AIQ Opening Bell Newsletter

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Momentum Trading with Candlestick Charts

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As a "swing" or "momentum" trader, picking strategic entry and exit points is paramount to your success. The moves are generally much shorter and more volatile than those afforded to longer-term traders and investors, and as such, your margin for error is smaller. In addition to conventional "western" technical analysis, the use of candlestick charts can help to improve your timing dramatically, not to mention your profits!

In this introductory article, I hope to inspire some of you to begin learning more about candlestick charting and how incorporating it into your own trading / investment strategy can help to increase your bottom line — a fatter schedule "D" at tax time.

The origin of candlestick charts can be found dating back to feudal Japan, when a trader named Munehisa Homma amassed huge fortunes trading rice commodities. He was a pioneer in recognizing that market movement is simply a reflection of masse human psychology. He set out to develop a system of charting that would document in visual form significant changes in trader psyche and underlying market momentum. From his early works, we now have modern day candlestick charts.

Both candle charts and bar charts contain the same exact price information: namely the opening / closing, and daily high and low. But it's how that information is displayed visually that makes candle charts superior to

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Place
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bar charts in assessing and conveying the market's mood. **Figure 1** shows the basic anatomy of a candlestick chart vs. a bar chart.

Let's look at a few real world charts and see how the candlesticks gave precise signals for both entry and exits. First up are several charts of Inktomi (INKT). The stock had been in a strong up-trend since October's earnings-season rally and was a great chart to swing trade **(Figure 2)**. Each time INKT bottomed before its next leg up, it posted some significant reversal patterns that are highlighted here.

After basing, the price then moved up rapidly to the upper trading band where, after meeting resistance, it turned down once again to consolidate with higher highs and higher lows being established. On its base at the end of December, there wasn't any particular reversal candle pattern per se, but with the increasingly smaller real bodies (difference between the opening and closing prices) and strong support around $6, it certainly appeared that the selling was evaporating and INKT was getting ready for another move up.

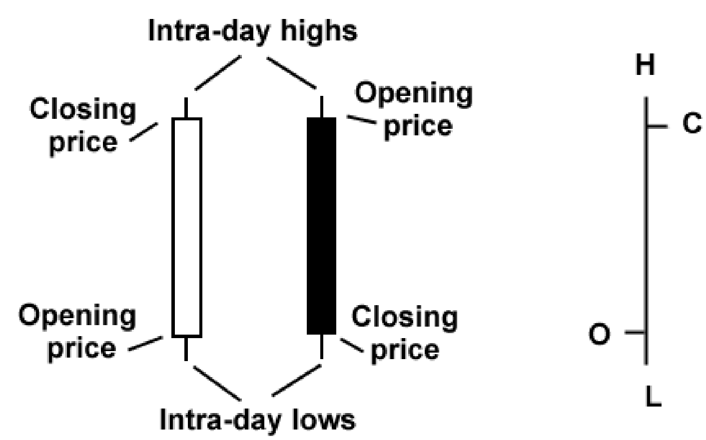

Figure 1. The difference between the opening and closing price of a candle is known as the *real body*. The upper and lower highs of the day are referred to as *shadows*. Consequently, a candle with a higher close relative to the opening is a white candle (bullish), whereas one in which the close was lower is black (bearish). A bar chart contains the exact same information, but lacks the color-coding and ability to quickly distinguish particular types of candles that contribute to significant reversal patterns.

The last 5 sessions showed some intraday resistance at around $6.55 so we had suggested to our members an entry at 6 5/8ths with an exit target of 8 since that was near the AIQ upper Trading Band and would likely serve as its next point of resistance.

Figure 3 is an intra-day chart after the entry price had been triggered and it shows the price leaving the base and heading up on its next leg of advance. Let's break down all the information here, and see if a candlestick chart could have been any more accurate in pinpointing the best time to exit.

The price had been climbing fairly steadily over several days, and on the opening of January 4th, the stock gapped upward and quickly ran to a high of $7.97, just 3 cents shy of our target. Meeting resistance here, the price then proceeded to violate an ascending trendline as well as an open gap-up, both being short-term bearish in nature.

Helping to confirm that the stock might not reach our target of $8 is the Money Flow RSI indicator…one of my favorite AIQ indicators to use in looking for price / momentum divergences.

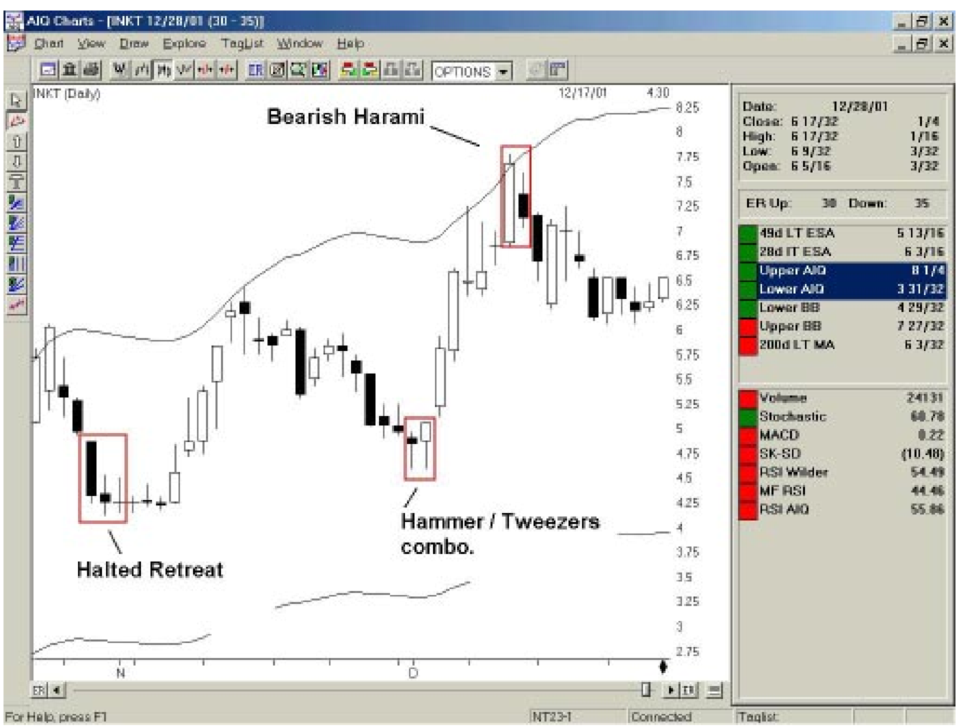

Figure 2. Candlestick chart of Inktomi with three different reversal patterns

Note the nice negative divergence marked by the peaks (see arrows) while the price continued to advance higher.

So by using all of this information, the most aggressive exit would be signaled at the violation of the ascending trendline, near $7.50. If you had wanted further confirmation of the ascending trendline violation, the closing of the gap at $7.38 would be the next logical place to assume that this short-term move was over (coupled with the momentum divergence which by now had clearly formed). The arrows in Figure 3 show the upper edge of the price gap now acting as resistance once it was breached. (Old support serving as resistance.)

Before we look at the candle version, we need to briefly cover a definition of a trend reversing candle pattern known as the "*Harami Cross.*" **Figure 4** shows the schematic version of this pattern.

Figure 3. Intra-day chart of Inktomi. Entry price of 6-5/8 was triggered around 13:00. Soon after the price leaves the base and heads up on its next leg of advance.

> ***"Both candle charts and bar charts contain the same exact price information…it's how that information is displayed visually that makes candle charts superior to bar charts in assessing and conveying the market's mood."***

Figure 5 displays the corresponding candle chart for the same 15 minute time period as in our bar chart example. Now, in addition to all the indices and trendlines we talked about in the bar chart, we see a very cleanly formed *Harami Cross* pattern develop with the doji-star candle signifying the top of the move.

The following black candle

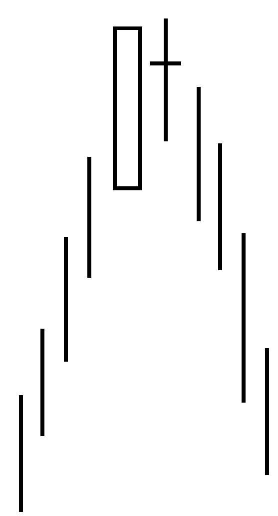

Figure 4. *Harami Cross* is a two-day (candle) pattern composed of a large white candle followed by a "doji-star." This is a candle whose opening and closing price are exactly the same, marking a balance between the bulls and bears. The doji candle lies within the *real body* of the preceding white one. This pattern can act as a potent top-calling pattern, especially after a long or rapid rally because it signifies the exhaustion of buyers.

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confirms the pattern and traders should've looked for the doors at about $7.70 (the opening price of the 2nd candle following the doji-star).

Your profit in taking cues from the bar chart exits: .87 (13%) for the 7.50 exit, and .76 (11%) from the $7.38 sell. From the candle chart post-Harami Cross pattern: $1.08 (16%). Maybe an additional 3% doesn't excite you that much…but remember, a fully margined account of $10,000.00 with a daily profit of just 2% compounded, can reach $1,000,000 in 12 months! Now THAT is exciting!

The INKT example makes it pretty obvious that using a candle chart not only acted as further confirmation for the bar chart version, but also gave an exit signal *earlier*, leaving the candle trader with a larger profit…and beating the bar chart traders to the exit door. Let's face it, the less trades you have to compete with at any given price, the more likely you'll get your order filled.

Our next example goes beyond showing candlesticks giving *earlier* signals, but rather giving completely *different* signals altogether. The example of Amgen (AMGN) in

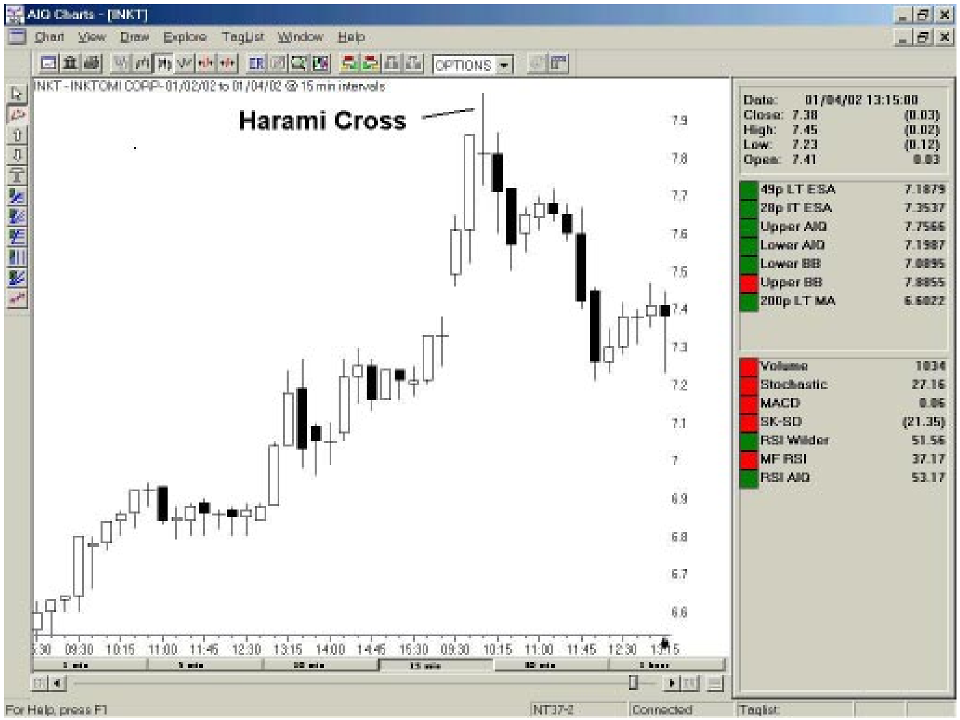


Figure 5. Intr-day candlestick chart of Inktoma with Harami Cross top-calling pattern

Figure 7 will show how reading a candle chart could have enabled a trader to avoid stepping into a false breakout, not to mention exposing a shorting opportunity not available in its bar-chart cousin. Again, I need to show you

> *"The addition of candlestick charting to more "conventional" technical analysis can help to increase the accuracy and profitability of your trading."*

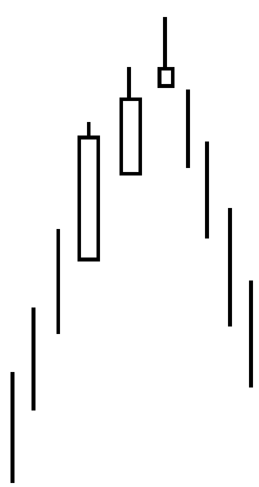


Figure 6. The Advance Block pattern is a bearish pattern made up of 3 successive white candlesticks. Each one has a smaller real body than its predecessor. In addition, each candle should have a longer upper shadow as well. This is a graphic picture of a stock losing its upward momentum. Its confirmation is a candle that follows with a lower close. You can almost see the bulls tiring while the bears are getting ready to stage a coup. Each day the price advances, but by a smaller amount, while closing more and more off the high of the day.

a definition of the involved candle pattern first for you to fully appreciate this. **Figure 6** is a sketch of what an "*Advance Block*" pattern looks like.

For much of the latter half of 2001, Amgen had been consolidating in a neutral triangle price pattern, seen in **Figure 7**. In the 3rd week of November, the price had broken out through the upper trendline signaling that a bullish move upward might be in store.

A similar break occurred in a Stochastic trendline acting as confirmation. Does this look like a stock you would think about shorting? Probably not.

Now let's take a look at the

candlestick chart and see if anything strikes you about the candlestick formations. Keep in mind the definition above (Figure 6) of an *Advance Block* pattern.

Figure 8 shows AMGN charted again, but with the following week included. What shows up is a large Advance Block pattern indicating that AMGN's upward move after breaking from the triangle had slowed considerably, and that a short-term reversal back down to test the descending trendline was very probable.

As a matter of fact, this exact chart was highlighted as a possible short play for members of our website after the pattern had completed. The following week saw AMGN quickly sell off more than 10 points! How's that for a quick "swing trade?"

Even if you had not participated in the short, recognizing the pattern could have served as a cue to hold off on buying any early retracement, as it ended up being a false breakout.

The addition of candlestick charting to more "conventional" technical analysis can help to increase the accuracy and profitability of your trading. Additional confirmation equals more confidence. More confidence equals a more consistent and less stressful trading experience.

I hope you've found this article helpful and informative and look forward to sharing more with you in future issues.

For more information on Allen Thomas and how candlestick charting can be applied to your daily trading, go to ***www.A-TeamTraders.com****.*

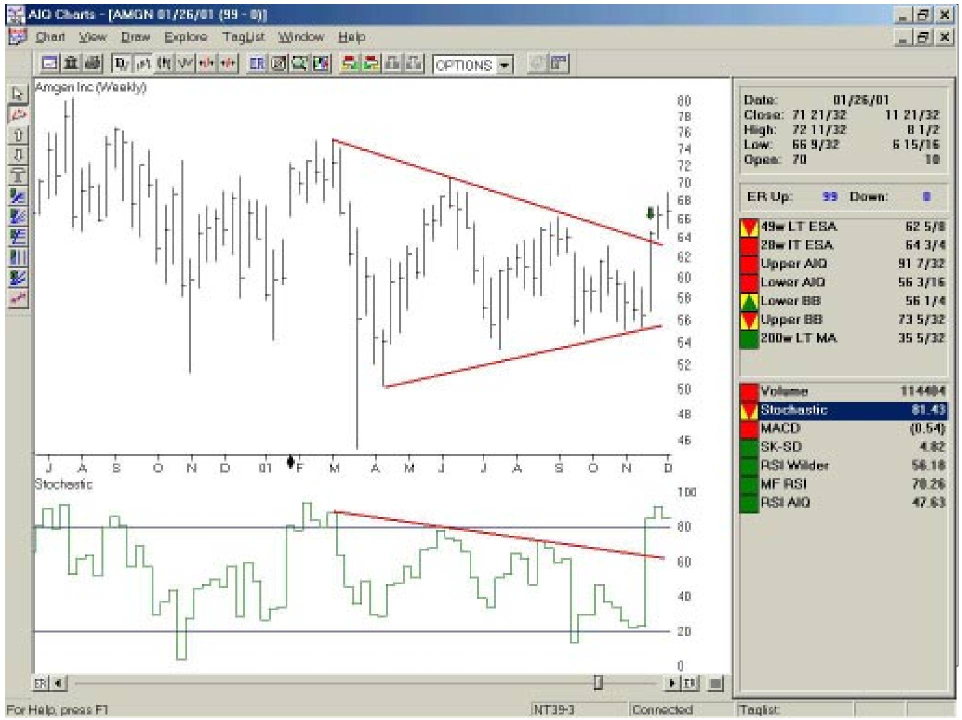


Figure 7. Amgen weekly chart with price breakout from triangle formation occurring at year end

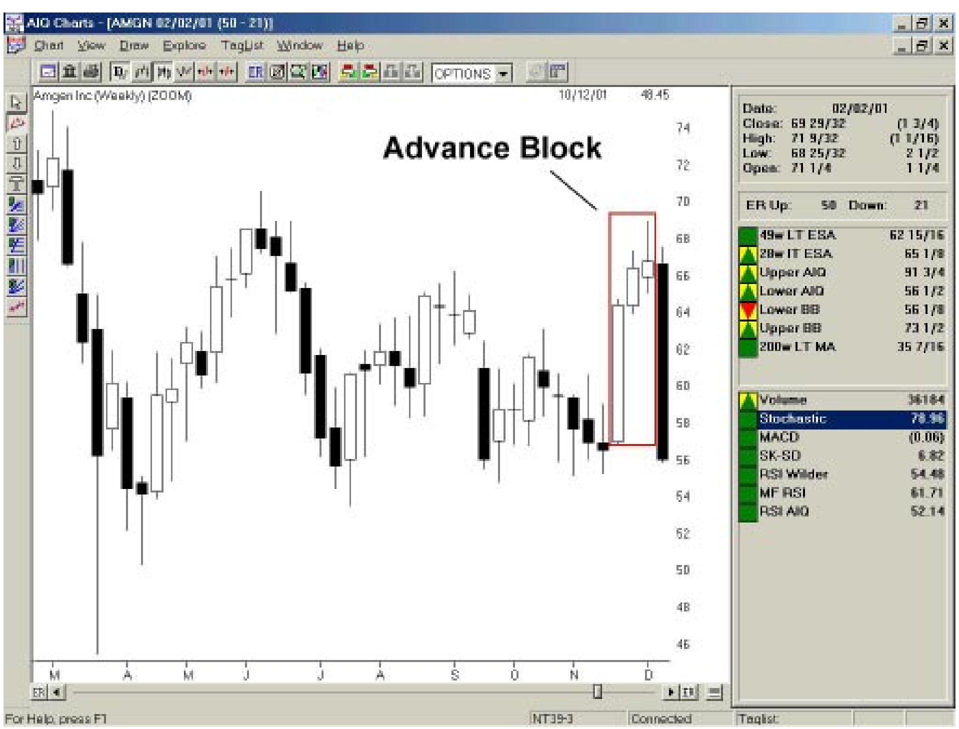
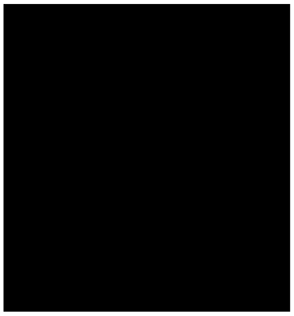


Figure 8. Weekly candlestick chart of Amgen with Advance Block pattern at year end

Year-End Index of 2001 Articles

Opening Bell subscribers may obtain a free Index of 2001 *Opening Bell* articles by calling AIQ at 1-800-332-2999.



DAVID VOMUND

New ! An EDS Model that Searches for Attractive Money Flow Situations

By David Vomund

For many years, AIQ has offered a fall seminar at Lake Tahoe, where the AIQ offices are located, and a spring seminar on the east coast. This year, we've changed the format. We will continue to have the fall seminar at Lake Tahoe but I will now give one-day seminars at different locations across the country, including Las Vegas and New York.

This one-day seminar series began in February in Orlando, Florida. At this meeting, I discussed market timing, group rotation, and stock selection techniques including a current analysis.

> *"This Expert Design Studio (EDS) model serves as a timesaving tool for people like myself who rely heavily on the Money Flow indicator."*

Much of what was discussed concerned the use of my favorite technical indicator, Money Flow. This indicator is especially useful because it doesn't necessarily rise when the stock rises and it doesn't necessarily fall when the stock falls. Divergence analysis using Money Flow becomes particularly valuable.

To briefly review this indicator, Money Flow looks at price and volume in order to determine whether a stock is being accumulated or distributed. The indicator becomes very bullish when a stock tends to close on or near the high point of the daily price bars, especially with high volume. That implies that big money wants to be in the stock before the market closes.

Conversely, the indicator falls in value when a stock closes near its daily low. For those not familiar with this indicator, please refer to its write-up in AIQ's *Technical Indicators Reference Manual*.

At the Orlando seminar, I spoke about how important it is to look for stocks whose Money Flow indicators are stronger than the stocks. I performed an analysis using current data, browsing the stocks that appeared on several of AIQ's screening reports. The goal was to find attractive stocks with bullish Money Flow indicators.

The stock that was selected as the most attractive was Devon Energy (DVN). On February 20, Devon Energy was drifting sideways but its Money Flow indicator was extremely strong (**Figure 1**). While the stock was consolidating, its Money Flow indicator was hitting new highs and was trending higher for most of the last six months. The stock was moving sideways but Money Flow indicated that it was under accumulation.

Similar examples that I encourage you to chart are Procter & Gamble (PG) on 02/12/02, Deluxe (DLX) on 02/06/02, Pactiv Corp. (PTV) on 01/04/02, and Gillette (G) on 11/29/01.

After browsing the stock reports looking for attractive stocks, a seminar attendee asked why I find these stocks by browsing the AIQ reports instead of using an Expert Design Studio (EDS) model that searches for attractive Money Flow situations? A good question. That's what we'll do now.

In creating the EDS scan, the first step was to use the pre-built Persistence of Money Flow formula. This rule looks for stocks with strong Money Flow indicators over the previous six months. By applying this screening rule on a large set of stocks with minimum price of 10 and minimum volumes of 100,000 shares, results were immediately impressive. Over the last three years, the average trade gained 2.5% during a time that the S&P 500 fell in value. A fixed 30-day holding period was used.

To get better entry points, I like stocks that are trending higher but have recently stalled. Therefore, a rule was added that required stocks to rise by at least 10% over the last 44 trading days but over the last 10 days have drifted sideways.

Having a strong Money Flow indicator over the last six months is good but more important is what the Money Flow indicator has done over the last few days. Obviously, we want the Money Flow indicator to be stronger than the stock. For that reason, a rule was added that screened for a positive divergence in the Money Flow indicator. During the last 10 days while the stock drifts sideways, our model requires the Money Flow indicator to hit a new high. In other words, the stock is still under accumulation even though it is off its highs.

This model was designed to give trading ideas. With these ideas, judgmental analysis mindful of market conditions can be performed. For that reason, a lot of stocks should pass the model. That gives us more stocks to analyze. I therefore tested each of the screening rules, seeing how many stocks passed each rule. I learned that by far the most restrictive rule was the one requiring a persistence of Money Flow. I therefore loosened this rule by requiring the Volume Accumulation Percent indicator to be above zero at least 80% of the time in the last six months (the default is 90%). This allowed more stocks to pass the screen.

At this point, the Money Flow model is complete. The model screens for stocks that have been increasing in value over the last two months but have stalled and are off their 10-day highs. At the same time, their Money Flow indicators have steadily moved higher over the last six months and are hitting new highs.

An Expert Design Studio backtest of this system over the last three years is found in **Figure 2**. For this test, a fixed 30-day holding period was used. I wanted this model to give a lot of trading ideas and it has. In the last three years, 2059 stocks passed this screen. The average stock trade gained 2.4% compared to a loss in the S&P 500 of 1.4%.

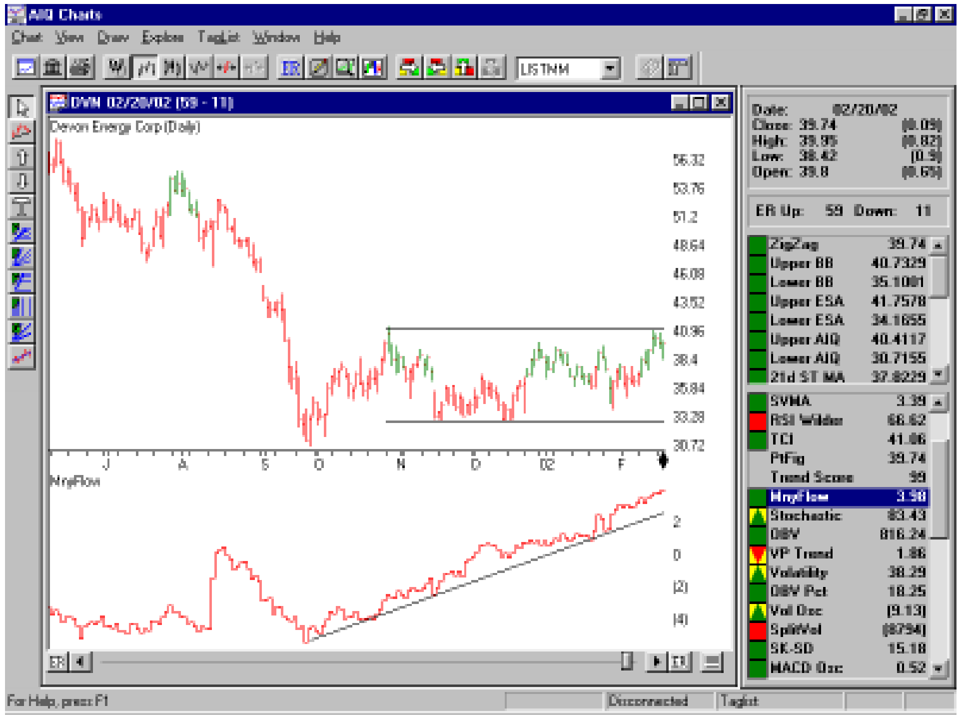


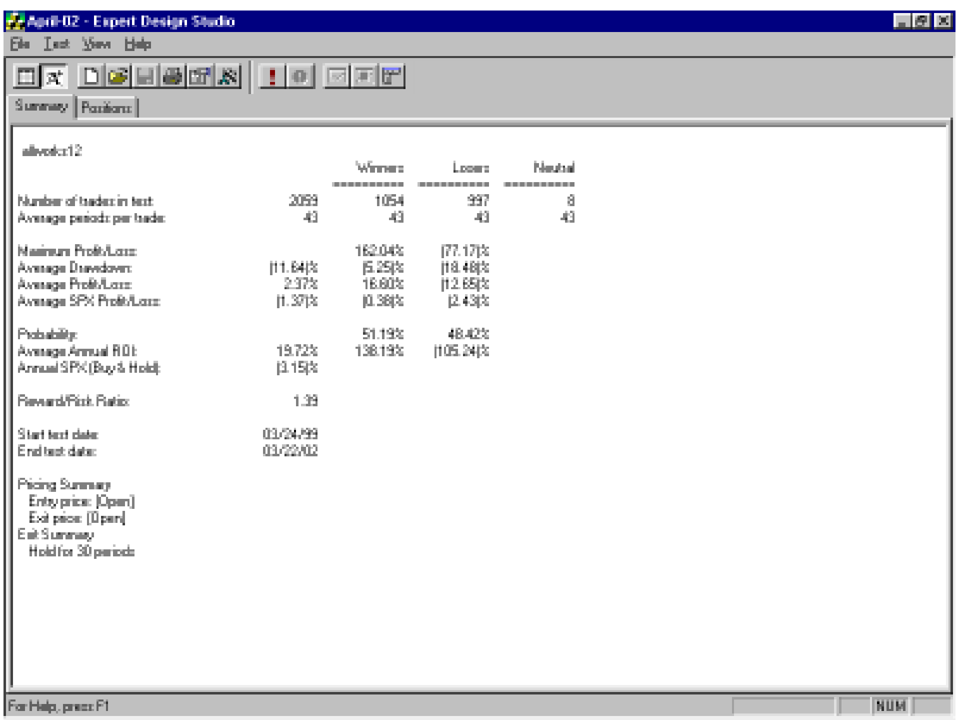
Figure 1. Devon Energy chart on 02/20/02 showing rising Money Flow and sideways price action

This Money Flow model can be downloaded from AIQ's web page at *www.aiqsystems.com*. Click on *Educational Products* and the *Opening Bell*.

This model serves as a timesaving tool for people like myself who rely heavily on the Money Flow indicator. Users will find it helpful to make changes to the model depending on current market conditions.

For example, at the September 2001 market low only a few stocks had increased in value over the previous 44 days while having persistently strong Money Flow indicators. By focusing on the positive divergence element of the model rather than the persistence of Money Flow element, the model would spot attractive Money Flow trades such as KLA Tencor (KLAC) on 10/22/01 or Sabre Group (TSG) on 11/15/01.

As noted above, the Money Flow model covered in this article is designed to give trading ideas. Next month, I'll make the model more restrictive and turn it into a viable mechanical model. Both the Expert Design Studio backtester and the Portfolio Simulator will be used.


April-02 - Expert Design Studio

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		Winners	Losers	Neutral
Number of trades in test:	2059	1054	997	8
Average periods per trade:	43	43	43	43
Maximum Profit/Loss:		162.04%	(77.17)%	
Average Drawdown:	(11.64)%	(5.25)%	(18.48)%	
Average Profit/Loss:	2.37%	16.60%	(12.65)%	
Average SPX Profit/Loss:	(1.37)%	(0.38)%	(2.43)%	
Probability:		51.19%	48.42%	
Average Annual ROI:	19.72%	138.19%	(105.24)%	
Annual SPX (Buy & Hold):	(3.15)%			
Reward/Risk Ratio:	1.39			
Start test date:	03/24/99			
End test date:	03/22/02			

Pricing Summary
Entry price: [Open]
Exit price: [Open]
Exit Summary
Hold for 30 periods

Figure 2. EDS Backtest Results of Money Flow Model for 3-year period 03/24/99 to 03/22/02

Market Review

For the first quarter of this year, the market has been stuck in a trading range. The S&P 500 has an interesting chart pattern. The lower half of the trading range is 1074, taken from the mid-February low. Interestingly, this is about the same level as the March 22, 2001 low. If you look at a weekly chart of the S&P 500, the March 2001 low and February 2002 low could be the two shoulders of a head-and-shoulders bottoming pattern. The top end of the trading range is 1177. The S&P 500 approached this level in December 2001, January 2002, and March 2002 without penetrating it.

While the S&P 500 has drifted sideways, the Dow has been moving higher and is in a pattern of higher highs and higher lows. Meanwhile, the Nasdaq has seen more weakness and corrected about 10% from its January high.

The strongest groups in the first quarter were Truckers, gaining 35%, Metals gaining 30%, and Hotels gaining 26%. The weakest groups were Wireless Telecommunications falling 46%, Computers-Networking falling 27%, and Electronics Instrumentation falling 21%.

Here are the Expert Rating signals for AIQ's timing model in the last two months: a 95 buy on February 7, a 95 buy on February 8, a 96 buy on February 13, a 98 sell on February 19, and a 95 buy on February 25. The February 25 buy signal lasted through the month of March.

S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Marshall & Iisley Corp. (MI) replaces Williamette Ind. (WLL). MI is added to the Banks (BANKGRP) group.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Iron Mountain	IRM	3:2	01/02/02
Jacobs Engineering	JEC	2:1	04/02/02
Alliance Gaming	ALLY	2:1	04/08/02
McCormick & Co.	MKC	2:1	04/09/02
Whitney Holding Co.	WTNY	3:2	04/10/02
T-HQ Inc.	THQI	3:2	04/10/02
Horton (DR) Inc.	DHI	3:2	04/10/02
D&K Healthcare	DKWD	2:1	04/12/02
Weingarten Realty	WRI	3:2	04/16/02
Applied Materials	AMAT	2:1	04/17/02
Autodesk Inc.	ADSK	2:1	04/19/02
Progressive Corp.	PGR	3:1	04/23/02
Dean Foods	DF	2:1	04/24/02
Oneida Financial	ONFC	3:2	04/24/02

Trading Suspended:
Finova Group (FNV), Global Crossing (GX)
Mead Corp. (MEA), National Steel Group (NS)
Niagara Mohawk (MNK), Prize Energy (PRZ)
Westcoast Energy (WE), Westvaco (W)
Williamette Ind. (WLL)

Name Changes:
Action Performance Cos. (ACTN) to Action Performance Co. (ATN)
BISYS Group (BSYS) to Bisys Group Inc. (BSG)
Clark/Bardes Inc. (CLKB) to Clark/Bardes Inc. (CBC)
Delphi Automotive Systems (DPH) to Delphi Corp. (DPH)
Eagle Wireless Int'l (EAG) to Eagle Broadband Inc. (EAG)
Old National Bancorp (OLDB) to Old National Bancorp (ONB)
Rockwell Int'l (ROK) to Rockwell Automation (ROK)
UtiliCorp United (UCU) to Aquila Inc. (ILA)