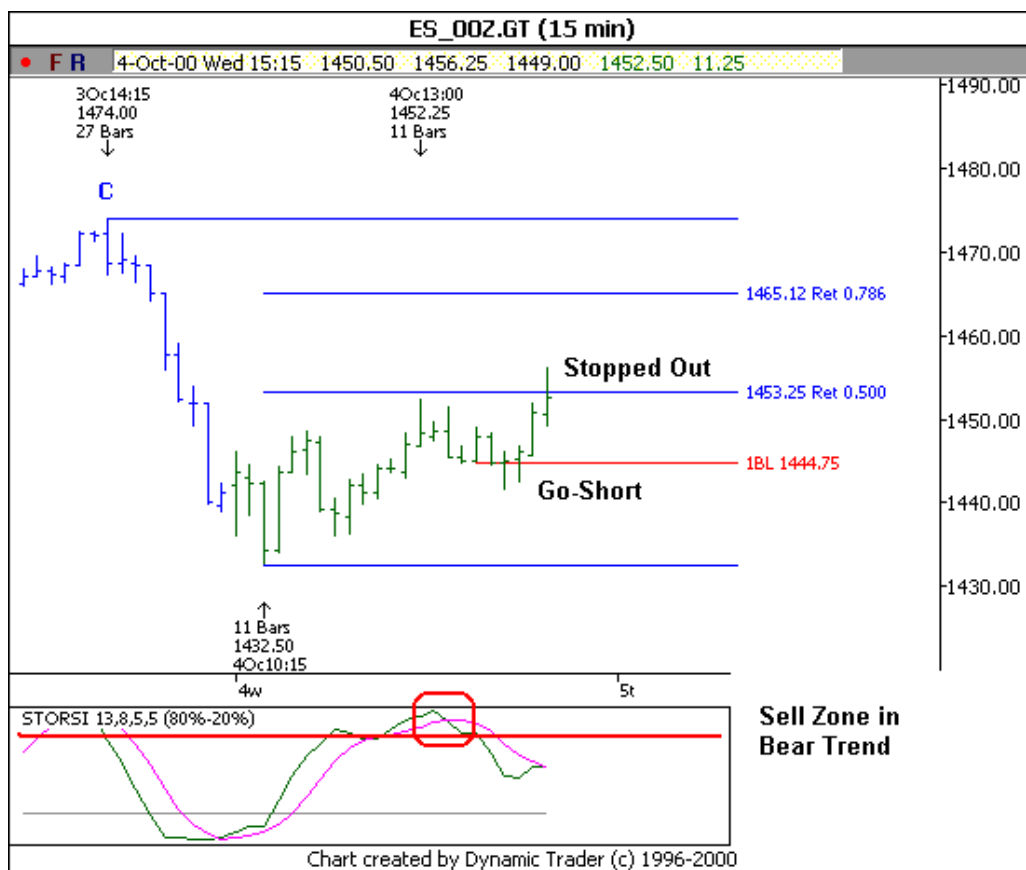
1. Mid-day on Oct. 4, the S&P reached to just one point below the 50%
   retracement and makes a cross over from the Sell Zone.

2. The sell-stop to go short is trailed at one tick below the 1BL.

3. The short trade is entered a few bars later at 1444.50, one tick below
   the one-bar-low.

4. The initial protective buy-stop is placed at 1452.50, one tick above the
   recent high.

5. The short position is stopped out for a small loss later in the day when
   the S&P makes a new high.

Trade Results: 1444.50 (Short) – 1452.50 (Stopped Out) = (**$400) (Loss)**

   Do we continue to take short set-ups? Of course, *as long as the trend
is down*. The corrective rally is choppy, unfortunately not a typical ABC
correction. As long as we continue to believe from our time, price and

pattern analysis that the S&P is in a bear trend and it does not close above the 78.6% retracement, we should take each short set-up.
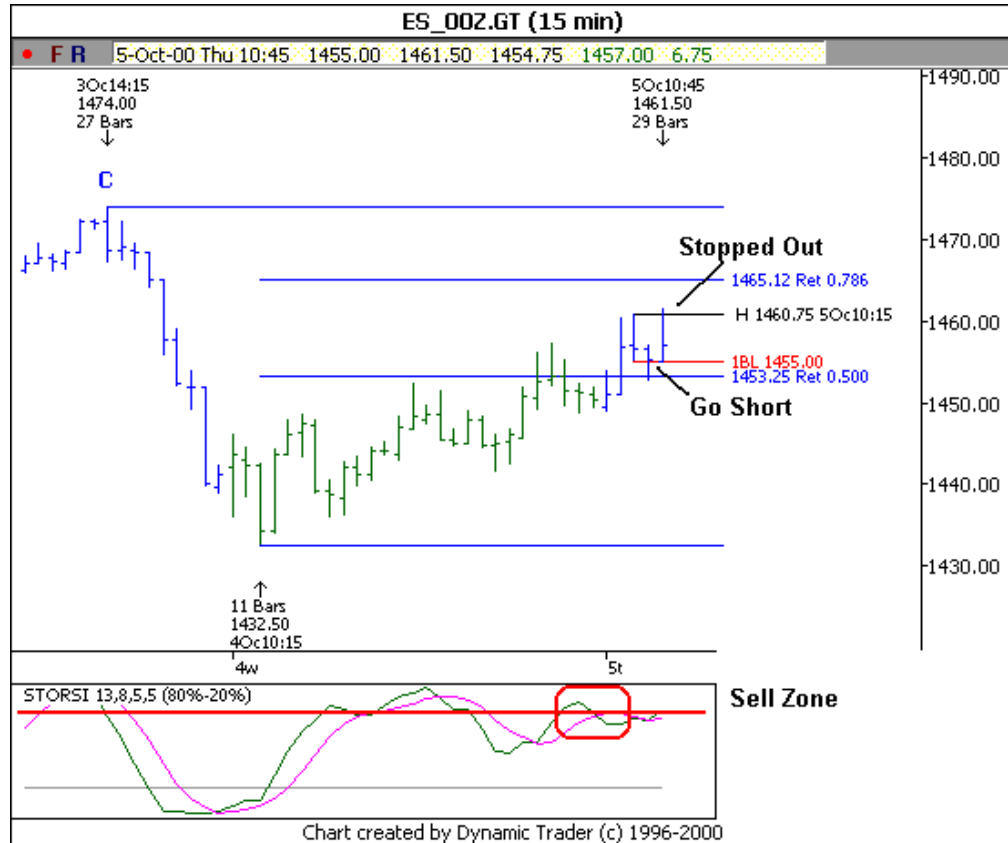
1. On the morning of Oct. 5, the S&P continues to rally higher but not above the 78.6% retracement.
2. The MA1 line reaches above the Sell Zone and crosses below the MA2. Note that the MA2 is not above the Sell Zone line. It doesn't have to be. Only the faster and more responsive MA1 must first reach to the Sell Zone.
3. The sell-stop to go short is trailed one tick below the 1BL.
4. The short trade is elected at 1454.75. The initial protective buy-stop is at 1461.75, one tick above the recent high.
5. The short trade is stopped out one bar later at 1461.75.

Trade Results: 1454.75 (Short) – 1461.00 (Stopped Out) = **($312.50) (Loss)**

Two losses in a row. Do we continue to take any short trade set-ups on subsequent crossovers? Yes, as long as the market has not signaled the trend is up by making a daily close above the 78.6% retracement.


1.   The MA1 soon reaches above the Sell Zone once again and crosses below the MA2.

2.   The sell-stop to go short is again trailed one tick below the 1BL.

3.   A couple bars later the sell-stop is elected for a short trade at 1451.50.

4.   Later in the day the short position is stopped out at 1461.75, one tick above the recent high.

Trade Results: 1451.50 (Short) – 1461.75 (Stopped Out) = **($512.50) (Loss)**

Now we have three losses in a row. Do we continue to take short set-ups? Of course, as long as the S&P has not closed above the 78.6% retracement at 1465.25. That's our plan and there is no reason to alter the plan. The pattern of the advance still clearly appears to be a correction. The S&P is now just a few points below this maximum target for a correction.

While we have taken three losses in a row, each loss has been relatively small, between $300-$500. The total of these three losses is still less than the total of the first two profits.

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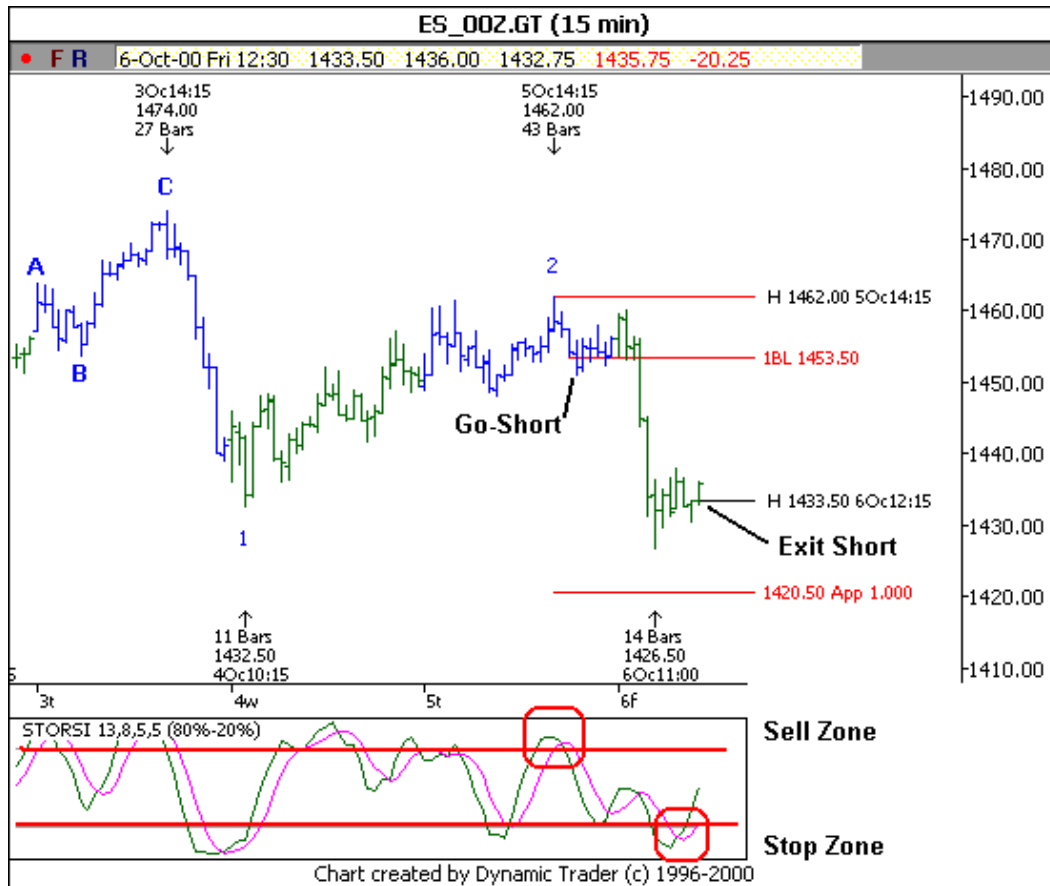
1.   A few bars after being stopped out, the MA1 again crosses below the MA2 making the set-up. The sell-stop to go short is trailed one tick below the 1BL.

2.   The short trade is elected on the next bar at 1453.25. This time the S&P declines sharply to a new low.

3.   By mid day the following day, the MA1 has reached the Stop Zone in a bear trend and made a cross to above the MA2.

4.   The stop to exit the short trade is trailed one tick above the 1BH.

5.   The short trade is exited later in the day at 1433.75, one tick above the trailing 1BH.

Trade Results: 1453.25 (Short) – 1433.75 (Out) = **$975.00 (Profit)**

This series of six trades over a one week period (Monday-Friday, Oct. 2-6) netted a profit of $1200 trading a one contract position with three profitable and three losing trades. While the win/loss ratio was 50%/50%, the average profit was considerably larger than the average loss resulting in a net profit.

I purposely used this period of the S&P because it included a prolonged choppy correction that resulted in three consecutive losses. It is important to keep your eye on the ball. What is the ball? *Trend Direction.*

Every trading strategy will have at least small losses in prolonged, choppy corrections or trading ranges and you will *never know in advance if a choppy correction or trading range will unfold.* As long as the other technical analysis continues to indicate the larger degree trend direction, you must continue to take each set-up.

In the case of this series of trades, missing the last short trade and the substantial profit of that trade would have considerably changed the overall profitability.

Like most trend-continuation set-ups, in prolonged and consistent trends this strategy works almost faultlessly. The key is limiting losses in choppy periods when you can have a string of several losses in a row until the larger degree trend reasserts itself.

Continued on the next page.

The Stop Zone and Trailing Stops

For each example above, the stop was trailed one tick above the one‑bar‑high or low at the first crossover in the Stop Zone. We did not consider the larger degree time, price and pattern position and trend targets with the exit strategy.

In most cases, the exit strategy in the Stop Zone should only be initiated if the market is approaching a trend target instead of at the first crossover in the Stop Zone. This assumes the time or price position is clearly defined to provide a high-probability trend target.

Let's take another look at the last trade and see how the strategy and profits may be enhanced by incorporating some very simple price projection analysis.

Continued on the next page.

1. The go-short set-up was made the afternoon of Oct. 5. The short-trade was elected at 1453.25.

2. Early in the day on Oct. 6, the S&P declined sharply to test the recent swing low and a crossover was made in the Stop Zone as the rate of declined decreased. Should we trail the stop at the 1BH?.

3. If our analysis considered the Oct. 5 high is a Wave-2, the typical Wave-3 target is the 162% Alternate Price Projection which is at 1394.75, almost 40-points lower.

4. It would be far more logical to maintain the position until the S&P at least approached the typical price target before trailing the stop at the 1BH.

Chart created by Dynamic Trader (c) 1996-2000
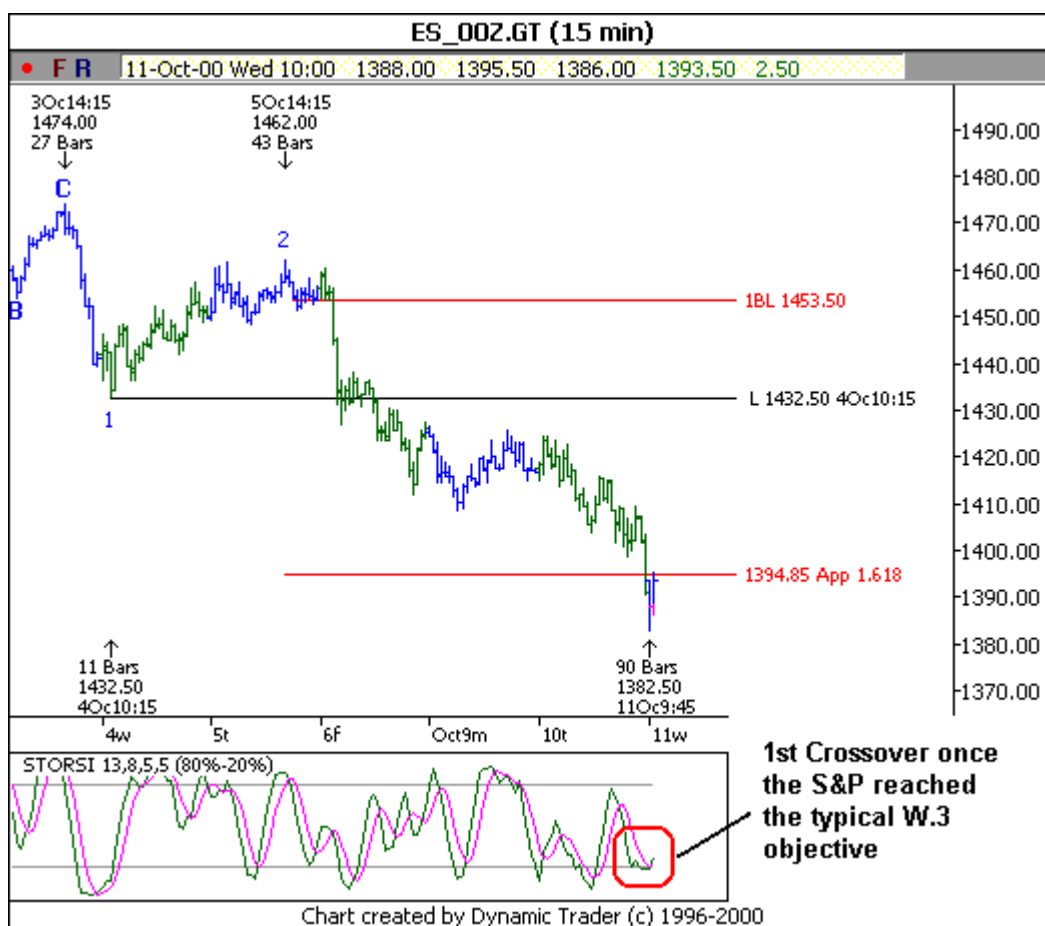
1. The S&P continued to decline. The S&P made three more crossovers in the Stop Zone before the market even approached the initial Wave-3 price target.

2. On the morning of Oct. 11, the market traded to the 162% APP and made a crossover in the Stop Zone. Now is a more logical time to begin to trail the stop one tick above the 1BH.

Chart created by Dynamic Trader (c) 1996-2000
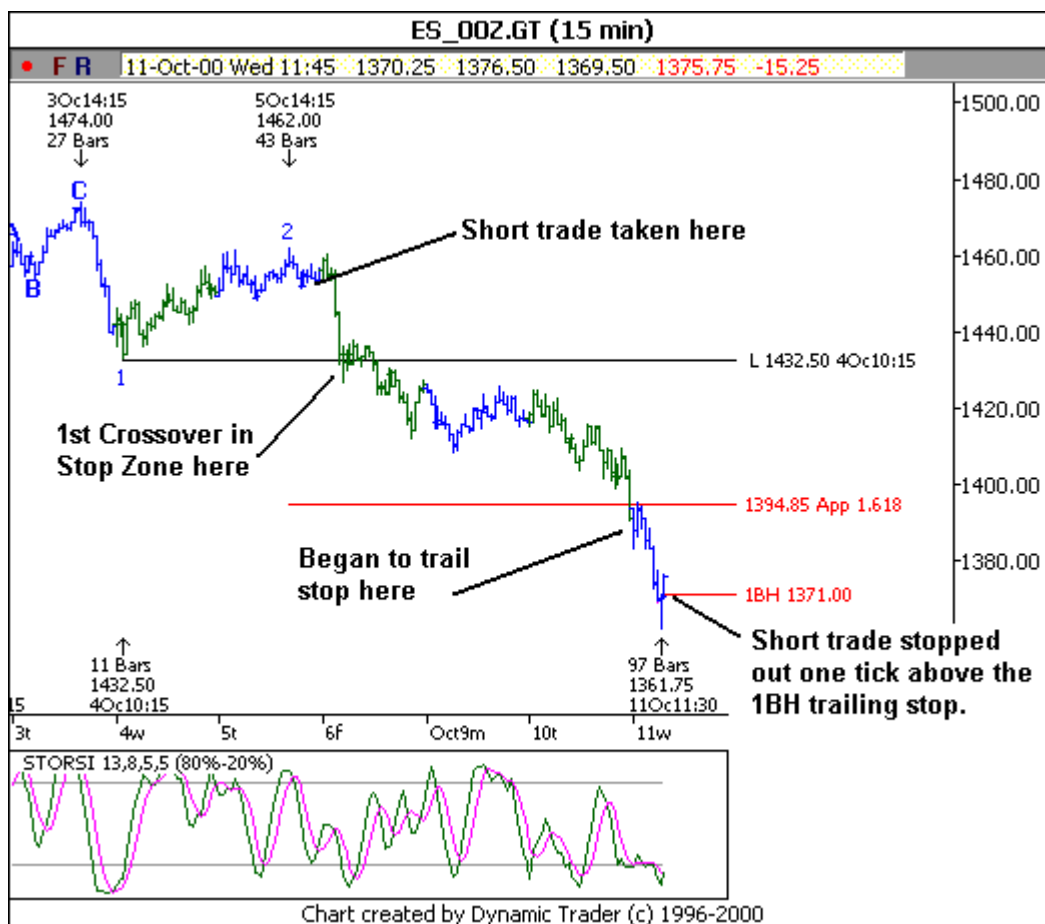
1. The market continued to decline and the protective buy-stop was adjusted lower with each new bar with a lower high. Later in the day, the 1BH was finally taken out and the short position was stopped out at 1371.25.

2. By incorporating a simple price objective in the strategy, the net profit was substantially increased from about 20-points at the first Stop Zone crossover to over 80-points at the first crossover after the market reached the 162% APP! What a difference!

You wouldn't want to leave the initial stop all the up near the entry position as the market made an 80-point decline. You would want to make some stop adjustments as the market declined to protect a least part of the unrealized profits.

Lesson Seven

Review and More Examples

The strategies outlined in the tutorials may be applied to any market, any time frame and any indicator.

Let's wrap up this tutorial series and put it all together with some more step-by-step examples.

Indicator Entry/Exit Rules Using StoRSI MA Crossover

These rules are for a bull trend and long trade. Reverse for bear trend and short trade. Keep in mind for the StoRSI, the MA2 is a moving average of the MA1 which itself is a moving average of the raw data. The MA2 will be a less volatile and "slower" changing line than the MA1.

Set-Up To Enter The Trade (Buy to Go-Long Set-Up)

1. Only take a trade in the direction of the trend. For these rules, the assumption is the trend is bullish.

2. The faster MA1 (green line) must first reach the Buy-Zone (lower extreme).

3. The MA1 turns up above the MA2 (pink line). The MA1 is a higher value than the MA2.

4. On the next bar, begin trailing the buy-stop to go long one tick above the one-bar-high (1BH).

5. If the long trade is elected, place the initial protective sell-stop one tick below the recent low.

Set-Up To Exit The Trade (Exit a Long Position)

1. The MA1 (green line) moves into the Stop Zone (upper extreme).

2. The MA1 turns down below the MA2. MA 1 is a lower value than the MA2.

3. On the next bar, begin trailing the stop one tick below the one-bar-low (1BL).

The rules are reversed to go-short from the Sell-Zone in a bear trend and exit the position in the Stop Zone.

On Jan. 7 the S&P made a high which was projected in the DT Futures Report to be a Wave-A high from the Sept. 21 low. The Wave-A high should be followed by a Wave-B decline lasting several weeks.

Trade #1

On Jan. 9, the StoRSI made the first crossdown from the Sell-Zone (SZ) in a bear trend. The stop to enter a short trade is trailed one tick below the 1BL once the StoRSI has crossed down from the Sell-Zone. A few bars later a short trade is elected.

The following day, the StoRSI crosses up from the Stop-Zone and the stop is trailed one tick above the 1BH. Later in the day, the short trade is stopped out for about a 7-point profit.
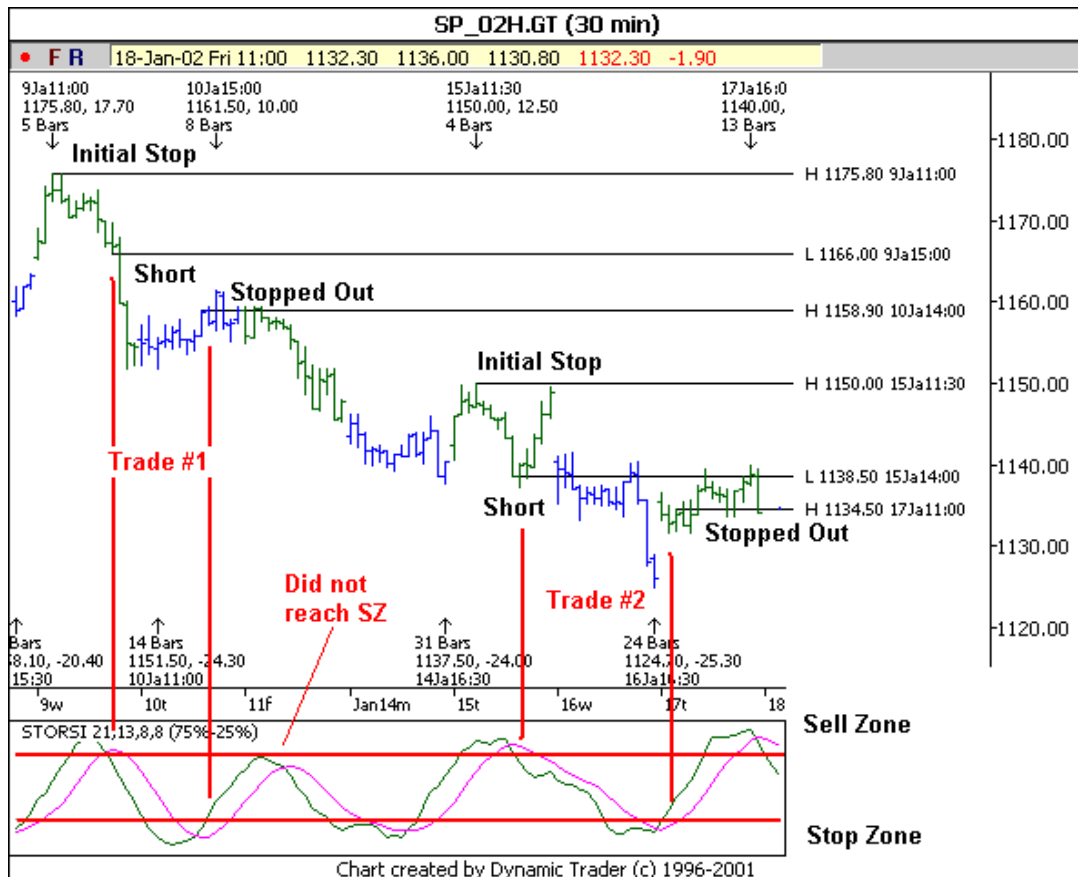
Crossdown But No Trade

The next day, the StoRSI makes a crossdown but the MA1 line had not reached the Sell-Zone. No trade was elected according to the rules.

Trade #2

On Jan. 15, the StoRSI crossed down from the Sell-Zone. A short trade was entered on the following bar. The initial stop is placed at the recent swing high made before the crossdown. Two days later, the StoRSI crossed up from the Stop Zone and the short trade was stopped out a few bars later for about a 4-point profit.

Note that I have not included any time, price or pattern analysis with these examples and strictly followed just the indicator entry, initial stop and trailing stop rules. Some simple price retracement and target analysis may have provided valuable information to include in the entry and stop strategy. For now, it is more important to learn to stick to objective rules and understand why these rules are valuable.

The trades were not entered at the price extreme of the corrections. The important lesson is – If the trend is bearish and the indicator has crossed down from the Sell-Zone, *the market is very unlikely to take out the swing high made just prior to the indicator crossing down.* The market is very likely to be sideways to down at least until the indicator reaches the Stop-Zone which is the extreme in the direction of the trend.
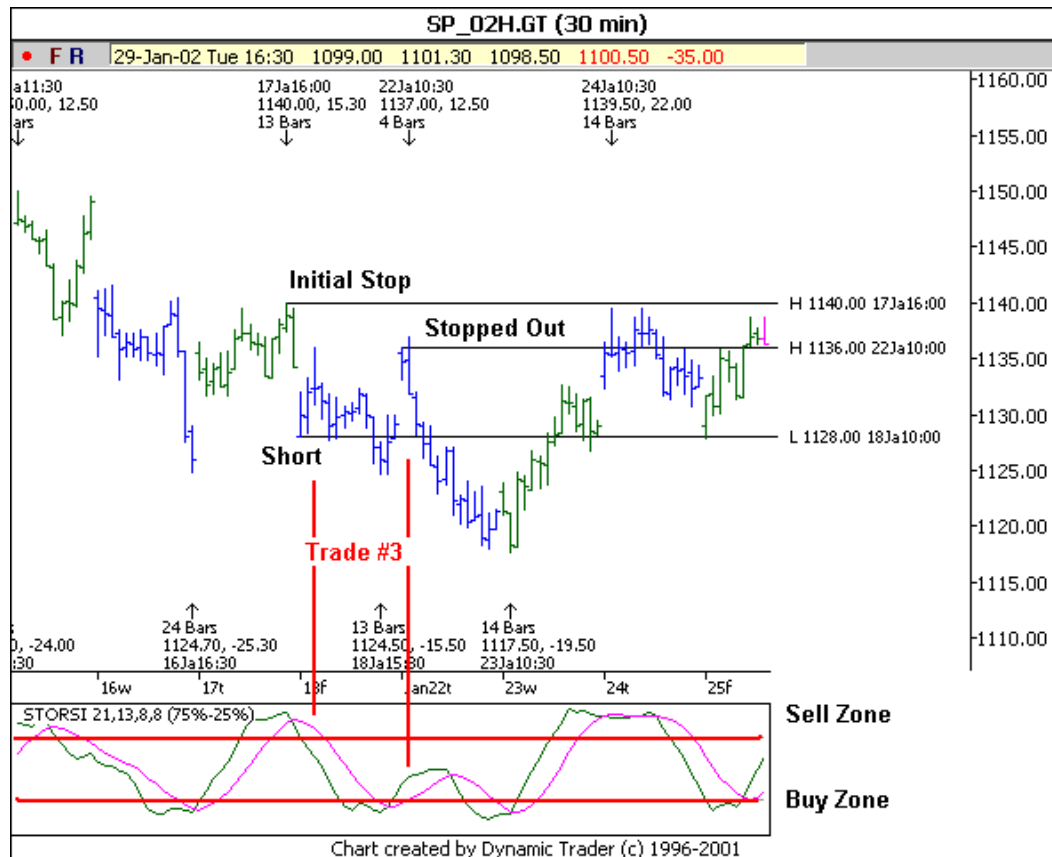
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Trade #3

On Thursday, Jan. 17, the StoRSI again crossed down from the Sell-Zone and a short trade was elected the next day Friday, Jan. 18. The StoRSI reached the Stop Zone late on Friday and the short trade was stopped out just after the gap up Tuesday (Monday was a holiday) for an 8-point loss.

This example shows that the market can move quite a bit away from the recent high or low where the initial stop is placed depending on when the indicator crosses over and how wide the range is of the next bar. Unless there is very compelling evidence other wise, follow the rules. The more you second guess the rules, the worse it will be in the long run. You will probably find that you usually second guess the rules to your disadvantage more time than not.
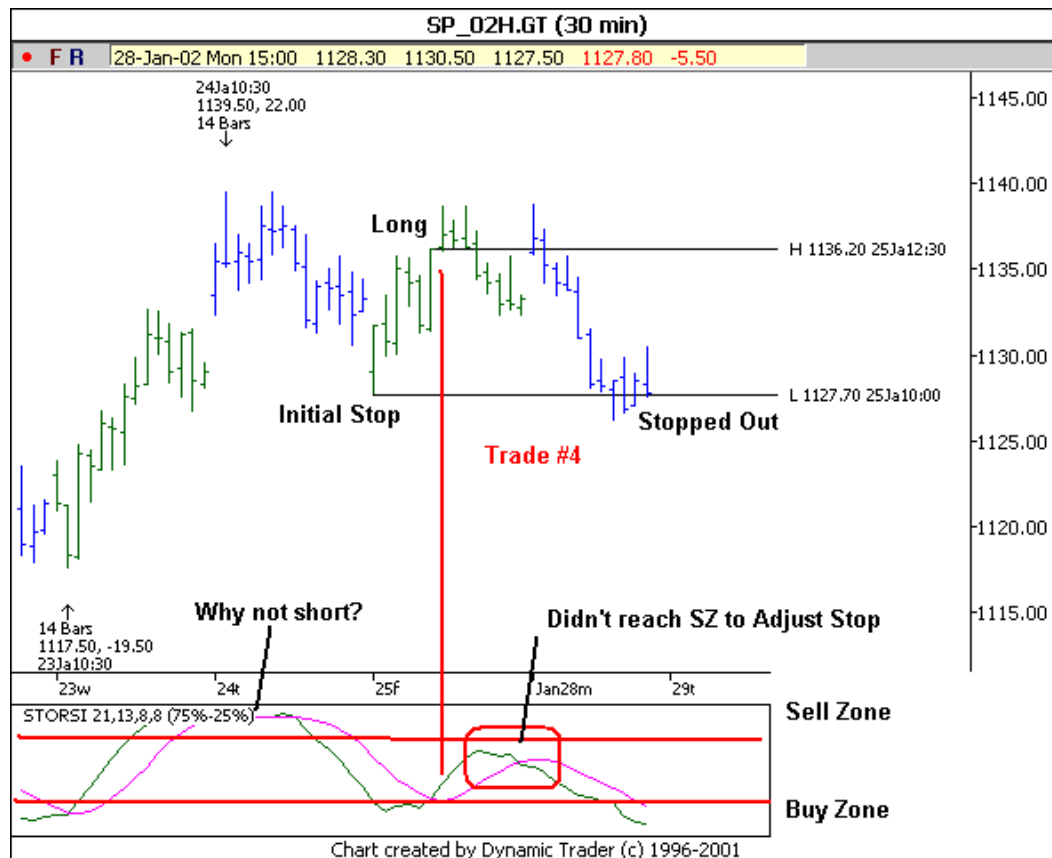
Trade #4

In the Jan. 24 issue of the DT Futures Report, the following commentary was included for the S&P:

"Today's high exceeded the 100% alternate time and price projections which indicates the S&P probably completed the W.a:B low yesterday. If this is the case, a decline tomorrow to the retracement zone with the StoRSI in the Buy-Zone is a set-up for a short-term long trade."

The expectation was for the S&P to make a corrective decline followed by a continued advance to above the Jan. 24 high.

Note that I've asked the question above the indicator window on Jan. 24 – *Why not short?* Because as of Jan. 24, the outlook was the trend was bullish from the Jan. 23 low relatively to this time frame of data. A short trade would no longer be considered, only a long position in the direction of the assumed bullish trend.

The next day, the StoRSI reached the Buy-Zone and crossed up. A long trade was elected a few bars later. The StoRSI never reached the Stop-Zone before turning down. According to the rules, the stop remained in the initial stop position just below the price low before the long trade was taken. The long trade was stopped out the following day at the initial protective sell-stop for about a 7-point loss.

This example shows that you may be incorrect on the assumption of the trend direction and a loss may result. However, with the objective entry and stop rules, the initial capital exposure is always known in advance.

These few examples have summarized and illustrated a variety of indicator set-ups and strategies. The time, price and pattern position of a market may easily be integrated with these entry and stop rules to your advantage.

You Now Know How To Use Indicators For Trade Strategies

This concludes the DT Indicator and Trading Strategies tutorial series. You now know all of the basics. The best way to continue learning the practical application of these strategies and their potential variations is for them to be referred to in "real-time" in the regular issues of the DT Futures Report. That is exactly what I do in each issue. In each issue of the DT Reports, you will learn more about how to use the indicator position to help confirm or invalidate the pattern position, how to drop down or move up a time frame or indicator setting to confirm the trend direction and set-up as well as other nuances of Dynamic Trading with indicators.