

Using ADX to Trade Breakouts, Pullbacks & Reversals

Charles Schaap

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Chicago Board of Trade

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

CBOT Webinar

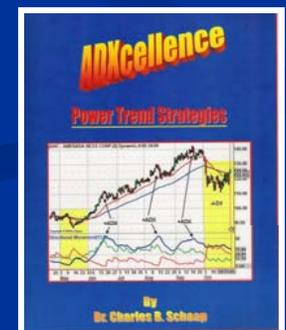
October 12, 2006

Dr. Charles B. Schaap

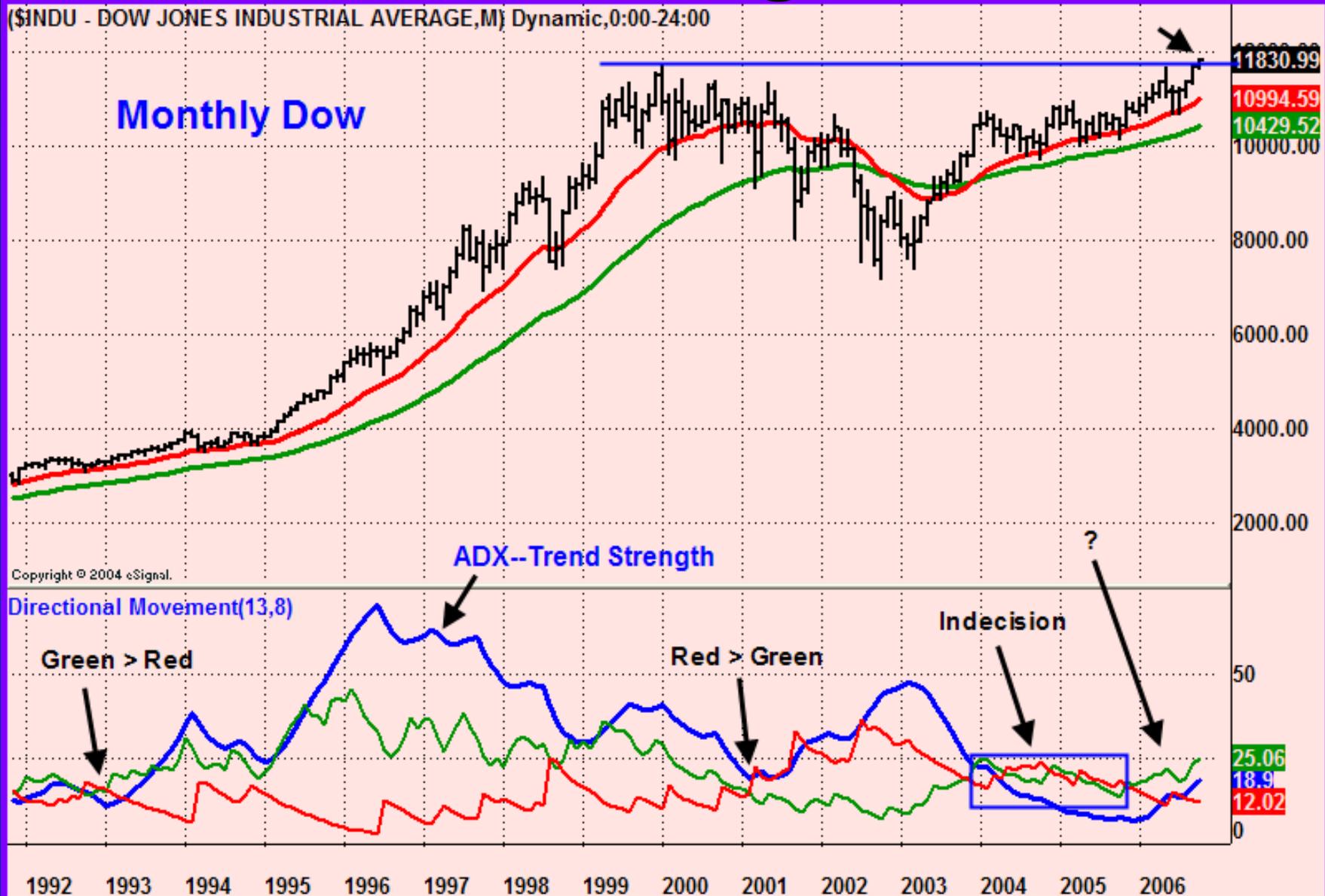
About Me



- 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



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 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.

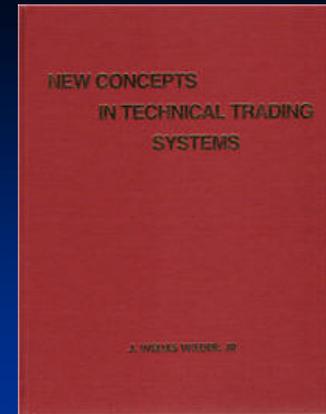
Truth: You must know what *you're* going to do before the market does what it does.



Lessons from the Pit

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

ADX and DMI



- Average Directional Movement Index (ADX) was developed by J. Welles Wilder and presented in his book, *New Concepts in Technical Trading Systems* (1978).
- ADX is derived from two indicators (developed by Wilder) known as the Positive Directional Movement Indicator (+DMI) and the Negative Directional Movement Indicator (-DMI).

ADXcellence

Power Trend Strategies

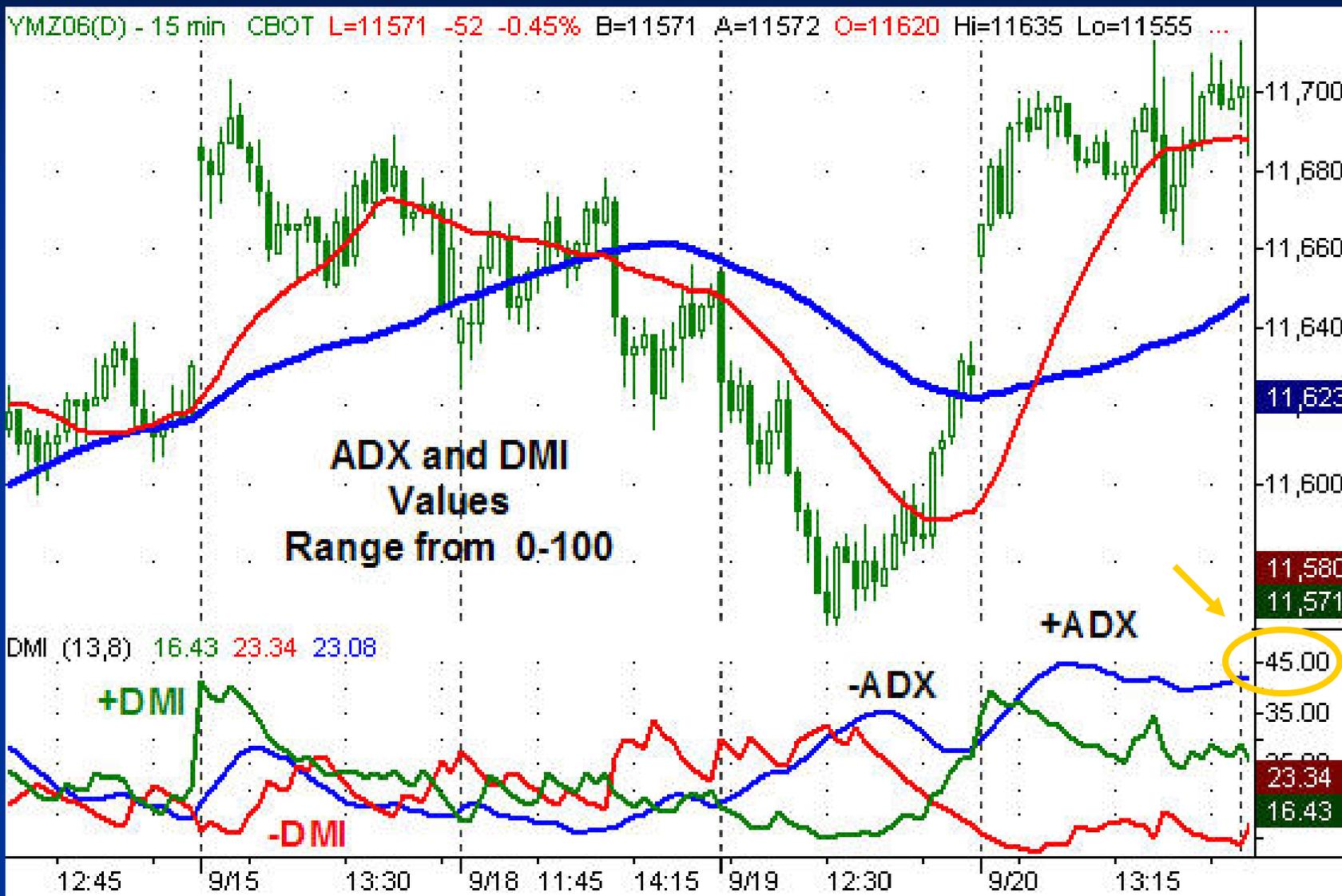


By
Dr. Charles B. Schaap

Material For This Lecture is based on
ADXcellence—Power Trend Strategies

Available: www.stockmarketstore.com

Settings: DMI 13, ADX 8



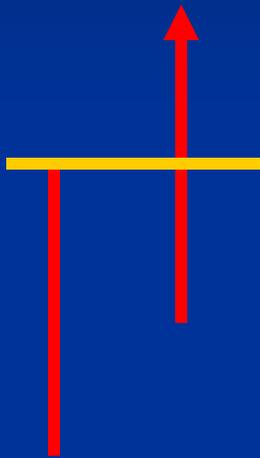
Directional Movement (DM)

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

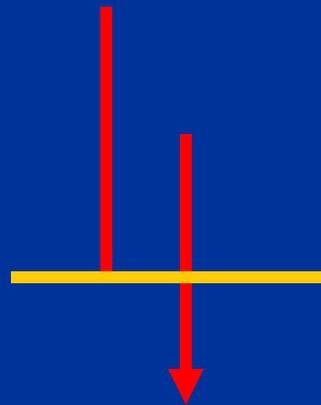
When the largest part of today's range is above yesterday's range, we get positive DM (+DM).

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

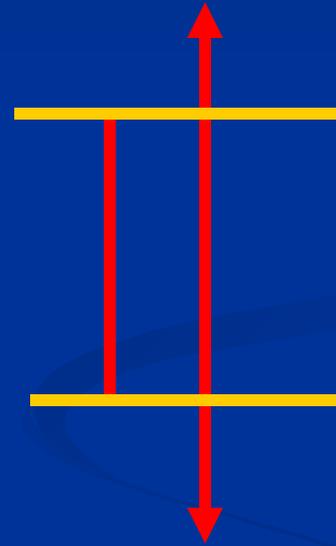
Directional Movement (DM)



+DM



-DM

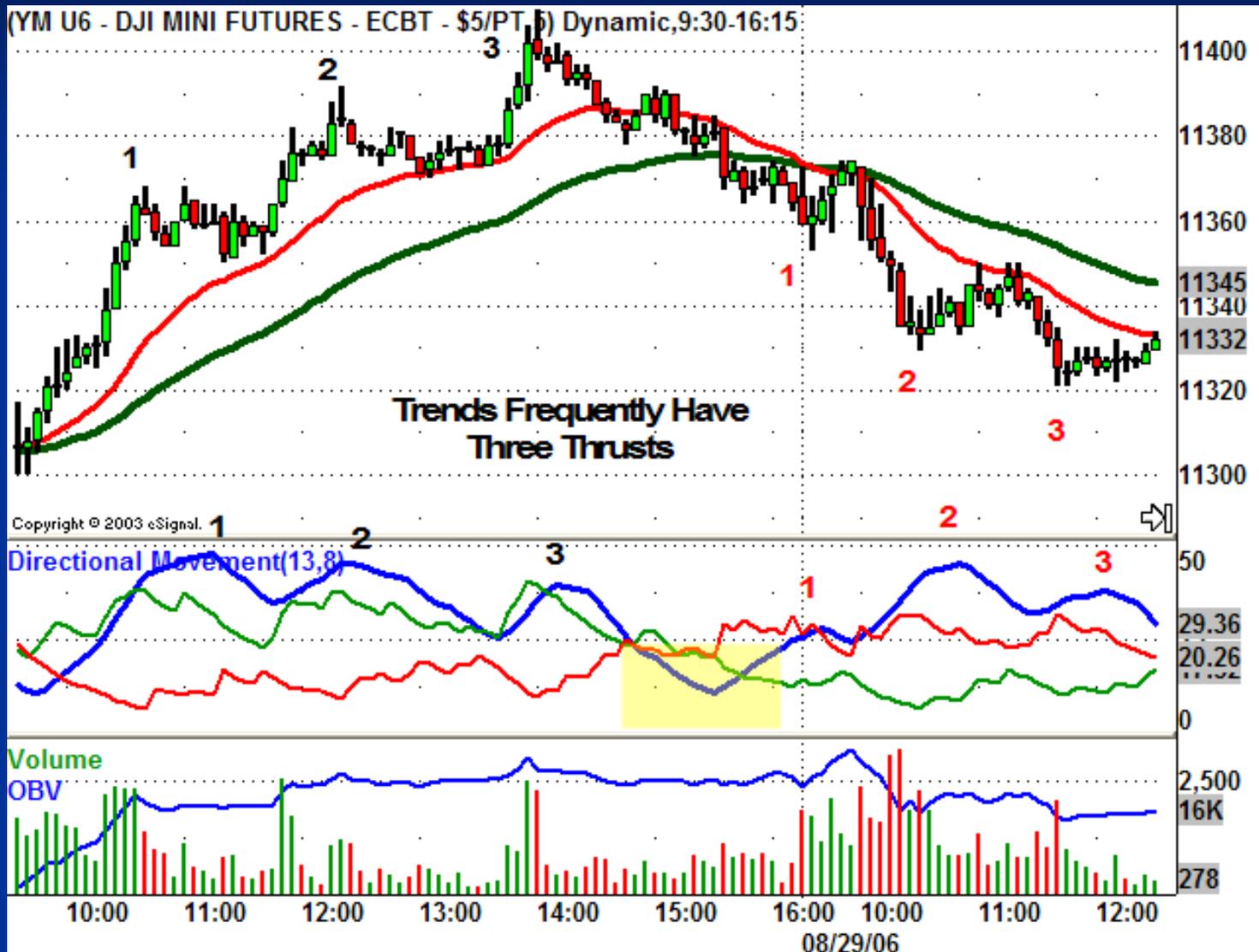


+DM and -DM



No DM

When DMI lines separate—ADX rises, trend strengthening
When DMI lines come together—ADX falls, trend weakening



ADXplained

- 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.

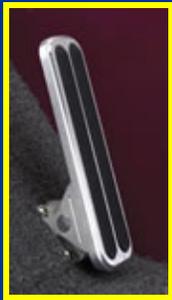
ADX is Nondirectional

- 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 Nuts and Bolts



ADX



DMI

Forward

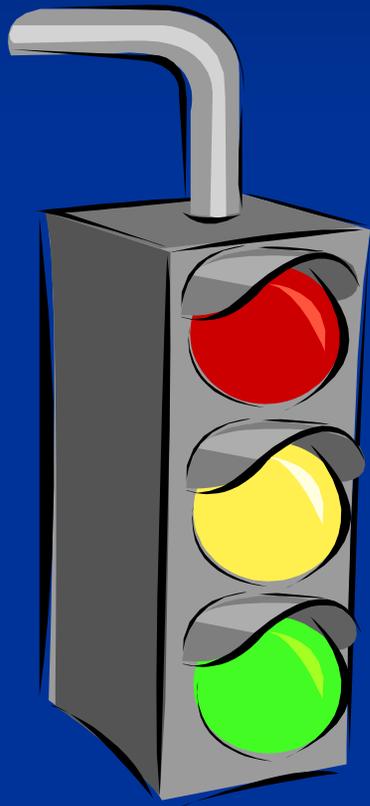
(Up)
+DMI

-DMI

Reverse

(Down)

ADX Basic Signals



- **Short Mode**
 - $ADX > 25$
 - -DMI above +DMI
- **Scalp Mode**
 - $ADX < 25$
 - DMI spikes above 25
- **Long Mode**
 - $ADX > 25$
 - +DMI above -DMI



Cruisin'

Power Trends

Pedal to the Metal



Engine Overheating



School Zone

Idling



ADXcelleration

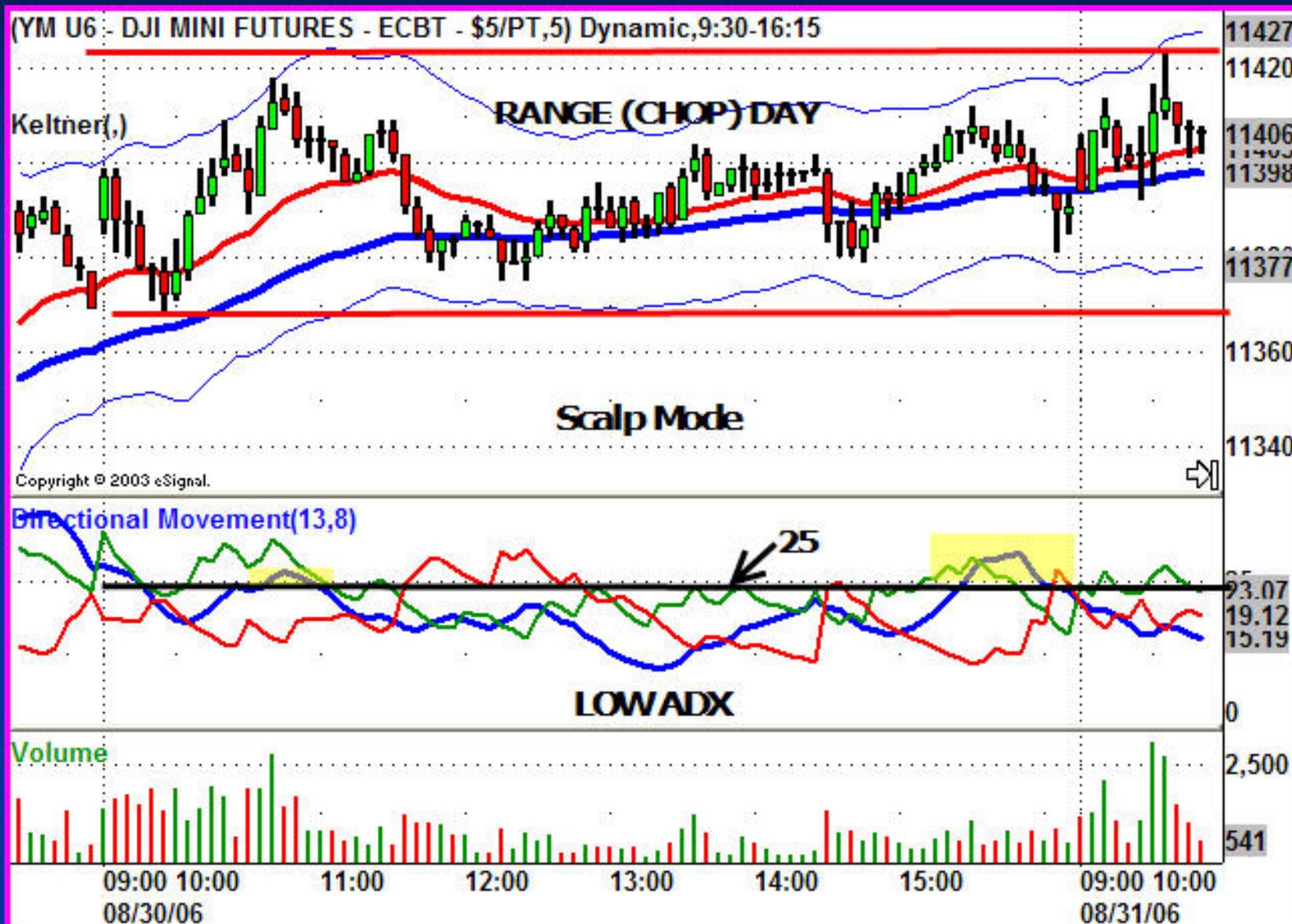
Point #1

Low ADX Periods—No Trend Trading

■ ADX Trend Strength Rule

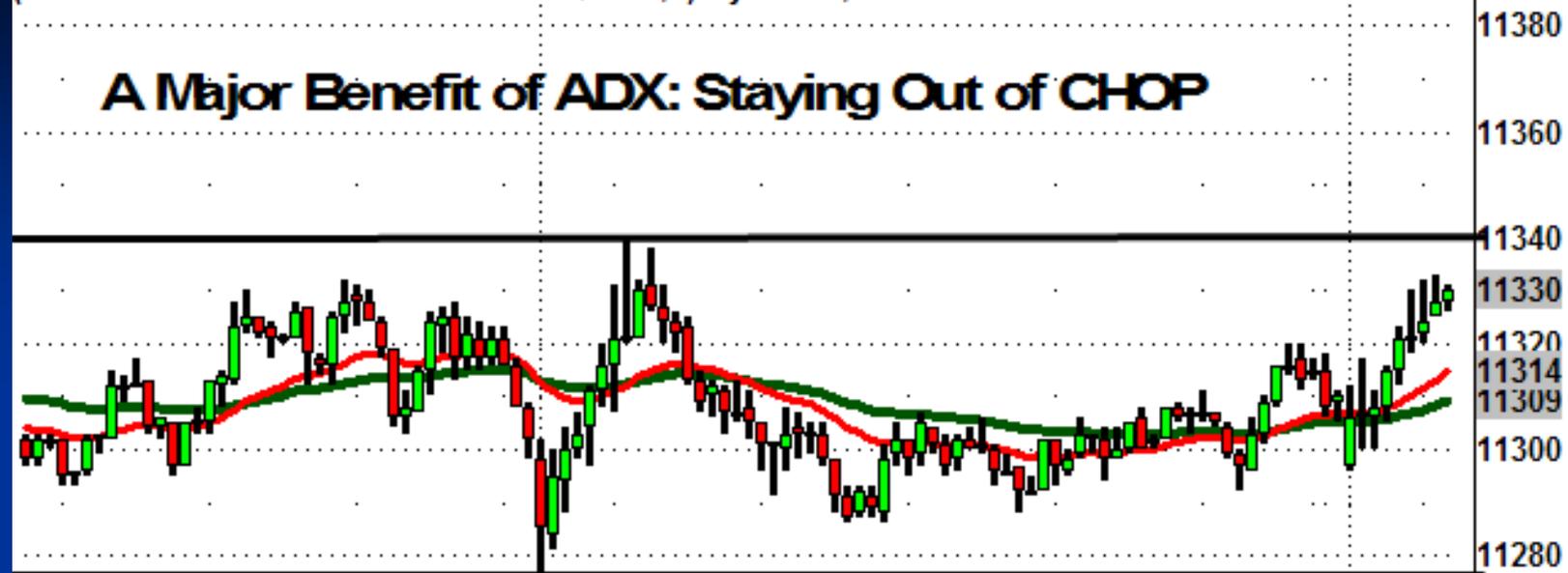
- When ADX is above 25, trend strength is strong enough for trend trading strategies
- When ADX is below 25, avoid trend trading strategies (optional: scalp trades)

Born to Chop



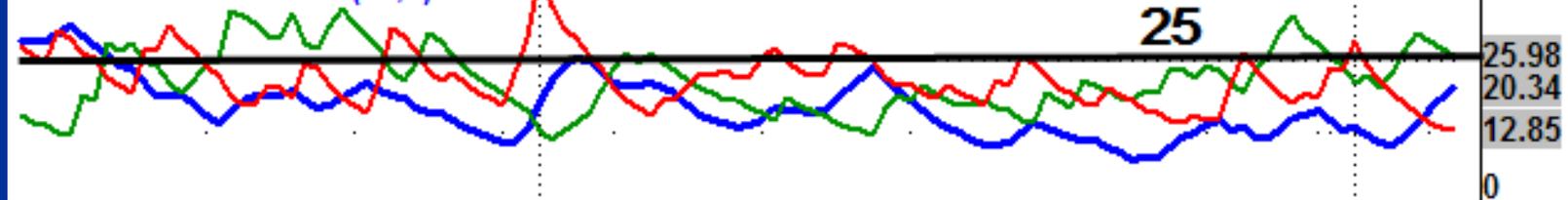
(YM U6 - DJI MINI FUTURES - ECBT - \$5/PT,5) Dynamic,9:30-16:15

A Major Benefit of ADX: Staying Out of CHOP

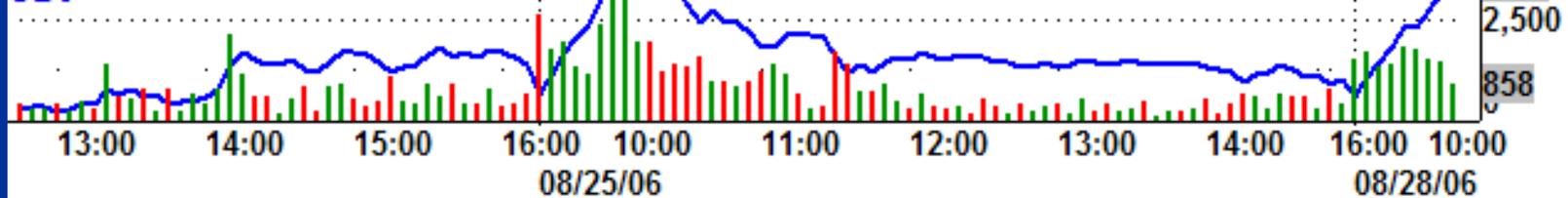


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Directional Movement(13,8)



Volume
OBV



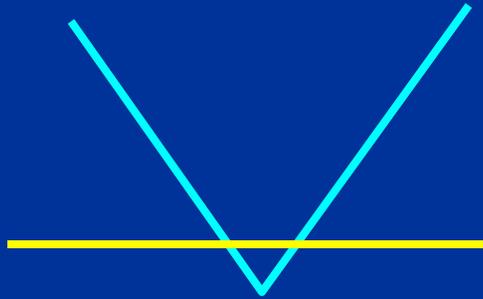
Stopped Out



When ADX < 25, scalp when DMI pops above 25



Swing on a Higher Timeframe = Trend on a Lower Timeframe



60 Minute



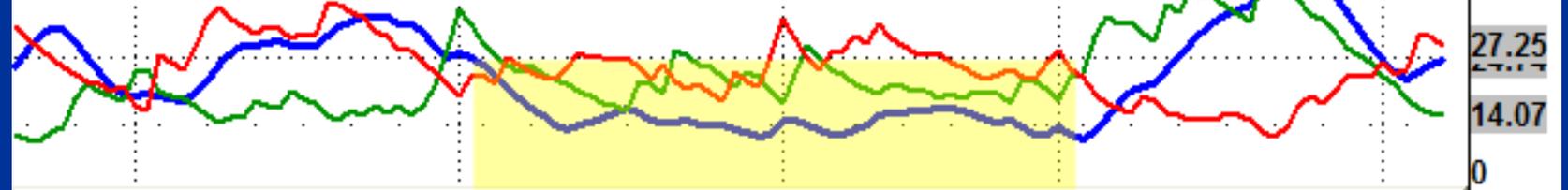
5 Minute

(YM U6 - DJI MINI FUTURES - ECBT - \$5/PT,15) Dynamic,9:30-16:15

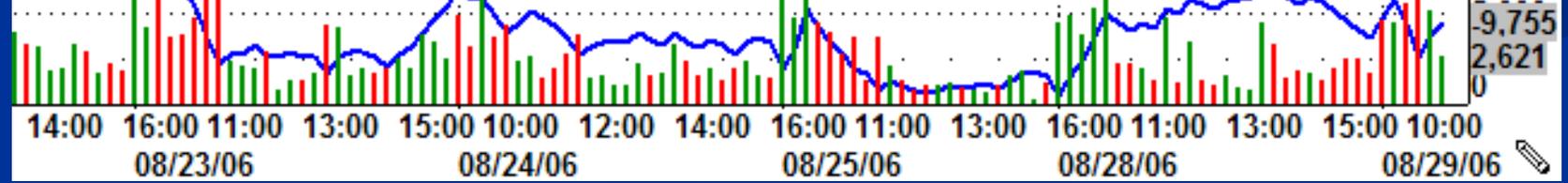
Low ADX 15 Min Scalps Between Support and Resistance



Directional Movement(13,8)

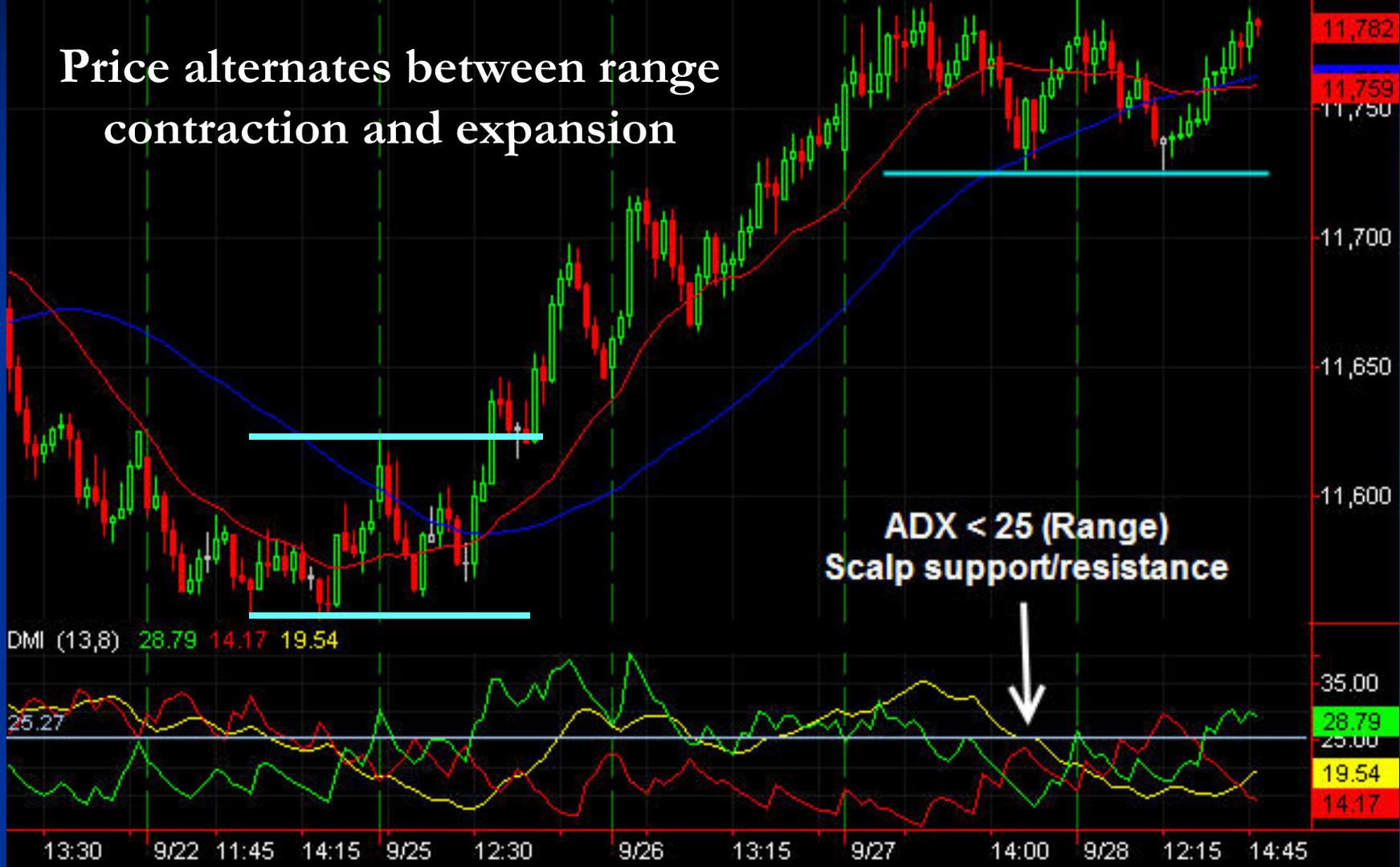


Volume
OBV



YMZ06(D) - 15 min CBOT L=11782 +8 +0.07% B=11781 A=11782 O=11770 Hi=11794 Lo=11727 C=11782 V=731...

Price alternates between range contraction and expansion



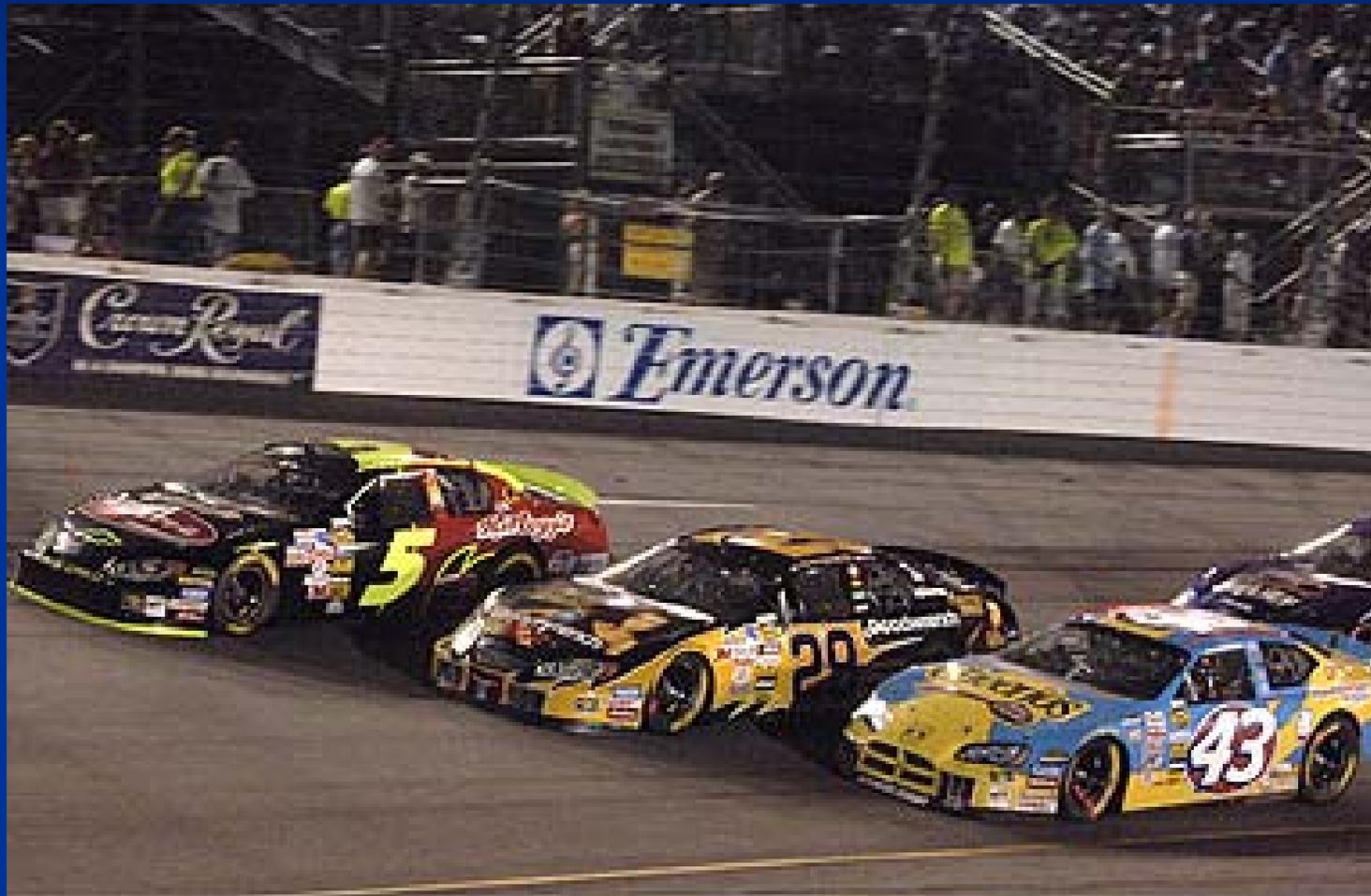
ADX < 25 (Range)
Scalp support/resistance

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

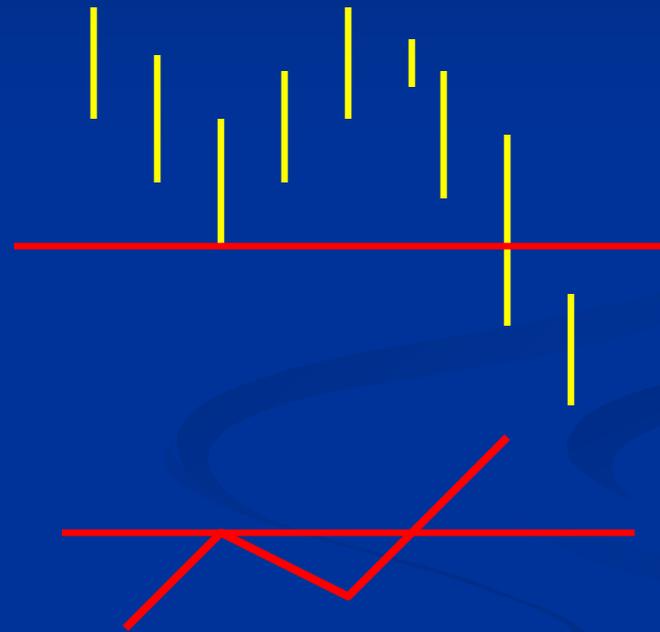
■ DMI Breakout Rule

- A valid breakout up requires a new high in price and a new high in +DMI (and +DMI > 25)
- A valid breakout down requires a new low in price and a new high in -DMI (and -DMI > 25)

Key DMI Momentum Signals



+DMI



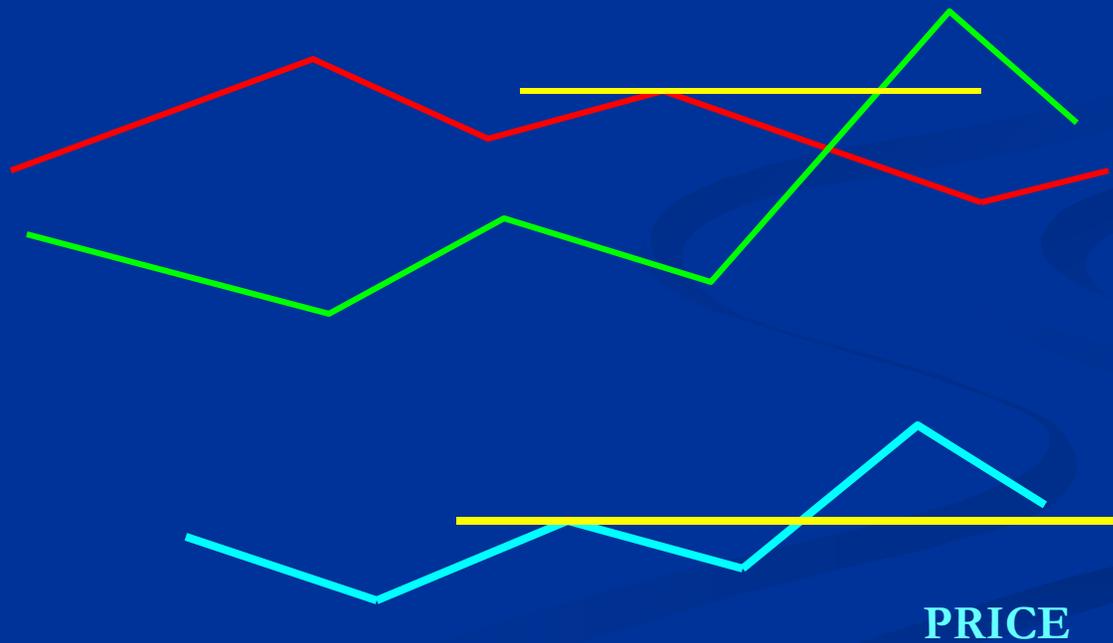
-DMI

ADXodus™

- 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

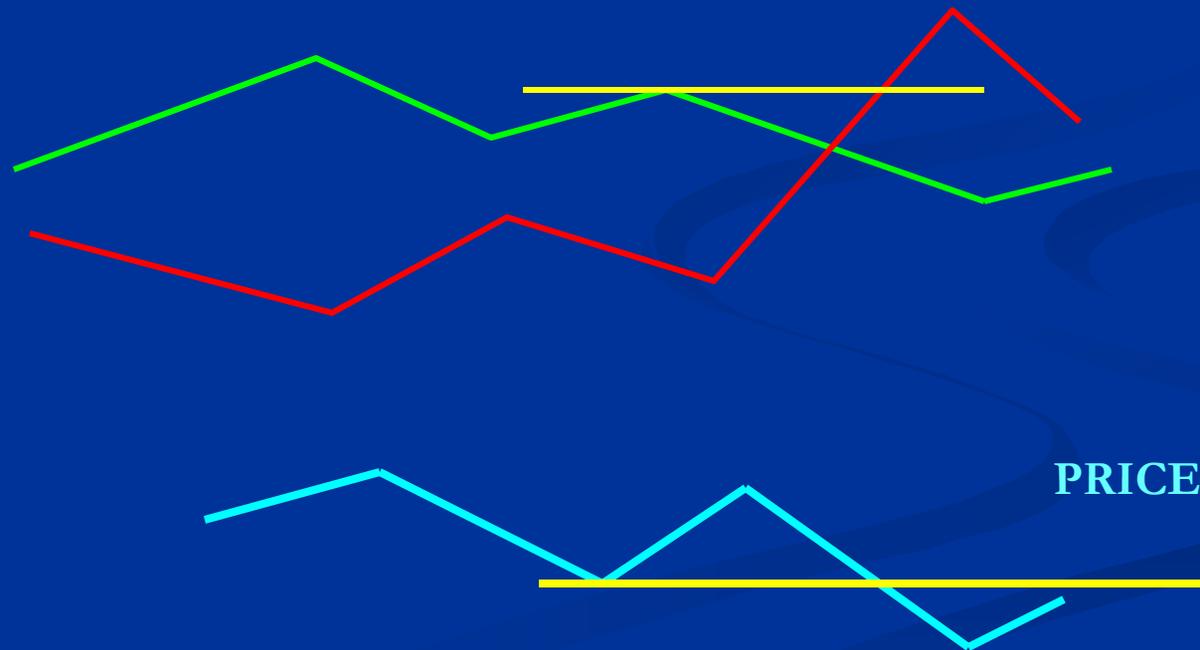
Crossover High (+DMI)

Change of Dominance



Crossover High (+DMI)

Change of Dominance



ADXodus™ LONG SETUP

- 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)

ADXodus™ SHORT SETUP

- 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).

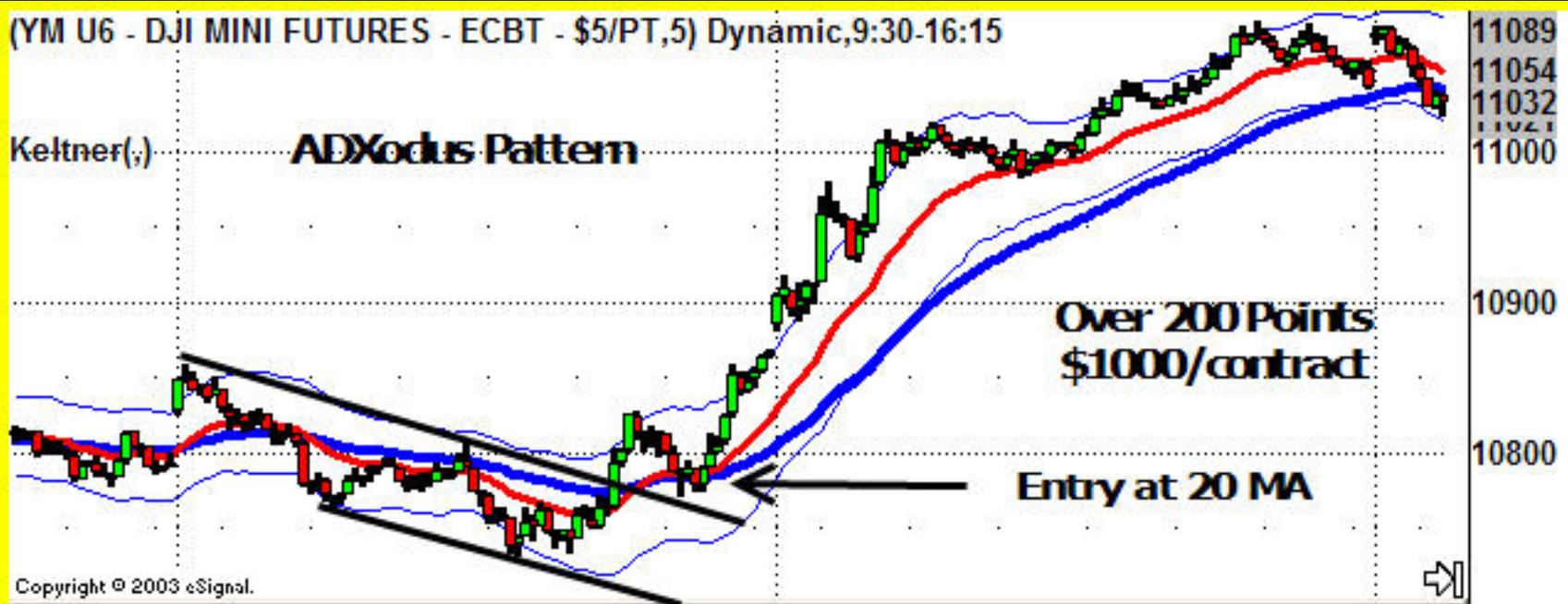
A Valid Breakout is Your Green Flag!



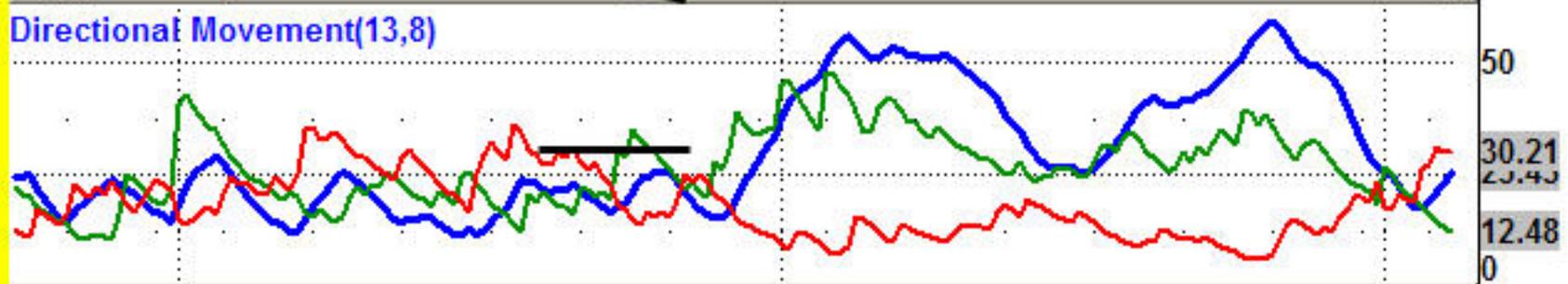
(YM U6 - DJI MINI FUTURES - ECBT - \$5/PT,5) Dynamic,9:30-16:15

Keltner(,)

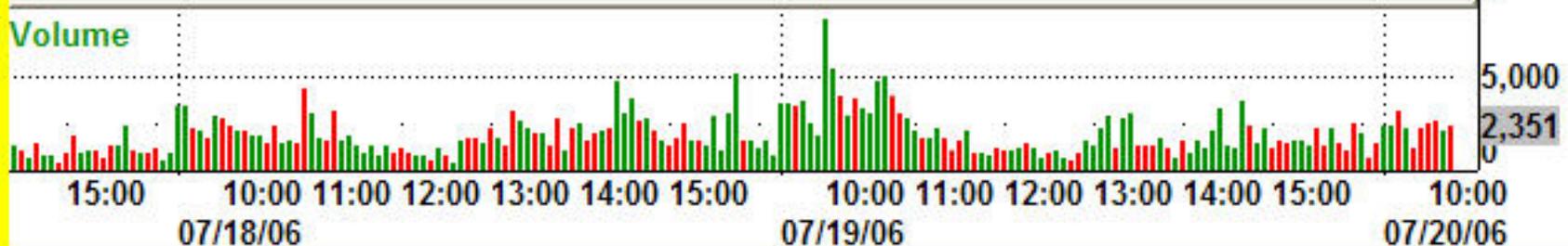
ADXodus Pattern



Directional Movement(13,8)



Volume



ADXodus (Intraday) Trade Management

- Lot = even # contracts, 4, 8, 10
- Entry:
 - Full Lot at 20 EMA pivot low
 - Optional: 1/2 Lot on a new price high after breakout; then 1/2 lot at 20 MA pivot low if 1st position profitable
- Initial Stop: 20 YM Points
- Exit 1/2 at entry + 20 points, move stop to breakeven
- Exit 1/2 at entry +40 points (or discretionary)

ADXodus



(YM U6 - DJI MINI FUTURES - ECBT - \$5/PT,2) Dynamic,9:30-16:15

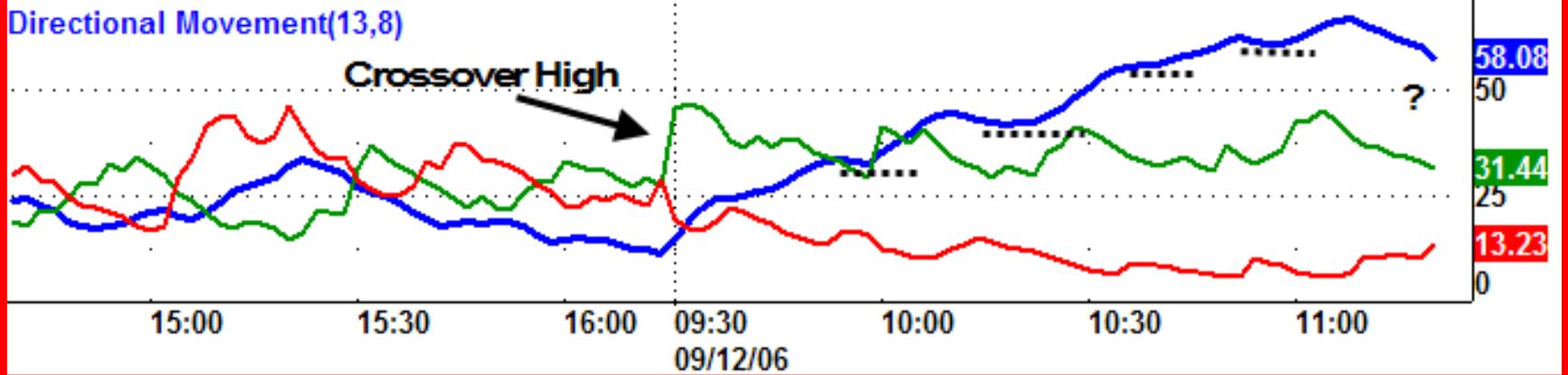
2 Min Trend
Stay long when ADX lows are >25



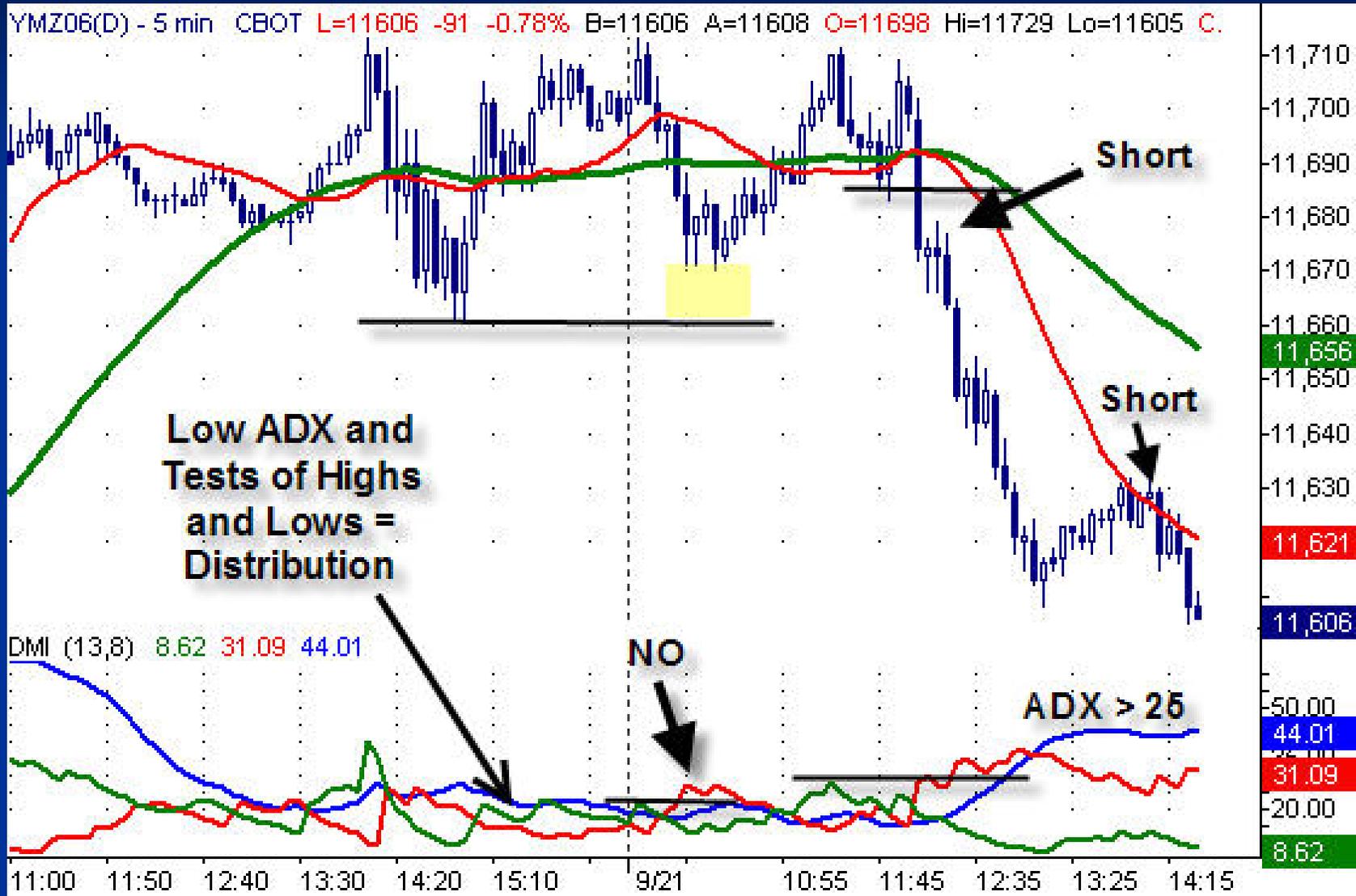
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Directional Movement(13,8)

Crossover High



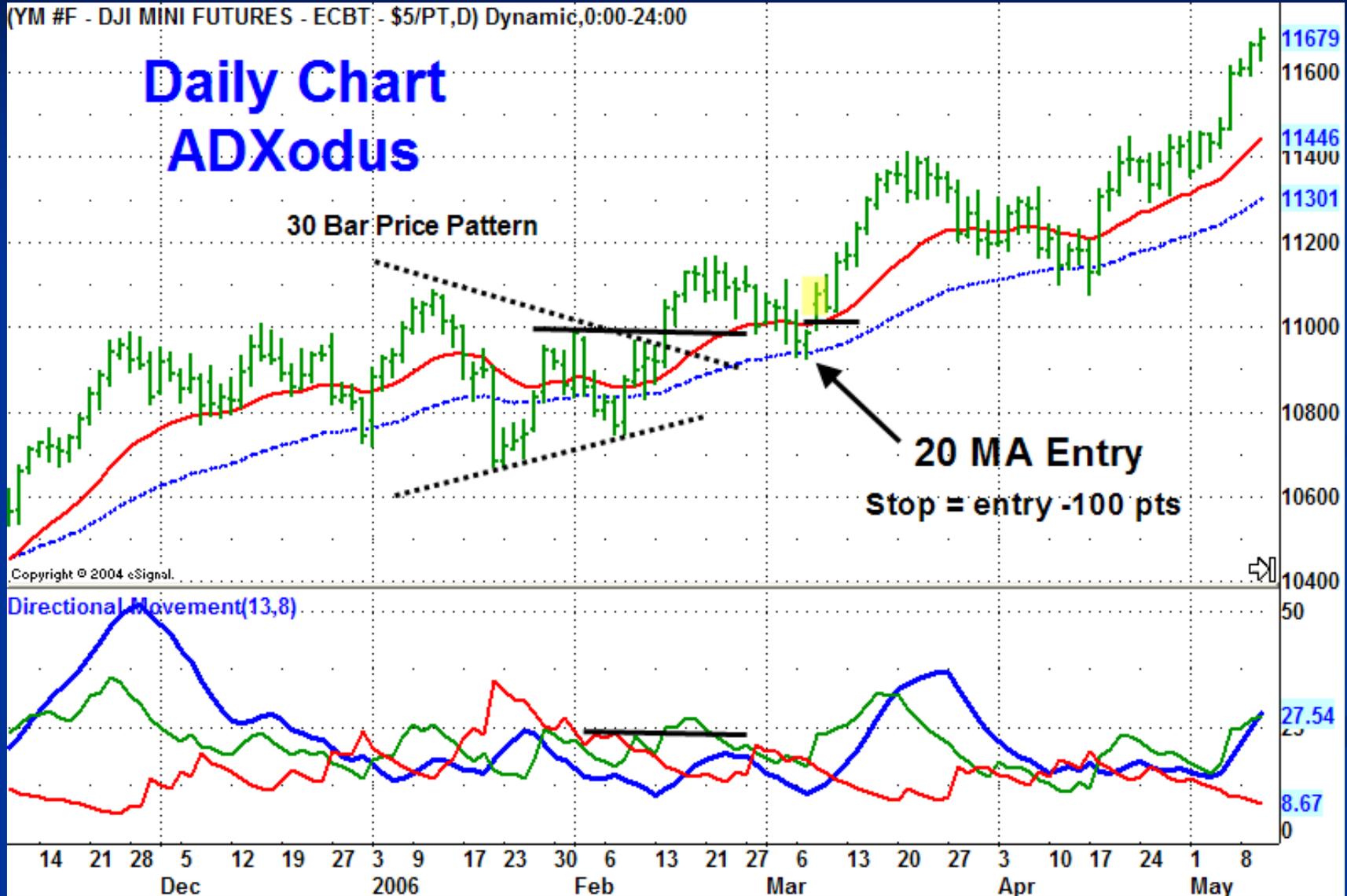
ADXodus (short)



Taking Daily Trend Positions

(YM #F - DJI MINI FUTURES - ECBT - \$5/PT,D) Dynamic,0:00-24:00

Daily Chart ADXodus



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 ADX_{tender}
 - DMI lines cross, but there is no change of DMI dominance

ADXtender™

- 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

ADXtender™ LONG SETUP

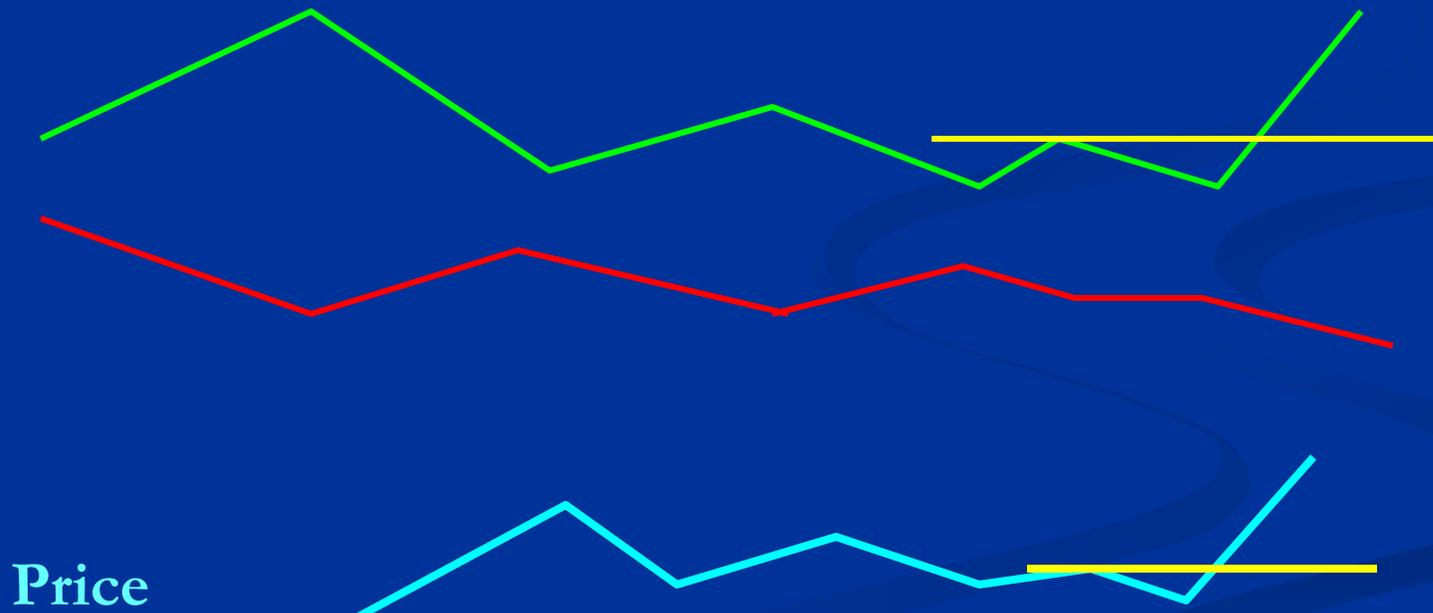
- Price makes a new high and ADX rises above 25.
- Price retraces down near the 20 EMA.
- ADX turns down during the price retracement.
- The -DMI does not cross +DMI on the retracement.
- Enter long when price makes a new high and +DMI makes new high.

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)



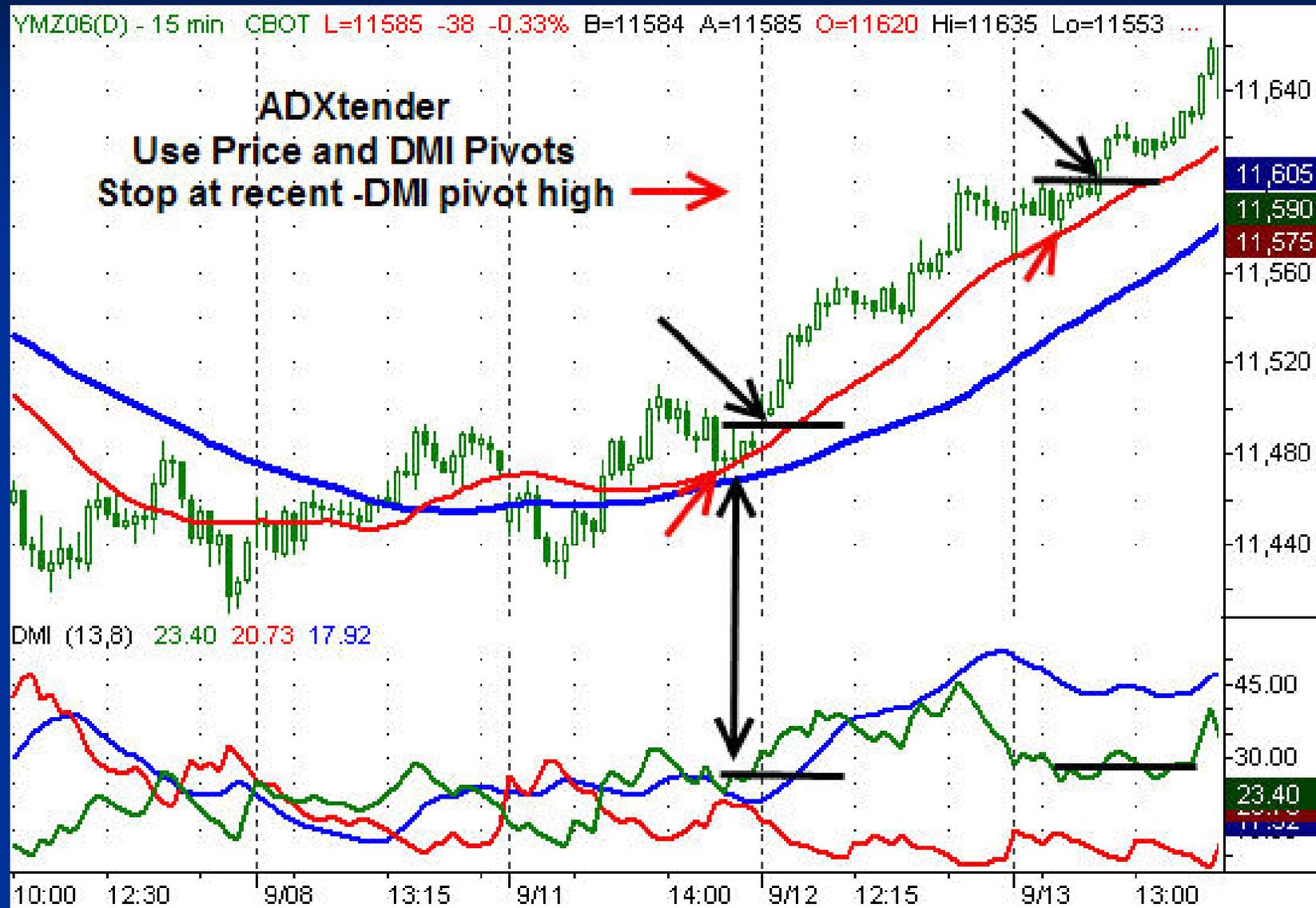
-DMI Continuation High (ADXtender™ Signal)



ADXtender (Intraday) Trade Management

- Initial Stop:
 - Longs: 20 YM Points below entry
 - Shorts: 20 YM Points above entry
- Exit $\frac{1}{2}$ at entry + 20 points, move stop to breakeven
- Exit $\frac{1}{2}$ at +40 points or momentum divergence, whichever come first

Don't Think! Follow Price/DMI Pivots



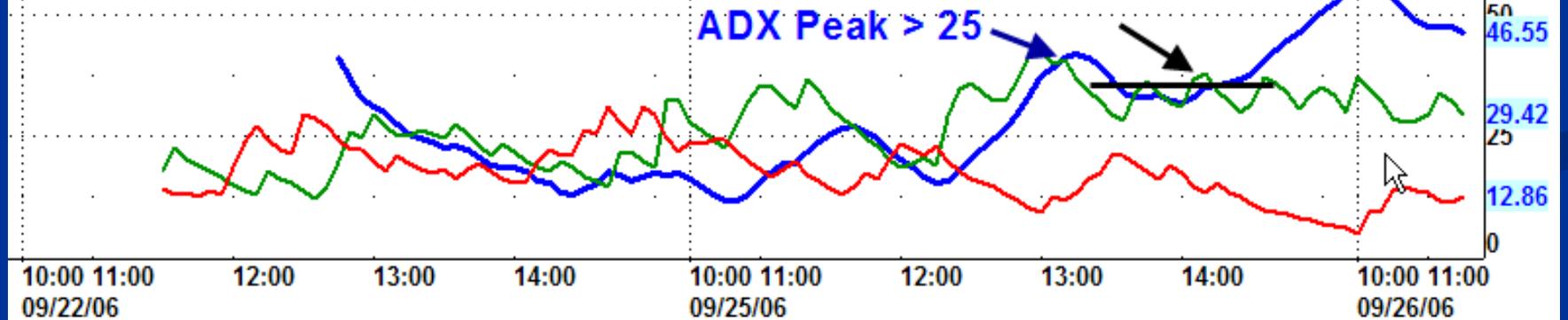
(YM.Z6 - DJI MINI FUTURES - ECBT - \$5/PT,5) Dynamic,10:30-15:15

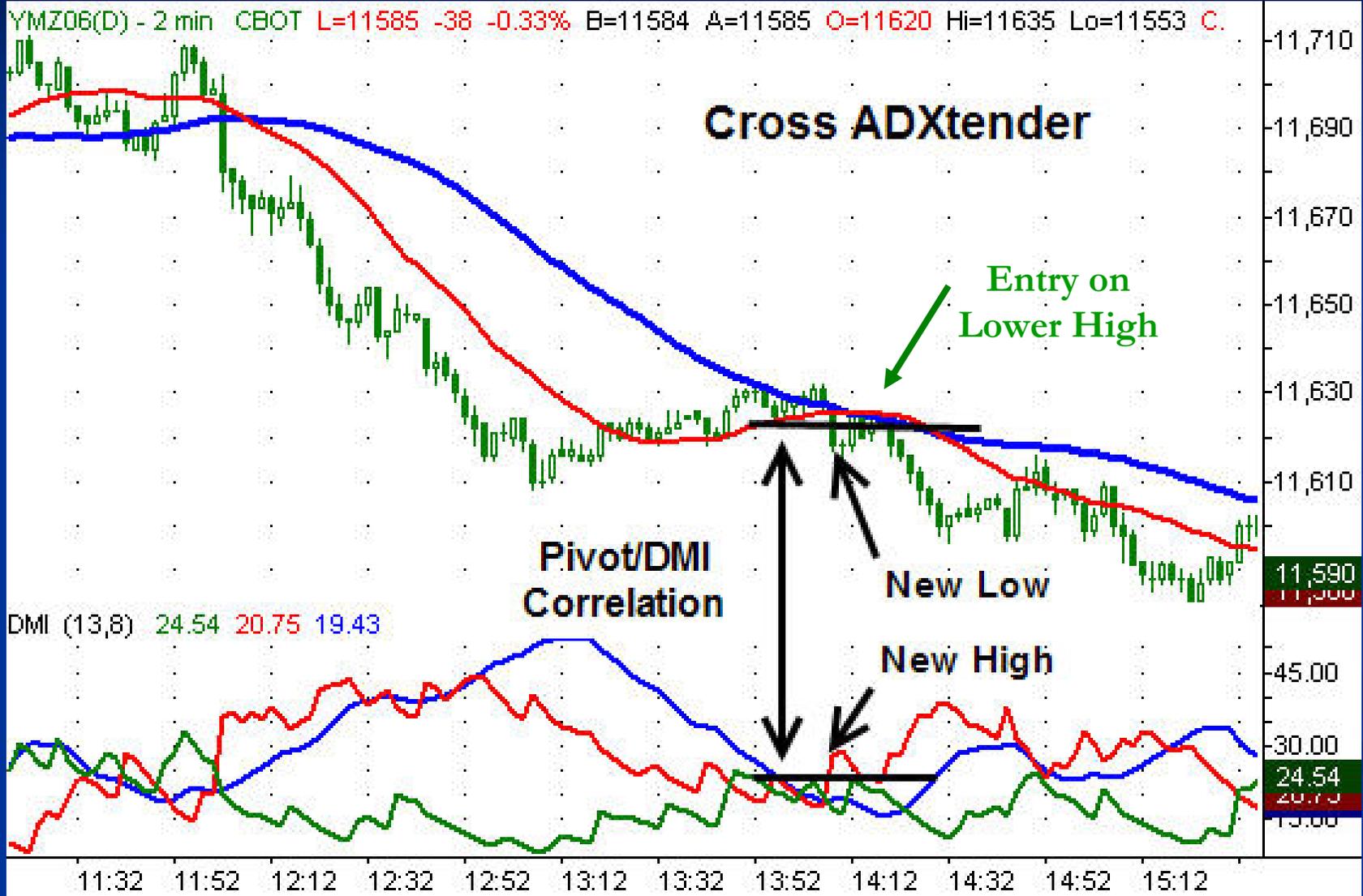
ADXtender 5 minute

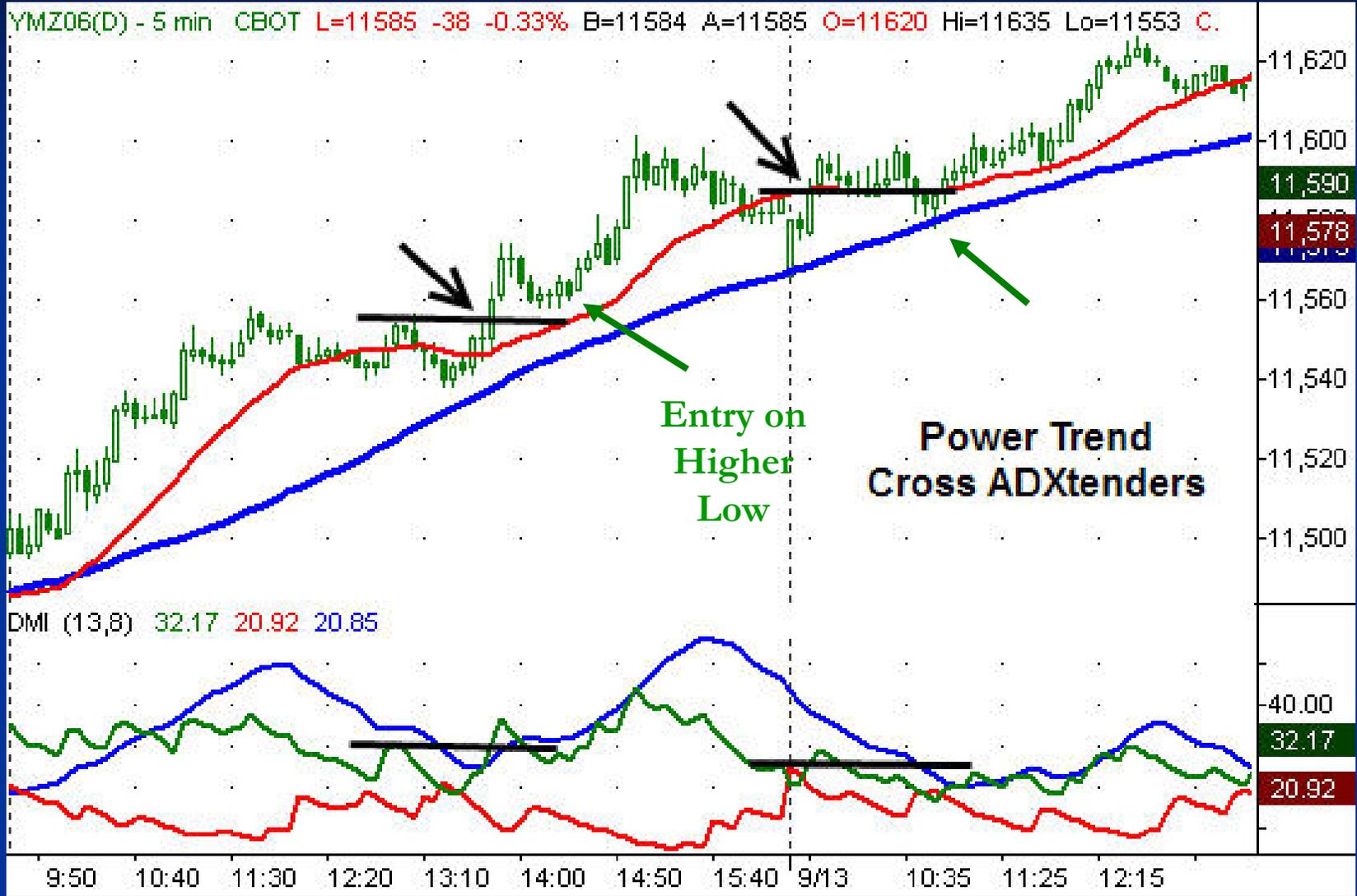


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Directional Movement(13,8)







YMZ06(D) - 1 min CBOT L=11730 +82 +0.70% B=11729 A=11730 O=11645 Hi=11735 Lo=11626 ...

ADXpediter

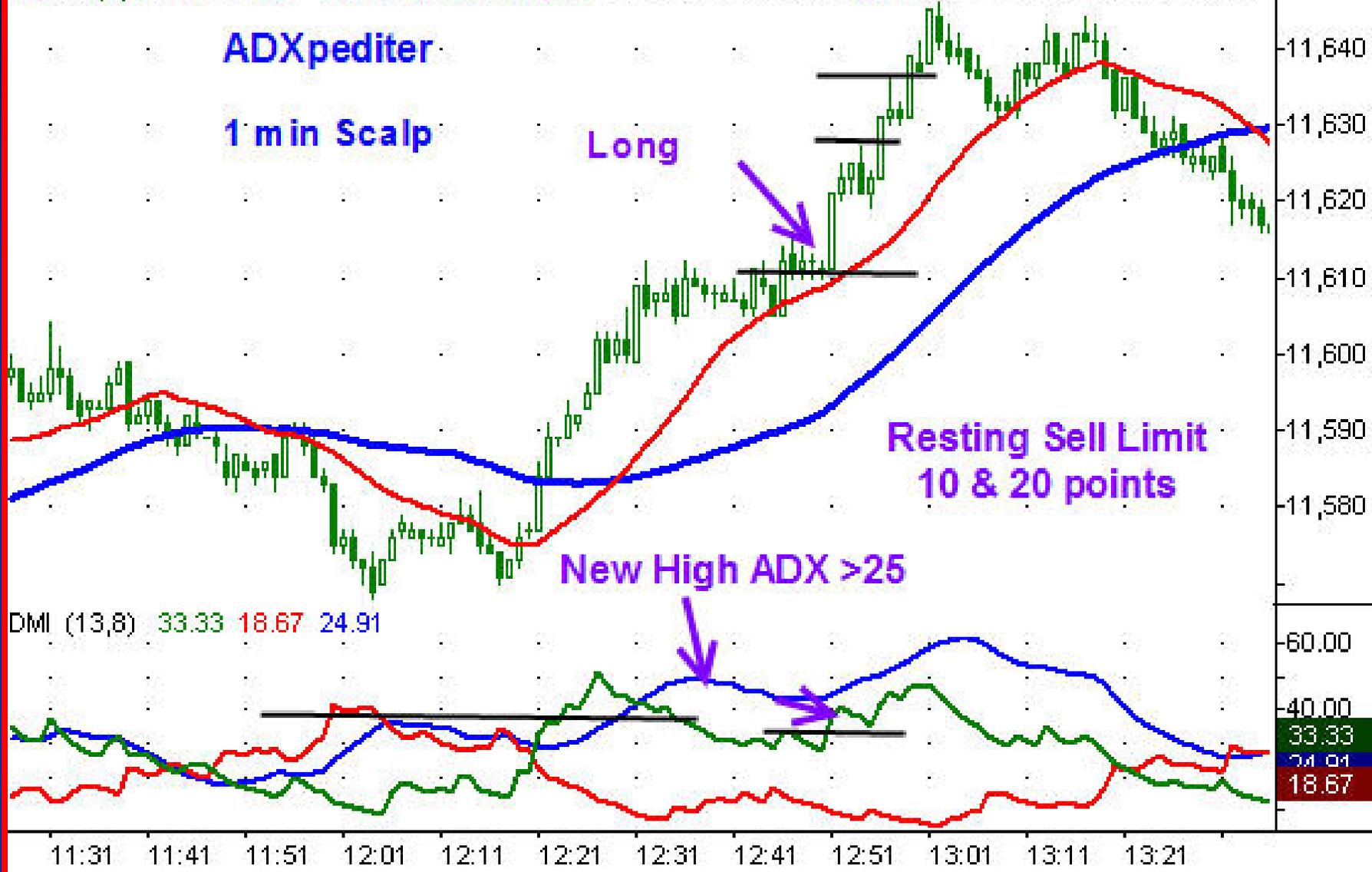
1 min Scalp

Long

Resting Sell Limit
10 & 20 points

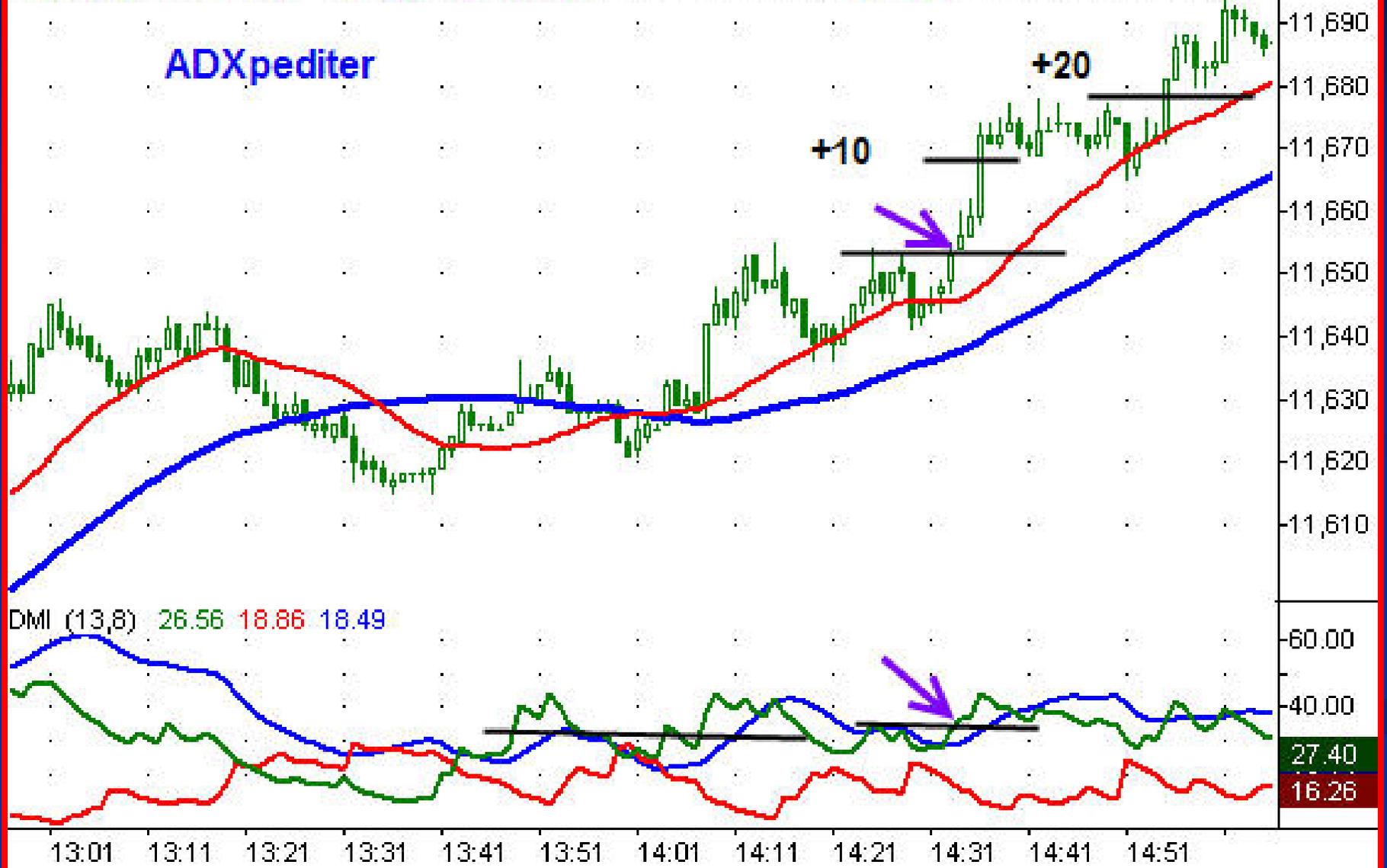
New High ADX >25

DMI (13,8) 33.33 18.67 24.91



YMZ06(D) - 1 min CBOT L=11728 +80 +0.69% B=11727 A=11728 O=11645 Hi=11736 Lo=11626 ...

ADXpediter



@YM(D) - 5 min CBOT L=11751 -18 -0.15% B=11751 A=11752 O=11771 Hi=11808 Lo=11747 C=11751 V=71485 ...



Xtended Play

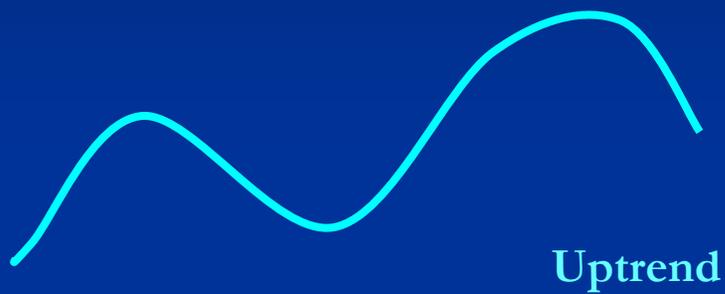


Point #4

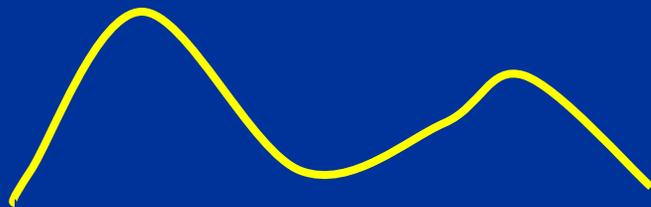
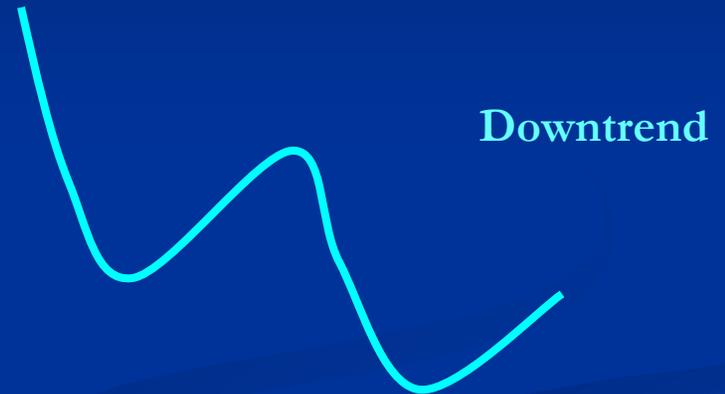
Get Out of a Trend Trade With ADX Divergence

- **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
- **D**ivergence = **D**ecision
 - Sell partial position (half) or full exit

ADX Divergences

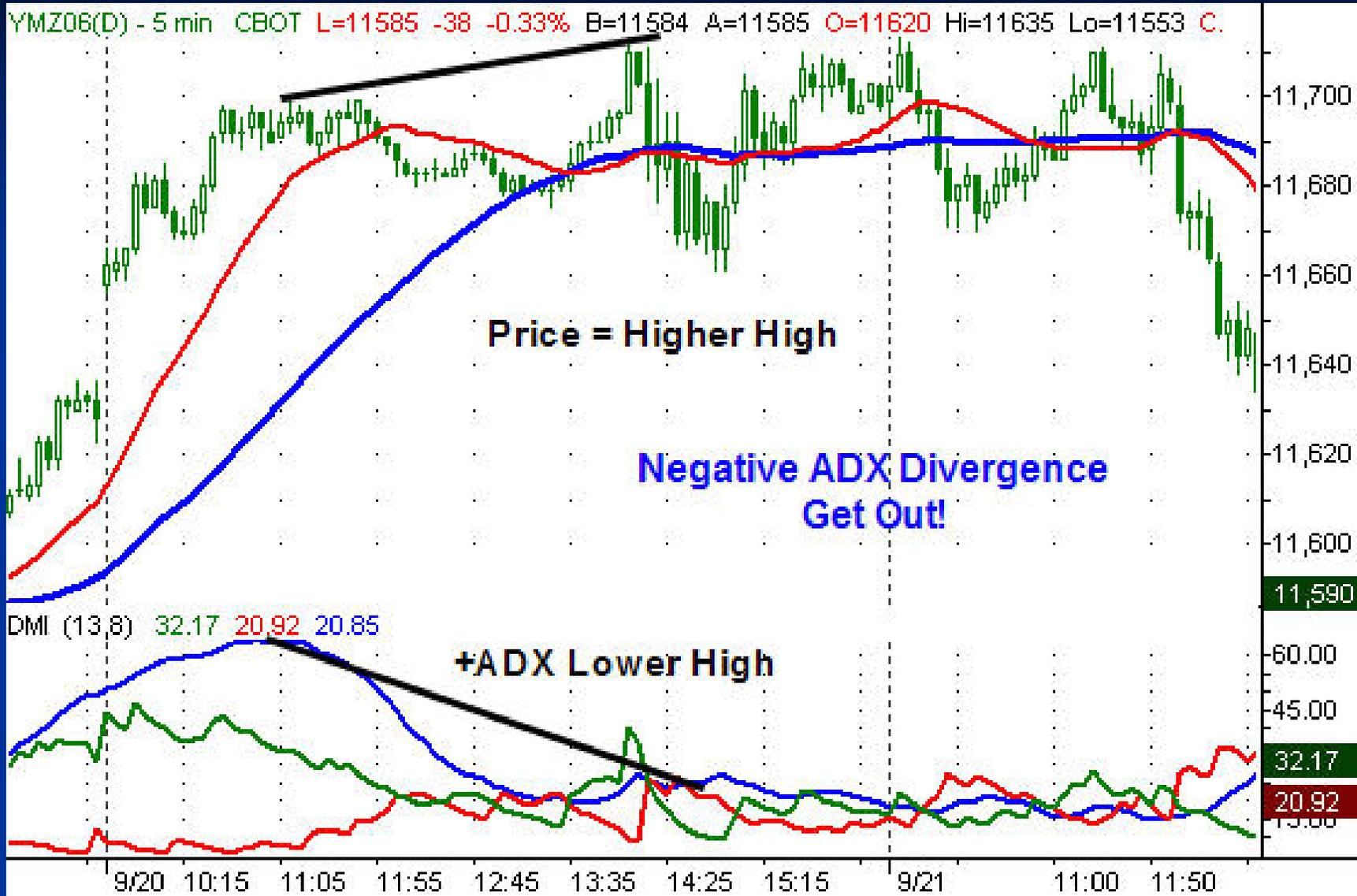


PRICE

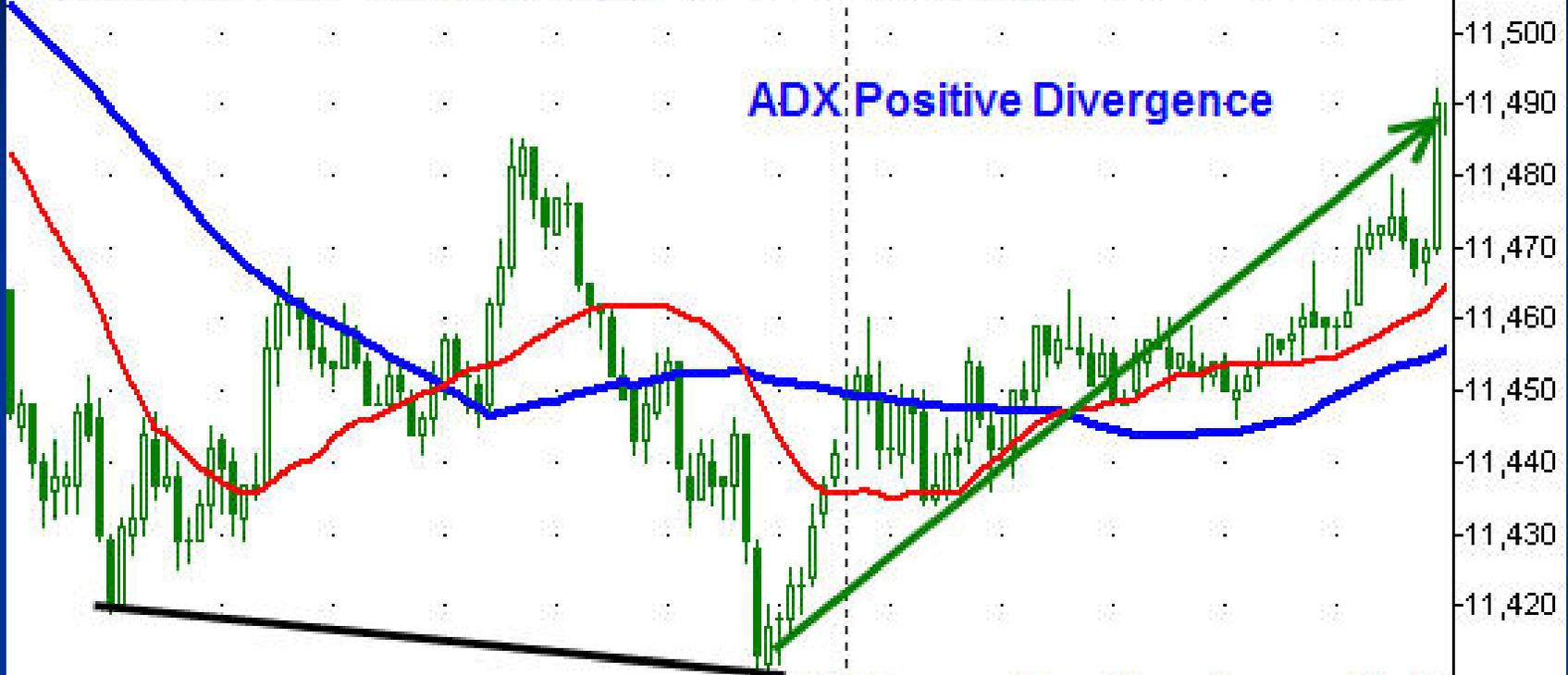


ADX

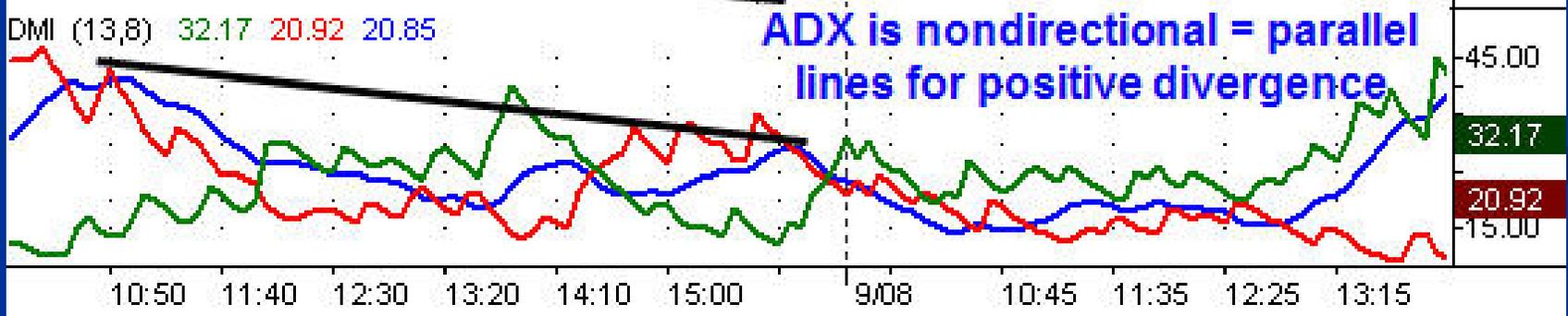




YMZ06(D) - 5 min CBOT L=11585 -38 -0.33% B=11584 A=11585 O=11620 Hi=11635 Lo=11553 C.



ADX Positive Divergence



ADX is nondirectional = parallel lines for positive divergence

DMI (13,8) 32.17 20.92 20.85

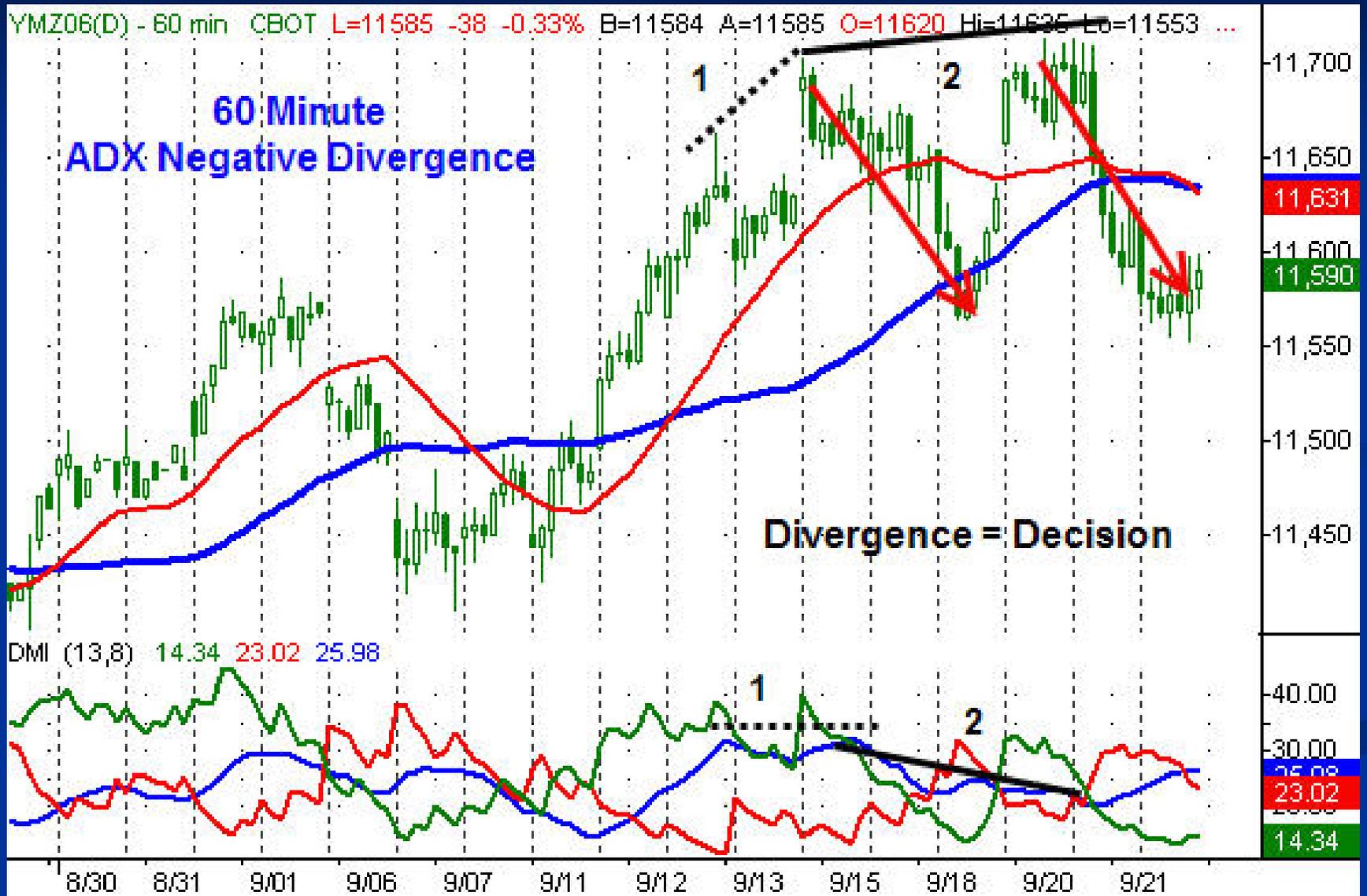
45.00
32.17
20.92
15.00

10:50 11:40 12:30 13:20 14:10 15:00 9:08 10:45 11:35 12:25 13:15

Divergence Deception = Climax



Exits May Be Countertrend Scalps



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

ADXhaustion™

- 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

@YM(D) - 60 min CBOT L=11774 +5 +0.04% B=11774 A=11776 O=11771 Hi=11777 Lo=11771 C=11774 V=175 M..



@YM(D) - 60 min CBOT L=11776 +7 +0.06% B=11774 A=11776 O=11771 Hi=11777 Lo=11771 C=11776 V=171 M..

ADXhaustion

Trend Reversal Confirmation



ADX Makes You Leader of the Pack



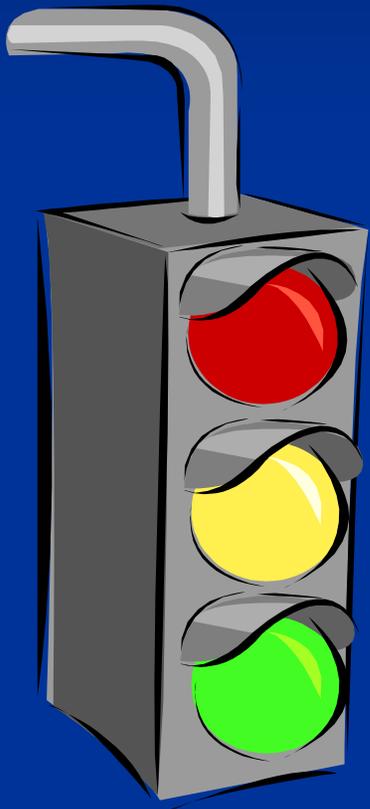
Have **ADX** on Your Dashboard When Trading the min-sized Dow



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 $-DMI$



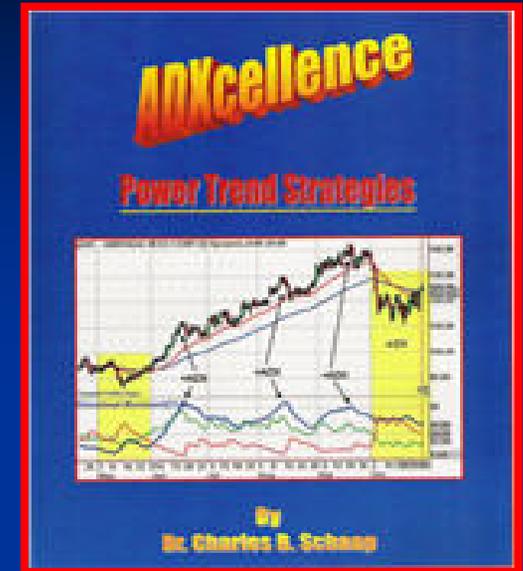


Sin City





ADXcellence



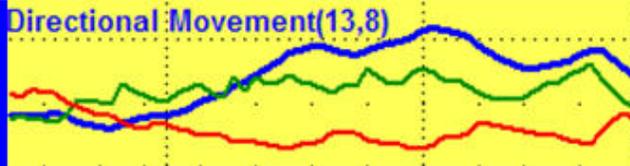
- ■ **ADXodus™**
- **ADXtra™**
- **ADXpress™**
- ■ **ADXtender™**
- **ADXplosive™**
- **ADXquisite™**

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Information

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

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