



## Daily "Idealized Trades" Report

### SPY (SPY 500 ETF) 5-min

Happy 2010! The market rallied sharply to fresh new recovery highs on a better than expected ISM Number, which indicates that the economy is showing signs of recovery. For intraday traders, this gave us a fresh trend day to trade - though in the opposite direction perhaps than expected. It also serves as a lesson on why we analyze charts as best we can and then end with "IF/THEN" statements to develop strategies instead of biases. In other words, formulate an opinion based on the chart, but then formulate a "what if the opposite happens" contingency plan which would be triggered. Many times, larger than expected moves occur when one side of the market is thrown off-balance, as was the case this morning.

Let's take a look at how we could have saw this development and traded it appropriately - or as best we could.

#### 1. POPPED STOPS

From Thursday's close of \$111.44, the market gapped open just shy of \$112.40 - an almost full dollar move (10 @ES points). This was certainly NOT a move that should have been faded, and in fact, the play was to trade long as price took out the high of the first bar at \$112.49. Realize that a lot of people were bearish going into the first trading day of the year, and so many of them positioned short ahead of the holiday weekend. When the market opened unexpectedly and strongly higher, those short-sellers were forced to buy to cover, driving the market even higher to pick off stops at higher levels, combined with - this time - new buying from bulls/buyers in what created a "Positive Feedback Loop" (shorts covering plus longs buying triggers additional short covering which gets more buyers off the sidelines, buying at higher prices). Such is the logic of a Trend Day, and most Trend Days - particularly Type 3 Trend Days - begin with a large overnight gap that is often caused by an economic report.

Your bias off the open and especially off the first 30 minutes should have been "Expect a Trend Day." We really haven't had a pure trend day in quite some time, so I'm sure most of our trend day trading tools and tactics were rusty. For a refresher, on a Trend Day bias, the strategies become the following:

- Ignore the 3/10 Momentum Oscillator (it reads false divergences)
- Pay close attention to price and the 20 period EMA (buy all pullbacks to the 20 EMA)
- Use the 50 EMA as the "Line in the Sand." Continue an upside bias as long as price is above this level, no matter how much you fee the market is 'overextended.'
- Watch Market Internals to see that Internals are confirming new price highs - buy pullbacks when they do
- As long as the picture remains bullish, buy ALL lower spikes (below zero) in the TICK (especially those that correspond with price pulling back into the support of the 20 EMA)
- Enter a 'scalp' mentality where you trade with larger positions when playing for small 'scalp' upside targets
- Do not ever catch yourself saying "The market can't go any higher - it is so overextended."

- DO NOT SHORT SELL on an up-trend day as long as price is above the 50 EMA.
- Put on a Core position (can be small) the moment you realize that odds strongly favor a trend day up, and then hold that position long until price clearly breaks under the 50 EMA (Line in Sand) or exit at close with a profit.

Instead of detailing every single trade, these guidelines/rules serve for the trades of the day. However, there are specific opportunities I wanted to mention.

## 2. ASCENDING TRIANGLE BREAKOUT

With price firmly making new highs, the strategy is to buy pullbacks. In the strongest trends - like today - you will not get a clean pullback to the 20 EMA, especially early in the session when the majority of the price action occurs. As such, conservative traders (and even aggressive traders) can identify consolidations or pullbacks and then BUY when price breaks a clear upper trendline to re-establish a long position, if you were not holding a core long position from early in the session into the close.

In this case, we had a bullish ascending triangle and then a strong range breakout candle. This is seen in better detail on the 1-min chart. Buy when price crosses above the upper trendline, place a stop under the lower trendline, and then continue holding long until a countervailing sell signal occurs. In this case, the entry would be as price rose above \$112.95 and a stop would be placed under \$112.85.

## 3. BULLISH ENGULFING CANDLE, DOJI, TRENDLINE BREAK

Similar in form and structure to Trade #2, we have the same situation, where price formed a retracement that did not pull back to the 20 EMA. Two doji candle formed at 11:20am EST, but the Bullish Engulfing candle of 11:25 EST triggered you in long on a break above the boundary line at \$113.19. A stop would be placed under the support line at \$113.09. As the day moves along, the price tends to flatten out (especially into lunch), leaving little room for easy profits. The best moves on a trend day come early, and the rewards go to those who recognize that odds favor a trend day early and aggressively take risk. When it is obvious a trend day is forming, there is less money to be made - the easy money comes early in the day. Otherwise, the final opportunities come as price forms a potential rally into the close.

## TICK DIVERGENCE

One educational note that I highlighted on the open blog this afternoon. Though other Market Internals were strongly confirming the Trend Day up, one was not - the TICK. We saw the morning TICK high occur at 10:30am EST, though price continued to push higher while the TICK formed lower swing highs. I can only attribute this to stronger buying by program trades in the morning when compared with the afternoon, and in the urgency to buy (and cover shorts) in the morning as opposed to the afternoon. Remember, the TICK is important because it compares up-ticks minus down-ticks for all NYSE stocks at a given point in time. Generally, new price highs should be accompanied by new TICK highs. TICK divergences - showing a weakness in participation by broader stocks - often precede reversals on the session. Today, we saw a lengthy TICK divergence that resolved with only slight downside action that took price back to the 50 EMA, or the "Line in the Sand." Even with the TICK divergence, you should not short-sell until price is under the 50 EMA, which leads us to believe that odds favor a "Rounded Reversal," and then you take advantage of all the buyers who are forced to sell their positions as the price heads lower and takes out their stop-losses.

We watch all market internals as best we can because they can give different signals. If the TICK, Breadth, and VOLD (Volume Difference) all registered exactly the same signal, then looking at three indicators would be meaningless - just look at one. However, the internals each measure a different thing, and the picture is clearer when all three (or more,

such as the TRIN) align, but then divergences or misalignment between the three internals cause us to pause, or expect a possible reversal in trend. It causes us to watch closer for any PRICE signs of deterioration, but divergences themselves are NOT trading signals.

If anything, the TICK divergence prevented you from buying pullbacks when you saw it, but it did not necessarily give permission to go short. Wait for confirmation to short, and the "Line in the Sand" is often the 50 EMA, upon which a price break beneath that level is a trigger to get short after a lengthy divergence.

Until then, the 50 EMA provides buying opportunities on Trend days, which brings us to the final two trades of the day.

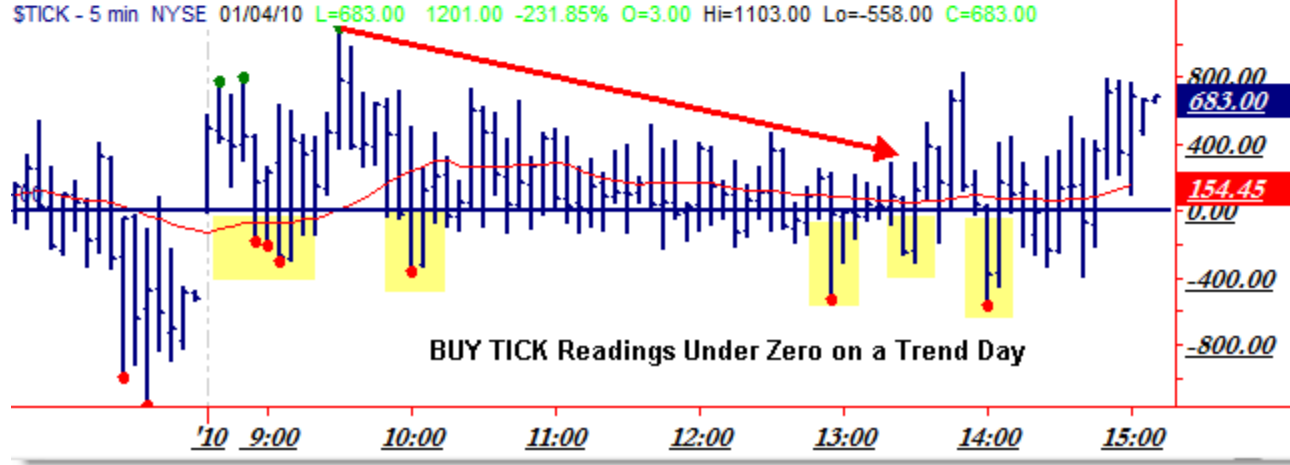
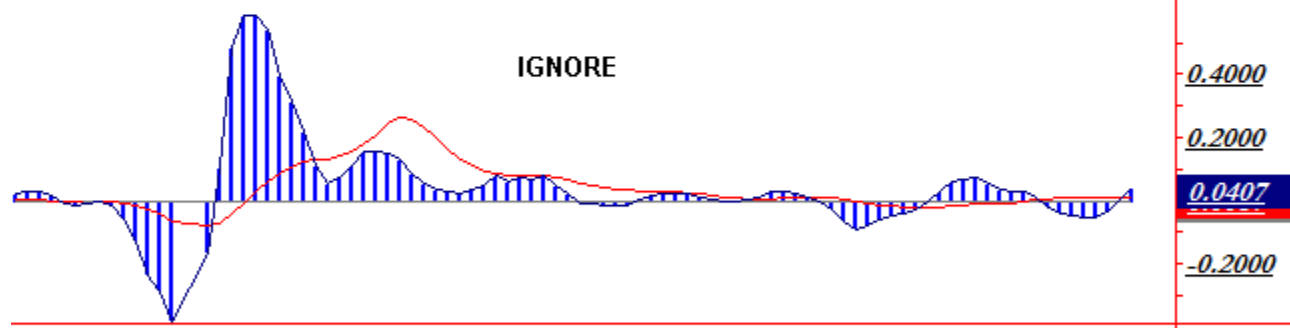
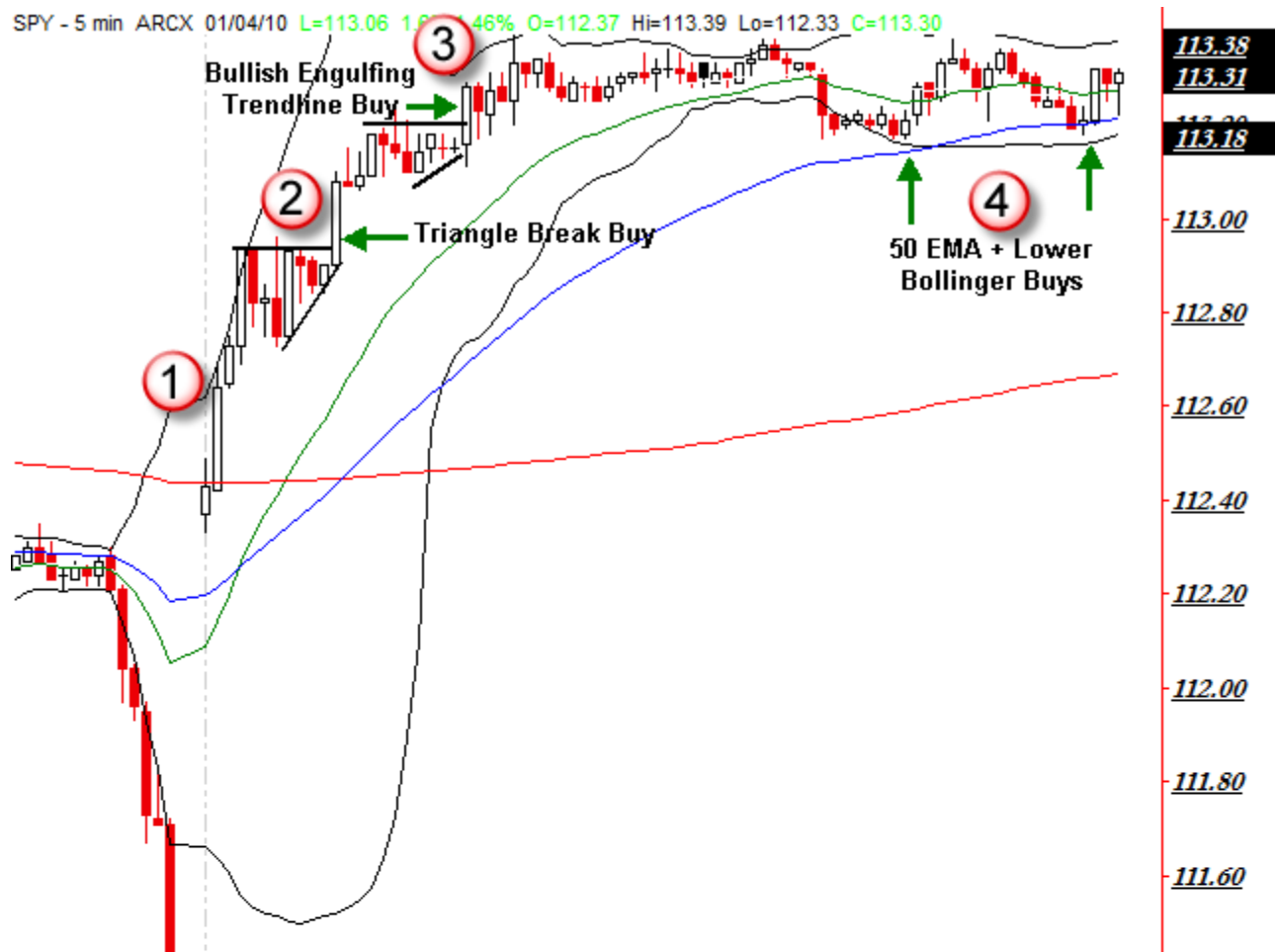
#### 4. 50 EMA "LINE IN THE SAND" TEST, BOTTOM BOLLINGER

I will combine the two tests of the 50 EMA and lower Bollinger that occurred at 2:30 and 3:45 EST respectively into one "ideal" trade description.

In both cases, price retraced to test the 50 EMA - considered the boundary line between continuation of the trend day and a rounded reversal set-up. And in both cases, price also tested the bottom Bollinger Band. It is fine if you saw the TICK divergences and passed on either of these set-ups, not taking a position at all, but these were high-probability (trends have greater odds of continuing than of reversing... and price had pulled back to a key confluence support area), low risk (the stop would be at least 5 to 10 cents under the 50 EMA while the target was 20 to 30 cents higher). Even if price had reversed, your stop-loss would have been smaller than if price rallied to test a prior resistance area, such as the \$113.35 price highs or the upper Bollinger Band.

Trading does not have to be about the accuracy of your calls, but about the edge present in your trades. Also, it serves as another lesson of planning for contingencies (IF/THENS). IF price broke and closed under the 50 EMA, THEN you would take a tight stop if you were long (nothing if you were not) and THEN you would get short to play for a Rounded Reversal. No matter what happened, you were prepared.

As it happened, price did rally both times off these confluence levels, and into the close of the session.





@ES Futures chart shows the morning 'pop' that began when the ISM number was better than expected.

Also, we see a potential "Three Push" pattern and negative TICK divergence - signals which collided with the principle "Trends, once established, favor continuing rather than reversing." When price principles are at odds with each other, the best trade might be no trade at all, or at least not to short unless price breaks under the "Line in the Sand."



It is very important to match SPY (or @ES) price highs with market internal highs - which I use green dots (Show-me) in TradeStation. To put these dots on your chart, insert indicator "New High for Day" (and new low for the day) and make sure in the "General" tab on the format indicator settings that you "Base Study On..." the \$ADD or the \$VOLD or \$TICK.

Other software programs may do similar highlighting functions, or you can write down the internal highs/lows and compare with price highs/lows. In this case, buyers drove the market higher despite a lengthy TICK divergence.

As a hint, the VOLD (Volume Differential) has been a powerful leading indicator - even better than TICK in the last few weeks. The VOLD rose all day, hinting that volume continued to flow into advancing stocks on the session, even while Breadth (\$ADD) began to break to new swing (but not intraday) lows. Watch Breadth, the TICK, and - if possible - VOLD.



This is one of those days where it pays to be an intraday trader and hurts to be anything else. Odds - from a swing-trading and intraday bias perspective - favored downside action (deterioration in market internals, momentum, and volume). However, just prior to market open, traders reacted very favorably to a better-than-expected ISM (Manufacturing) report showing economic growth. That was enough to propel the market higher, taking out the stop-losses of the short-sellers and driving in new buyers into the market as the New Year began.

Where does that leave us now? Support rests at \$113.00, so be long biased above there. Secondary support appears to be \$112.75 (50 EMA) on the 30min frame. Short only under these levels - the trend is clearly up. Each successive new high propels more shorts to cover, which creates easy trades for you, the intraday trader, no matter how irrational it may seem.



We now have a clear rising trend channel on the 60 min chart, with upper boundary (here) at \$113.50. The lower boundary combines with the 200 SMA, both at \$110.75. This - along with \$111.50 - would be downside targets on any price weakness here. Price is at the upper Bollinger Band and the upper trendline, leading us to believe that the next move could be a downside retracement swing into lower support (\$112.75 or \$112.50) so be prepared to trade any downside action tomorrow.

Otherwise - like always -be prepared and ready to trade even more popped stops on any new high above \$113.40 tomorrow.