Chapter 4

How to stay on the right side of the market:

Before we proceed further there are a few other things you need to know about markets.

To WIN at trading you have to view market price action on levels that reflect the MINOR – MEDIUM and MAJOR degree. This approach is in tune with the principles of Elliott Wave teachings and also Gann methodology to market analysis. Elliott Wave basically teaches us that market movements have binding structures that unfold in 3 to 5 wave sections, where each section will relate mathematically to the past sections.

It is possible to break market swings into smaller, small, MINOR, MEDIUM, larger and MAJOR.

Now the point is that markets move in swings up and down, and as they go they are said to IMPULSE or CONTRACT as the trader moods constantly change from good to better or from good to not so good. In down markets moods change between bad and getting worse to not so bad and maybe things are getting better. The MAJOR degree is either good or not good. And so goes the fate of the market as you move down in each swing degree.

It is your job to determine what the market has to do to tell you if we are moving from one swing degree of good to better or not so good, or from one swing degree of bad to worse or maybe better now.

So if you analyze the market PRICE ACTION and swing degree from weekly back to 5 minute you should get the right answers about the most probably direction the market is about to take in the next trading session. If you follow my rules for defining swing degree the market should guide you along and meet all your expectations. The main objective is to trade with the current swing flow until the market confirms any change.

Double bottoms in an uptrend can be considered higher lows. Double tops in a downtrend can be considered lower highs.

If the market makes lower highs or lower lows by breaking below or above prior pivot points by anything outside of a false break the situation must be taken on board for what it represents by my rule book.

The following concept is non-negotiable if you want to trade by my rules.

CAVEAT 1:
The TREND is UP in each degree when the market is making higher highs and higher lows and the indicators remain steadily overbought.
The TREND is DOWN in each degree when the market is making lower highs and lower lows and the indicators remain steadily oversold.

CAVEAT 2:
The TREND is UP in each SWING degree as long as the corrections in that degree do not exceed the prior corrections of that degree in amplitude (points lost) on a continuation basis.
The TREND is DOWN in each SWING degree as long as corrections upwards in that degree do not exceed prior corrections of that degree in amplitude on a continuation basis.

CAVEAT 3:
Now this is a little more complex. It has to do with the OEX and the SPX.

The top 100 stocks in the SPX 500 stocks also have their own index known as the OEX. These 100 Blue Chips represent 60% of the total SPX content.

The other 400 stocks in the SPX only account for 40% of the total value of the 500 stocks in the SPX as they are well less capitalized.

The OEX stocks therefore have a 3:2 influence over where the SPX and the ES go at anytime. Simply because the ES will never trade in day time sessions far outside its premium or discount borders based on fair value to cash. If it does and the cash SPX is not confirming the arbitrage computer programs will buy and sell stocks and futures at the same time to bring everything back into line.

So it is very important to monitor the OEX for its relative technical position to confirm your thoughts about the directional possibilities for the ES and the SPX.

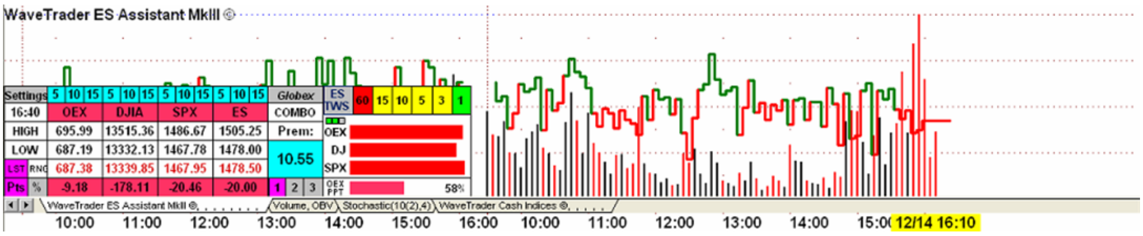
The main point to learn is that when the OEX and the SPX are both strong in the same direction the SPX and the ES will move faster in that direction.

When the OEX is slow moving the SPX and ES will also move a lot slower.

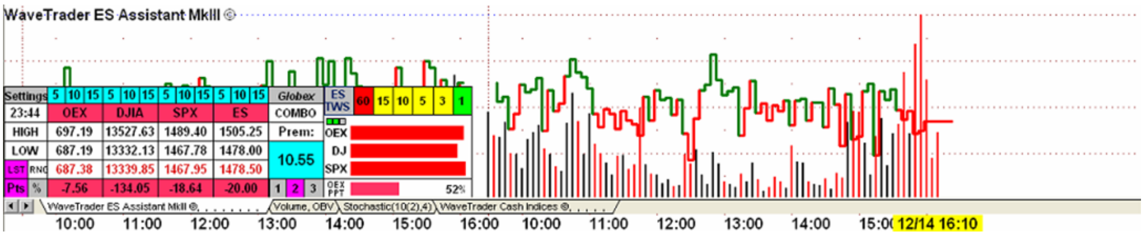
Also you need to remember that the 500 stocks in the SPX can also be segregated into SECTORS of interest. Fund managers have sector trading programs and can rotate from sector to sector as they see better value elsewhere.

In times of stress money will rotate from lesser capitalized stocks into the "blue chips" sector.

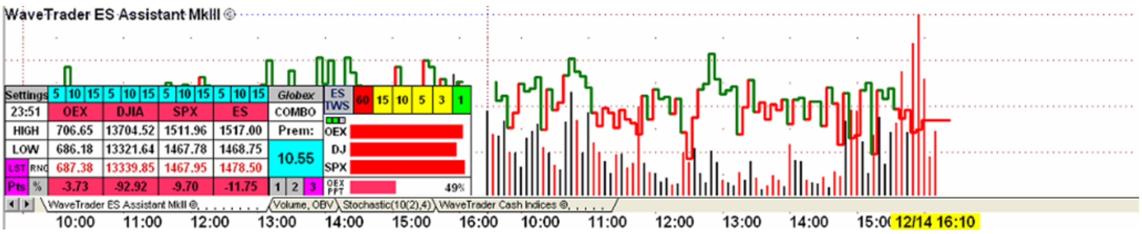
The basic approach I take to the market each day is to calculate the MOB levels (Make or Break) for the OEX, SPX and ES. Then once the cash markets are trading follow the strength or weakness in the OEX and compare it to the performance of the SPX.



This snapshot of my WT Assistant was taken at the end of the trading day. In the bottom right corner you will see an OEX PPT gauge indicating a 58% reading. This means that the OEX stocks generated 58% of the total move today in the SPX. Basically this is what they should have done and demonstrates an orderly across the board weighting to the movement in the SPX.



This next shot shows the OEX PPT over a two day period at 52% which indicates the OEX had less participation in the SPX losses and not up to the full weighting you would expect from this index if the down trend was being driven by the OEX.



This third shot shows the overall losses for 3 days and the OEX PPT for the period at 49% indicating an under performance in the downtrend by the OEX.

It could also indicate that as the market has been falling there has been a small rotation going on between broader market stocks and back into "blue chips"; which has had the effect of lessening the force of the decline in the overall SPX and ES over these past 3 days. It also tells us that that the present decline is not life threatening to the bull department at this stage.

What you will learn is the best directional moves come when the OEX has a high PPT in the SPX direction. So it is important for you to monitor the OEX to get a clearer picture of things as the new trading day unfolds. When the OEX is participating at over 70% or more of the SPX direction it gives you the opportunity load up some extra contracts.

Some traders follow the total number of stocks UP DOWN or UNCHANGED as an indicator of the market internals but I don't concern myself with that as it is trivia in my book.

When the market is going up you should expect the "blue chips" to lead. When they cease to lead it means they are assumed to be at full value and this alerts you to the possibility of a correction or sideways market activity ahead.

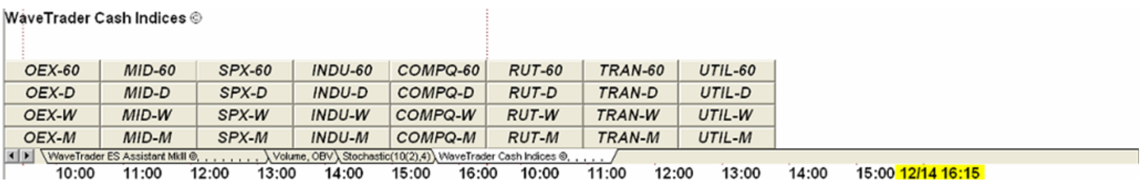
The reason for this may not be obvious to new comer's but there is always a rotation process going on in physical stocks amongst fund managers, but when they come out buying without any rotation in mind the trend is going to be much more dramatic.

Of course the same situation also applies when the market is going down. If the "blue chips" are over participating it means they are being sold off to raise cash, maybe for redemptions if the downtrend has developed into anything serious.

Usually when investment managers are rotating from one sector to another they cause the market to become a little stagnant when moving from blue chips to broad market stocks. Or they can cause the market to be buoyant if they move from the broad market stocks into blue chips.

Generally in bearish trends the investment managers will move from lower cap stocks into blue chips for protection. At the end of a bearish trend they will move more money into lower caps as these will have generally suffered more and will offer greater potential value.

You can work out when they are doing it because the charts will tell you.



As part of my analysis arsenal I have instant access to the following tickers in 60 minute, daily, weekly and monthly. The MID and the RUSSELL generally give you a good idea of how the mid caps in the market are performing.

THE REAL ISSUES of Caveat 3 are:

The trend in the OEX versus the SPX is extremely important and I can tell you very simply if you want to stay on the right side of the ES futures market it is so important for you to listen to what I am saying.

I can give you a lot of examples and you will know why, but it is better for you to do some work for yourself and then you will get the idea; if the high end of the market is moving in the same direction as the low end the market is broad based in its direction. If it isn't there is a lot of rotation between sectors.

The implication of course is that the market perceives one side or the other is reaching overvaluations or under valuations and you will begin to see adjustments to portfolios when the fund managers identify the situation.

For the moment I am going to show you a period where the OEX stands out as the leader after the SPX made a severe pull back and then rallied to new yearly highs. You can never underestimate the power of the "blue chips".

The price move in the OEX was much stronger after the breakout of the May 2006 highs as the OEX was the leader and the broader market was less attractive to investors after it had had larger overall gains into May 2006.

Now if you peruse these last 2 charts you will see the improved performance in the SPX when the OEX is moving strongly, meaning rotation to "blue chips".

A 1 point move in the OEX adds or subtracts approximately 1.4 points to the SPX index.

The things I will teach you about PRICE ACTION in the market will never change, they will endure forever in time.

The first thing you need to learn about the markets in general is the levels traders consider to be IMPLIED RESISTANCE & IMPLIED SUPPORT as it moves along its natural path guided by outside influences and the actions of the buyers and sellers.

We will address these in the following chapters.

Gann's famous statement was, "there is nothing new under the Sun". I believe it and I am sure I can convince you to believe it, especially when it comes to market behavior.