

## USING ACTIVE AVERAGES

A vital component of our price action model is that of activated averages. An average in any particular time frame becomes 'active' when momentum pushes price such that the average directional index (ADX) is pushed above the 16 level and preferably equal to or greater than the 30 mark. Once above the 30 mark price, on a price retracement back towards the moving average, that moving average should act as price support/resistance in an uptrend/downtrend.

The minimum target of this move when the retracement has run out of volume is the previous high/low. Price often moves much farther than this depending on the market environment (i.e. what the longer-term price charts are doing). This is the basic model of active averages; there are many refinements and chief among them are market environment, price interrelationship with other indexes, economic views, the behavior of large commercial interests, and other factors all of which assure the trader that no approach will always work in the market.

The best we can do, as traders with relatively small capital, is to quantify the market as best we can on any particular market open, or shortly thereafter. If the market qualifies, the concept of active averages can become a low-risk, very high profit approach.

Quantification goes beyond this basic outline and includes: daily volatility characteristics, news, intermarket analysis, gap size, direction, etc.

An excellent example of the application of active averages occurred on October 28th, 1999. The market environment at the close of the 27th is illustrated by Figure 1 entitled "30 Minute Market Environment."

As shown, there were three large pushes down in price at the points labeled A, B, and C. The attempted retest of the low 'A' on the 25th at the end of the day was on substantially lower volume than typical. The lower low at 'B' was also on low volume. The move down at 'C' was met by substantial supporting volume by the larger commercial interests.

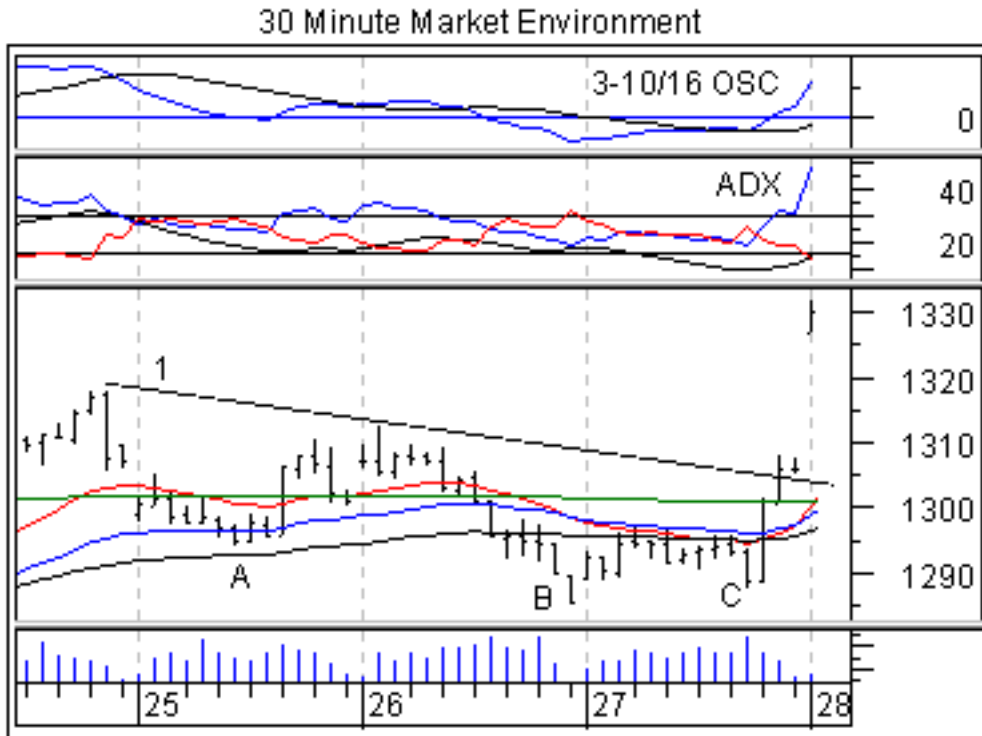


Figure 1

The strong move up at the end of the day on the 27th was on reduced volume yet price did not move down. Additionally, note that the 27th was an inside day. Price was, at the time, in a long-term consolidation zone with much resistance above the highs, even though price had tested higher and lower than the consolidation.

The open on the 28th was on a 21.00 point gap up above strong resistance which had now become strong support. Note that as price moved up on the afternoon of the 27th, a multiple-day down trendline labeled 1 was broken and the 30M ADX was moving off its lows (and was above 16 within the first 30 minutes on the 28th) At the same time as price broke the down trendline, price also moved above the 20-period exponential daily moving average. These factors combine to indicate a very strong move up.

The size of the gap on the 28th is significant. Statistically, in the S&P 500, a small to moderate size gap should be faded. A small to moderate gap in this case is based on average true range. A large gap however should be traded in the direction of the gap.

Our next chart (Figure 2) labeled "Buy Indications for October 28th, 1999" is a 3-minute chart of price action and the up arrows show the buy points as

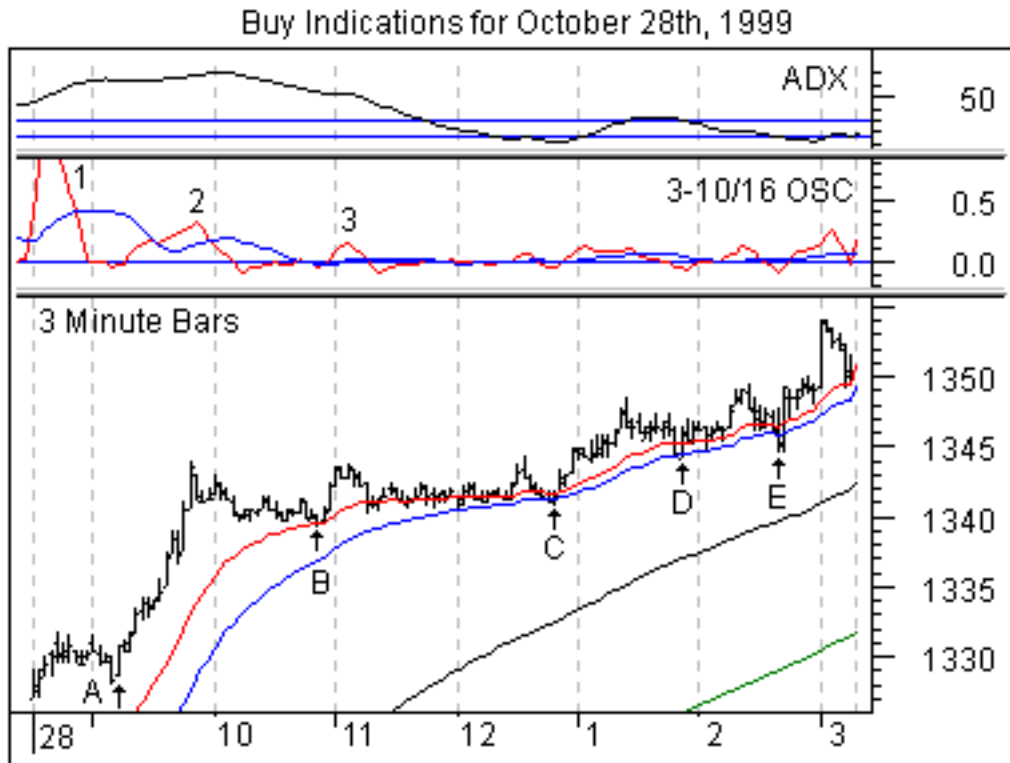


Figure 2

given by the active averages. The letters A through E associated with the arrows correspond to the arrows on the 1-minute charts. As one can easily see, price moved up from each of these points and most trades were profitable almost immediately except D, which occurred around the closing of the Treasury Bonds. When market conditions are right, this approach, as shown by this chart, works extraordinarily well.

Our next chart (Figure 3) is titled “The Opening” and is a 1-minute chart as are the balance of our charts in this series. This is the opening price action on the 28th after the large 21.00 point gap up. The natural tendency for most traders is to short this early price action based on the structure with three pushes up and labeled 1 through 3. Realize that the target for this move down is initially at maximum the distance from the low (labeled a) to the high of peak 1 (labeled b), or about 4.50 points. This is where experience, discretion, and a sense of balance comes into play.

Given the price action at the close of the previous day, the large opening gap, and the other market environment considerations, one should not short



Figure 3

this market based only on what we see here. And indeed, if one were to short the peak at 3, the trader would be lucky to break even.

As price moves below the 1M average, price moves into the 3M Zone. This is the area between the 1M average and the 3M average. If the 3M ADX is at 30 or above and price is not in consolidation or going into consolidation, then the 3M average is termed “active” and should force price to retest the highs, at a minimum. The 3M ADX was above 60 at this time -- a very high reading, Price consequently reversed and moved above the dashed support line at 1329.30, tested the 1332.00 high and moved 15.00+ points higher. Note the positive divergence of the MACD histogram compared to price.

Price moves 15.00+ points higher and then goes into a tight 2.00 to 3.00 point consolidation zone as evidenced by price’s indifference to the 1M

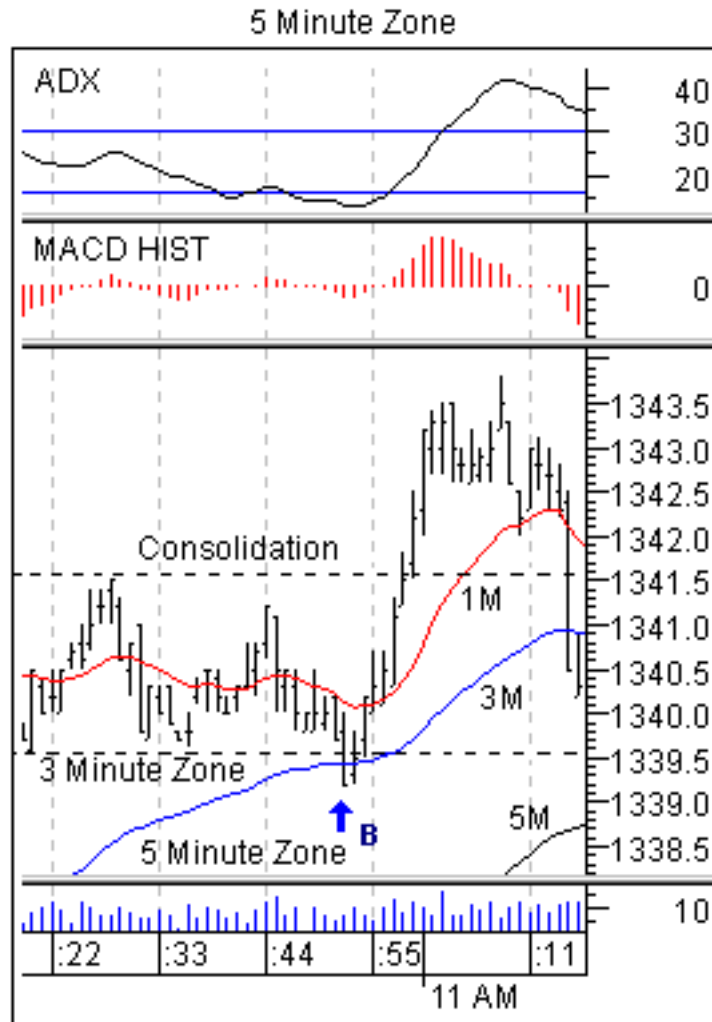


Figure 4

active average. There are additional reasons for the formation of this consolidation which is beyond the scope of this discussion. Refer to Figure 4 – the 1M chart titled “5M Zone.”

As price exits the bottom of the consolidation zone at 10:52 CST, it immediately moves into the area between the 3M average and the 5M average - the 5M Zone. When price moves into the 5M Zone and the 5M average is active, as it is in this case, price should retest the highs (the 1344.00 level in this case). This is precisely what happens. Price attempts a retest of the highs but falls just short of the high.

An aside here: Looking back at Figure 2 – “Buy Indications for October 28th, 1999,” note the three peaks on the 3-10 price oscillator (shown with a 16-period simple moving average and labeled 1, 2 and 3). Typically in a

weak or consolidation market, price and/or an oscillator will make three peaks or lows and reverse. These particular peaks are potent for two reasons: their peaks are descending, forming a powerful negative divergence with price and the cycles of the peaks are the same. (If something should occur but does not, such as a move down in this instance, expect the opposite to occur). Instead price moves sideways into another consolidation zone. If price cannot move lower on three divergent peaks with price, then this must be a very strong market.

For those not familiar with our concept of recurrent structures, you should review the following Mentor Updates: Issue 5-3, Trading the Short Term Recurrent Structure; Issue 5-1, An Entry Technique for Trending Price Action; and Issue 3-1, Introduction to Structural Recurrence. These Mentor Updates will give you the conceptual background and practical examples for the next part of our discussion.

Refer now to Figure 5 – the 1M chart “15 Minute Zone.” Price is in consolidation and moves a couple of points higher. Is the market moving higher without us? The tendency is to go long on the move up. This, however, does not fit our established recurrent structure. What is happening is that price is testing the high of the consolidation zone and reverses at the top. Price now moves down to the area between the 5M average and the 15M average - the 15 Minute Zone. The 15M average is active (its ADX is greater than 30) and price moves higher -- much higher just as our recurrent structures say it should. Price breaks through the top of the consolidation and finds support at the top of the consolidation zone.

At this point, the 1M average has become reactivated (as shown by the movement of the ADX above the 30 level). Also on the 15M Zone chart note the structure formed by the price action at 1, 2 and 3 and its relationship to the top of the consolidation zone. We will see this price action recur soon.

If you look at a 15M, 3-10/16 price oscillator at this point in the day, you will see that the oscillator has moved below a new 16-period average high. This is a powerful sell signal in many cases but is neutralized by the market environment factors mentioned at the beginning of this topic. The oscillator then makes three pushes down without price selling off. The 15M ADX has now moved higher and can again move price higher.

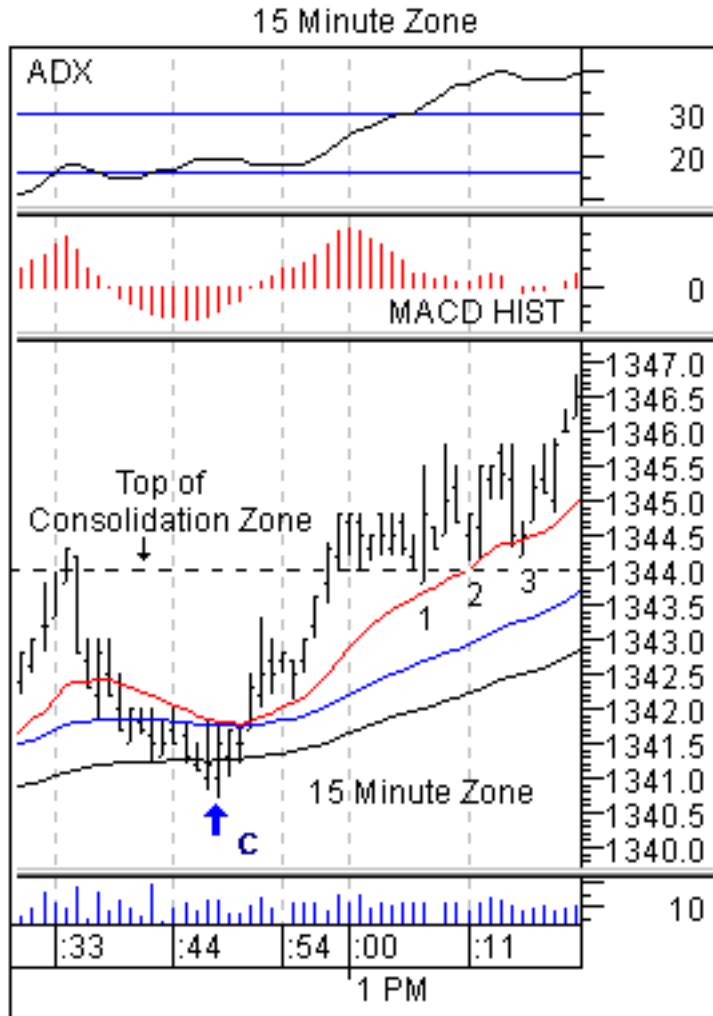


Figure 5

Again, refer to the 3M Buy Indications chart – Figure 2. At approximately 1:30 CST price has made a new high and has again gone into consolidation (as evidenced by its indifference and cycling on either side of the action 1M average). Will price now progress down to the 30M Zone and reverse? Probably not since price action is so strong and the 30M Zone is quite distant. We also have the Treasury Bond closing here at 2:00 CST. On the next chart (Figure 6) titled “15 Minute Zone Redux” note that price moves into the 15M Zone and price reverses sharply back up at D. The best course here is to wait.

Note the similarity of price action here at 1 through 3 as on the 15-Minute Zone chart (Figure 5). We should expect price to move higher here. The 15-minute time period has become the “controlling time frame.” Expect price to

be supported by the controlling time frame zone each time price moves to that zone. As price moves higher and the trend weakens, expect price to move deeper into the zone until a longer (or shorter) time frame becomes the controlling time frame. This can be caused by negative divergences in the 15M or longer time frames. In the case of a shorter time frame becoming the controller, positive divergences would usually precede price action.

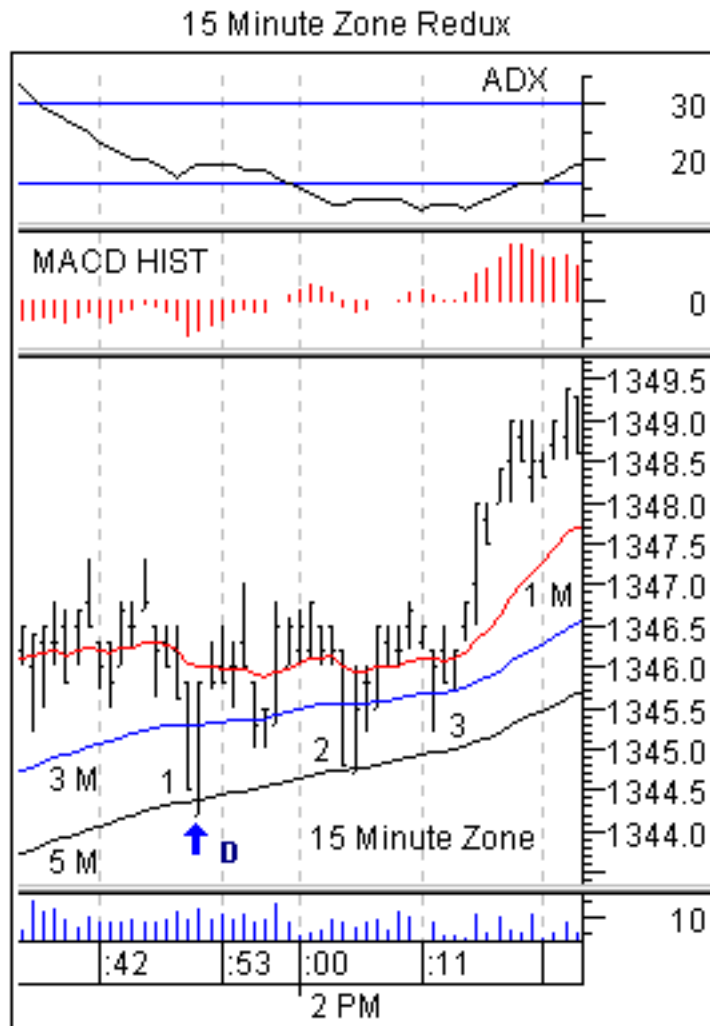


Figure 6

Our final 1M chart (Figure 7) shows price action late in the day and is titled "Near Close October 28th, 1999." Here price has moved farther into the 15M Zone and sharply reversed, making new highs in the process.

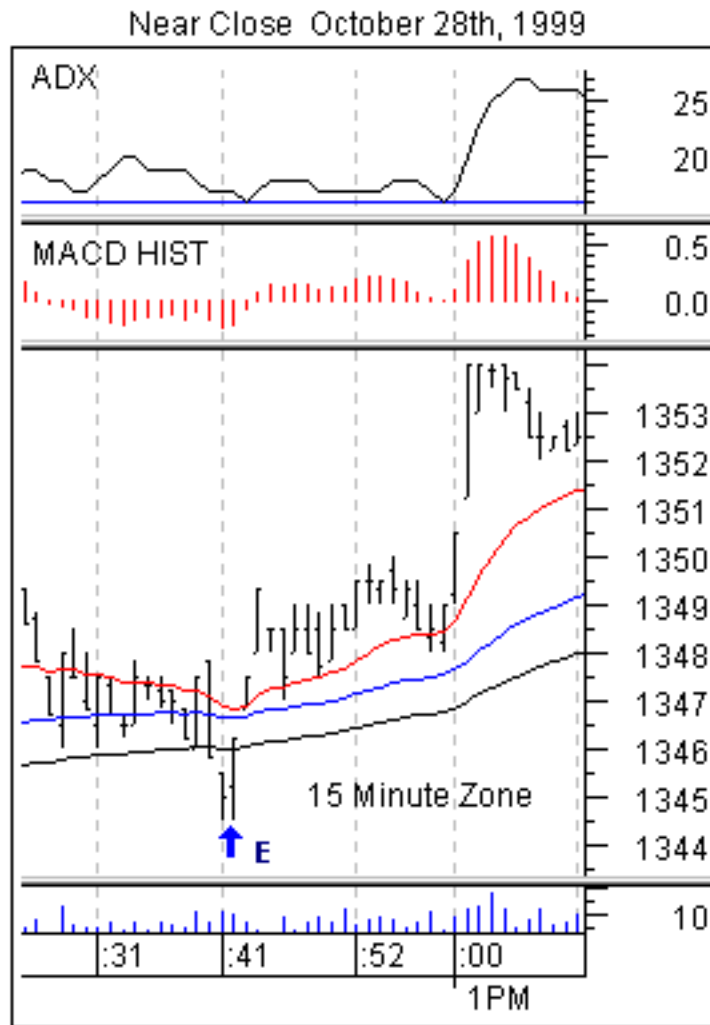


Figure 7

The concept of active averages and moving average zones is very potent if used in the appropriate market environment. Excellent entry points become easily recognizable and often point to very low-risk setups. Optimally, when daily volatility characteristics suggest a breakout possibility, an early entry can often be managed. With patience, the trade can be held very long term and added to, as price retraces into active zones.