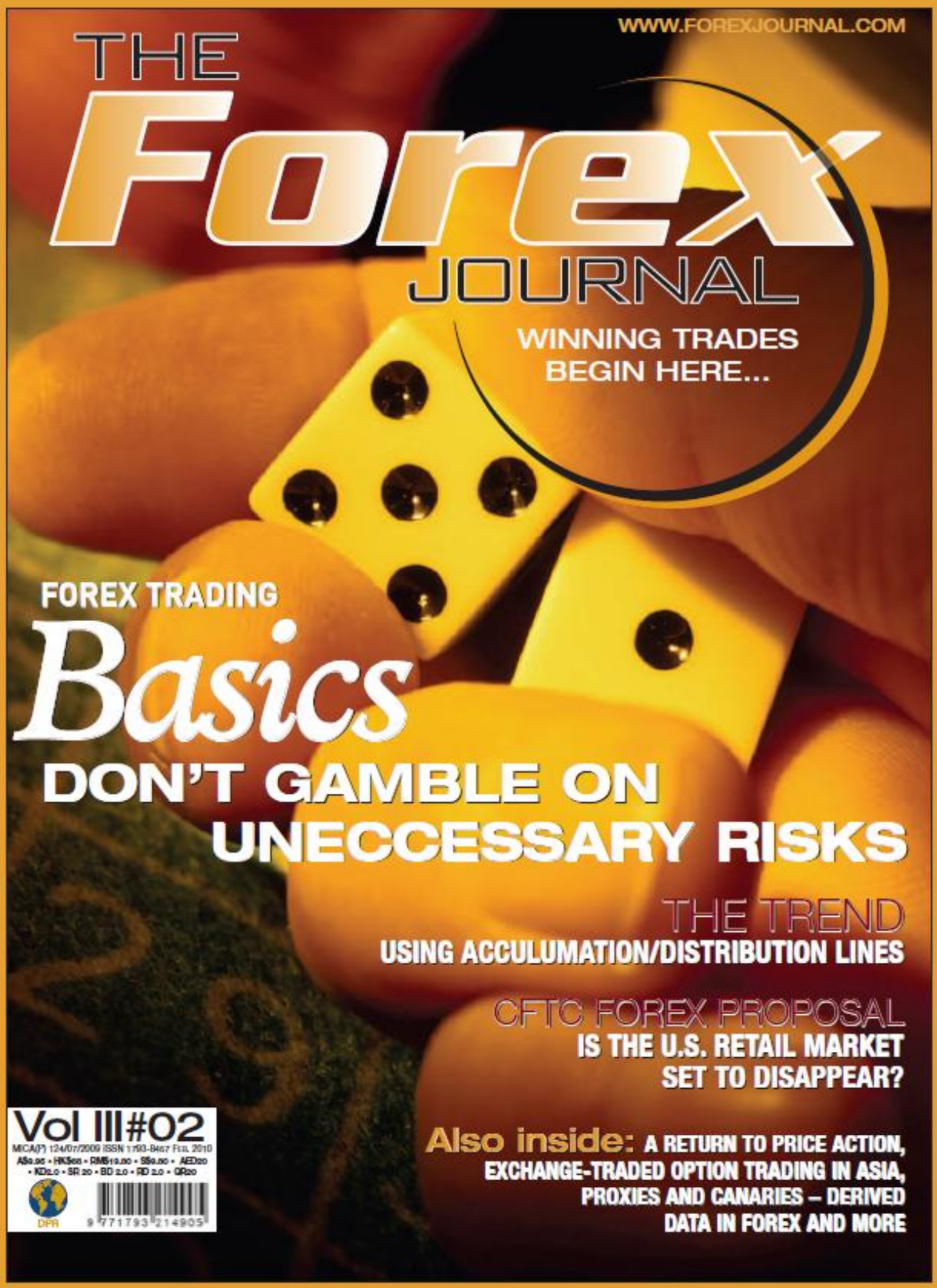
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SMART BASIC CHART READING

How valuable would it be to know when a moving average is going to cross two or three days in advance? Ron Schelling provides insight into two indicators that can be used in daily market analysis.

IN THIS ARTICLE, I WILL REVIEW TWO SPECIAL INDICATORS AND SHOW HOW TO USE THEM IN YOUR DAILY TRADING.

Detecting a Moving Average Crossover before It Happens

We all know the many ways that moving averages can be used in basic chart reading, but have you ever wished to know when the moving averages would crossover earlier? I am going to show you a way to detect moving average crossovers before they actually happen. Knowing that the moving averages are going to crossover gives an edge over other traders who simply follow the signals after the fact. You can take advantage of the extra time this knowledge gives you to cross check other confirmation signals, price your orders better, etc.

The following chart *(Chart 1)* shows the 20-period and 50-period moving averages.

ILLUSTRATION GERALD MURPHY

The PriceToCross indicator is calculated with the following formula.

```
P2C
$period1 := 20;
$period2 := 50;
ma1 := average (data1, $period1);
ma2 := average (data1, $period2);
$period1 * $period2 / ($period2 –
$period1) *
(ma2 – ma1 – data1 ($period2 – 1) /
$period2 + data1 ($period1 – 1) /
$period1);
```

PriceToCrossFromClose is the subtraction indicator taking the difference between the PriceToCross indicator and the data series close values.

SMACross indicator is the Crossed indicator that shows the crossover signals generated by SMA20 and SMA50. It is colored red.

PriceToCrossFromCloseCrossZero is the Crossed indicator that shows the crossover signals generated by *PriceTo-CrossFromClose* and the Zero line. It is colored green.

Notice that the green signals happen before the red ones. The green signals predict the occurrence of the red signals.

In general using the predictive method, you get the signal one bar ahead. For some situations, the prediction occurs 2 to 3 bars ahead. For steep turning points, the predictive method will happen at the same time as the actual signal. The predictive method never lags the actual one.

Using the predictive method, where P' crossover zero, sometimes generates false signals as the actual crossovers between the moving averages do not materialize. Here is a chart *(Chart 2, next page)* showing 2 false signals.

On the morning of March 3rd, the moving averages are close together for multiple bars, thus the P' that we have also jittered around the zero line, producing the false signals.

This technique can be utilized with all moving averages, not just applied to price. For example, if you trade stochastic signals, if you use two (2) simple moving averages to smooth your indicator, you can utilize the same concept presented here for early crossover detection.

The Relative Price Indicator

The Relative Price indicator is an indicator demonstrating a less known technical analysis techniques called Relative Price Analysis.

Relative Price Analysis is the study of the value of a financial instrument relative to another financial instrument.

A common use of this analysis is to look at the ratio between a stock's value and its sector index to determine if the stock is relatively stronger or weaker to the overall performance of its industry.

Chart 2 – False Crossover Signals

SOURCE: METASTOCK SOFTWARE

Another use of this concept is to study the relative valuation of a financial instrument based on a reference instrument that is deemed to have better objective value. For example, many people like to chart various stock market indices relative to the price of gold.

There are 2 standard ways to determine the relative value – the Ratio method and Percent Change method.

The Ratio Method

The Ratio method divides the instrument of interest by the reference instrument. The resulting data series is an abstract series that is good for normal chart pattern comparison, potential divergence identifications, etc.

The Percent Change Method

The Percent Change method requires a starting date as the reference valuation point. From this point, the percentage change from the reference value is applied to the instrument of interest.

EXAMPLE 1 (CHART 3)

This example shows the Dow Jones Industrial Average relative price based on the Philadelphia Gold/Silver Sector Index (XAU). By setting the starting date to January 1, 2008, and the scaling method to Percent Change, I am able to review the index from a very different perspective.

EXAMPLE 2 (CHART 4)

This example shows the S&P 500 index relative price based on the U.S. 30-Year Treasury Yield index using the Percent Change method.

EXAMPLE 3 (CHART 5)

Using the Ratio method, the relative price indicator shows the ratio between the S&P 500 index and the NASDAQ 100 index. In this example, the indicator is changed to plot the close line only as opposed to showing meta bars. TFJ

Ron Schelling is an independent trader in The Netherlands with over 25 years experience trading Forex and futures arbitrage trading. Ron

"For steep turning points, the predictive method will happen at the same time as the actual signal. The predictive method never lags the actual one."


^DJI_D1
Chart 3 – Percent Change Analysis
13,950
12,400
10,850
9,300
7,750
6,200
^XAU_D1
210
180
150
120
90
RelativePrice
13,026
10,261
7,536
4,791
2,046
Jan 2 2008
Jul 1
Jan 2 2009
Jul 1


^GSPC_D1
Chart 4 – Percent Change Analysis
1,630
1,360
1,190
1,020
850
680
^TYX_D1
5
4.50
4
3.50
3
RelativePrice
1,520
1,330
1,140
950
760
570
Apr 1 2008
Oct 1
Apr 1 2009
Jul 1


^GSPC_D1
Chart 5 – Ratio Analysis
1,300
1,170
1,040
910
780
650
^NDX_D1
2,090
1,900
1,710
1,520
1,330
1,140
RelativePrice
0.760
0.740
0.720
0.700
0.680
0.660
0.640
0.620
Oct 1 2008
Apr 1 2009
Jul 1
SOURCE: METASTOCK SOFTWARE