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TRADING OPPORTUNITIES After the flood

by Dr Mircea DOLOGA

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CONTENTS

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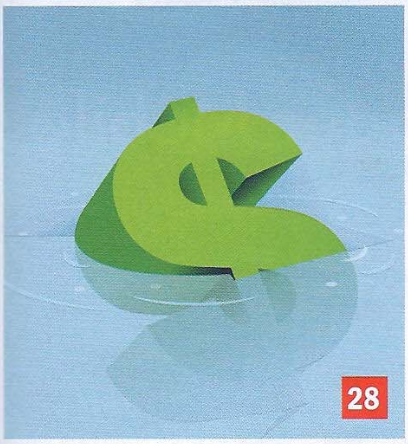
COVER STORY



28

COVER STORY

FEATURES

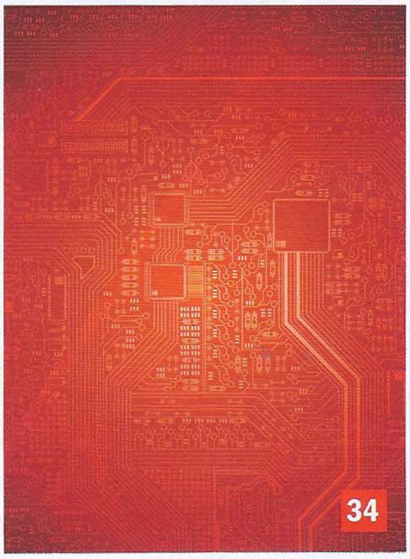
REVIEWS

INTERVIEWS

66

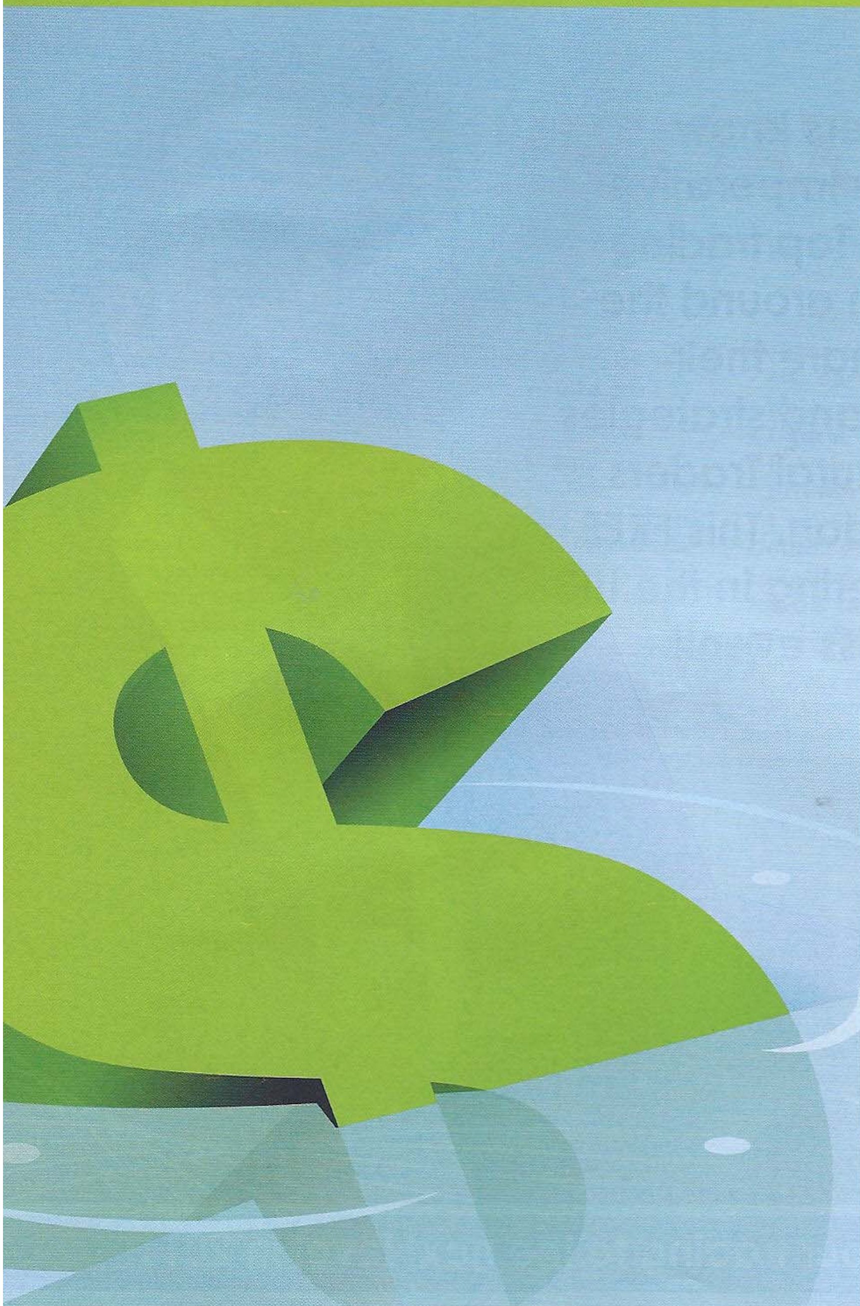
COLUMNS

REGULARS



34

■ NEWCOMERS ● INTERMEDIATE ▲ EXPERIENCED



AFTER THE FLOOD

Dr Mircea Dologa, MD, CTA asks: can cotton farmers affected by Queensland's floods be helped by technical analysis?

From a fundamental point of view, at first glance one might believe there will be a cotton shortage – a real scarcity that forces the price of cotton sky-high. However, before we adopt this belief, let's look at two questions: how deficient will the world cotton market be; and, how important will the effects of the floods in Australia be on world cotton market prices?

Russia 2010

In order to better understand the impact of these extreme conditions on world commodity markets, let's look at an example – the event that occurred in the summer of 2010 in Russia, when drought doubled wheat prices from 4254 to 8410 in almost two months. In 2009 Russia, the world's fourth-largest wheat grower, produced 61.7 million metric tons of wheat, which is nine per cent of the total 681.9 metric tons of world production.

How does the Australian flood compare?

The difference between the Russian example and the Queensland flooding lies not only in the market share of each country for each product, but also in the charting situation: the cotton futures market is now close to its highs, and the wheat futures was then close to its lowest lows (see figure 1).

We should keep in mind that the Australian yearly average production of cotton (two to three million bales) represents less than two per cent of the production of China and the United States alone (50 million bales), not counting here the domestic production of India, Pakistan, Brazil, Turkey and Greece. Furthermore, approximately only one-third of the Australian production is grown in Queensland (the flooded area) and the remaining two-thirds are grown in the state of New South Wales. All this is important to note, because the disaster area in Queensland produces only a minor part of the Australian cotton production – less than one-third of the two per cent (or less) of world production. This being said, it seems probable that there is a high probability that this incident will cause world cotton prices to do no more than 'stumble', and that the market will continue on its usual way.

Past natural disasters and interconnected agricultural markets

From a charting point of view, our dilemma is to decide whether the market has already reached its highest high, and is already starting its descent, or whether it could still go up. That problem can be solved more easily if we take a look at the past behaviour of this market, and at the behaviours of the interconnected agricultural markets, including detailed pattern studies of natural disasters.

Russian drought – summer 2010

Looking at the behaviour of the wheat price (figure 1), we observe that the parabolic swing of the summer of 2010 (from 11 Jun 2010 to 6 Aug 2010) was terminated by a market bar close below the bar's 50% level, in the vicinity of its lower 33% threshold (a decisive reversal signal). Afterwards, the market entered into a consolidation over several months. It is worth mentioning that the parabolic swing was rather steep, an almost upward arrow-straight swing whose 85-degree angle reminded us of a rocket launch at Cape Canaveral.

Ongoing wheat market before the highest high (13344 on 29 Feb 2008). Taking a closer look (figure 1), at the period preceding the highest high level (from 16 Nov 2007 to 29 Feb 2008), we can observe that the last Elliott wave [labelled (5)] is composed of five sub-waves (labelled 1, 2, 3, 4 & 5); they all form a terminal Elliott pattern, named an 'ending diagonal triangle', which is generally characterised by a devastating zigzag corrective pattern. This is what really happened, and the market performed an abrupt 68% fall until the end of 2010! It still did not exceed the high key-level (8410) of the parabolic maximum level of the 2010 summer incident.

The chart of the cotton market's perpetual futures (figure 2) was analysed using the Top-Down approach associated with Integrated Pitchfork Analysis.

Description of the multiple time frames using these two techniques

The cotton chart (figure 2) illustrates the parabolic pattern – using multiple ellipses whose last bar not only tested the 88.6% Fibonacci ratio ellipse, at the union of the upper third with the middle one, but closed right on it. It is important to note that the close of the last bar is located exactly on the 33.3% key-level, thus performing an average correction, which is a signal of there being a high probability of continuing the ongoing up move.

The second monthly chart (figure 3) shows the entire cotton market and includes multiple un-orthodox trend lines, associated with Elliott waves. Therefore, we can observe that the last market swings belong to a terminal pattern, named 'ending diagonal triangle', which is usually terminated by a devastating ABC correction. The last bar tested the middle un-orthodox trend line and closed right on the lower trend line.

There are two questions : is the sub-wave w5:W(5) of the ending diagonal triangle already terminated or isn't it? This question can be

FIGURE 1: WHEAT 16 NOV 2007 TO 29 FEB 2008

reformulated as: is there any probability that this sub-wave will reach the upper un-orthodox trend line?

Let's continue and see what the possible answers are.

The third monthly chart (figure 4) illustrates the ending diagonal triangle pattern of the cotton market of the last nine years. This chart signals several decisive factors:

- The terminal wave [w5:(W5)] seems to be extended to 2.382*w3. This value of the extension signals two probable scenarios:
  - o The ascending wave W(5) is already terminated, but only if the market will comply with two conditions: a waning volume, which is not the case right now and the breakdown of the low of the last bar – key-level 11691.
  - o The ascending wave W(5) is still in progress, ready to break up the highest high 15912 key-level, being strongly directed toward the 2.618*w3 location, at the 17167 key-level.
- One can see that the last bar's ascending volume (green colour) is at its average level, which exceeds the third standardised level, the first level being the minimal activity value. This kind of volume situation doesn't characterise a reversal pattern.
- The location of the close of the last bar is at its upper 33% threshold, which tells us that the market desires to continue its ascending ongoing move. Again, the breakdown of the low of the last bar – key-level 11691 – will invalidate this scenario.
- The previous three arguments (the sub-wave w5, the last bar's ascending volume and the close location of the last bar at its upper 33% threshold) plead rather for a further extension of the market to the 2.618*w3, at the 17167 key-level. We can see on the development of this terminal pattern more clearly on lower time frames, as explored below.

Weekly charts

Figure 5 illustrates the double parabolic pattern, which is an excellent technique – not published yet – that reveals dual advantages:

- The inner parabolic pattern signals the probable highest high target, if there is a two- or a three-bar reversal pattern
- The outer parabolic pattern reveals the probable corrective landmark of the ongoing down move, which is usually confirmed if the previous swing's correction attained the 25% threshold. As an example, refer to the 9890 key-level of figure 1 – a wheat monthly time frame. It seems clear that at the touched zone of this level, the wheat market paused briefly, to take a single deep breath in order to continue its downward move. This is an excellent technician's tool to confirm an ongoing downtrend through the use of dual parabolic patterns.

On the weekly cotton chart (see figure 5) the ascending momentum performed a nice reversal pattern, right on the inner parabolic pattern, with a fall from the 15912 level to the 13697 level, but the last bar closed in its upper third with a huge down tail. Would we say that the bears lost the game, and the bulls are becoming strong? I would not confirm that, unless the highest high level at 15912 is exceeded with high ascending volume. On the other hand, the confirmation of the down move initiated by the three-bar reversal will be confirmed only if the descending market reaches a corrective landmark, at the earliest as it breaks progressively down through the 13697 and 12642 key-levels.

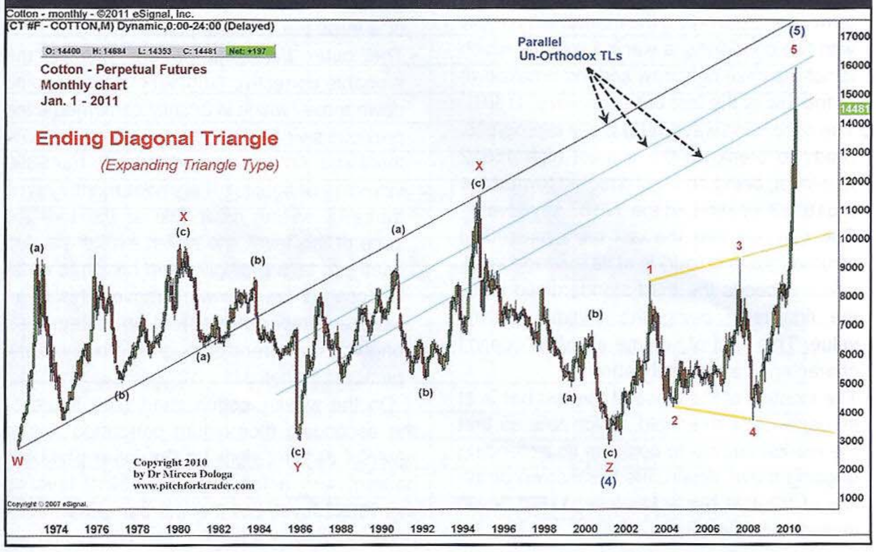
The weekly chart in figure 6 shows that the ascending pitchfork was quite involved in the development of the cotton market by serving, with its main body, as a cruising ascending channel from February 2009 until October 2010. It stopped the two highs with the assistance of the warning line n° 5 and served as a strong support of the median line (ML) at the 11113 reversal key-level. The next couple of weeks will establish if the market will break above warning line n° 5 (which halted it previously) – and so above the 15912 highest high level – or, on the contrary, will drop towards the pitchfork's main body, once it breaks below warning line n° 1. Definitive confirmation – even if late– will occur if the median line is broken downwards. That level might coincide with the corrective landmark location, which we discussed previously.

The ADX (11 period) is one of the preferred technical tools of Mrs Dawn Bolton-Smith, one of the founders of the Australian Technical Analysts Association. She taught us that the 11 setting is the most convenient period to use. Very subtly, the ADX (11) on figure 6 shows several decisive advantages:

- The highest high of 60.49 was attained, and the ADX (11) is on its way down, presently at the 49.31 key-level. We can't confirm the market's reversal until the +DI and –DI cross over. However, this intersection will take place only if several ADX levels (old ADX highs) are broken successively in a downward direction: 48, 41 and 39.51. Until this confirmation occurs we are still oriented upwards, expecting a nice bounce on the 48 level or on the 39-41 level zone!
- The ADX (11) is an excellent tool, and the trend lines and/or pitchforks can be successfully drawn on its portion of the chart, as if they were on the price's chart portion. Their parallel interpretation will help us tremendously in the decisive process of trading.

FIGURE 2: COTTON – PERPETUAL FUTURES – MONTHLY

FIGURE 3: COTTON – MONTHLY CHART (MULTIPLE UNORTHODOX TREND LINES)



Daily chart

Figure 7 illustrates the magnified parabolic pattern associated with Elliott waves and volume studies.

The last bar of the current market is right on the curve of the parabolic pattern, oriented downwards. The sub-wave w5:W(5) of the ending diagonal triangle is in progress. The volume of the last bar is still ascendant, but under the average curve with a standardized n° 2 value, which doesn't suffice for an ascendant move.

So far, as the market did not break down the 13755 key-level, we are still oriented towards an ascending market.

Conclusion

As we already know, there are two strategies to enter a trade: an aggressive or a conservative approach. I support the latter. Being conservative means that we have a better chance to keep our initial capital, and more efficient risk management, even though the final results might be smaller than those of the aggressive approach.

In our cotton study, we have seen that there aren't any certain signs of reversal, or in other words, 'heavy proof of trend reversal'. On the contrary, the Top-Down approach shows us that there is a high probability of the cotton market still being in an uptrend, and the fundamentals couldn't convince us otherwise.

Trading approach of the new market participant

The new market participant practising an

FIGURE 4: COTTON – MONTHLY (ENDING DIAGONAL TRIANGLE PATTERN OF THE COTTON MARKET OF THE LAST NINE YEARS)

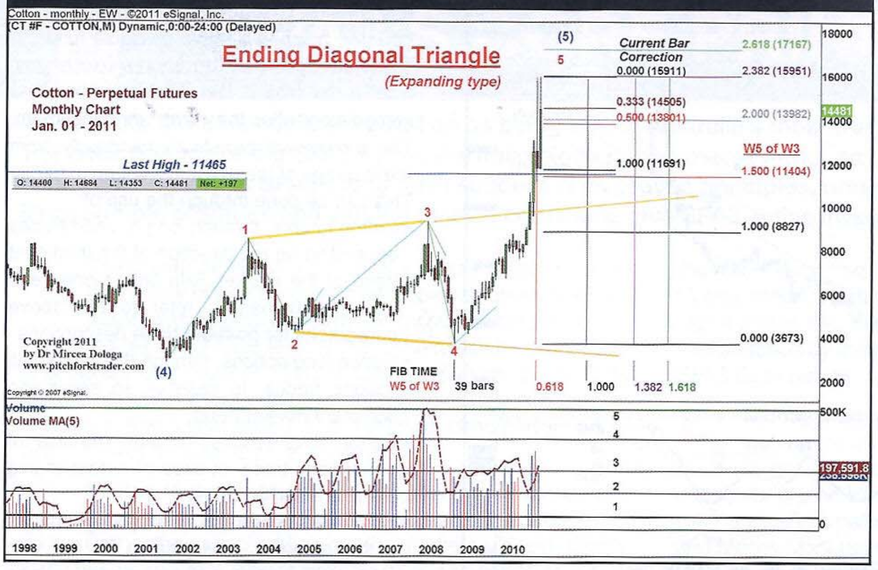
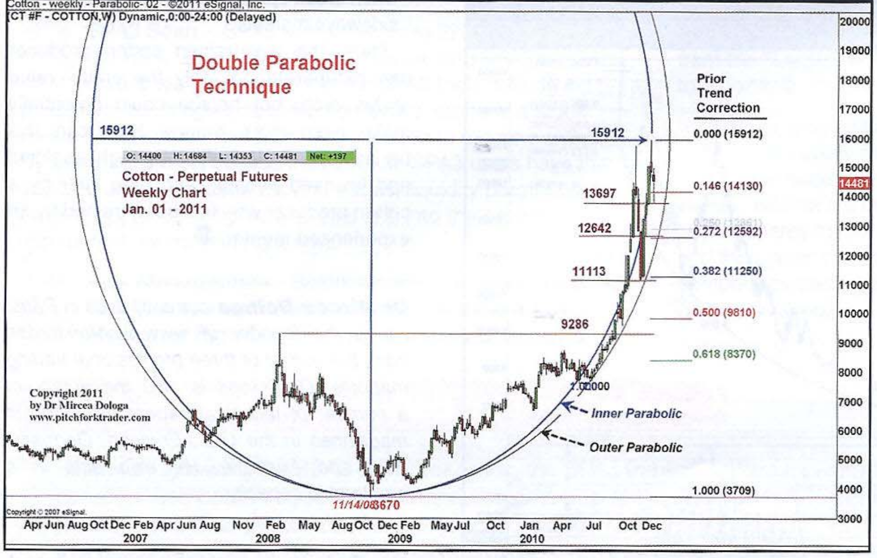


FIGURE 5: COTTON – WEEKLY (DOUBLE PARABOLIC PATTERN)



aggressive approach will go long above the highest high level (15912). Usually no other conditions would be taken into account. His short position will be enabled as soon as the low of last week's bar is broken down at the 13697 key-level. Both trades will probably be executed with a psychological stop loss.

The new market participant practicing a conservative approach will go Long a few ticks above the highest high level (15912), but will wait for the close of the breaking bar in order to enter. The trade will be performed only if two conditions are met:

- The opening of the second bar after the break-up, is higher than the close of the breaking bar;
- The volume of the bar breaking upwards is twice the size of the average volume on a five-bar period.

Otherwise, he/she will wait for the next pullback to occur. The trade will be associated with an automatic stop loss, carved in the computer's memory. Its usual size is between 1.5 and 2.5 Average True Range [ATR(14)] of the operative timeframe chart. It is essential that the location of the stop loss should be below or above a technical landmark element of the ongoing upward or downward trend.

The short position will be initiated only if 'the heavy proof of the trend reversal' has occurred. In our cotton case chart, we will count on the occurrence of:

- The breakdown of the low of the last bar, on the December 2010 monthly chart – key-level 11691 – followed by the breakdown of the 11113 key-level on the weekly chart (an excellent location for an add-on short position). It is important to mention that the breakdown of the 13755 key-level, the low of the last descending swing (wave iv) on the daily chart might incite some conservative participants to enter short at this level, before price reaches the 11691 key-level. In our opinion, this position may be initiated only if the stop loss has a minimum value (placed a few ticks above a strong resistance) and the breaking down bar of the 13755 key-level had an adequate descending volume.
- The occurrence of the corrective landmark on the outer parabolic pattern – refer to weekly chart n° 5 – will certainly enhance the probability of a down trend occurring. Watch for an associated cluster formation with the 11113 key-level. As we probably are already in a short trade, this level is an excellent location for an add-on short position.

Trading approach of the cotton producer

The approximate 900 Australian cotton growers have several sale choices, in order to be protected from the loss of their crop. They can sell the cotton to a merchant or to a ginner even before it has been processed.

The process of selling is done in several ways:

- Direct sale in a cash market, at a daily or spot price;
- Transfer of a part of a grower's cotton production to a seasonal pool, where an agent (who uses cash or options methods) is responsible for selling;
- Direct sale, through a personal agreement, at a convenient price for both parties;
- Use of a forward contract established between a producer and a buyer (local merchant or an international company, depending of the size of the farmer's crop). The contract defines the specified quality, quantity and agreed price of the crop, which will enable the farmer to know the crop price, even before he/she has planted it.

However, very few farmers use futures cotton contracts, traded by an exchange (like

FIGURE 6: COTTON - WEEKLY

FIGURE 7: COTTON - DAILY PARABOLIC

New York Board of Trade (NYBOT), and renamed ICE Futures in September 2007; or NYMEX Cotton Futures), where a specialised trader can buy, sell or hedge cotton financial securities. The absence of cotton growers on these exchanges is due to a lack of qualifications in fundamental and technical analysis. In most cases their hedging process is limited only to a forward contract, already explained above. This is very unfortunate because the forward contract established between a producer and a buyer protects the grower only as long as there is a crop, compliant with the conditions specified about quality, quantity and price. But what will happen when the crop is wiped out by floods or drought? That is a different story! The only solution that applies to this flooding disaster, is to start trading derivatives (cotton futures or cotton options) that are most adapted to the individual farmer's needs. If he/she has already cashed-in the crop before the disaster, he/she will have available funds to speculate on the cotton futures exchanges, even if the crop is lost. This must be done immediately after the news announcement. The grower will benefit tremendously from the leverage of the derivative cotton markets. This can be done through the use of:

- Cotton futures, through long or short trades depending on the direction of the dominant trend of the market, with tight money and risk management – refer to the above paragraphs for possible trade descriptions;
- Cotton long options, through the use of call options trades, in case of an ascending dominant market trend;
- Cotton long options, through the use of put options trade, in case of a descending dominant market trend;
- Combined cotton short and long options – the spreads – associated or not with futures. They may not only protect a long or a short futures position, but they can even become an additional profit source when credit spreads are used, especially in sideways markets.

Thus, the well-trained cotton producer can recuperate not only the entire value of his crop, but he/she could potentially make even more money. How can this be achieved? Well, first through qualified and licensed people;, and then later by a cotton producer who has been trained by an experienced mentor.

Dr Mircea Dologa *currently lives in Paris. He is the founder of www.pitchforktrader.com, the author of three professional trading manuals. Dr Dologa is also the author of a number of technical papers published in magazines in the U.S., England, Germany, Asia and Australia. He also acts in a mentorship capacity.*

Dr Dologa *publishes a weekly report, 'World Charting Report', containing charts of international indices, FOREX charts and Romanian stocks and indices. Anyone interested in receiving free copies of the report, together with excerpts from his trading manuals, can send a request to mircdologa@yahoo.com.*