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After the Flood II

by

Dr Mircea Dologa

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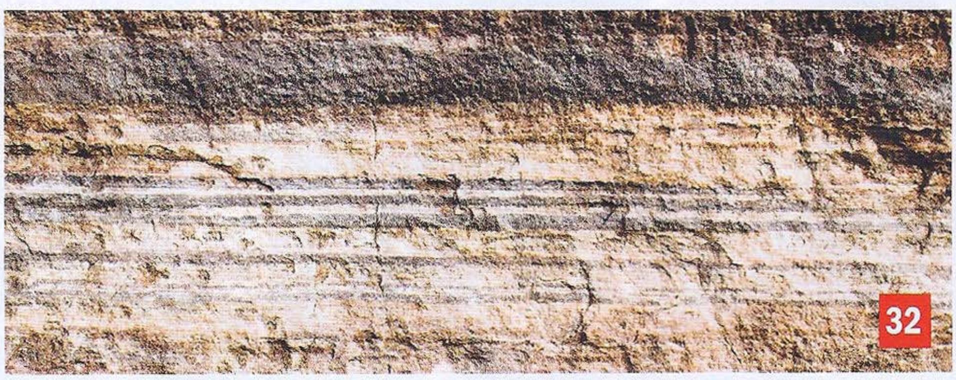

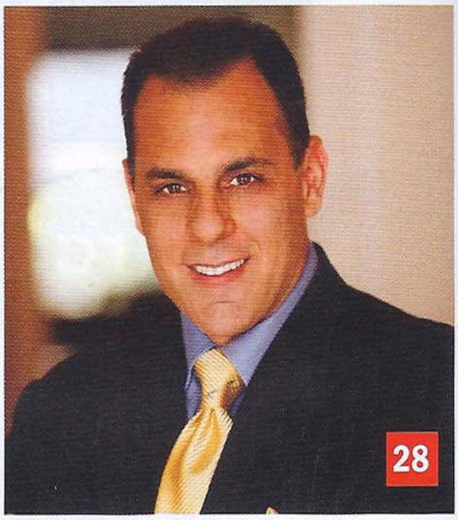

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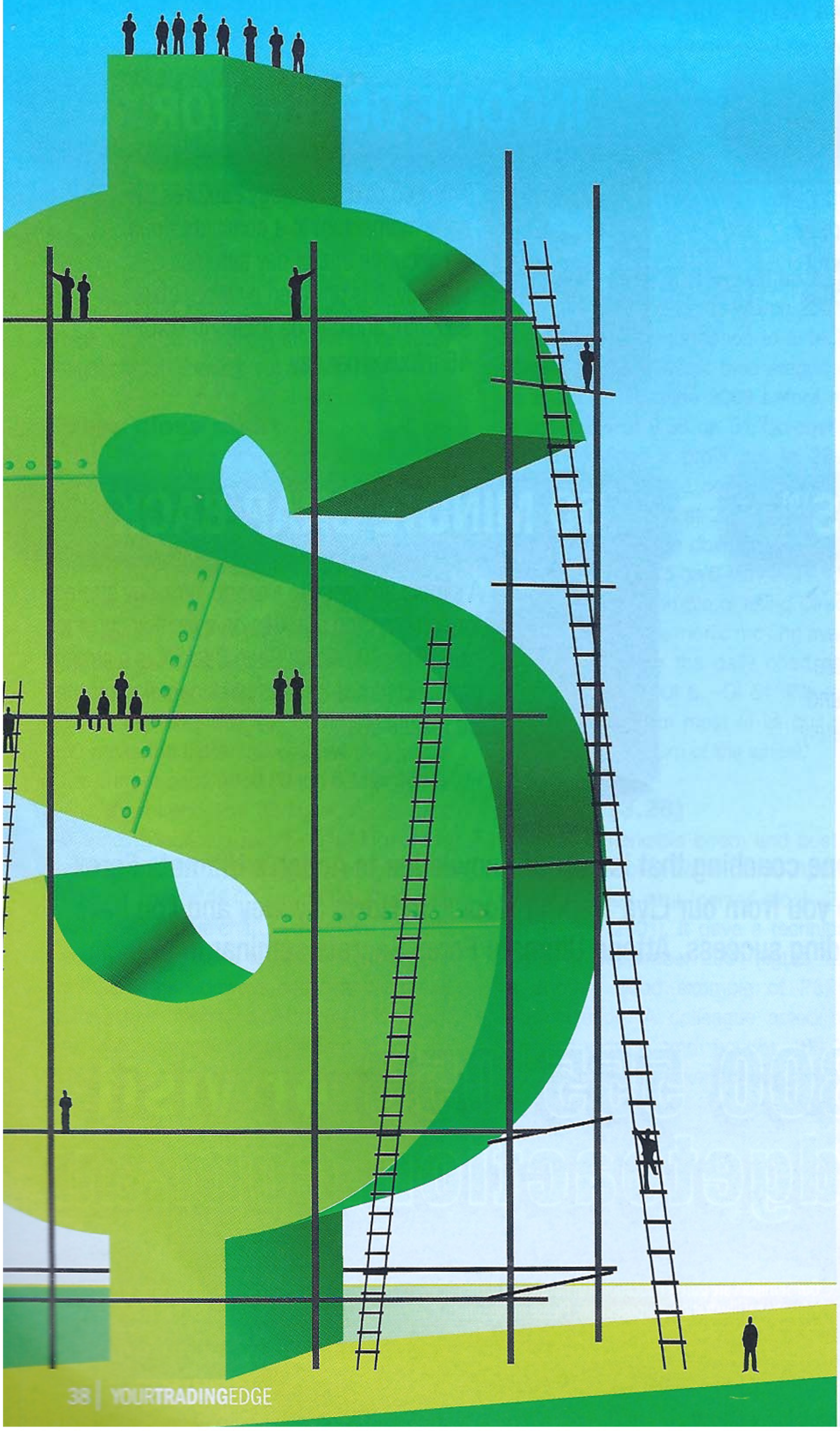
AFTER THE FLOOD PART II

Dr Mircea Dologa, MD, CTA: Can cotton farmers affected by Queensland's floods be helped by technical analysis? (continued)



The 2010/2011 season has been one of the best in the history of the Australian cotton harvest. Farmers planted around 650,000 hectares of cotton during October to September 2010, responding to the greater availability of water after a wet spring. High prices, compared with those of 2009, also encouraged farmers to greatly increase cotton plantings. In 2010 cotton prices were the highest they had been since the US Civil War in the 1860s.

The impact of the Queensland floods

A devastating flood spread over one million square kilometres, resulting in 41 of Queensland's 73 municipalities declaring a natural disaster. However, according to administrative sources, the outcome for cotton looks good. This year's crop is expected to exceed last year's 3,600,000 bales with around 4 million bales expected (one Australian bale = 227 kilos or 4.4 bales = 1 ton). This will set another crop-harvest record and is excellent news, specially just one year after the floods.

Although there were anecdotal reports of a significant negative impact of the flood on the cotton crop due to waterlogging, they were not substantiated. The current very comfortable wholesale price is estimated to total more than $2.2 billion, with high demand from China. This is very good news for Australian exporters, and for the entire economy.

Part I of this article (After the Flood, Mar/Apr 2011 YTE) was written on 3 January 2011. On that day, the price of cotton perpetual futures was 14650. At that time there were no signs of a reversal, because proof of trend reversal was missing. We concluded then that the uptrend would continue for a couple of weeks because of low Australian stocks of cotton. There was indeed a cotton price surge to 21970 on 7 March 2011, after which cotton settled to its crop-harvest price of 14780 (10 May 2011).

Are these figures good or bad? Judging from the price of last year's crop harvest – 8710 on 26 April 2010 – we can say that there has been a comfortable 41 per cent increase from 2010 to 2011.

Where to now?

We now need to assess whether, at the time of writing (10 May 2011) the market has yet reached the year's lowest low at 14300. Will it continue to fall, or will it climb to the 17244 level, in the vicinity of the continuation gap. Past behaviour of this market might hold the answer.

Charts for Cotton – perpetual futures, are again analysed using the top-down approach associated with Integrated Pitchfork Analysis.

The charts

Cotton Monthly – Jenkins Circles and Ascending Pitchfork

The monthly chart (figure 1) shows a parabolic pattern. On the last swing of multiple Jenkins circles, price not only dropped like a stone in a silent lake but also closed in its lowest 10% portion, giving a good signal of a high probability that the swing's downward move will continue.

In our quest for the lowest low of this correction, we have constructed an ascending pitchfork that not only shows where the market flow halted at the highest high – 21970 – but is also ready to stop the vigorous down move with its parallel trigger line, which is associated with the main trigger line (see the two arrows on figure 1). The multiple Jenkins circles serve as support and resistance by themselves or together with the pitchfork.

Cotton – Perpetual futures monthly chart

The monthly cotton chart in figure 2 illustrates a rarely used but very efficient technique, called 'price and time confluence', in which market mapping forecasts price/time meeting points where market flow might end. Fibonacci price and time have been used to show the most likely meeting points. The use of OSC (5, 40), or OSC (5, 35), helps in identifying the end of the ABC pattern, which constitutes wave 4 (W4). The OSC territory fluctuates between 0.9 and 1.4 in value. The most probable key levels for the end of W4 are the following: 12820 (Fibonacci 50%); 11465 (last high); and the less probable 10660 (Fibonacci 61.8%). The Alternation Principle shows that W4 will be of short duration and of short magnitude, due to the huge temporal W2 extension.

Cotton – Perpetual futures weekly chart (ellipses)

The weekly chart in figure 3 illustrates the ellipse pattern using multiple ellipses, which can serve as curvilinear support and resistance with time and price taken into account. An ellipse has two radii: a long radius (here measured vertically) and a short radius (here measured horizontally). There are four ellipses, in two groups.

- Group 1, formed of only one ellipse, which is encircling the circle's centre (C1), with the 61.8% Fibonacci ratio as its long radius;
- Group 2, formed from three ellipses, which describe the right side of the chart (the last 6 months). The inner has as its long radius a 1.000 Fibonacci ratio, the middle has as its long radius a 1.125 Fibonacci ratio and the outer has a greater long radius (1.236 Fibonacci ratio). The first ellipse has guided market flow as support for more than three years (July 2007 to November 2010). The middle ellipse has recently been a symmetry

FIGURE 1

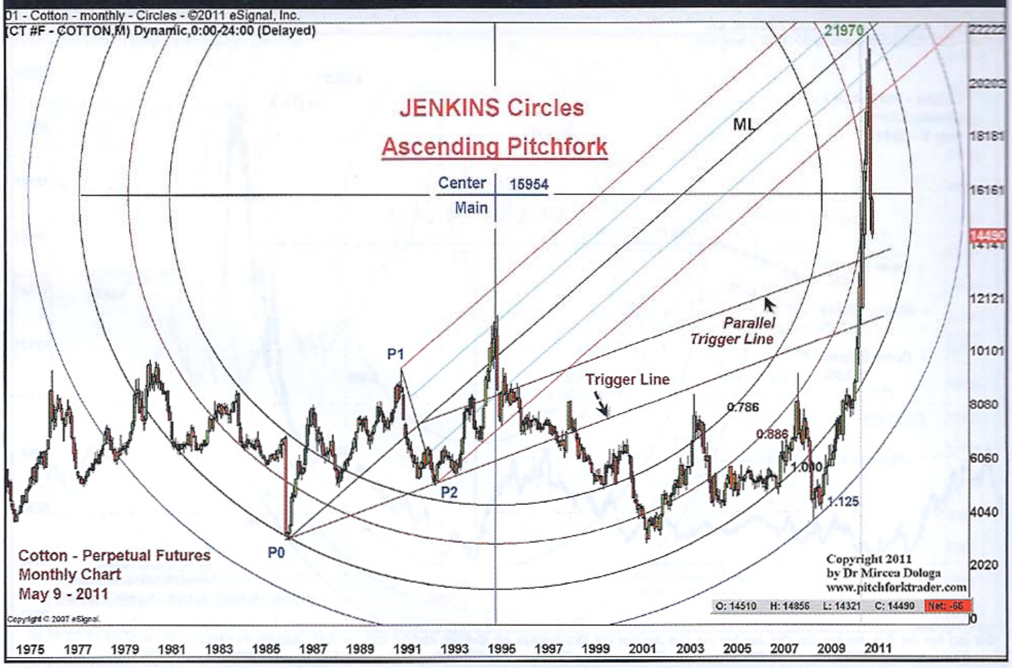


FIGURE 2

axis for several months, as well as support or resistance. The current correction halted exactly on this middle ellipse at the 14380 key level, which corresponds to a 42% current swing retracement with regard to the previous swing.

Cotton – Perpetual futures weekly chart (pitchfork)

The weekly chart in figure 4 shows the ascending pitchfork, which encompasses the entire cotton market. The main body of this contextual pitchfork was a cruising ascending channel, from November 2008 until October 2010. It not only indicated the end of the two lower highs – around 16000 – with the assistance of the warning line 4 (WL-4), but it also showed the reversing market flow at 21970 by warning line 13 (WL-13). The current downward correction was halted at the 14380 key level by warning line 1 (WL-1), in the vicinity of the pitchfork's main body. This level might coincide with the important location of the wave (iii) termination. If that is the case,

FIGURE 3

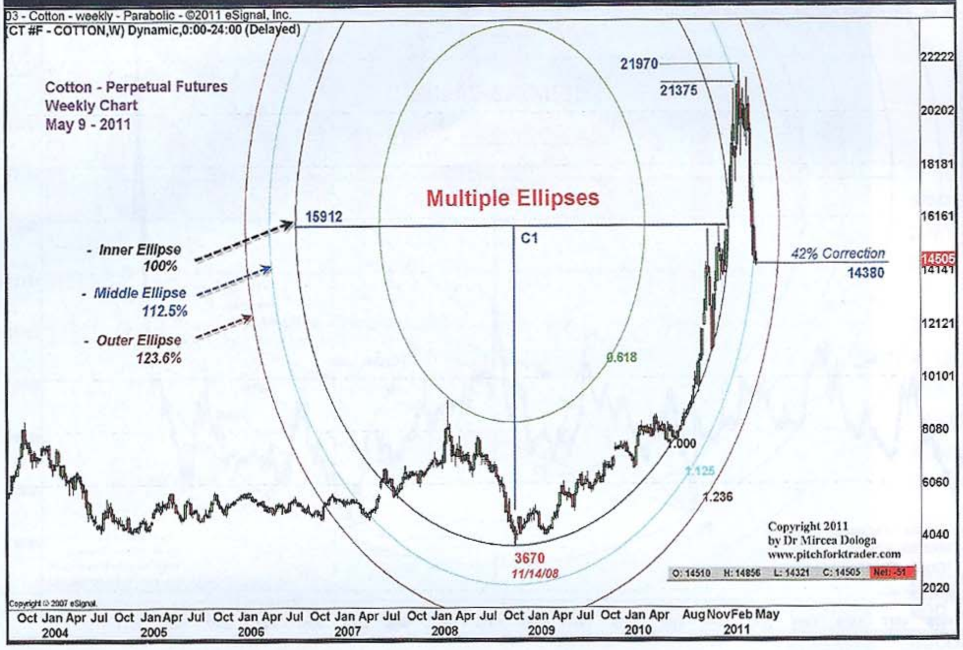


FIGURE 4

the next wave, wave (iv), will probably reach 17126, corresponding to a 38.2% wave (iv) retracement. This level is set by Elliott Waves' Alternation Principle, according to the 78.6% Fibonacci ratio corrective depth of wave (ii).

The ADX (11) is one of Mrs Dawn Bolton-Smith's preferred technical tools. Mrs Bolton-Smith is a founder of the Australian Technical Analysts Association (ATAA). She teaches that setting 11 is the most convenient. In figure 4, the ADX (11) shows several subtle but decisive indications. The ADX (11) is on its way down, from its highest high at 60.49 to just below 39.51 (an old high), and is presently at 37.05. The market's downwards reversal is on its way to being confirmed, due to an upward crossing of the –DI and the +DI. It is expected that the ADX will continue its descent to below the 25 threshold. It is interesting to note that this final crossover happened progressively, as multiple ADX levels (old ADX highs) were successively broken down at 48.41 and 39.51.

Close monitoring of market movements through price bars and using the most efficient indicators will ensure the best trading decisions. So far, until full confirmation occurs, the market is still moving up, but we are expecting a nice bounce on the TL-1 at the 35–36 level.

The ADX (11) is an excellent tool. Trend lines and/or pitchforks can be successfully drawn on its part of the chart, as if they can be on price. Their parallel interpretation can help decision making.

Cotton – Perpetual futures day chart

(The dates on figure 5 show the month first, then the day and finally the year.)

The daily chart in figure 5 shows a regional descending pitchfork associated with Elliott Waves. The market is on its way to ending the impulsive wave (iii) with the following price relationship: w(iii) = 200% * w(i). Thus, there is a high probability that the corrective wave (iv) has already started. If not, we have to reiterate these calculations, if wave (iii) extends to the 2.236, 2.382, 2.618 Fibonacci ratios. The Alternation Principle between waves (ii) and (iv) suggests that wave (iv) should retrace around the 17120–17244 level – a highly probable 38.2% price retracement, at 17120.

The same principle applies for time. Wave (iv) duration should follow the time formula: Time of (iv) = n * Time of (ii), where n= 1, 2, 3, … Thus the duration of wave (iv) will be at least 100%, 200% or even 300% the duration of wave (ii).

It is interesting to notice that wave (ii) had 16 bars, which projects the duration of wave (iv) into the following dates for 2011:

- 22 May [wave (iv) = 1.00 * wave (ii) = 1*16 = 16 bars]
- 7 June [wave (iv) = 2.00 * wave (ii) = 2*16 = 32 bars]
- 23 June [wave (iv) = 3.00 * wave (ii) = 3*16 = 48 bars]

Conclusions from technical analysis

There are two strategies for entering a trade: an aggressive or a conservative approach. Being conservative is recommended. It means we have a better chance of keeping our initial capital, and offers more efficient risk management, even if gains are less than those from a more aggressive approach.

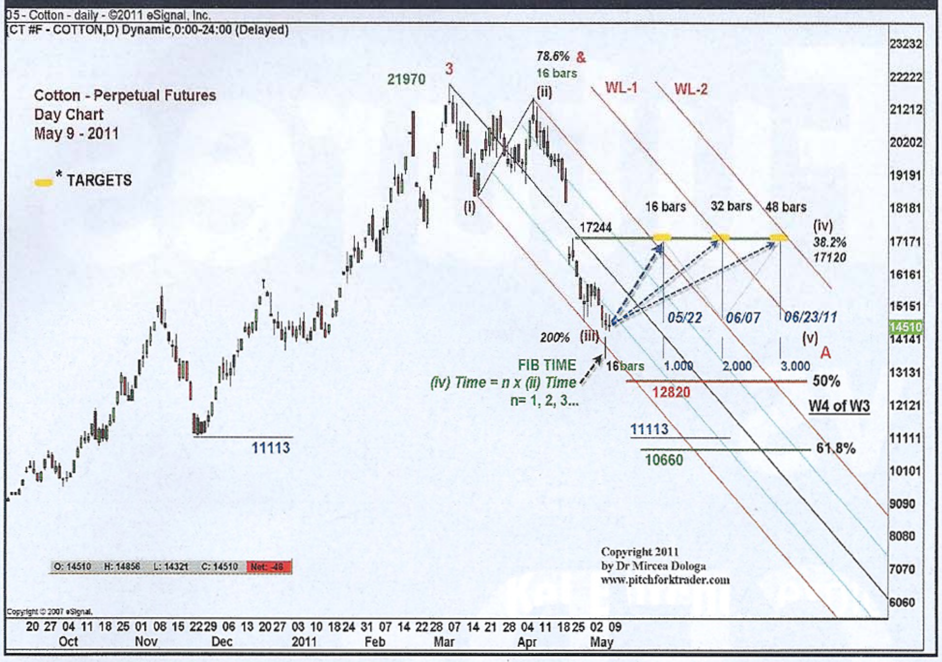
There have not been any signs of a reversal in cotton prices. The Elliott Wave environment and the top-down approach show market flow currently evolving within the sub-waves of wave A, of an ABC pattern of wave 4. The W1 to W5 impulsive ascending pattern is continuing (figure 4). The top-down approach shows a high probability of the cotton market still being in an uptrend; the fundamentals couldn't convince us otherwise.

The aggressive approach

A trader taking an aggressive approach would go long above the highs of the last two small daily bars (the 15000 zone) with a target around 17244 (figure 5). No other conditions would usually be considered. The short position would be enabled as soon as the price of the current bar closed in its lowest 20% portion on the daily chart. The first target would be the value of the 2.382 Fibonacci ratio of the wave (iii) extension [wave (iii) = 2.382 * wave (i)], followed by a second target at the value of the 2.618 Fibonacci ratio of the wave (iii) extension [wave (iii) = 2.618 * wave (i)]. The optimal target would be an eventual price-cluster on the daily chart at 12820, which would coincide with the level of W4 = 0.50 * W3.

Both trades should be executed with a well-planned stop loss.

FIGURE 5



The conservative approach

A trader taking a conservative approach would proceed as follows.

A long trade would not be initiated until wave A ends. An experienced trader would try to ride long the ensuing wave B, as far as its 38.2% retracement. (Figures 4 and 5 show the downwards wave A; wave B is not shown.)

A short position would be initiated only at the end of wave B. The trader would trade the devastating downward wave C, which has excellent profit potential. It could drop as low as 11113 or even 10660. A more precise target would be evaluated once wave B ends. The best entry would be to make sure of the end of wave B by an obvious proof of swing reversal. The trade must also be executed with a well-planned stop loss. (Figure 5 shows the downwards wave A.)

Both the conservative and the aggressive approaches must have an automatic, computer-generated stop loss of a size that is between 1.5 and 2.5 Average True Range [ATR(14)] on the operating time-frame chart. It is vital that the stop loss be placed below/above a technical landmark indicative of the ongoing up/down trend.

Trading approach and cotton producers

To guard against loss, the approximately 900 Australian cotton growers have several choices when selling their crops. One method is to sell the cotton to a merchant or to a ginner before it is processed. This can be done in a number of ways:

- Direct sale for cash, at a daily or spot price;
- By transferring some cotton production to a seasonal pool, where an agent does the selling using cash or options;
- Direct sale, through personal agreement, at a convenient price agreed by both parties;
- Using a forward contract established between a producer and a buyer (a local merchant or an international company, depending on the size of the crop). The contract defines the quality, quantity and agreed price of the crop, so the farmer knows the crop price before planting.

Very few farmers deal in cotton futures on an exchange such as the New York Board of Trade (NYBOT), or NYMEX cotton futures, where traders buy, sell or hedge cotton financial securities. Most cotton growers lack the necessary experience in fundamental and technical analysis. Mostly, growers hedge using forward contracts only. Unfortunately, a forward contract between a producer and a buyer protects the grower only if the crop meets the specified contractual conditions concerning quality, quantity and price. Problems arise if a crop is wiped out by flooding or drought.

The best hedge against disaster is to trade derivatives such as cotton futures or cotton options, which can be adapted to the farmer's needs. If the farmer has already cashed in the crop before the disaster, there will be funds available to speculate on the cotton futures exchanges, even if the crop is lost. This must be done immediately after the news announcement. A grower can benefit substantially from leverage in the derivative cotton markets through the use of:

- Cotton futures, with long or short trades, depending on the main direction of the market, and with tight money and risk management;
- Cotton long options, through call options trades, in a dominant market uptrend;
- Cotton long options, through put options trades, in a downtrend;
- Combined short and long options, or spreads, which may or may not be associated with futures. The options would not only protect a futures position, but they could even become an additional source of profit, if credit spreads are used, especially in sideways markets.

Thus, a skilled cotton producer can not only recover the entire value of his crop but also can make more money, first by using qualified and licensed agents, and then later personally, if trained by an experienced mentor.

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

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.