Advanced Swing Trading

Strategies to Predict, Identify, and Trade Future Market Swings

JOHN CRANE

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I would like to dedicate this book to my wife, Angela, and to my two daughters, Ana and Holli—the three most special people in my world.

J.C.

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Preface

The continual need to expand one's knowledge or to improve an existing idea is an inherent one in all of us. After finishing my earlier book *A Traders Handbook: The Reversal Day Phenomenon* (Traders Library, 1998) I continued to work on my theories of Action/Reaction, with the objective of finding new ways to expand and to improve this unique trading approach. I discovered, or stumbled across (depending on how you look at it), a whole new way of using time, price, and patterns to predict market moves. In this book, I share with you my exciting new discoveries.

This book deals with the Action/Reaction theory by combining price levels, timing methods, and confirmation patterns that strengthen the predictability of future market moves. I take a step-by-step look at the Action/Reaction theory and illustrate how the market goes through a complete and predictable cycle that I call the Reaction cycle. Using this technique, a trader can predict the beginning of a new trend and then project the time and price of the center and end of this new trend.

One of the unique techniques in this book is the method of projecting future prices. I have not seen this technique published before. By using my Action lines and Reaction lines within the Reaction cycle, I illustrate how to project the time and price of major market reversals. This cycle tells the trader if the market is going to make a major turn or if the market is going to make only a small correction against the prevailing trend.

One of the most frequent questions people asked me after reading my earlier book was, "Does this method also work for stocks?" The answer is: Yes, it does! Chapter 15 shows how the Reversal dates work just as well for stocks as they do for futures. Since most of my experience has been in the futures market, the majority of the examples in this book are from futures markets. However, this in no way means that this technique can be used only in the futures markets.

My hope is that the information in this book will increase your awareness of the market's true behavior and serve as a confirmation of your own market analysis.

I offer help throughout every step of your learning process. My specially trained staff is available to answer questions and guide you through the rough spots. You can also follow my daily updates and compare your results with mine. See the end of the book for more information on how to take advantage of this valuable resource.

Introduction

In the latter part of 1999, I was at a small neighborhood gathering. One of the wives at the gathering was giving out stock advice to anyone willing to listen. (I was amazed at how many people were actually listening.) She was telling the group about how well her investment club was doing (the club was a small group of women from her work at a local computer company) and about how she and her husband were moving the majority of their retirement savings into the tech stocks, because the move was just beginning. "This is the new economy," she said. "And if you don't buy now, you will be left behind!"

I remembered thinking about a television program that I had seen just a couple of days before this little gathering. The business channel was profiling a young market analyst and giving him almost celebrity status. For the prior two years, this analyst's stock recommendations had been on target and had registered double-digit returns. He was only 28 and had been in the business for just six years. He was so brash that he predicted the Dow Jones Industrial Average at 15,000 in the next six months.

One of my wife's friends was telling her how her husband would come home during his lunchtime and day trade stocks over the Internet. He was doing so well that he was considering leaving his engineering job.

One of the clients who trades at my firm called me to say that he wanted to put most of his capital into the Nasdaq futures and that he had already moved his retirement account into the tech stocks.

The whole nation was bullish and the stock market was the favorite topic of conversation wherever you went. It seemed everyone had become a stock expert overnight. It was easy money. All you had to do was just buy and hold on for the ride. Whenever the market staged a small correction, the cry was "Buy more," because the market would go back up, as it always had before! This strategy was the only one that most of these new investors knew, and it was the only one they needed. Or so it seemed.

This reminds me of the story told about a time when Joseph Kennedy was having his shoes shined in Grand Central Station. As he was sitting and reading his newspaper, the young man who was shining his shoes told Joe that he had bought some stock for himself, which meant that he now had himself a piece of the American dream. This conversation convinced Joe that the bull market of the 1920s was over. He reasoned, "If the shoe shine boy is in the market, who is left to buy? If everyone is in the market, there is nowhere for it to go but down." The story goes on to tell how Joe Kennedy pulled his money out of the stock market and avoided the disastrous crash of 1929.

Thirteen weeks after the neighborhood gathering, the Nasdaq topped! During the next three weeks, the Nasdaq lost what it had taken more than 20 weeks to gain. It recovered over the following two weeks, but then collapsed again, and traded even lower for the next four weeks. Here we are two years later and the Nasdaq is still down. All the gains made during the runaway bull market have been taken back.

Like many people, the neighbor's wife and husband lost a large percentage of their retirement savings and are no longer speculating in the stock market. I don't hear much about the young market analyst anymore, as the young rising star had never experienced a bear market before. He didn't know how to predict a market that could actually go down. A trader even called me to say that his broker quit out of frustration, because he didn't know how to trade in this type of a market.

Much of this distress and financial loss could have been avoided had investors taken some time and a little effort to educate themselves on market behavior. When all the inexperienced investors were jumping on the bandwagon, the market was actually waving red flags of warning all over the place. Some investors, knowing what to look for, saw these warnings and took action. About the time the market was coming to a climax, I was speaking at a seminar in San Francisco on the Reversal date and Action/Reaction theory (the subject of this book). After the presentation, I was approached by one of the attendees, whom I knew from one of my previous seminars. He pulled out a chart of the Dow Jones index, on which he had applied some of my timing indicators and reversal patterns. Based on this analysis, he said that he had just pulled all his money out of the tech stocks and was going to short the Dow Jones futures. This man is a perfect example for us to emulate. He took the necessary time and effort to educate himself on market behavior and he was rewarded with close to one million dollars in profit. In addition, his education helped him recognize the market top and the need to step out of the market entirely.

In the current "I want everything in a hurry" trading atmosphere, investors and traders have little patience. However, if you study the paths of successful traders from the past and the present, you will find that they have many things in common. The most important of these similarities are patience, discipline, and a willingness to work as hard and as long as it takes to succeed. Successful traders realize that the pathway to continued success comes not from inside information or even from an overabundance of knowledge, but from the understanding of human behavior and how it translates into the market. This formula has not changed since the early 1800s, when U.S. futures trading began on the Midwestern frontier and could probably be traced back as far as 1640, when trading took place in tulip bulb futures.

Jesse Livermore, one of the great traders during the early twentieth century, stated that one of the most important keys to his success as a trader was understanding market behavior and cutting his losses quickly. Jack Schwager, in his book *Market Wizards*, interviewed Paul Tudor Jones, who is possibly one of the most successful traders of our time. Paul Tudor Jones insists that a huge part of his success comes from cutting his losses quickly. If the market is not behaving the way he thinks it should, he gets out.

Of the millions of people involved in speculative markets, only a small percentage spend the time and effort needed to learn how to trade. Although there is no Holy Grail to trading success, there are road maps and warning signs available to guide you toward your desired destination.

I find it interesting to note that new technology (faster computers and more sophisticated software) has not made current traders better or more successful than many of the early traders who used nothing but a pencil and charting paper.

Yes, there are many stories of traders who made a killing off one trade, or maybe even a string of trades. This will always happen, as it is the nature of the markets to offer these types of opportunities. However, you need to be ready to take advantage of these opportunities when they are offered, because the market will take them away quickly. Unfortunately, for every lucky trader there are countless others who are not so lucky. The good news is that long-term success is available to everyone who has desire, dedication, and a strong work ethic.

As I write the introduction to this book, there is a young man from our town getting ready to ski in the Olympics. He and his older brother started to ski when they both were very young. A friend asked the older brother how he felt about his younger brother being an Olympic skier and a top contender for the gold medal. He replied, “I’m a better skier than he is!” When asked why his younger brother made the team and he didn’t, he replied, “I quit skiing a long time ago. I got tired of all the work—to me it was not worth all the effort.” This statement says volumes about the difference between success and failure. You have to believe the rewards will outweigh the effort.

This book is not meant to be a road-to-riches, no-risk type of book. It is a serious endeavor that will require study and concentration on your part. But as you read through it and study the examples and explanations, you will quickly realize the tremendous value of the information and indicators.

I share with you the indicators used by the gentleman at my San Francisco seminar to determine when it was time for him to exit the market, near the all-time high in the Dow Jones index. In my book, I also introduce you to a trader who achieved the remarkable feat of taking his $100,000 account to over $1,500,000 in six weeks—not just once, but twice in one year. He would wait patiently for the right moment and market setup and then make his move. The one pattern he used so successfully to enter the market is described and illustrated in this book.

This book is about time, price, and patterns, and the overall behavior of the market. It is not meant to be a turnkey system. The methods concentrate on helping you understand market behavior that will enable you to see current market action and know, with a high degree of reliability, what will happen next.

My goal is to provide you with the knowledge and confidence so that you can add what you learn in this book to whatever trading approach you are most comfortable using. Since most of the information in this book is designed to anticipate trend exhaustion or trend reversals, it may appear unconventional to some traders familiar with technical analysis. The Reversal day and Action/Reaction techniques described in this book can be applied to either stocks or commodities. In addition, they work equally well on daily or intraday charts. I will introduce you to the Reaction swing and the concept of the Reaction cycle. I strongly encourage you to apply them both.

In the past few years, many investors have evolved into traders. This is a natural and comparatively easy progression that requires no additional abilities or experience. The current environment of easy access to information and the lure of easy riches has made the growth of trading similar to the Gold Rush in the mid-1800s. This pattern was predictable and glorified by the media. In this book, I present an easy and objective way to determine market direction and identify pending market reversals. Though no person is infallible, I believe learning the methods described in this book will give the trader a tremendous edge, as well as reduce the stress of blindly trading without the knowledge of market behavior. The ability to look at the market and have confidence in your trading decision is worth its weight in gold.

Trading offers one of the last great frontiers of opportunity in today's economy. It is one of the few avenues that offer everyone equal opportunity. There are very few venues where an individual can start with a relatively small bankroll and actually become a millionaire. While I hardly expect all readers of this book to suddenly transform into supertraders, I do believe the information contained in it will open your minds to a new way of looking at the market that will improve your personal trading performance.

CHAPTER 1

Order from Chaos

Have you ever looked at one of those pictures that at first glance seem to be only a hodgepodge of colors, dots, and shapes splashed randomly across the page? Initially, the picture doesn't excite you. However, if you stare at it long and hard enough, it starts to blur and you begin to see an actual picture within the picture. Slowly, a 3-D image begins to take shape and emerge from within the mass of colors and shapes. Once you have seen the image, it is much easier to see each subsequent time you look at the picture. It always seems that there is one person who can see the image immediately. For others, even though it takes more time and effort, the image finally appears. And then there are those people who just can't see it or just don't want to put in the effort.

Initially, a price chart is similar to that hodgepodge picture. It is really nothing but a series of lines and numbers illustrated in a visual form. At first glance, it may not reveal a lot of information. However, with study and experience, a clear picture begins to appear out of this clutter. Price trends start to be seen and chart patterns begin to be identified. With sufficient experience, one can use this information to predict future price movements.

Although the price fluctuations may seem random, they are the result of many forces working together in a very efficient manner. Out of this apparent disorder, one begins to see a market that is moving in a very deliberate pattern, driven by buyers and sellers with different opinions about future prices.

One February afternoon in 1999, I was on a flight traveling from Denver to New York City to attend a meeting with representatives of the New York Mercantile Exchange. I was serving a second term as president of the National Introducing Brokers Association at the time. As I often do during long flights, I pulled out my stack of commodity futures price charts and began to calculate Reversal dates, using a technique that I had developed a few years earlier. Even though the Reversal dates had served me well, I always felt there was more to the picture than I was seeing. I decided to apply a couple of theories that I had been mulling over. After some time, a pattern that I hadn't noticed before began to unfold as clear as day. There on the chart was a distinctive, repetitive pattern. All of a sudden it was very simple.

How many times have you looked at a great idea and been amazed at its simplicity? That is how I felt when I finally noticed what I now call the Reaction cycle. I tried it on numerous other charts and found that it still worked. After testing this new discovery on several commodity charts, I decided to test it on some stock charts. To my amazement and delight, it worked just as well. I became very excited because for the first time I was truly able to understand market behavior.

I now possessed the tool that would allow me to identify the beginning of a major trend, to identify when and where the center of the trend should occur, and to determine the price level and time frame when the trend would be exhausted.

Most of the current technical analysis is just a rehash of discoveries introduced years ago by great trading legends such as W. D. Gann, R. N. Elliott, Allen Andrews, and others. Although their trading approaches were different, the premise of their methodologies was the same. They all believed that there were natural cycles circulating throughout the markets.

Yes, the factors of supply and demand do play a key role in market behavior. However, they do not play the role that most people think. You see, the simplistic law of supply and demand is constantly subjected to a force that is equally powerful, very hard to measure, and infinitely less logical. That force is human emotion. As a result of two emotions that are as old as humanity (greed and fear), most traders have a tendency to overreact to market conditions. When things are going well, traders succumb to greed and overbuy in an effort to maximize profits. When the market is not going their way, fear kicks in, followed by a flurry of selling. These two opposing market forces have been around since the market began and will continue to always be a large factor. Supply and demand may change, but human emotions remain constant.

PRICES LEAD FUNDAMENTALS

The statement that prices lead fundamentals has probably shocked or upset many traders. The fact is that I believe price leads fundamental news in the marketplace. Markets seem to top just when the fundamental news is the most bullish and bottom out when the news or reports are the most bearish. I'm unable to count the number of times traders have asked me, "How can the market be trading higher? We just had a very bearish report." The answer is simple: The price has already discounted the fundamental news. Successful traders are already looking into the future, while novice traders are still trying to trade off past news.

I am not saying that fundamentals do not influence market prices. In fact, they can have a dramatic effect on prices. Market fundamentals of supply and demand are the ultimate decision makers in the marketplace. These forces will move the markets over the long term, while the technical side provides entry and exit signals in the short term.

TECHNICAL ANALYSIS—WHAT IS IT?

Technical analysis is devoted to the internal studies of the markets and not the fundamental (or outside) forces that influence market movement. It looks at the forces that lie within the particular market activity. These forces are generally considered the human qualities and emotions.

It is not important how much a commodity should be worth, but rather how much people are willing to pay for it and the intensity of their belief. In a market based on supply and demand, the intensity of emotion will reveal which one is more powerful—those demanding the commodity or those supplying it.

Each individual has his own reason for buying or selling a commodity. (We do not need to know the reason.) Whatever the reason, it is reflected in the price action with the strongest hand leading the change.

Technical analysis is the study of the actions and net results of all outside influences. The relationship of the two competing forces of supply and demand is reflected in the market by the characteristics of the price action, the nature of the activity, when the action appeared, and how much time it takes to unfold.

The law of supply and demand should and does apply to all free markets. However, sometimes government regulations interfere for short intervals with supply and demand. But, as always, after this interference fails, the markets are given back to the people and the natural laws that govern them.