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Technical Analysis

To Play TA, You Have to Adapt

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Everyone is talking about how the market is broken these days, with supply/demand destroyed by rampaging program algorithms. It's hard to argue against the conclusion, given last week's crazy tape, but charting works just as well now as it did two weeks or two decades ago -- picking out price levels where market inefficiencies signal trading or investing profits still works.

It's lazy for the trading community to complain about an uneven playing field, rather than make the adjustments needed to prosper in this digital world. It's a different story for investors; as *RealMoney* contributor Tim Melvin has pointed out so well in recent years, that discipline has been permanently altered by our fast-fingered derivatives-driven market culture.

But charting guys and gals have no one to blame but themselves if they can't find classic technical structure within the volatile price swings. This has always been true; market prediction has never worked according to the simple scripts or formulas promulgated in the old-school TA books.

Charts and indicators make no predictions. Instead, they point to price levels of high probability, in which complex events can trigger breakouts, breakdowns, reversals, follow-throughs or indecisive periods. The interpreter needs to take these raw data and translate it into a definable edge that produces consistent profits.

Es -- 60-Minute
Source: eSignal

I'll make my case with a 60-minute chart of the 24-hour **S&P 500** index futures (the Es). In recent years, it's been common for downtrends to find resistance at the 50-bar exponential moving average. That didn't change after the bottom dropped out on July 26, with every bounce into Aug. 9 stalling at or near that mean-reversion level.

The single penetration of the moving average (red rectangle) on July 31 stopped momentum dead in its tracks, yielding a failure swing in the following session. This is another commonly observed phenomenon, often providing a decent short sale; the entry signal triggers when price breaks the moving average in a small-scale failed breakout.

Now look at the recovery attempt that started on Aug. 9. The 50-bar EMA acted as a price pivot (red circles) eight times in the next three sessions, perfectly illustrating a natural thrust and testing process that was transparent to any trader willing to set aside their frustrations and watch the process unfold in real time.

I didn't discover this algorithmic footprint during the current decline. I've actually been using it as a trading tool for four years now, starting back in the summer of 2007. That time period is highly instructional for market players wanting to understand the evolution of high-frequency trading and the ways we can thrive in this digital environment.

Es -- Daily
Source: eSignal

The market hit a multiyear high in July 2007 and then sold off in a wicked decline that bottomed out in August. This was the first time that algorithms were blamed for a big selloff, and for good reason. We found out afterward that software engineers had failed to make adjustments for volatility before unleashing their programs on the falling market.

Coding changes were implemented and perfected during the bear market ... or so they thought. The May 2010 "flash crash" proved otherwise, when the system collapsed due to a vacuum in order depth. In other words, if algorithms back away and shut down their systems, the market crashes because there aren't enough human traders to maintain the auction house.

The 2011 decline shows how algorithms have adapted to the "flash crash." Look at this real time e-mini market depth chart, from data-feed provider Nanex. August depth shows clearly that HFT now stays in the game, adapting to rising volatility by thinning quote size. Add in massive phantom quoting, which vanishes when orders get hit, and you have the price discovery mechanism that now dominates our markets.

In response, I've created a simple volatility filter that gets me on the sidelines when the order book thins out, and gets me back in when depth of book returns. The adaptation is simple for any strategy, yet it requires a level of discipline that most traders will fail to achieve:

1. Daytrade or cut overnight size by three-quarters when the CBOE Volatility Index (VIX) is over 25, rising, and above its 10-day simple moving average (SMA).

2. Resume normal strategies when VIX is above 25, declining, and below the 10-day SMA.

3. Resume trading strategies when VIX is below 25.

In conclusion, if you want to stay in the trading game in 2011, it's time to stop complaining and start adapting with new tools. There's still a ton of money on the table, ready to be scooped up by those willing to live in peace with the digital markets.

At the time of publication, Farley had no positions in the stocks mentioned, although holdings can change at any time.

Alan Farley is a private trader and publisher of Hard Right Edge, a comprehensive resource for trader education, technical analysis, and short-term trading techniques. He is also the author of The Daily Swing Trade, a premium product from TheStreet that outlines his charts and analysis. Farley has also been featured in Barron's, SmartMoney, Tech Week, Active Trader, MoneyCentral, Technical Investor, Bridge Trader and Online Investor. He has written two books: The Master Swing Trader and The Master Swing Trader Toolkit: The Market Survival Guide, due out in April. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks.

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