Weekly Trading Education Article

The Art of Professional Trading during Tumultuous Times, Part I

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Before getting straight to the main topic of discussion of this two-part article, I will present, briefly, my view of the current international economic situation, focusing on the U.S. economy and, then, provide an abridged description of the two types of market analysis used in my study.

Let us start with fundamentals analysis, which is the tool of choice for investors, but less so in the case of traders. This type of analysis attempts to evaluate the financial health of an economy and any financial instrument, whether we're talking about indices, currency pairs, inter-connected markets or any individual industry sector (as present in many geographical locations around the world, within the same economy or the same industry [crude oil, for example]).

As is the case with classic or modern technical analysis, fundamentals analysis uses a top-down approach, starting with a global context: Analyzing the international context, the U.S. economic indicators, such as the growth rate of the entire economy, the gross domestic product (GDP), the interest rate, the domestic currency rate, the EUR-USD currency rate, the rate of inflation, the unemployment rate, as well as public debt.

Talking about the U.S. economy, we can say at this moment that almost none of the above-mentioned rates provide a picture of a more-or-less healthy or growing economy. Still, some analysts claim that the economy has entered the recovery phase with respect to the current recession, which is considered to be worse than that of 1929.

However, I hold a different opinion, taking into account the **four warning signals**, which have proved themselves quite reliable over the last 30 years:

1. The unemployment rate is still greater than 9 percent, a figure not seen for a long time, and this fact is not compatible with a growing economy.
2. The risk of deflation is very much present. Even though the inflation figure for 2010 in the U.S. has improved somewhat, 2009 inflation reached a negative value as low as -2.1 percent.
3. The interest rate reached 2.2 percent in 2008 and is currently trying to recover some ground in order to avoid deflation. The progress has been slow so far, considering that the interest rate only climbed to 2.9 percent in July 2010.
4. The role of public debt in an economy shows us that any poor management or even sloppy management by politicians has a drastic effect on the economy. And, when we talk about the U.S. economy, such mismanagement could also affect economies operating, whether they want to or not, under American influence.

The negative impact of public debt on the living standards of the American people and the people of the above-mentioned economies becomes clear in financial, real estate, domestic, educational and social terms.

For example, the U.S. public debt has oscillated between 60 and 70 percent in the last two decades, and the estimated figure for 2012 is well in excess of 100 percent. In such circumstances, I find it hard to believe that the U.S. economy is currently in the recovery phase and in a growing trend.

The recent massive $600 billion cash infusion by the Fed into the American economy has reached its intended target, at least for now. The issue here is whether other countries would accept this "dollar printing", which, in the short term, decreases the dollar's intrinsic value and boosts U.S. exports. Maybe this action is such a bad thing afterall.

However, as we all know, the U.S. dollar is the main currency used in commodities trading; its devaluation would automatically trigger a counter-action that would lead to a hike in commodity prices, especially in energy-related commodities, as well as precious and non-precious metals, such as gold, copper and palladium.

Is this cash infusion just an act of currency manipulation, or is it, rather, an anxious measure, even a desperate one, taken by the Fed to avoid the fate of the Japanese economy, which has been struggling with deflation for the last 10 years or so?

I tend to agree with the second hypothesis when I see how concerned the Fed officials are with a sudden collapse of banking profits, which would diminish the role of the banking sector in a market economy and would subsequently generate a new crisis...

Having looked at the basic tenets of fundamentals analysis, which indicates a high probability that the current financial crisis will linger on for quite a while, let's move on -- to the second type of analysis -- and study the role played by technical analysis, be it the classic or modern version.

Technical analysis is much more accurate than fundamentals analysis because it represents a mirror image of it, giving us a graphical representation of the macroeconomic phenomena that describe not only the past -- recent or distant -- but also try to project into the future the dynamic consequences of a supply-and-demand imbalance in a specific market.

Classic technical analysis -- born more than 100 years ago -- employs certain already identified elements in the statistical analysis of a given market. These elements, such as trend lines and chart patterns (triangles, head-and-shoulders, wedges, flags, pennants, price- and volume-based indicators, and so on), will reveal to market operators -- investors and traders alike -- the optimal timing for a trading decision. Such a statistical analysis can identify:

- Trends and chart patterns
- Market strength and weakness, which, in turn, can pinpoint ideal levels for profitable trades
- Price-volume interconnected analysis, which can gauge market momentum
- Entry, target and exit levels, which protect the trader from the adverse movements of the market through rigorous capital and risk management; nothing left to chance, so the investor or trader identifies and selects only highly profitable, low-risk opportunities

Modern technical analysis is much more efficient and profitable than the classic type because it is able to project target levels very precisely within only a few ticks and is also capable of identifying highly profitable, low-risk trading opportunities. But, you may ask, "How is that possible?"

I can tell you that, over the last few decades, the mastery of some market operators has given birth to a number of highly profitable trading techniques, such as the Relative Strength technique (not to be confused with the RSI indicator), Elliott Waves, Wolfe Waves, the original and efficient Gann and Jenkins methods, integrated pitchfork analysis and others.

More details about the two types of technical analysis (classic and modern) can be found in my three professional trading manuals.

Now, let us proceed to the study of the evolution of the U.S. market, as well as the Romanian market.

As you will clearly see in the following charts, I started with classic technical analysis tools -- mainly chart patterns and trend lines -- with an emphasis on modern technical analysis: elements of integrated pitchfork analysis with a clear focus on:

- The Relative Strength of various trading instruments (2 to 5)
- Cash flow
- Fibonacci and Gann methodologies
- Bollinger and Keltner volatility bands

As of the first writing of this article, the Dow Industrial Index has managed to break above the 11,258 key level -- the last high -- generating a surge of momentum for a number of days, but, unfortunately, the volume didn't follow (see Figure 2). This move brought the market up to the 11,452 level, only 3 points shy of the 11,449 level, which satisfied the classic Elliott relationship (W3=1.382*W1).

Can we assume that this breakout was just a "flash in the pan"?

At this point, it is a bit difficult to issue a clear verdict because, after touching the 11,452 level, the market retraced below the 50 percent threshold -- the 11,301 level -- corresponding to the diamond pattern's up thrust.

Figure 1. The Monthly Chart of the Dow Jones Industrial Index

The monthly chart (Figure 1) reveals the following:

- The 31 January 2000 high, at the 11,750 level
- The 31 May 2006 high, at the 11,670 level
- The 11,617 key level that corresponds to the retracement of wave (B), up to the 66.6 percent threshold

In conclusion, we can state that this so-called "flash in the pan" is invalidated if the Dow Jones Industrial index continues on this ascending path and even climbs above the 11,617-to-11,750 multi-layer cluster zone (let's call it Cluster A).

Figure 2. The Daily Chart of the Dow Jones Industrial Index

The daily chart (Figure 2) reveals the following:

- The 11,575 - 579 cluster, corresponding to the diamond pattern's up thrust to the 66,6 percent level, also satisfying the classic Elliott relationship (W3=1.50*W1) applied to the primary wave (B)
- The 11,708 - 713 cluster, corresponding to the diamond pattern's up thrust to the 75 percent level, also satisfying the classic Elliott relationship (W3=1.618*W1) applied to the primary wave (B)

If, however, this "flash in the pan" is validated and the Dow Industrial index retraces below the 11,258 cluster zone (let's call it Cluster B) on a closing basis, we can safely say that the short-term interventionist Fed policy has lost a great deal of its initial momentum. The risk of a renewed descending move becomes, therefore, significant, but, this time, it can have a devastating strength.

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