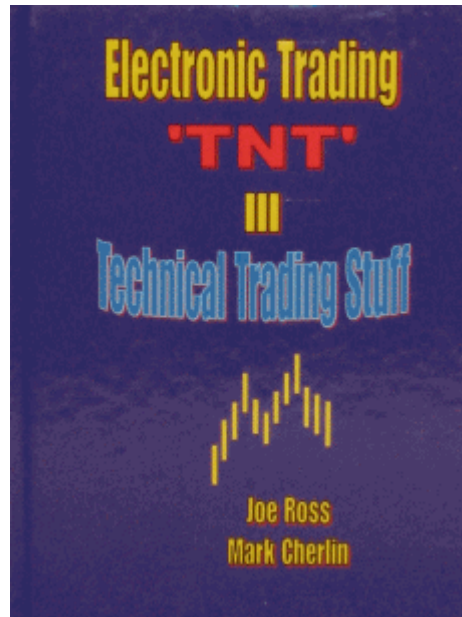


Chapter 7



Electronic Trading 'TNT' III Technical Trading Stuff



The Following is provided by:

ATC Analytics, LLC
5200 Keller Springs, Suite 812
Dallas, Texas 75248

Phone: 972-661-1283

Fax: 866-825-7661

Web Site: www.nexttrend.com

Email: support@atcanalytics.com

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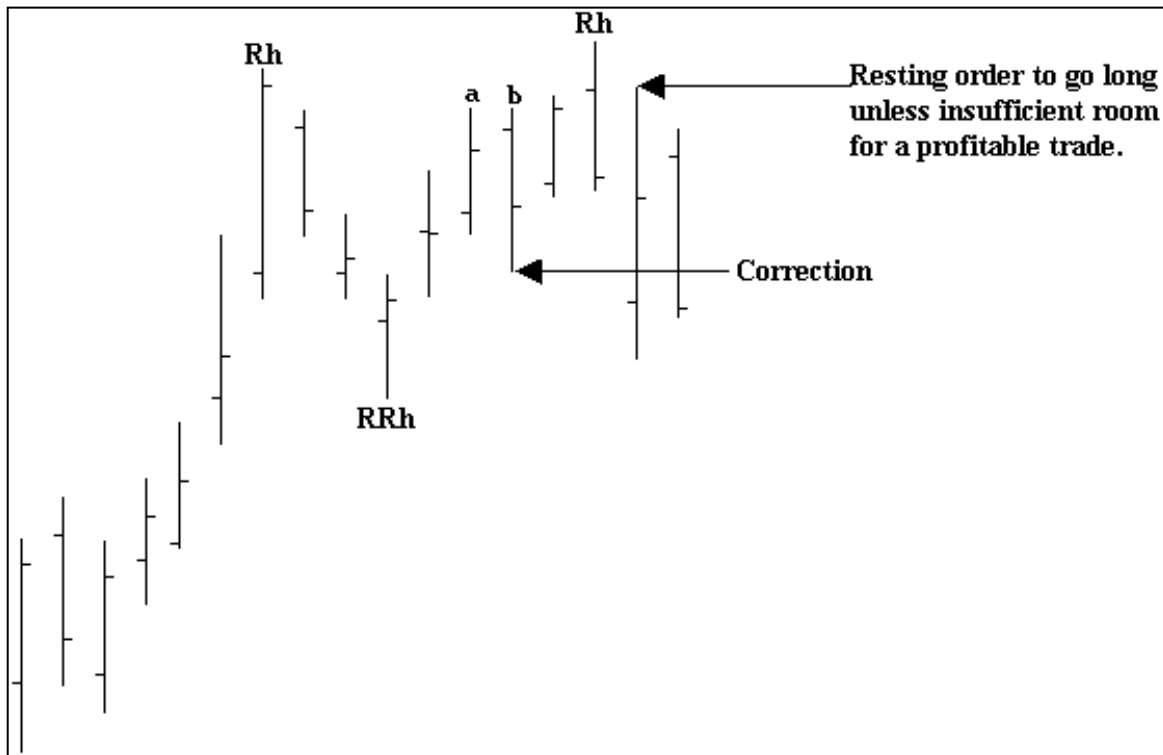
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Chapter 7

TREND REVERSALS

The Reverse Ross Hook always has the potential of becoming the beginning of a true trend reversal. A Reverse Ross Hook is always the number 2 point of what *may* become a new 1-2-3 formation in the direction opposite to the most recent trend.

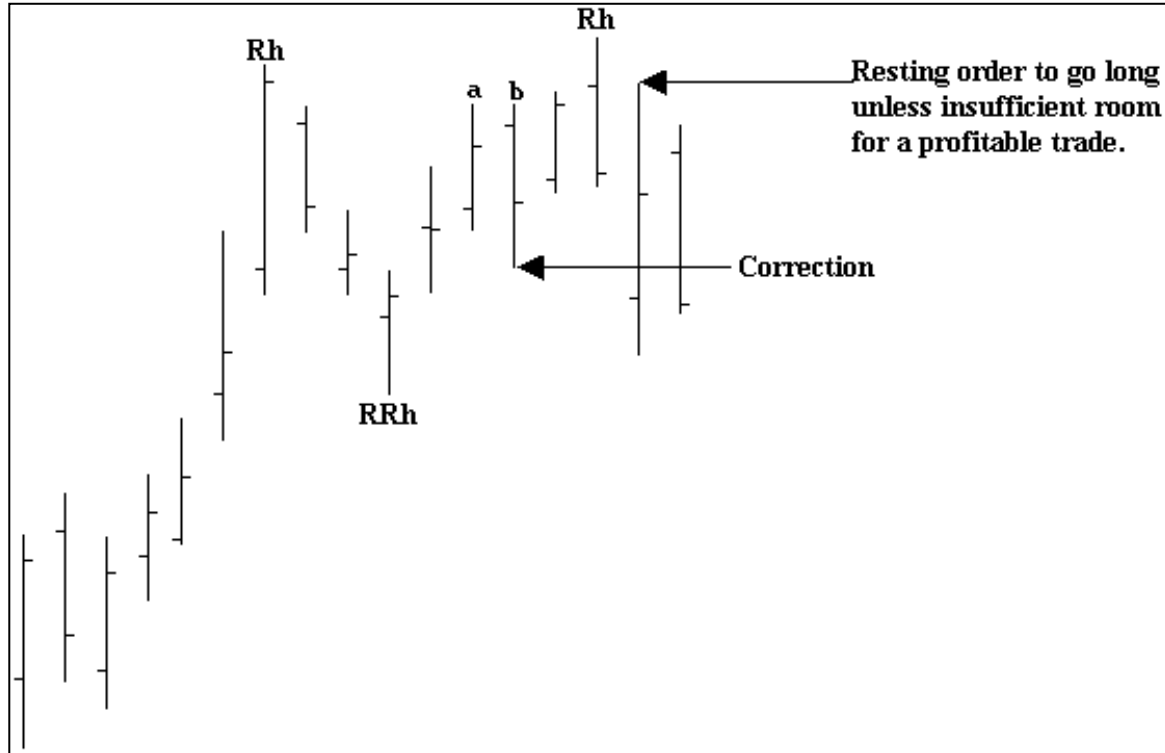


On the chart above, a Reverse Ross Hook (RRh) is labeled on the third bar after the first Rh bar on the left side of the chart.

Moving from left to right, the Rh became a number 1 point when prices failed to move higher. The RRh became a number 2 point when prices on the bar following the RRh failed to make both lower low and a lower high.

The subsequent bar to the RRh bar was a fourth bar having its close within the range of a measuring bar, in this case the Rh bar.

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The bar that ended up being the point of the first Rh also qualified to become the beginning of congestion, as a measuring bar, because the four bars following it have closes within its price range. The bar subsequent to the RRh qualifies as having established that congestion because it *is* the fourth bar to have its close within the price range of a measuring bar. Therefore, at the time the price bar following the RRh completed, prices were by, definition, in congestion.

RRh's are important in spotting trend reversals. **Some** RRh's occur in the correction that follows a market top. When that happens, we have the following scenario having taken place:

Demand has been sufficient to take prices to new highs. Then profit takers sell into the strength of the rally to the top, pushing prices back down to what is to become the point of the RRh.

Then the remaining bulls step in again to push prices up to the next, but not necessarily higher, high. Usually volume is thin compared with the previous up legs. Thin volume as prices move to new highs is a clue to what is happening and may be used as a filter.

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Finally, one last sell-off follows on heavy volume, pushing prices down through the RRh.

It is when you see prices approach a previously made Rh on lower than previous volume, and then fail to take it out, that you have one signal that prices may be ready to reverse. Such an event *is* a first clue as to what the market may be saying.

Then, when prices drop down and take out the bar labeled RRh, we have a second signal to indicate a trend reversal is in the making. At this point, we do not blindly take a breakout of that RRh. There must be a filtering process. The filtering process will give us the third signal that a trend reversal is taking place. We will look a step at a time at a chart that demonstrates this concept, but first we want you to learn a few facts about offset moving averages.

DISPLACED MOVING AVERAGE OF THE CLOSE (DMAC)

A moving average is like any other indicator, lagging, because it is always computed on history. Unfortunately, all of the things that we can compute in trading are based upon what has already happened. No one has ever been able to figure out what tomorrow's numbers will be other than by inconsistent approximation and just plain guessing. Yet it is possible for us to be forward-looking in our thinking. That is where the displaced moving average comes into play. Although it is still a lagging indicator, it is "forward-looking." Keep reading, you will see what we are talking about.

For the sake of ease, we will compute a three-day moving average of the close and displace it three days in time (3x3 DMAC). Here is how we compute it, and it is quite simple:

Close Day 1 + Close Day 2 + Close Day 3 = Total of three closes.

Total of three closes divided by 3 = 3 MAC.

3 MAC is then moved to Day 6 to become a 3x3 DMAC

Note the table on the following page:

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Day 1 Close	50	3 MAC	0	3X3 DMAC	0
Day 2 Close	49	3 MAC	0	3X3 DMAC	0
Day 3 Close	48	3 MAC	49	3X3 DMAC	0
Day 4 Close	47	3 MAC	48	3X3 DMAC	0
Day 5 Close	46	3 MAC	47	3X3 DMAC	0
Day 6 Close	45	3 MAC	46	3X3 DMAC	49

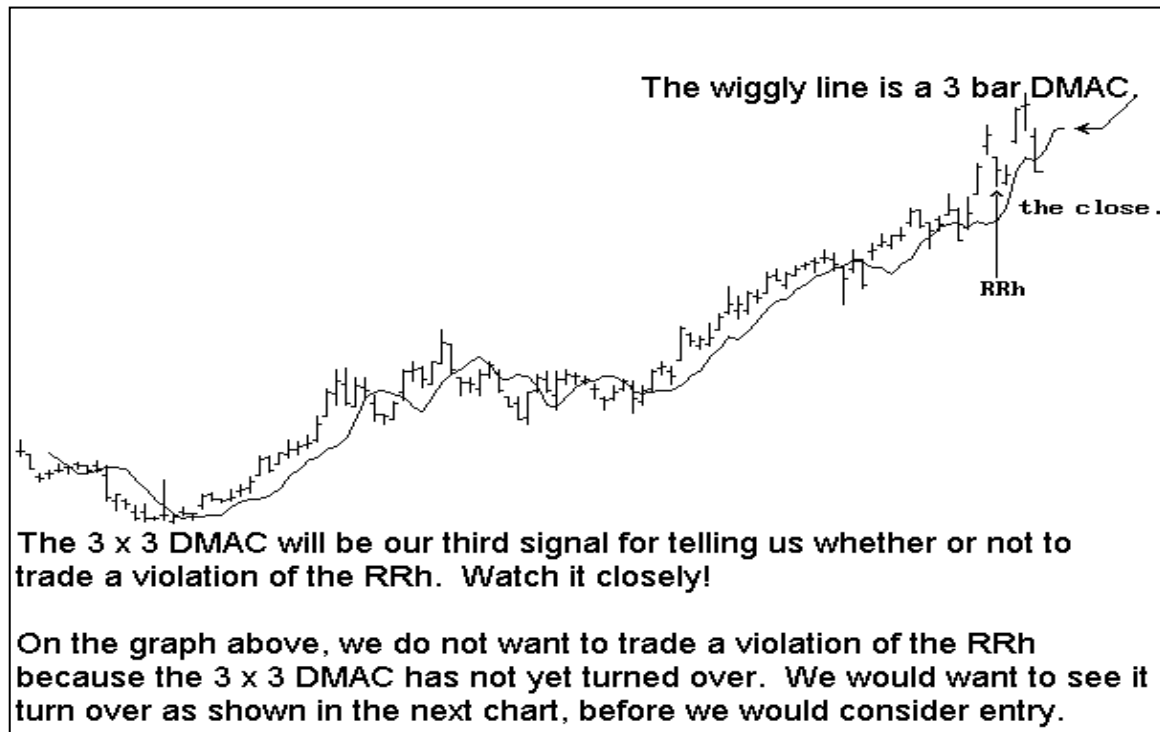
What we've done is to take the 3 MAC from Day 3 and place it as the 3x3 DMAC for Day 6.

A displaced moving average has a number of benefits over that of a non-displaced moving average. The main benefit is that it does a better job of *visual* containment. Buy and sell signals can be taken from price penetration, but only with great caution. Penetration should be treated as you would a gap, it is an alert. **A double penetration of the moving average by the price is an especially strong signal of a failure of the trend to continue.** Finally, a displaced moving average keeps us much closer to the price action than a non-displaced moving average, because it is projected forward in time. You have a rough idea of the extreme at which prices will be at the next price bar. This is true only in the absence of any unusual price action.

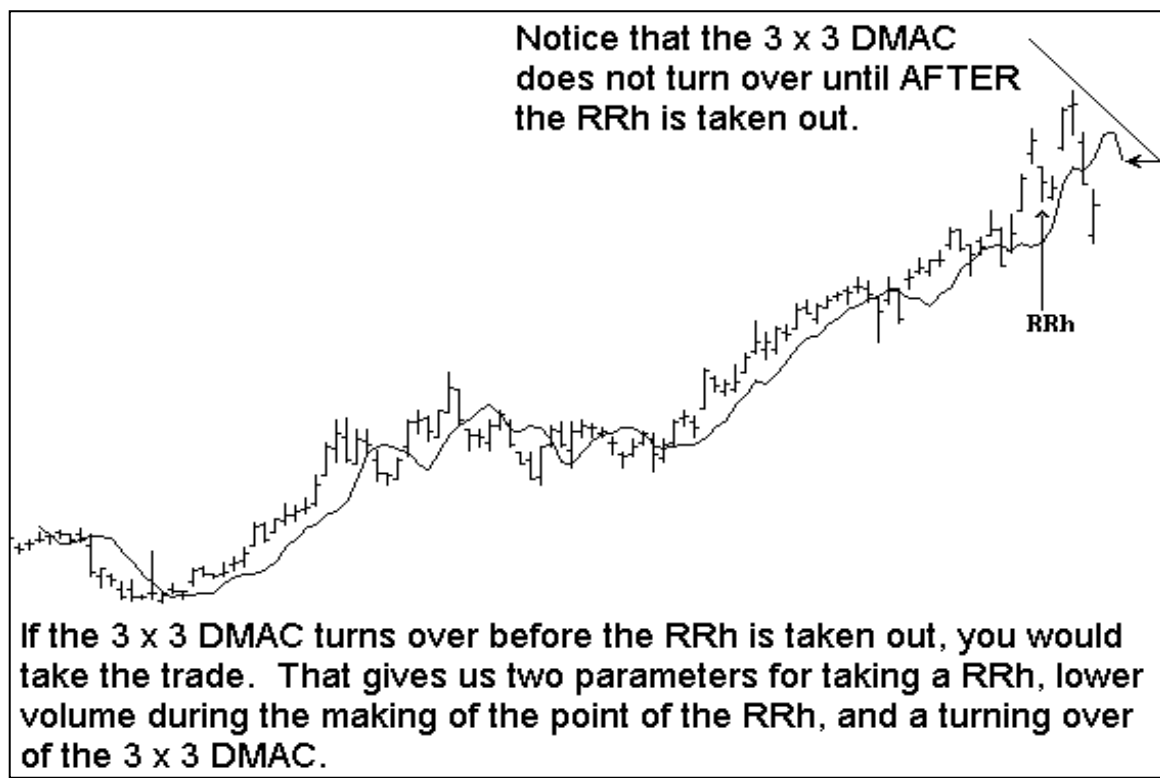
The 3 bar moving average displaced by 3 bars can be used when a market is moving steeply. If the closing price of a price bar penetrates the moving average, it may be a signal of imminent change. If the closing price then turns around and re-penetrates in the opposite direction, then an extra strong signal is given to trade in the direction of the close. If the market is moving less steeply, we want to lengthen either the number of bars used, or the amount of the displacement. Please, do not think for a moment that there is anything magic about a 3 x 3 DMAC. It is primarily a visual aid which can be used in any time frame.

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FILTERING A TRADE WITH A 3 X 3 DMAC

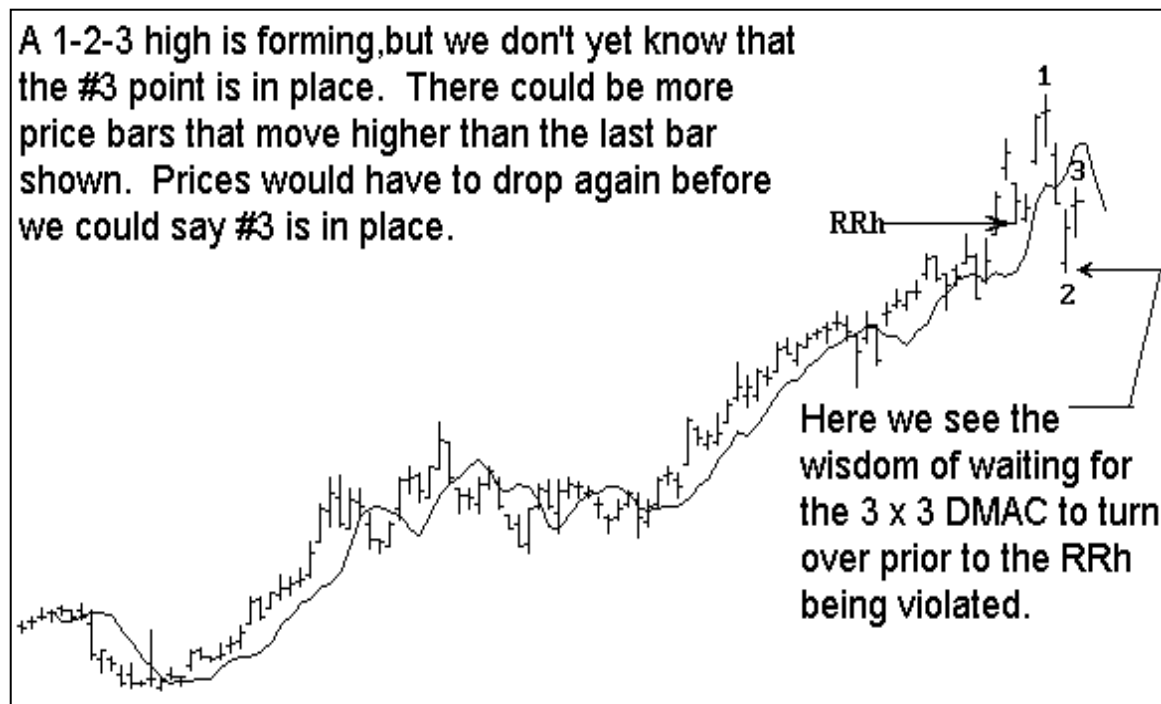


It can be argued that looking ahead, we can see that a violation of the RRh would cause the 3 x 3 DMAC to turn over. This is true, and is a more refined, advanced way to trade, one that has made considerable money.



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However, in any instance where we are trading from a chart, if a turnover by the 3 x 3 DMAC is anticipated, we must be prepared to daytrade any violation of the RRh, as the trade may be only short lived. In other words, if we are trying to trade the anticipation as a position trader using a daily chart, we must be prepared to take a short term scalp by having a short term objective stop. Violations of RRh's are often false. We have to keep that firmly in mind when we trade them. RRh's are not nearly as high percentage trades as are Rh's preceded by 1-2-3's and capable of entry via the Trader's Trick. We also need to realize that because we often do not have time or space to trade RRh's using the Trader's Trick, we can use the 3 x 3 DMAC as our signal to get in early ahead of an RRh being violated.



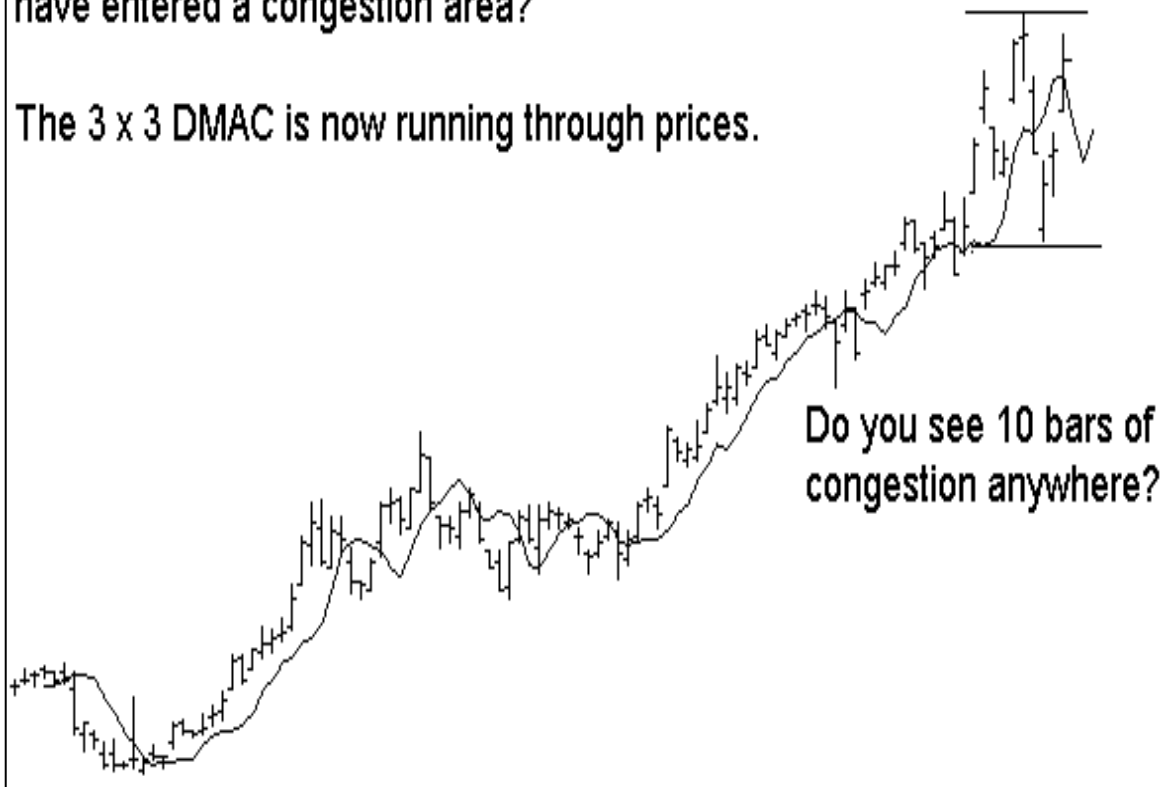
If we had taken a violation of the RRh without the 3 x 3 DMAC having turned over, our entry would have almost immediately gone against us.

Care must be taken as prices approach a RRh. Hold back any trade entries until the 3 x 3 DMAC turns over, and prices show a more definite commitment as to direction. We want to be sure as to whether or not prices may be moving into a Trading Range after the violent blow-off at the top.

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Can there be any question as to whether or not we have entered a congestion area?

The 3 x 3 DMAC is now running through prices.

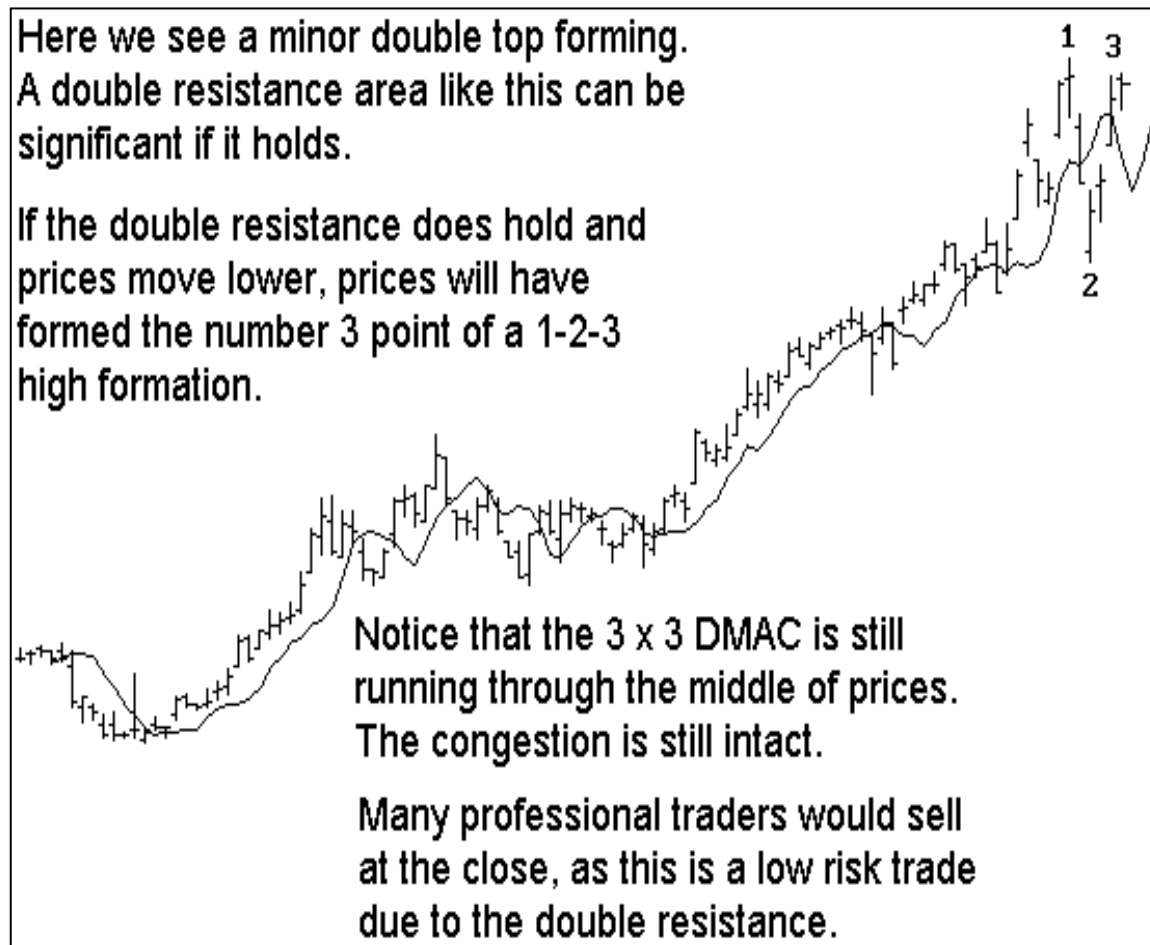


In fact, by our definition of congestion and the flip-flopping of prices, we are now seeing congestion on the chart. If we include the last price bar and count backward nine additional bars, we can see that we have had sets of reversing bars, and two bars which are very close to being defined as doji bars.

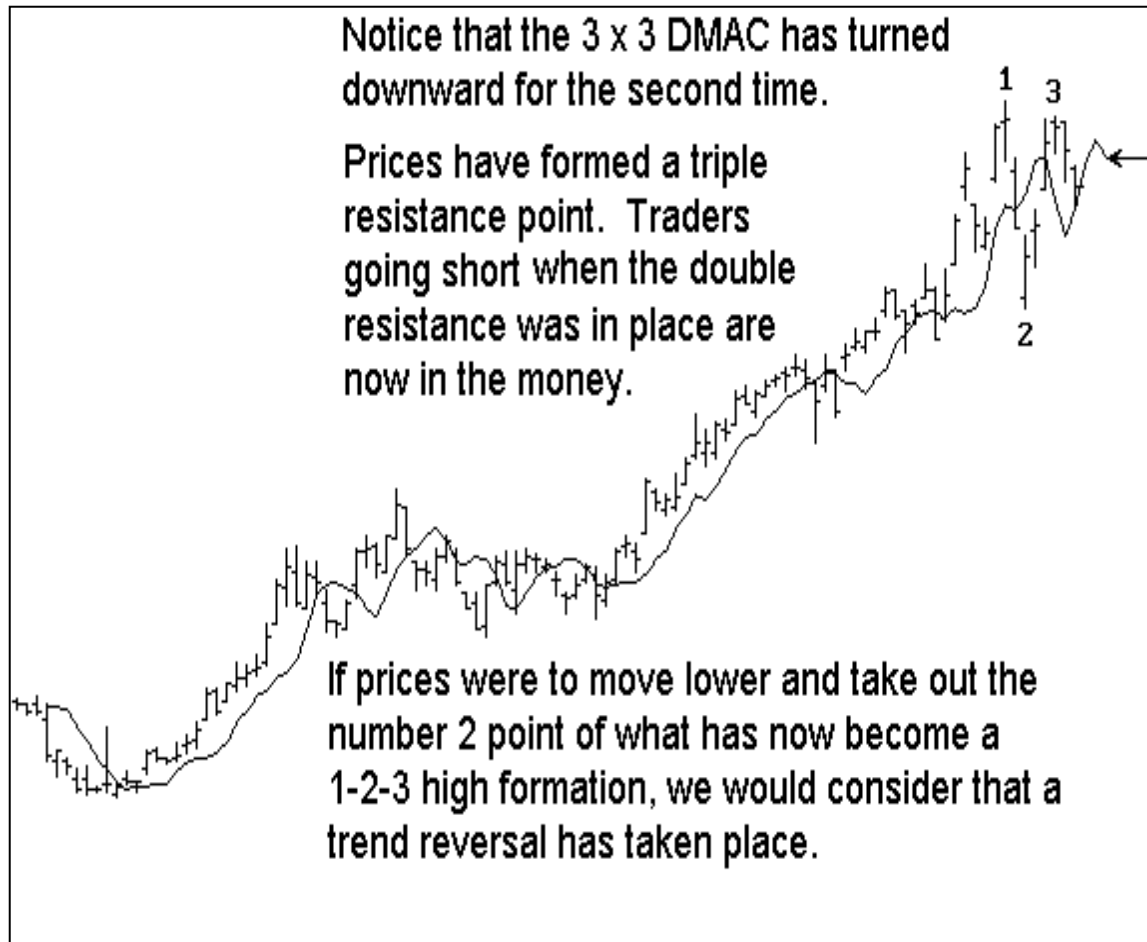
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Prices next form a double resistance, minor top. If prices go no higher, and in fact move lower, the number 3 point of a 1-2-3 high will be in place.

A double resistance point provides a relatively low risk entry point, if you want to trade within the congestion. Trading within congestion is a topic that goes beyond the scope of this manual but is covered in **ELECTRONIC TRADING 'TNT' IV — TIPS-TRICKS AND OTHER TRADING STUFF**. Here we are covering only the trading of trends and trend reversals.



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With the 3 x 3 DMAC having now turned over twice, we have an excellent chance of a winning trade if we enter ahead of a violation of the # 2 point, a RRh. In fact, entry based on a violation of the low of the last bar on the chart has the same probability of producing a winning trader as if we were able to enter the market based on a Trader's Trick entry, as long as there is enough room between the entry point and the number 2 point to allow us to cover costs and take a small profit.

Do keep in mind that, until the # 2 point is taken out, we will not, by definition, have a defined trend.

It is the combination of three things that determine that a trend reversal has indeed taken place. Let's review them here, noting that numbers 2 and 3, as well as 2 and 4, may reverse the order of their occurrence:

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1. A failure to take out a Ross Hook on lower volume at the end of a trend, signifying weakness in the market.
2. A move in prices strong enough to violate the point of an RRh.
3. The 3 x 3 DMAC turning down ahead of the violation of an RRh which occurs when prices fail to move to a new high.
4. The 3 x 3 DMAC turning down ahead of the violation of the #2 point of a new 1-2-3 high when prices have moved to a new high as part of a congestion area following an Rh, as in the example just shown. Later on, in the chapter on plain vanilla trading, we'll see how you can know, without any indicators, whether or not to take an RRh trade.

We've shown the beginning of a trend reversal at a market top. If you want to see what such a reversal looks like at a market bottom, simply turn the page upside down and hold it up to a mirror. This works really well, try it.

When there is a test of an extreme followed by a failure, be aware that you may be looking at a trend reversal. However, be cautious. Before the trend reversal goes into full force, there may be a trading range or congestion area. Congestions at a trend reversal are far more common than total and absolute reversals.

Such a trading range can be indicative of accumulation or distribution. We cannot be sure which. We want to be sure to wait for definite commitment by the price action before beginning to look for Ross Hooks. Such commitment can be seen in the form of a 1-2-3 breakout, followed by the forming of a Ross Hook.

Yes, we will miss a part of the move, but we will, if we follow what has been shown, trade most of the time in a trending market. Since most of the money to be made by us, the outsiders, occurs when prices are trending, this represents a conservative and effective way to trade.

We've now seen something of trends, trend reversals, and Reverse Ross Hooks.

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We've seen that the RRh in itself is one signal that helps us to suspect a trend reversal may be imminent. We regard every correction in a trend as suspicious.

We've also seen that a filtering process is necessary in combination with the RRh for determining the plausibility of entering a trade based solely on the fact of the RRh being there.

The RRh as a signal must be filtered. In the case shown previously, we used the 3 x 3 DMAC as our filter for the RRh.

In the chapters ahead we will be looking at various ways to filter Ross Hooks and Reverse Ross Hooks, as well as nuances, concepts, and intricacies that will help you. These will add new strategies and techniques that undoubtedly will add to your success in trading.