How to evaluate the strength of a trend

This document was written in October, 2009 by Pascal Willain as part of a training program on the use of the Effective Volume tools.

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The author is French speaking.
This report has not been proof-read for the proper use of English language.

Two days ago, the 20DMF/SDS combination pushed us to the short side.

After a sharp fall, the S&P500 seems to have now regained its footing around its 50MA.

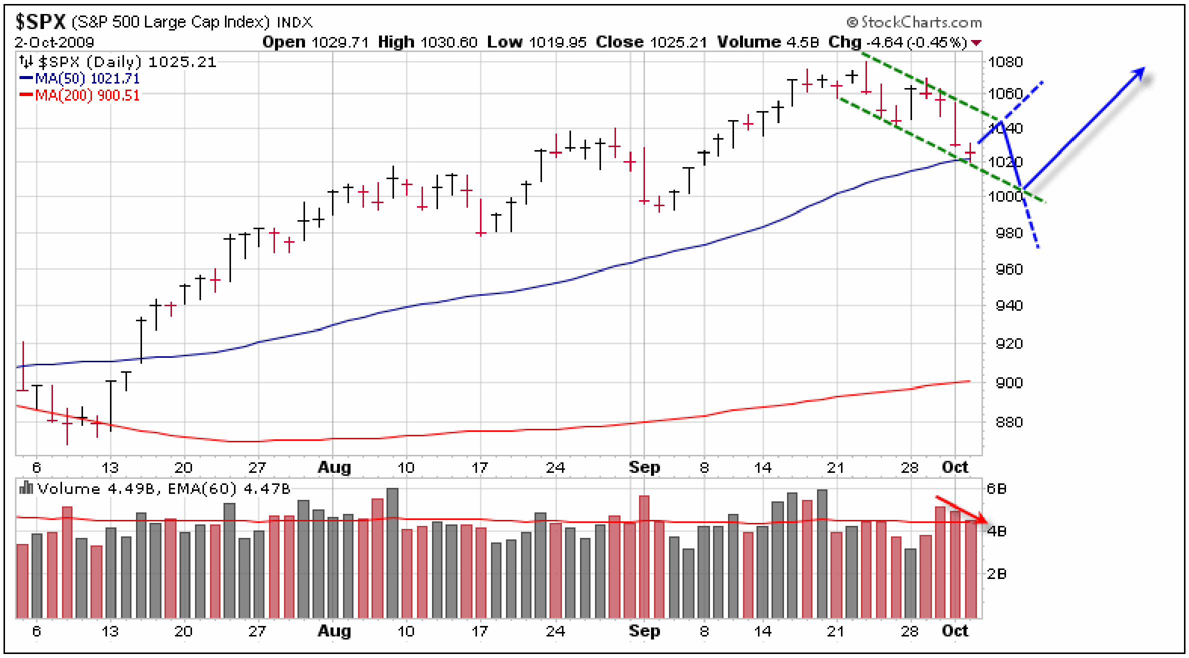
Since many sectors show a slight positive divergence, this indicates that a reversal is probably coming.

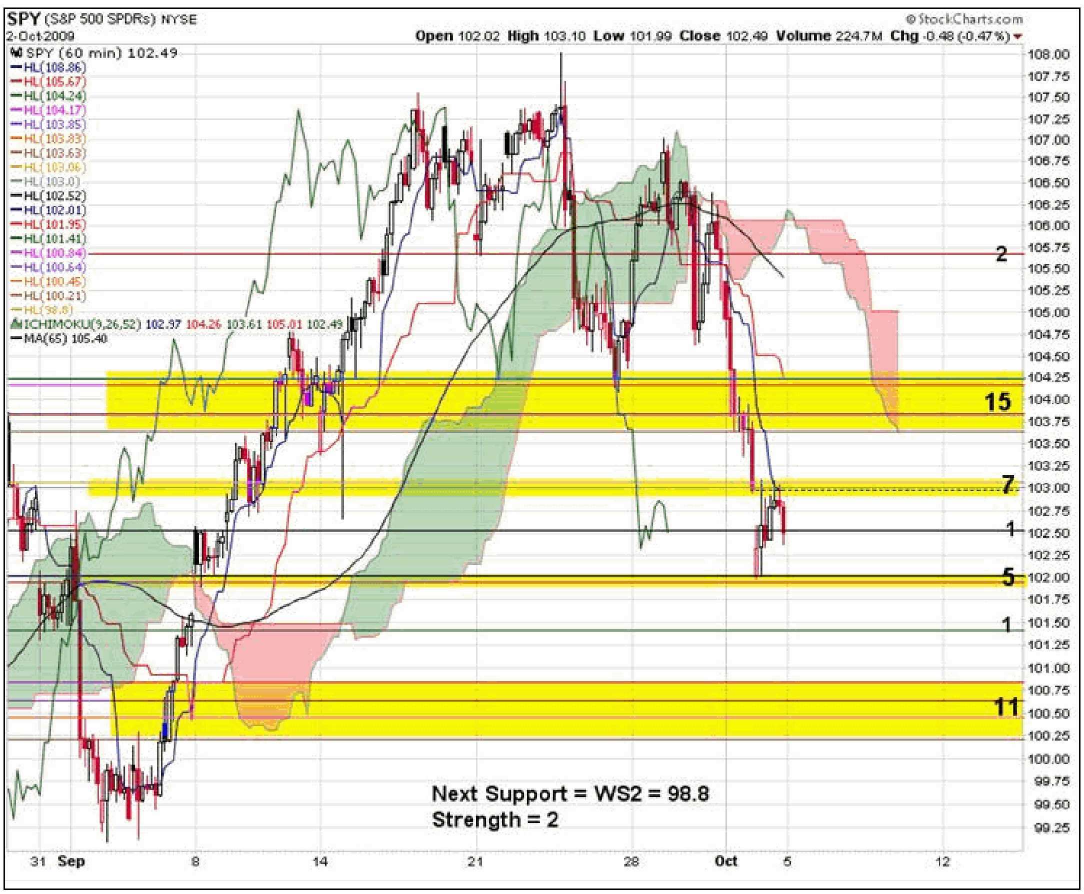
We can summarize the situation as follows:

1. The big picture is a still valid uptrend (the 50MA is not broken)

2. The intermediary trend (green dashed) is down. This has been pointed by the 20DMF and the fact that this signal is sharply down indicates that this intermediate downtrend is quite strong: money is leaving the market with a force that is seldom seen (the last time we had such a vertical down move in the 20DMF was last September)

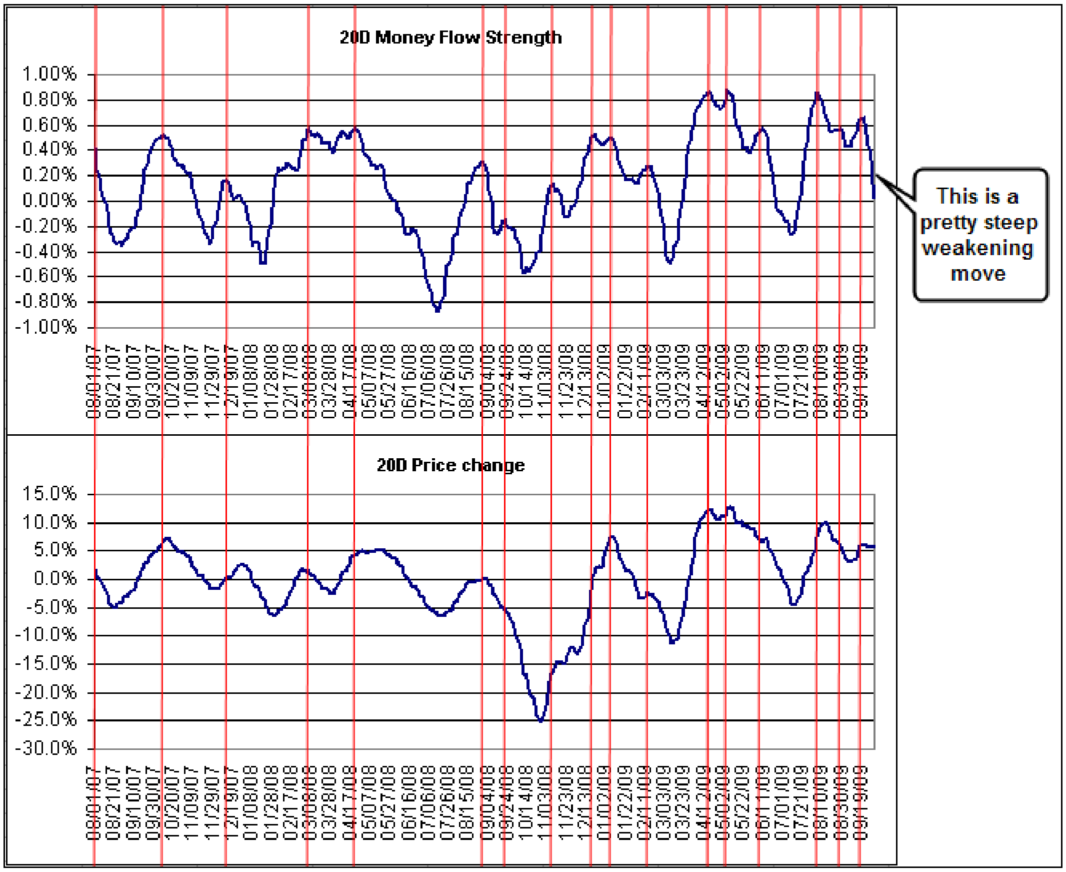
3. The ripple (in blue) shows a reversal that has the potential to at least visit the upper band of the intermediate trend. This upper band corresponds to the "15" resistance zone in the now famous Billy's pivot point analysis. We might break that resistance or we might not. If we do not break it, the next support level will be the "11" around SPX at 1000, which is exactly the next bottom of the green downward trend (text continues below the figures)


$SPX (S&P 500 Large Cap Index) INDX
© StockCharts.com
2-Oct-2009
Open 1029.71 High 1030.60 Low 1019.95 Close 1025.21 Volume 4.5B Chg -4.64 (-0.45%)
$SPX (Daily) 1025.21
MA(50) 1021.71
MA(200) 900.51
Volume 4.49B, EMA(60) 4.47B
6 13 20 27 Aug 10 17 24 Sep 8 14 21 28 Oct


SPY (S&P 500 SPDRs) NYSE
© StockCharts.com
2-Oct-2009
Open 102.02 High 103.10 Low 101.99 Close 102.49 Volume 224.7M Chg -0.48 (-0.47%)
SPY (60 min) 102.49
HL(108.86)
HL(105.67)
HL(104.24)
HL(104.17)
HL(103.85)
HL(103.83)
HL(103.63)
HL(103.06)
HL(103.0)
HL(102.52)
HL(102.01)
HL(101.95)
HL(101.41)
HL(100.84)
HL(100.64)
HL(100.45)
HL(100.21)
HL(98.8)
ICHIMOKU(9,26,52) 102.97 104.26 103.61 105.01 102.49
MA(65) 105.40
2
15
7
1
5
1
11
Next Support = WS2 = 98.8
Strength = 2
31 Sep 8 14 21 28 Oct 5 12

The figure below shows the upper panel of the 20DMF compared to the 20D price change. I drew red vertical lines from the peaks on the upper panel, to see if the 20DMF signal occurred before the 20D price change. Most of the time - not every time - it did. My back-test has shown that the 20DMF topping occurs on average about 2 days in advance of a price change.

This time (at the right of the signal), we can see that the 20DMF is very steep (the last top was Sept 21), while the price did not change much. This is not a usual pattern and is the reason why I believe that the green dotted downtrend might have legs.

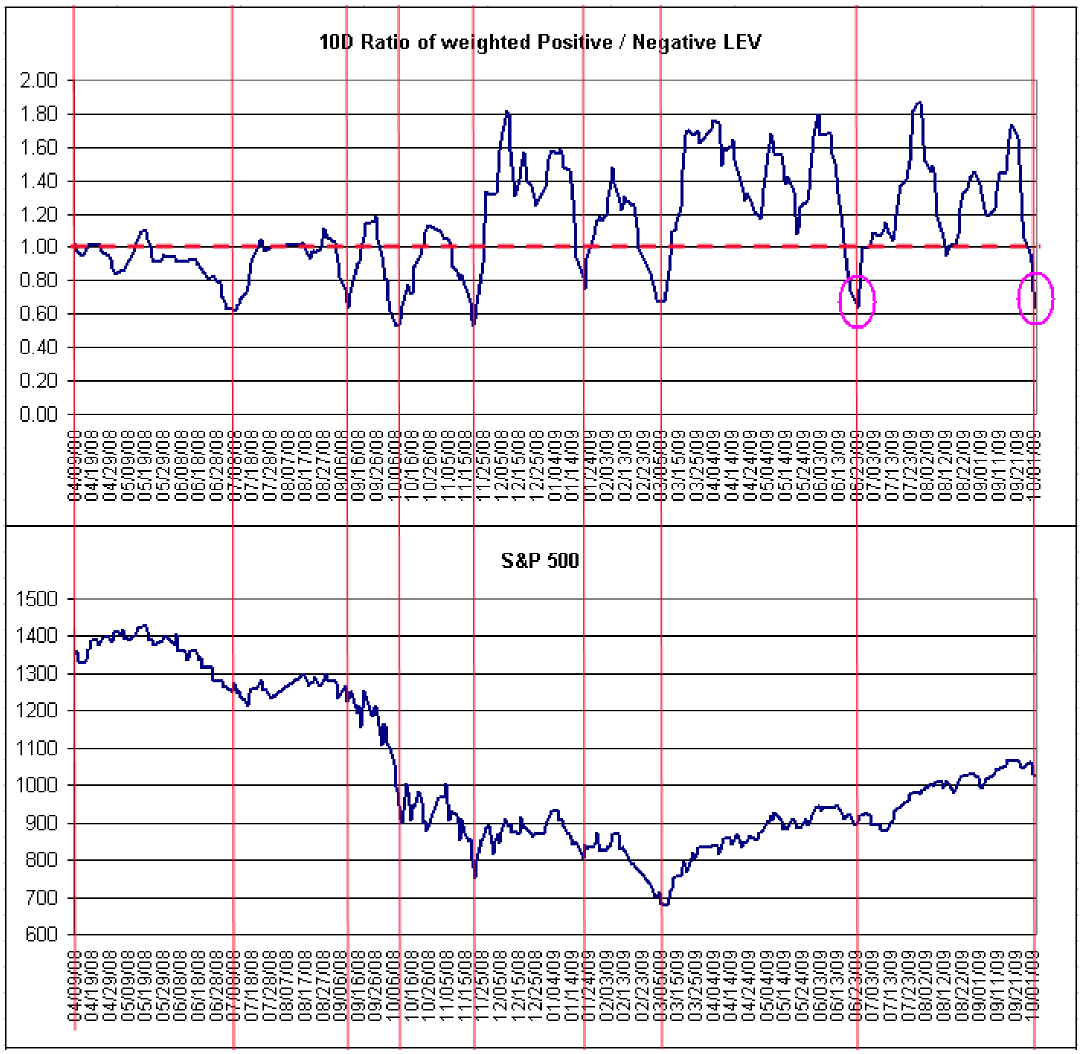


We can run different scenarios, but my preferred scenario would be a VVV type of correction instead of a VV type, simply due to the force of the 20DMF.

Keeping money into stocks at the eve of the earnings season, just after such a bad employment report that came after a negative durable goods report might be too difficult. We also need to understand that GS and friends will need a little bit of help to convince the FED to free more liquidity, which is necessary for them to produce leveraged trading profits. Therefore, a break of the 50MA on the S&P500 would make everyone scream at a trend change which would be a good time to free funny money and push the markets higher.

Below is another figure that shows how strong the selling has occurred. This figure shows the ratio of positive/negative LEV stocks for the past three days (smoothed with a 10 days average). The "1" level is the equilibrium. During the bear market (left side of the figure) the blue line was often below equilibrium. The vertical red lines connect troughs'.

We can see that today's bottom (which is not yet formed by the way) is at the level last seen in June, when we had a two phase correction. This is the reason why I think that this correction could be similar to what we had in June.



My message here is that we need to use all possible tools to try to make a correct assessment of the market direction in the long and intermediate term.

If we are position traders, we should focus on the intermediate trends (the July - October trend is an intermediate trend).

If we want to get more juice out of the markets, ripples can be also played.

Those who entered market short positions (SDS for example) below the "12" resistance level could try to cover these positions and enter them when we reach the strong resistance (if we do). Others might keep these short positions and add to their shorts - or cover them - depending on how the markets behave when reaching the "S&P 1042 zone.