Using ADX to Trade Breakouts, Pullbacks & Reversals

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Using ADX to Trade Breakouts, Pullbacks, and Reversal Patterns in the Mini-sized Dow

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About Me

- Retired from medical practice in 1999—began full-time trading in stocks, futures, and options
- Author: *ADXcellence—Power Trend Strategies (2006)*
- Articles in *Technical Analysis of Stocks & Commodities, SFO, Working-Money, Medical Economics*, various newsletters
- Speaker for the International Traders Expo and other investment organizations
- Director: The Hedge Fund Association
ADX and the Long-term Dow

Monthly Dow

ADX--Trend Strength

Directional Movement(13,8)

Green > Red

Red > Green

Indecision


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Goals for Today

- Explain the ADX Indicator
- Show trade Setups for the mini-sized Dow using ADX
  - ADXodus, ADXtender
  - Momentum Divergence, Reversals
- Demonstrate 5 major benefits of using ADX for trading the mini-sized Dow futures
- Review/Questions
What is ADX?
(with DMI)

ADX is an indicator that measures trend strength and shows trend direction. ADX tells us whether the bulls or the bears are in control.
Benefits of Using ADX

- Free indicator, no system to buy
- Quantifies trend strength
- Allows us to see the strength of bulls and bears at the same time
- Tells when the trend is strong enough to trade
- Tells us when the trend is weak (stand aside)
- Works on all timeframes and products
- Can be combined with other indicators
Trading is a Race for Profits

**Myth:** To make money in the stock market, you must know what the market is going to do.

**Truth:** You must know what *you’re* going to do before the market does what it does.
Lessons from the Pit

Traders often confuse their ability to read technical analysis with their ability to properly execute and manage trades.

ADX is derived from two indicators (developed by Wilder) known as the Positive Directional Movement Indicator (+DMI) and the Negative Directional Movement Indicator (-DMI).
Material For This Lecture is based on *ADXcellence—Power Trend Strategies*

Available: www.stockmarketstore.com
Settings: DMI 13, ADX 8
Directional Movement (DM)

DM is the largest part of today’s range that is outside of yesterday’s range.

When the largest part of today’s range is above yesterday’s range, we get positive DM (+DM).

When the largest part of today’s range is below yesterday’s range, we get negative DM (-DM).
Directional Movement (DM)

+DM  -DM  +DM and -DM  No DM
When DMI lines separate—ADX rises, trend strengthening
When DMI lines come together—ADX falls, trend weakening

Trends Frequently Have Three Thrusts

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The primary use of ADX is to measure trend strength.

DMI CONFIRMS trend direction and CONFIRMS price entry/exit signals.

When ADX > 25

- If +DMI is above −DMI, prices are trending up.
- If −DMI is above +DMI, prices are trending down.
ADX is Nondirectional

- **ADX measures the strength of a trend, but doesn’t distinguish between uptrends and downtrends.**
- **When there is a strong uptrend, ADX rises.**
- **When there is a strong downtrend, ADX rises.**
ADX is Nondirectional

DMI (13,8) 18.76 20.48 14.45

-ADX  
+ADX
ADX Nuts and Bolts

Forward
(Up)
+DMI

Reverse
(Down)

ADX

DMI

Nuts and Bolts

Forward
(Up)
+DMI

Reverse
(Down)
ADX Basic Signals

- **Short Mode**
  - ADX > 25
  - 

- **Scalp Mode**
  - ADX < 25
  - DMI spikes above 25

- **Long Mode**
  - ADX > 25
  - +DMI above -DMI
School Zone

Cruisin’

Pedal to the Metal

Idling

Engine Overheating

ADXcelleration
Point #1
Low ADX Periods—No Trend Trading

- **ADX Trend Strength Rule**
  - When ADX is above 25, trend strength is strong enough for trend trading strategies
  - When ADX is below 25, avoid trend trading strategies (optional: scalp trades)
Born to Chop
A Major Benefit of ADX: Staying Out of CHOP
When ADX < 25, scalp when DMI pops above 25
Swing on a Higher Timeframe = Trend on a Lower Timeframe

60 Minute

5 Minute
Low ADX 15 Min.
Scalps Between Support and Resistance.

Directional Movement(13,8)

Volume

Price alternates between range contraction and expansion.
25 Horse Power Minimum

- The magic ADX number for a trend to be designated “strong” is 25.
- When ADX falls below 25, price is usually in a consolidation period and trend trading strategies will normally fail.
- Once ADX rises above 25, the trader can use trend trading strategies.
Breakouts
Point # 2
Best Trades Begin From Low ADX Periods

- **ADX Trendline Rule**
  - When ADX is below 25 for an extended period, draw trendlines on price and wait for a breakout

- **DMI Breakout Rule**
  - A valid breakout up requires a new high in price and a new high in $\text{+DMI}$ (and $\text{+DMI} > 25$)
  - A valid breakout down requires a new low in price and a new high in $\text{–DMI}$ (and $\text{–DMI} > 25$)
Key DMI Momentum Signals

+DMI

-DMI
The ADXodus™™ is a classic power trend strategy that finds price breaking out following a period of consolidation.

ADXodus™™ gets its name due to the large number of accumulated/distributed shares ready to begin their exodus from consolidation and start a new trend journey.

Trend Principle: momentum precedes price

Goal: Get on a risk free trade and ride the trend
Crossover High (+DMI)

Change of Dominance

PRICE
Crossover High (+DMI)

Change of Dominance

PRICE
Price has a consolidation period for at least 30 bars (any timeframe) with a price pattern.

ADX is less than 25 during the consolidation (preferably less than 15).

Both DMI lines are above ADX prior to the breakout.

The +DMI makes a crossover high as price breaks the top trendline.

Price retraces to the 20 EMA and holds (first retracement) while the +DMI makes a pivot low at or near 25.

Enter long on a price pivot low reversal (up)
Price has a consolidation period for at least 30 bars (any timeframe) with a price pattern.

ADX is less than 25 during the consolidation (preferably less than 15).

Both DMI lines are above ADX prior to the breakout.

The DMI makes a crossover high as price breaks below the bottom trendline.

Price retraces to the 20 EMA and holds (first retracement) while DMI makes a pivot low at or near 25.

Enter short on a price pivot high reversal (down).
A Valid Breakout
is Your Green Flag!
ADXodus (Intraday)
Trade Management

- **Lot** = even # contracts, 4, 8, 10

- **Entry:**
  - Full Lot at 20 EMA pivot low
  - Optional: ½ Lot on a new price high after breakout; then ½ lot at 20 MA pivot low if 1st position profitable

- **Initial Stop:** 20 YM Points

- **Exit** ½ at entry + 20 points, move stop to breakeven

- **Exit** ½ at entry +40 points (or discretionary)
2 Min Trend
Stay long when ADX lows are >25
ADXodus (short)

Low ADX and Tests of Highs and Lows = Distribution

ADX > 25

Short
Taking Daily Trend Positions

Daily Chart
ADXodus

30 Bar Price Pattern

20 MA Entry
Stop = entry -100 pts

Directional Movement(13,8)
Continuations
Point #3
Following ADX Peak >25, the Trend is More Likely to Continue Than Reverse

- DMI Continuation High Rule
  - During a retracement, when DMI dominance is maintained, a new high in the dominant DMI confirms continuation of the trend
  - New high - DMI and new low in price, or new high in +DMI and a new high in price

- Variation: Cross ADXtender
  - DMI lines cross, but there is no change of DMI dominance
The ADXtender™ is a trend continuation strategy following an ADX peak of 25 or greater.

ADXtender™ gets its name from a strong ADX which extends price higher.

Some retracements are brief, some longer.

Trend Principle: trends are more likely to continue than reverse.
Price makes a new high and ADX rises above 25.
Price retraces down near the 20 EMA.
ADX turns down during the price retracement.
The –DMI does not cross +DMI on the retracement.
Enter long when price makes a new high and +DMI makes new high.
**ADXtender™ SHORT SETUP**

- Price makes a new low and ADX rises above 25.
- Price retraces up near the 20 EMA.
- ADX turns down during the price retracement.
- The +DMI does not cross –DMI (or crosses slightly without a change of dominance).
- Enter short when price makes a new low and -DMI makes new high.
+DMI Continuation High
(ADXtender™ Signal)

Price
-DMI Continuation High

(ADXtender™ Signal)
Initial Stop:
- Longs: 20 YM Points below entry
- Shorts: 20 YM Points above entry

Exit ½ at entry + 20 points, move stop to breakeven

Exit ½ at +40 points or momentum divergence, whichever come first
Don’t Think! Follow Price/DMI Pivots

Use Price and DMI Pivots
Stop at recent -DMI pivot high
ADXtender 5 minute
Entry on Lower High
Entry on Higher Low
ADXtender 5 minute

Stop = Entry + 20 pts

Short
Point #4
Get Out of a Trend Trade With ADX Divergence

- **ADX Divergence Rule:** When ADX is divergent with price, exit part or full position
- Most trading education focuses on making the perfect entry
- Exits are harder and more important for profit consistency

- **Divergence = Decision**
  - Sell partial position (half) or full exit
Price = Higher High

Negative ADX Divergence
Get Out!

+ADX Lower High
ADX: Positive Divergence

ADX is nondirectional = parallel lines for positive divergence
Divergence Deception = Climax

ADX Climax Reversal Pattern
Exits May Be Countertrend Scalps

60 Minute ADX Negative Divergence

Divergence = Decision
Reversals
Point #5
ADX Warns a Trend is About to End/Reverse

- Declining ADX peaks suggests trend is nearing completion
- An ADX peak of 25 or less often precedes trend reversals
- The end of a trend is an exit, but not necessarily a reversal entry
The ADXhaustion™ is a trend reversal strategy following a series of lower ADX highs, the last being 25 or less.

ADXhaustion™ gets its name from gradual price exhaustion at the end of a trend.

Price is divergent with ADX peaks.

Trend Principle: trends seldom reverse without warning.
ADXhaustion

Trend Reversal Confirmation

Trendline on -ADX Peaks
ADX Makes You Leader of the Pack
Have ADX on Your Dashboard When Trading the min-sized Dow
Review of Today’s Points

- **Point #1**: Low ADX Periods—No Trend Trading
- **Point #2**: Best Trades Begin From Low ADX Periods
- **Point #3**: Following ADX Peak >25, the Trend is More Likely to Continue Than Reverse
- **Point #4**: Exit a Trend Trade When There Is ADX Divergence
- **Point #5**: ADX Warns a Trend is About to End/Reverse.
**ADX Basic Signals**

**(Review)**

- **Short Mode**
  - ADX > 25
  - -DMI above +DMI

- **Scalp Mode**
  - ADX < 25
  - DMI spikes above 25

- **Long Mode**
  - ADX > 25
  - +DMI above -DMI
1- Rising ADX without Divergence
2- The +DMI is dominant
3- Price uptrend
Sin City
Available at
www.stockmarketstore.com
Chart Study and Free Newsletter
www.adxcellence.com

１-Cross and Hold
２-New High +DMI (confirms)

Entry on New Price High

Entry
Exit

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Directional Movement(13,8)
Information

- TraderDoc Webinar: ADX Power Profits (for stocks)—Thursday, October 19, 2006
- Mini-sized YM: [www.CBOT.com](http://www.CBOT.com)
- My email: [traderdoc@traderdoc.com](mailto:traderdoc@traderdoc.com)
- My websites
  - [www.adxcellence.com](http://www.adxcellence.com)
  - [www.traderdoc.com](http://www.traderdoc.com)
  - [www.stockmarketstore.com](http://www.stockmarketstore.com)
May All Your Trades Be ADXcellent!

Thank You.
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