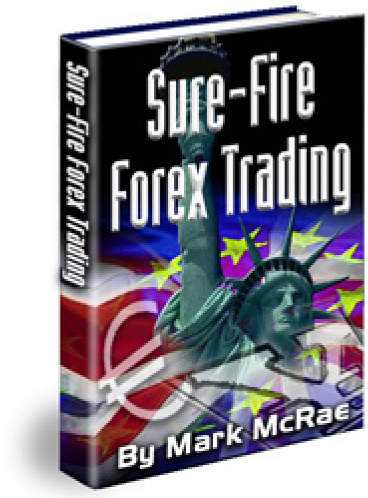


This Lesson Is Provided By
www.surefire-forex-trading.com

Bollinger Bands & ADX

If there is one thing that a trader would want to know for certain, it would be how to pinpoint the bottom or top of a trend.

But simple as it sounds, it is easier said than done. Trying to determine if a certain market wave is complete or just a retracement in the larger trend becomes more of an art than a science.

In such situations, using multiple sources of confirmation helps to avoid the potential false signals and preserve our capital for only those situations that provide us with the most favorable risk to reward scenarios.

Keeping that in mind, we will use two very different indicators – the Bollinger Bands and the ADX - to form a method which should help us to "catch a falling knife."

Bollinger Bands is an indicator that allows users to compare volatility and provide a relative definition of high and low. The indicator consists of three bands which usually encompass the majority of price action:

- A simple moving average in the middle
- An upper band (SMA plus 2 standard deviations)
- A lower band (SMA minus 2 standard deviations)

The basic interpretation of Bollinger Bands is that price tends to stay within the upper and lower bands. Because standard deviation is a measure of volatility, Bollinger bands adjust themselves to the market conditions. When the markets become more volatile, the bands widen (move farther away from the average), and during less volatile periods, the bands contract (move closer to the average). The tightening of the bands are often used by technical traders as an early indication that the volatility is about to increase sharply.

Bollinger Bands Characteristics:

- Sharp price changes tend to occur after the bands tighten as volatility lessens.
- When price moves outside the bands, a continuation of the current trend is implied.
- Bottoms and tops made outside the bands followed by bottoms and tops made inside the bands call for a reversal in the trend.
- A move that originates at one band tends to go all the way to the other band. This observation is useful when projecting price targets.

Based on these, one may go long or buy the market below the lower band while selling short the market above the upper band. However, this can become a dangerous proposition if the market develops a strong trend, and price starts “walking the band” creating new extreme price levels.

To counter this disadvantage of the Bollinger Bands, we can use the ADX indicator.

The ADX indicator measures the strength of the current trend, rising during extreme trending states, and falling as the market retraces in a range-bound state. The ADX line has definite advantages because it filters out a lot of the false oscillator signals which are frequently given early in a move.

ADX Characteristics:

- When the ADX starts rising from a low level, it signals the beginning of a trend.
- The trend is confirmed, when the ADX has risen above the 20-25 value.
- When the ADX has reached an overbought level of 40-50 and starts consolidating or turning down, it signals the end of the current trend.
- A decline of the ADX signals the consolidation or indecision of the market.

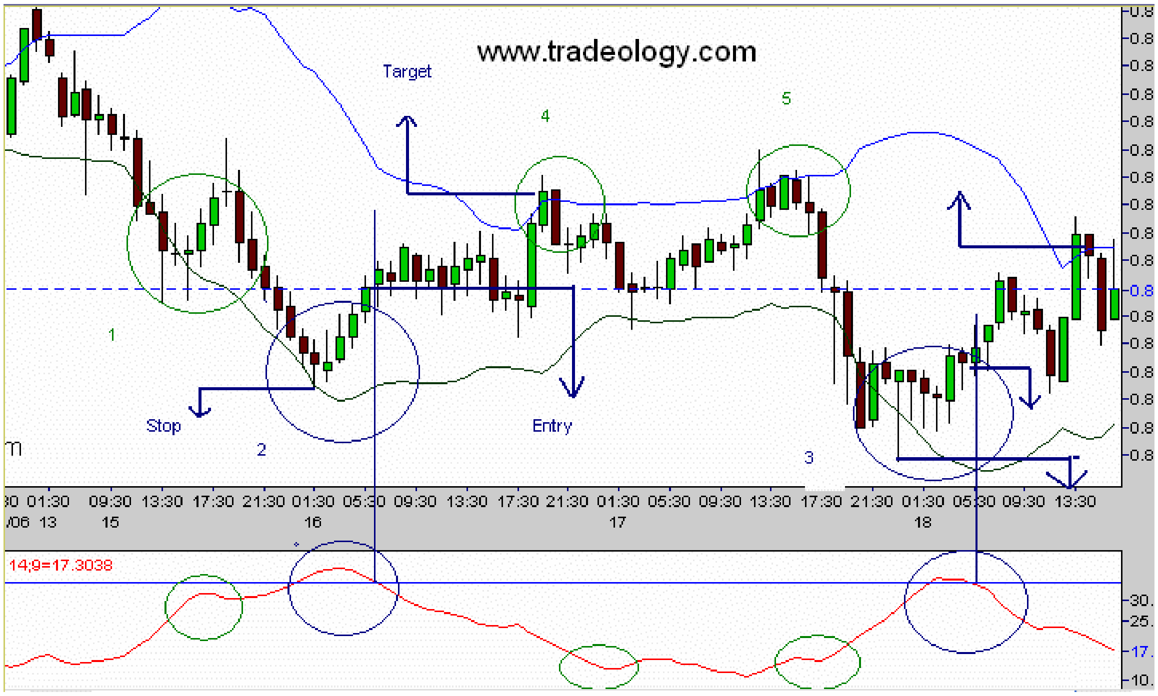
It is this last feature of the ADX that we shall combine along with the Bollinger bands.

If we are looking for a downtrend to end, we would look for price to thrust outside the lower Bollinger band by reaching an extreme oversold level. This by itself may not be the confirmation that the trend has run out of strength.

But at this point, if the ADX starts declining from its overbought values, then we have a better probability of the momentum changing. The market then reaches “a critical turning point” as the ADX turns back to the downside, while the price falls below the lower Bollinger Band.

This indicates that although the market has accomplished a relatively oversold state, the internal strength of the trend has weakened and now stands a smaller chance of continuing lower.

Let us observe the use of this strategy on the following chart example.



The very first example marked as circle.1, proves the effectiveness of this technique. Price had been in a downtrend, and we had a retracement with a close inside the lower band.
By itself, this should have been a good signal to go long. But if we observe the ADX, it had not yet reached the overbought area, indicating that there is still some momentum left in the downtrend. And surely enough, this turned out to be a minor retracement with price resuming the downtrend.

We had a similar situation (at circle.2) only this time the ADX had crossed over to the extreme overbought zone, and had started retracing down, indicating the trend had weakened.
Since there was the required confirmation form the ADX, we could enter a long trade on the price bar which causes the ADX to cross the 40 line to the downside. The stop should be placed beneath the low of the price bar which breached the lower band, and we set our price objective on the upper band.

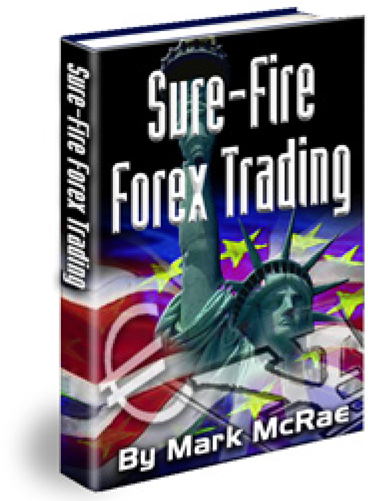
As it turned out, this trade did not give much of a move, as we exited as soon as price reached the upper band. The stop was also safe as the slowly made its way to the upper band.

We had a similar situation at circle.3, where the breach of the lower band was confirmed by the ADX reaching its overbought level. By following our rules, we had another confirmed long trade.

If we look at situations 4 and 5, the breach of the upper band was followed by a price reversal, but we ignore those trades since the ADX is absolutely at its lower levels and the Bollinger bands are flat, indicating that the market is in a non trending state. In such cases, we do not enter a trade as we do not know when and where the price is going.

So with the proper use this little technique and a good amount of patience and discipline, we can take advantage of these frequently occurring setups.

Good Trading
Mark McRae



Information, charts or examples contained in this lesson are for illustration and educational purposes only. It should not be considered as advice or a recommendation to buy or sell any security or financial instrument. We do not and cannot offer investment advice. For further information please read our disclaimer.