THE KEVIN HAGGERTY INNER CIRCLE TRAINING PROGRAM

January 16th, 2006

Chapter V: RSTs

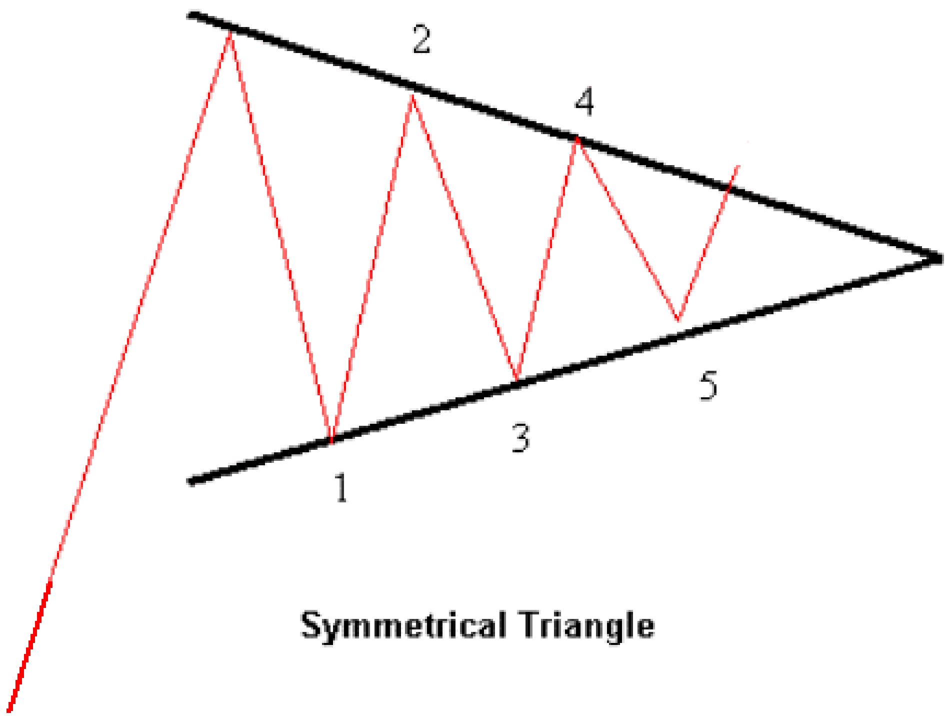
Kevin Haggerty's
"Trading with the Generals IV"

RSTs

The RST is a very powerful reversal pattern that sets up when there is expanding volatility. It is named RST because it resembles a Reverse Symmetrical Triangle and sometimes a Broadening Formation. Expanding volatility in the case of the RST means ascending highs and descending lows. This is in contrast to the symmetrical triangle, which has contracting volatility with lower highs and higher lows.

Before we look at an RST graphic, it is better to see examples of symmetrical triangles in both an uptrend and downtrend.

RSTs

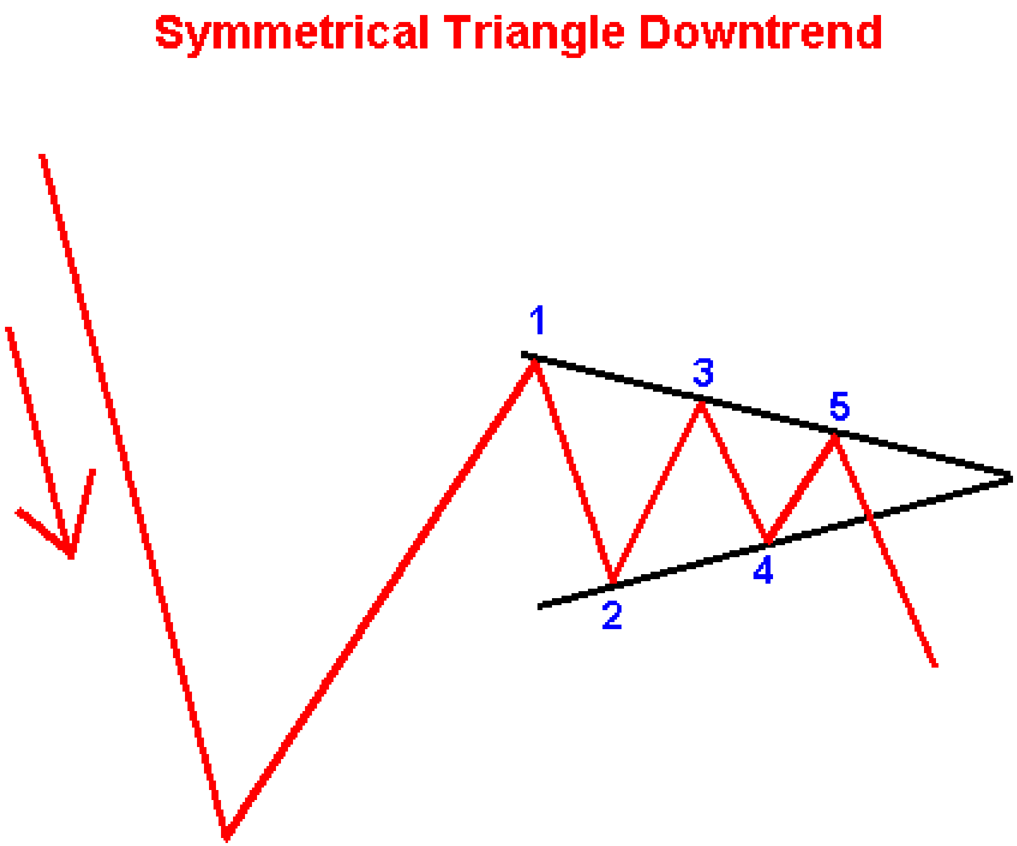


Symmetrical Triangle

Symmetrical triangles with good definition will have five swing points, and usually the 5 point will fall short of the trendline opposite the direction of the breakout, which gives you an early indication of the impending breakout.

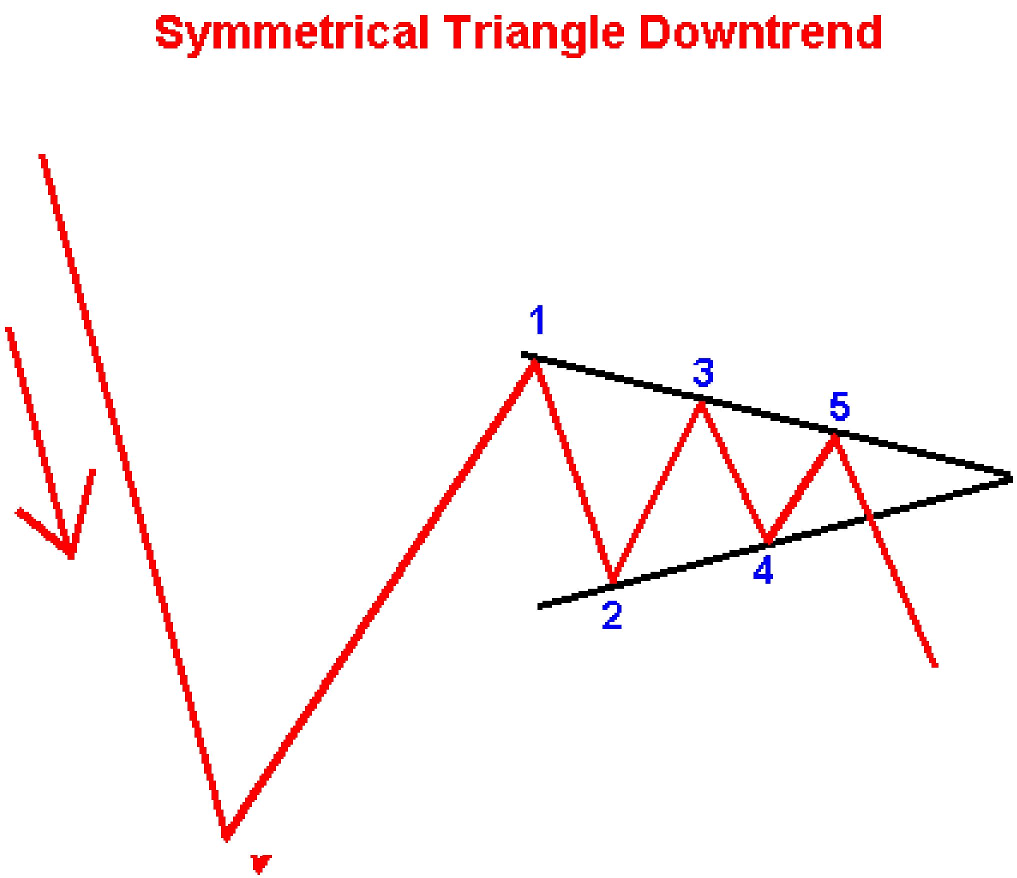
When you number your triangles correctly, the breakout in direction of trend will be across the 2 - 4 line, not the 1 - 3 - 5 line.

RSTs



Contracting volatility patterns like triangles and Slim Jims are excellent setups because the highest probability is that volatility will revert to the mean and the breakout will be in the direction of the trend, provided the pattern is not extended to the extreme Fibonacci extension levels and STDV bands because the longer-term trend is too mature/extended.

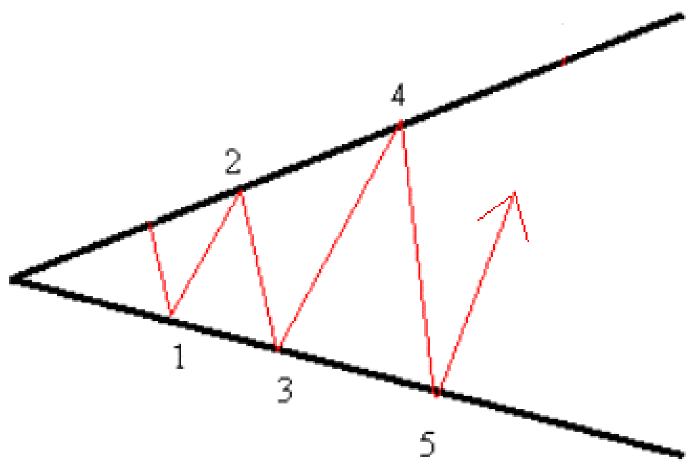
RSTs



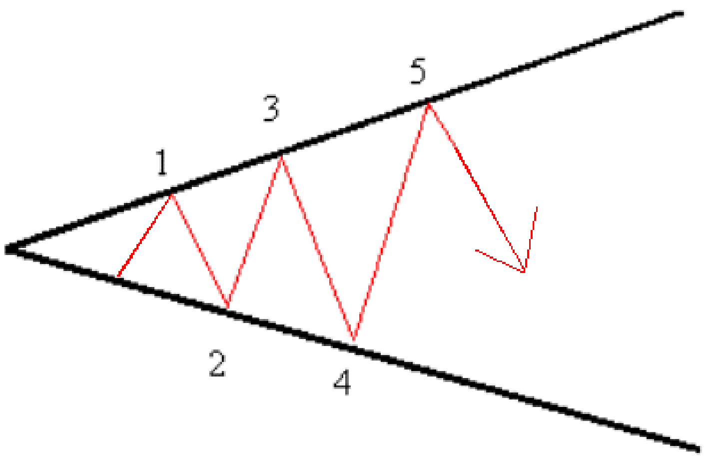
<u>Key Point</u>: When you enter a contracting volatility pattern, you do so because you expect price to advance in the direction of the trend. If it is a strong move, the volatility will at least revert to the mean, but most often will get extended, and your sequence tools will identify those levels. Your initial entry from the triangle is usually at the narrow volatility end. It is important to realize that in the RST, you will be doing the exact opposite and entering the trade at an expanded volatility level relative to the timeframe you are trading.

RSTs

The following graphics are examples of the RST buy and sell patterns.



RST Buy Pattern



RST Sell Pattern

RSTs

In the real world, the RSTs won't have the exact symmetry all of the time that is seen with the graphics, but you will have no problem identifying the pattern after some practice.

Key Point: You identify the RST by starting on the right side of the chart and work back to the left until you have identified five swing points, which includes the initial high or low which is marked as swing point 5.

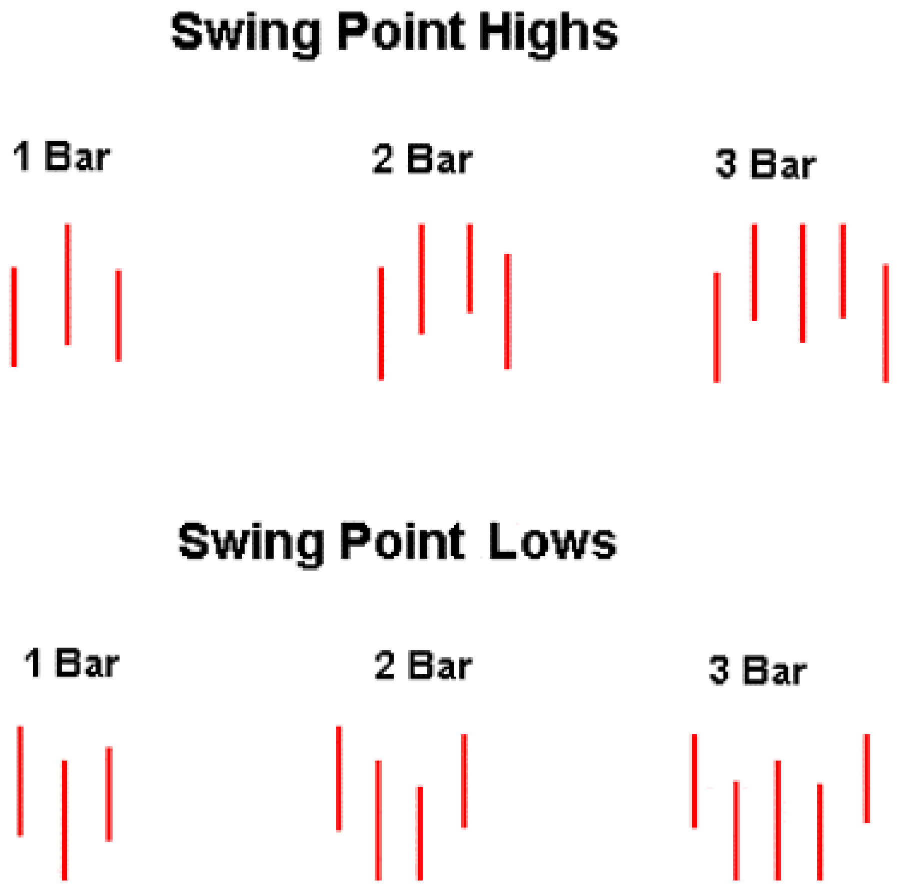
Key Point: The pattern is not valid unless all of the swing points are higher highs and lower lows.

RSTs

Swing Points Defined

- Swing Point High: This is a high with a lower high on each side.
- Swing Point Low: This is a low with a higher low on each side.

Swing point highs/lows are usually one bar, but sometimes are either two- or even three-bar swing points.



RSTs

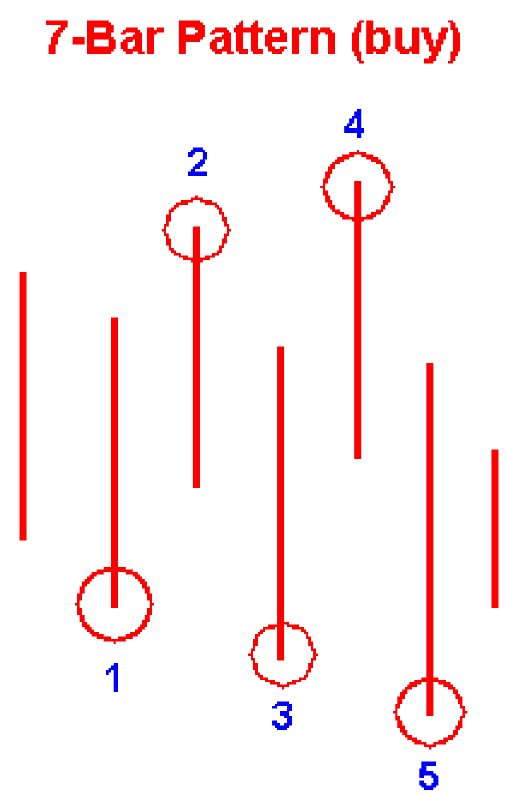
Key Point: When identifying swing points, make sure to close any gaps on either side of the low/high. By doing this, you will see that what appears to be a swing point is really not and avoid the mistake of taking an invalid pattern.

Key Point: The minimum number of bars needed to form the pattern is seven.

RSTs

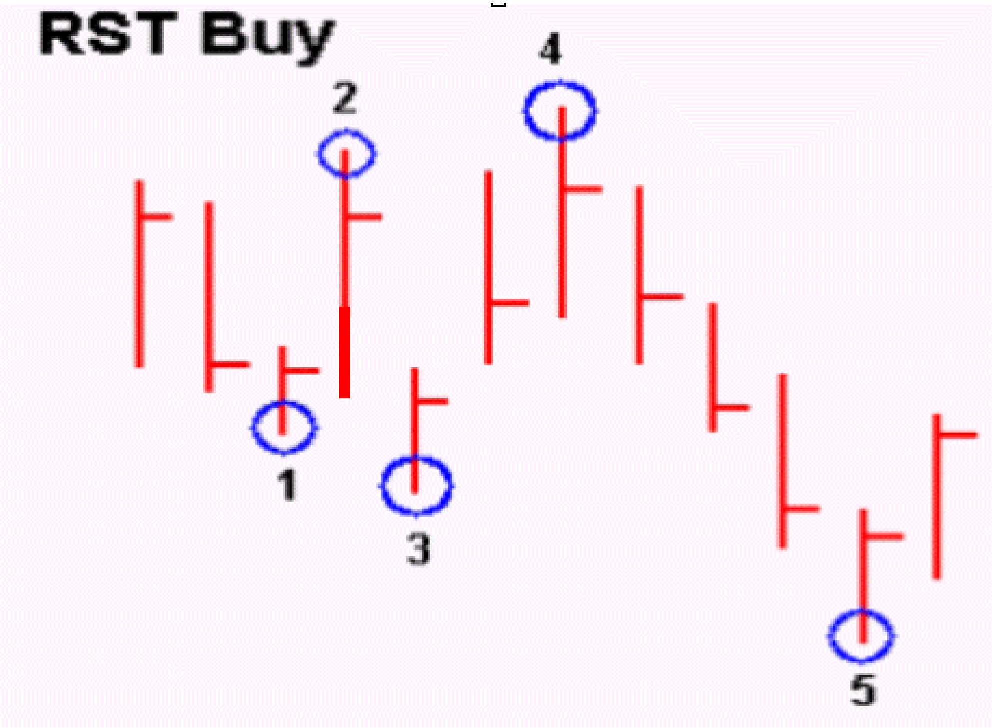
Starting from the 5 point on the right, you can count back to the left and see the other four swing points. You have lower lows with the 5 point below the 3 point, which is below the 1 point. There are also higher highs with the 4 point above the 2 point.

<u>**Key Point**</u>: It is rare that you will see just a seven-bar pattern, but it demonstrates that you must be diligent when looking for the pattern starting on the right side of the chart from the recent high or low and reading the swing points right to left.



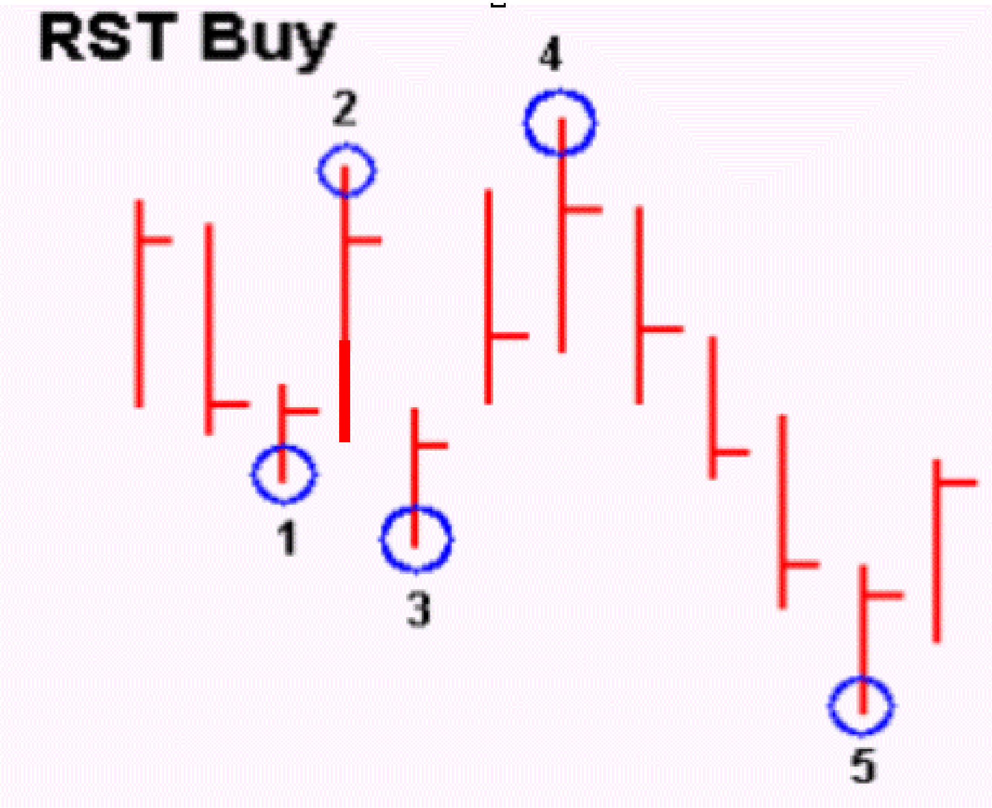
RSTs

Practice your count on the following examples.



- Start on the right side at the most recent low swing point, which is 5.
- Count the swing points to the left until you identify points 4,3,2,1.
- There must be ascending highs and descending lows for a valid pattern.

RSTs

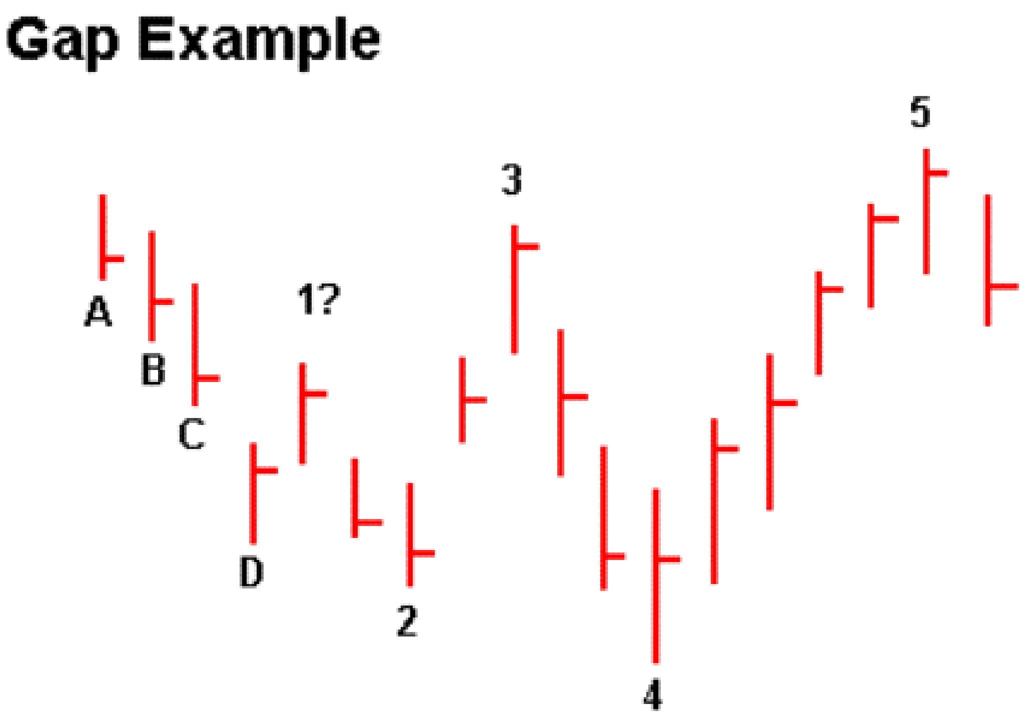


- Start on the right side at the most recent high swing point.
- Count the swing points to the left until you identify points 4,3,2,1.
- There must be ascending highs and descending lows for a valid pattern.

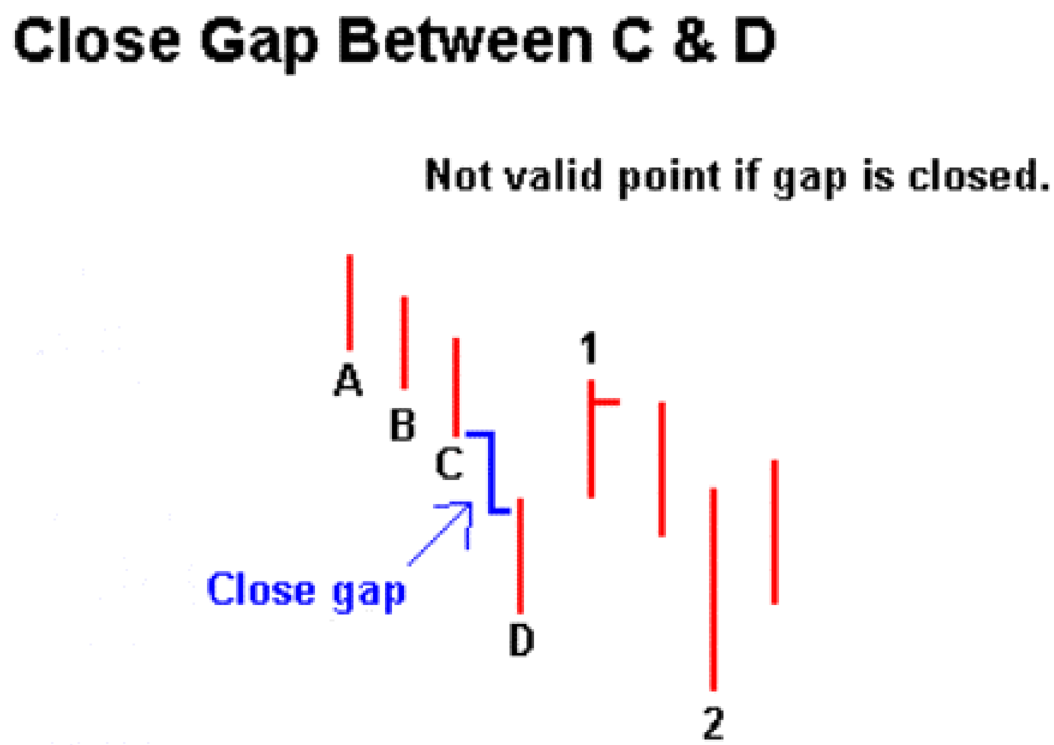
RSTs

RST Gap Example

This will clarify what I mean by closing the gap. Notice in the graphic RST sell example that swing point 1 has a question mark and that is because there is a gap between the C bar low and D bar high. If that gap is closed, then 1 would not be a swing point.



RSTs



In this graphic, you can see that closing the gap between C and D invalidates 1 as a swing point because it doesn't have a lower high on the left of it.

RSTs

Unlike the 1,2,3 patterns that have an initial trendline break indicating a possible change in direction, the RST entry is as close to a bottom/top that you can get in a reversal strategy. Sometimes you will see a positive or negative divergence in some of the lagging indicators, like RSI and stochastics, but very often these indicators are of little value. The leading indicators, which are the sequence tools in conjunction with the RST, make it very powerful, but you should remember that the RST also stands by itself. When you take an RST entry, it means you are getting in at the earliest point of a reversal.

RSTs

Key Point: The RST is an expanding volatility pattern and usually is the result of a good news/bad news scenario as the Generals are not sure whether to buy it or sell it, and also when the same uncertainty exists in the major indices.

Key Point: You should use the daily charts when searching for position RSTs. They will be found after significant declines or advances. They are also to be found around the longer-term moving averages, such as the 150- or 200-day EMAs. RST buy patterns that set up below or at a rising longer-term MA are very high-probability trades, as are RST sell patterns that set up above declining longer-term MAs.

Key Point: You will find many RSTs on the intraday charts and sometimes over a period of several days, not just the specific day you are trading. They will almost always be in confluence with volatility bands, STDV and Fibonacci tools, which enhance the probability of success and a high reward-to-risk.

RSTs

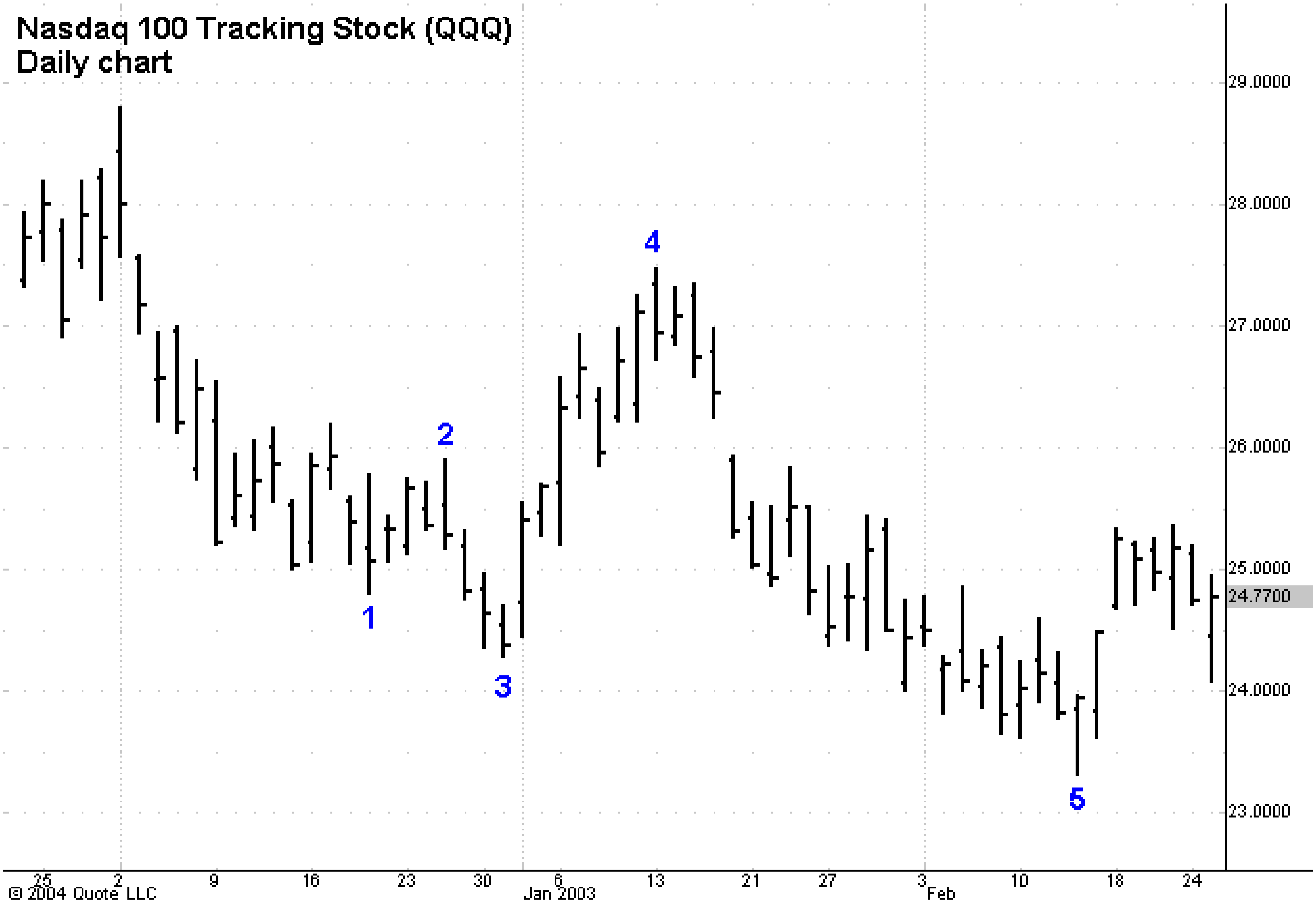
The more charts you look at, the better you will become at identifying the RST because sometimes it's easy to miss a small swing point or two and not all RSTs have as much symmetry as the graphics. I have included this exercise to get you into the habit of starting on the right side of the chart at the most recent high or low and counting backward to the left for the 4,3,2,1 swing points.

One chart will just have the price bars, and you will identify what you think are the swing points that form the pattern. The following page will have the same chart, but with the answer to the correct swing points.

RSTs

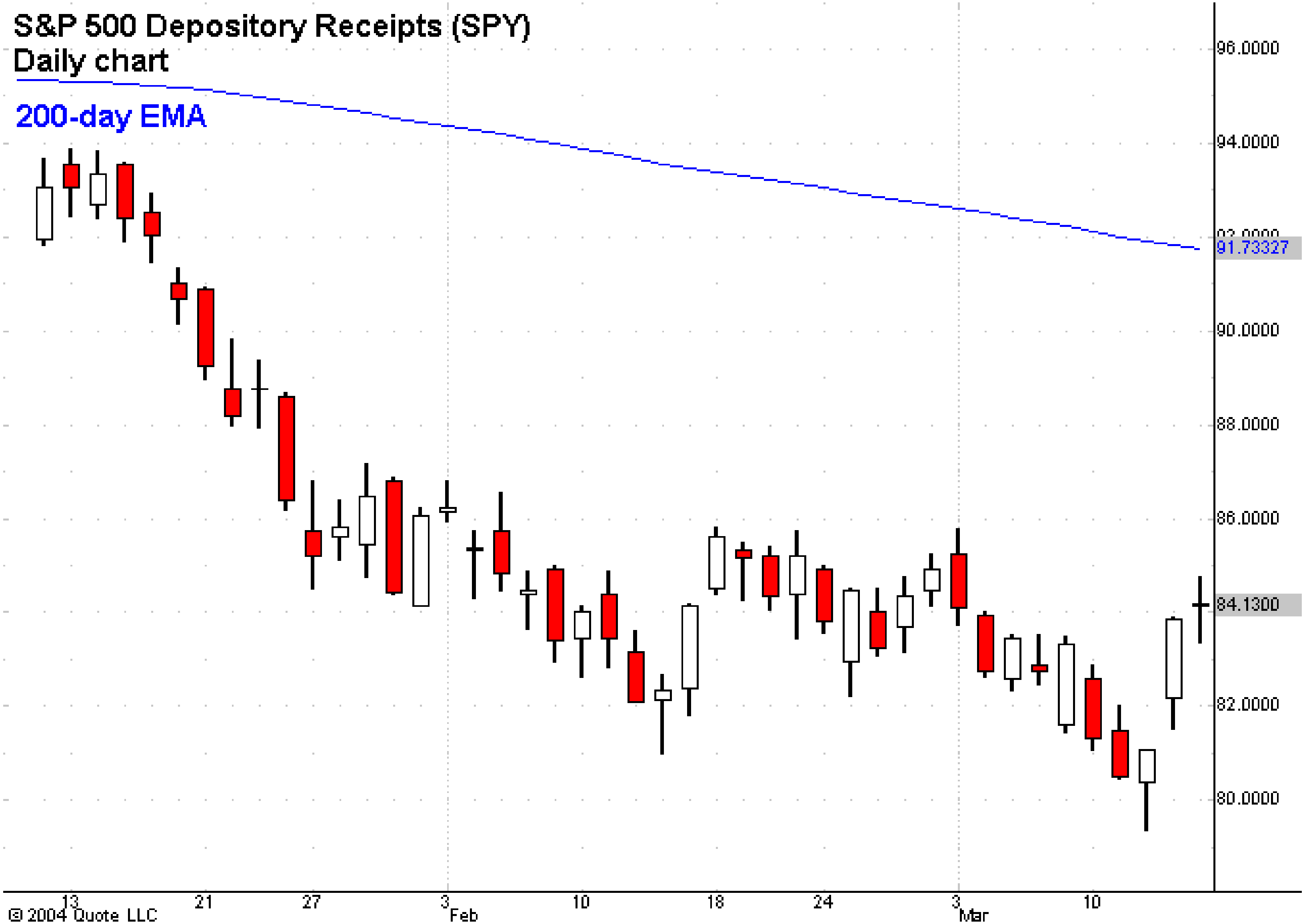
Nasdaq 100 Tracking Stock (QQQ)
Daily chart
29.0000
28.0000
27.0000
26.0000
25.0000
24.7700
24.0000
23.0000
25
2
9
16
23
30
6
13
21
27
3
10
18
24
Jan 2003
Feb
© 2004 Quote LLC

RSTs



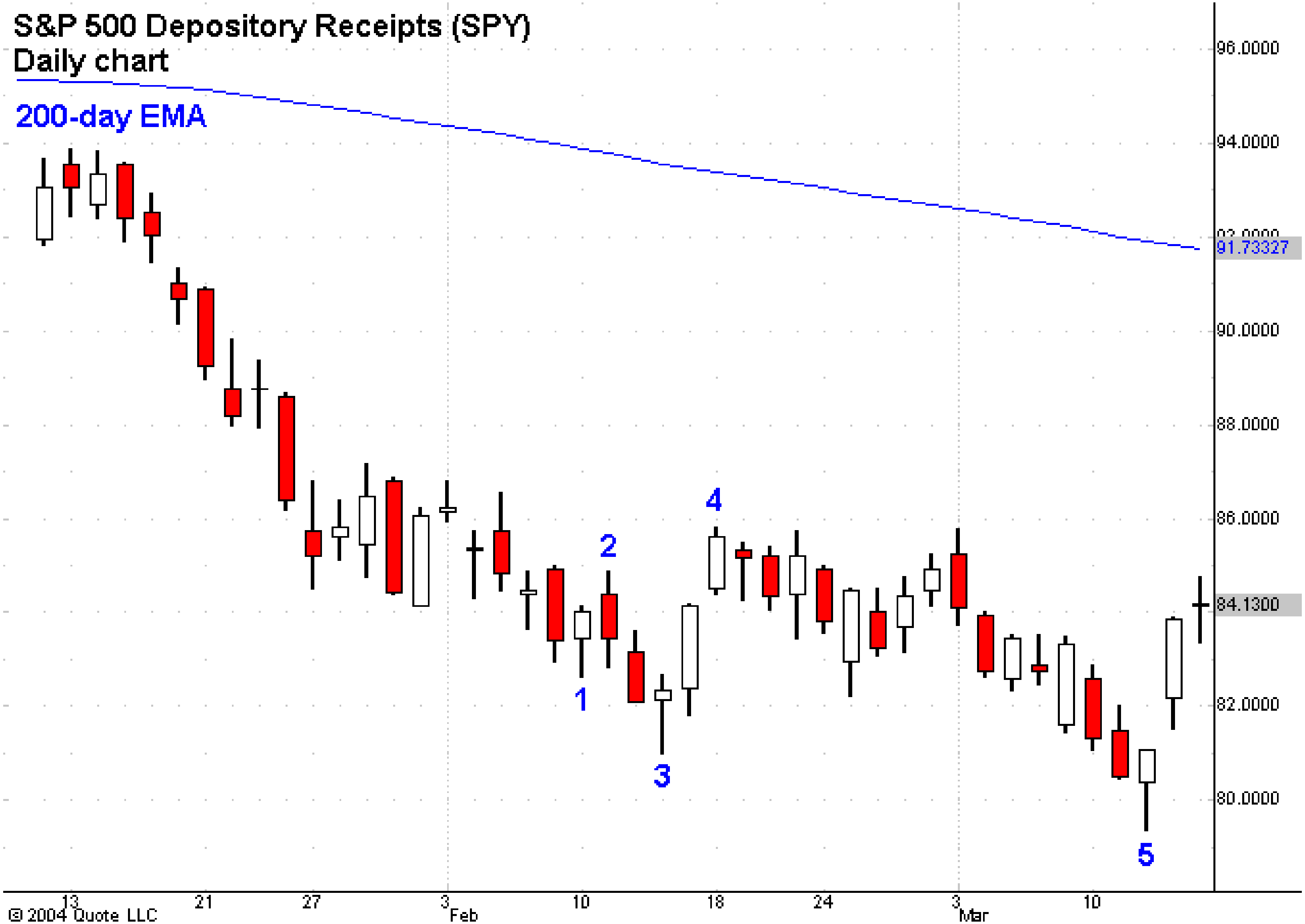
Nasdaq 100 Tracking Stock (QQQ)
Daily chart
1
2
3
4
5
29.0000
28.0000
27.0000
26.0000
25.0000
24.7700
24.0000
23.0000
25
2
9
16
23
30
6
Jan 2003
13
21
27
3
Feb
10
18
24
© 2004 Quote LLC

RSTs



S&P 500 Depository Receipts (SPY)
Daily chart
200-day EMA
96.0000
94.0000
91.73327
90.0000
88.0000
86.0000
84.1300
82.0000
80.0000
13
21
27
3
Feb
10
18
24
3
Mar
10
© 2004 Quote LLC

RSTs


S&P 500 Depository Receipts (SPY)
Daily chart
200-day EMA
96.0000
94.0000
91.73327
90.0000
88.0000
86.0000
84.1300
82.0000
80.0000
1
2
3
4
5
13
21
27
3
Feb
10
18
24
3
Mar
10
© 2004 Quote LLC

RSTs


Nasdaq 100 Tracking Stock (QQQ)
Daily chart
125.0000
120.0000
115.0000
110.0000
105.0000
100.0000
95.0000
90.0000
85.0000
81.88374
80.0000
75.0000
70.0000
200-day EMA
↑2 for 1
18
24
31
Feb
7
14
22
28
Mar
6
13
20
27
© 2004 Quote LLC

RSTs


Nasdaq 100 Tracking Stock (QQQ)
Daily chart
1
2
3
4
5
200-day EMA
125.0000
120.0000
115.0000
110.0000
105.0000
100.0000
95.0000
90.0000
85.0000
81.88374
80.0000
75.0000
70.0000
↑2 for 1
18
24
31
Feb
7
14
22
28
Mar
6
13
20
27
© 2004 Quote LLC

RSTs

Lam Research (LRCX) -- Daily chart
200-day EMA
34.0000
32.0000
30.0000
28.0000
26.0000
25.20650
24.0000
22.0000
20.0000
18.0000
16.0000
14.5000
14.0000
12.0000
28
5
11
18
25
2
Oct
9
16
23
30
Nov
6
13
20
27
4
Dec
11
18
26
© 2004 Quote LLC

RSTs


Lam Research (LRCX) -- Daily chart
200-day EMA
Symmetry
1
2
3
4
5
34.0000
32.0000
30.0000
28.0000
26.0000
25.20650
24.0000
22.0000
20.0000
18.0000
16.0000
14.5000
14.0000
12.0000
28
5
11
18
25
2
Oct
9
16
23
30
6
Nov
13
20
27
4
Dec
11
18
26
© 2004 Quote LLC

RSTs

Nasdaq 100 Tracking Stock (QQQ)
Daily chart
200-day EMA
108.0000
106.0000
104.0000
102.0000
100.0000
98.0000
96.0000
94.6250
94.0000
92.0000
89.94258
88.0000
86.0000
84.0000
82.0000
5
12
19
26
3
Jul
10
17
24
31
Aug
7
14
21
28
5
Sep
11
18
© 2004 Quote LLC

RSTs


Nasdaq 100 Tracking Stock (QQQ)
Daily chart
1
2
1
2
3
4
5
200-day EMA
106.0000
104.0000
102.0000
100.0000
98.0000
96.0000
94.6250
94.0000
92.0000
89.94258
88.0000
86.0000
84.0000
82.0000
5
12
19
26
3
Jul
10
17
24
31
Aug
7
14
21
28
5
Sep
11
18
© 2004 Quote LLC

RSTs

RST Guidelines

On daily charts, the best RSTs are found after significant declines or advances to new lows or highs. It helps to check the new 52-week high/low lists. The fastest way to check all stocks is to use a regular chart book. I can go through over 600 major big-cap stocks in less than 20 minutes because it is so easy to identify the pattern. All trading-range stocks get eliminated immediately, as do those that have not made new highs or lows after a significant move. If you have a quote vendor that has flip charts, you can accomplish the same thing.

RSTs

RST Guidelines

You can anticipate where an RST will set up by checking what level the next swing point high or low will be and then count left to see if all of the swing points form an RST. On individual stocks, I make a list up in advance with the price level that has to be penetrated to form an RST. You will see that is always what becomes the 3 point. On intraday charts, it is more dynamic than the daily chart, but you still anticipate where the RST sets up by checking previous days' prices and making note of it in your trading plan. Daytraders using five-minute to 15-minute charts will usually spot the RST pattern over one to three days' time. You should also look for RSTs on 30-, 60- and 120-minute charts and when you find one that sets up on the larger and also the smaller timeframe, it is that much more powerful. The longer intraday setups can be over a longer period.

Key Point: Daytraders should be aware at all times where the next level is that forms an RST and at the completion of each trading day, you can anticipate where an opening Trap Door move will also become an RST.

RSTs

Don't forget that if you get an RST setup, you are also looking to see if there is a confluence of the sequence tools, in addition to any longer-term moving averages.

The RST without any other sequence tool is a powerful pattern, but it is always a higher probability when there is more weight of the evidence.

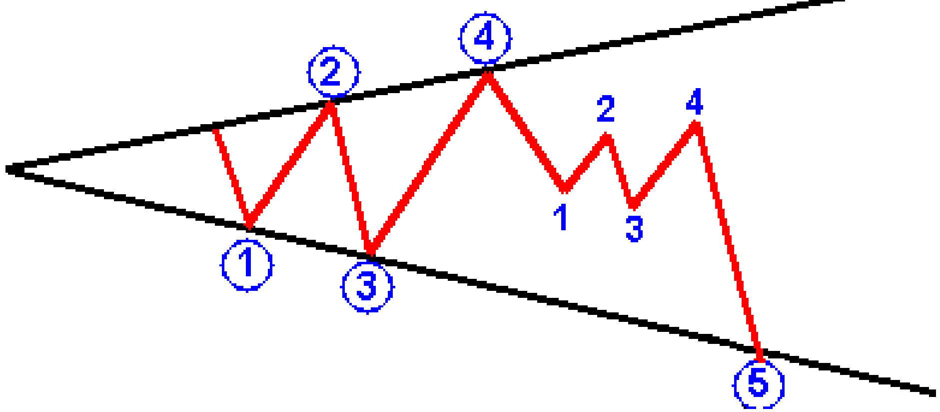
- If you identify an RST after a long decline or advance, it is better when the long-term moving average is starting to flatten out or roll under after a long decline, or else starting to roll over after a long advance. (You can check the 150- and 200-day MAs, both EMA and SMA.) This will clearly indicate that momentum has slowed.
- If the RST buy pattern sets up and the 5 swing point low is at least 25% - 30% below a longer-term moving average, you can take the trade and not worry as much about the longer-term MA. If it's a bull market, look for price to be about 35% or more above the long-term MA. In both cases, it is best when there is confluence with the primary sequence tools.

RSTs

- RST buy patterns that set up at or below a rising long-term MA after a significant advance are excellent setups, and you will find that they are usually at a Fibonacci level. The same holds true when an RST sell pattern sets up above a declining longer-term MA.

Key Point: The moving average filter where it must be starting to turn under or roll over is not an absolute if there is significant confluence with Fibonacci levels and extended STDV. On intraday charts, it is not as much of a factor.

RSTs



There should be some symmetry to the pattern, and the following graphic is an example that you will encounter. If there is no real symmetry in the initial RST, then keep looking left, and you will often find a larger pattern with symmetry. In this example, the 4,3,2,1 points are just a narrow trading range followed by a knife down to 5, which is not symmetry. Looking left, I see the larger pattern and 4,3,2,1 which has symmetry.

<u>Key Point</u>: If you can draw an extended line above points 2 and 4 and below 3 and 5, so it kind of looks like a megaphone, there is good symmetry. Sometimes the lows will be at sharper angels than you see on the graphic, but I think you get my drift.

RSTs

The entry rules for RSTs are few and simple.

Entry for daily chart position trades is on the close above the high of the low day for buys and a close below the low of the high day for sells.

Key Point: If you sense that it is an RST with strong confluence and the price action into the 5 point indicates momentum has slowed, then you can get more aggressive with your entry because the day that it trades above the high or low might turn out to be an explosive wide-range-bar day, and there will be too much slippage on your entry. In order to do this, you might take an intraday entry above the high or low, then keep the position if it is closing above that high or low. You would only do it this way if you daytrade on a regular basis. Longer-term traders should buy it on the close, and if it's a very wide-range bar, maybe wait for a retracement the next day and enter the position.

RSTs

- The sequence tools in play will make your decision to take the trade easier because after a long decline, for example, it will seem like the last thing you should do, as there will be negative vibes from most analysts, media, etc., and the reverse is true at extended highs. More confirmation will be if there are positive or negative divergences in indicators like RSI, stochastics, or my favorite, the Chande Momentum Oscillator, over a short, intermediate or longer-term period.

RSTs

- Price action, and especially volume, will be a key factor in your decision. After a longer-term decline in both time and price, you will most often see a volume increase as the Generals decide to enter the stock in some kind of size. You don't always see a volume alert on RST sell patterns after long advances. If you get rising prices on declining volume into a Fib retracement or extension zone and maybe at an extended STDV zone, then your decision is much easier because that is an indication of a possible reversal. Volume spikes are another alert for potential reversals, as would be narrowing range on an increase in volume, which would also indicate a potential turning point.

RSTs

- Initial stops are placed below and above the 5 point, unless they are wide-range bars and the percentage stop is more than the maximum amount you normally risk on each trade.
- On longer-term RST sell trades, it is better to buy puts because who wants unlimited risk or a short squeeze? For RST buys after a stock or market has had a very significant decline over a period of time, it is also a good strategy to buy calls (three-month or more on both puts and calls), unless you decide to use longer-term LEAPS or even spreads.

Key Point: Do not use options unless you are qualified and have the proper education.

RSTs

- If you are stopped out on your first RST, you can take a second RST entry if it sets up at lower or higher prices, provided you see that the zone still has confluence or a volume alert.
- Intraday entries are similar, except that you will sometimes enter before price trades below or above a wide-range bar because price might be at a key sequence tool level. Stops are handled the same way.
- Managing a trade is different for everyone based on capital, risk aversion, emotions, etc. I will highlight some of my thoughts (methods) as we move through the actual examples.

RSTs

You should have a good idea of the RST by now, so let me take you on a tour of some actual charts and include some sequence tools. I also want to show you that RSTs and the tools cover many markets other than just equities. If you are invested in your IRA with index proxies or 401(k) with mutual funds, sooner or later you will have to make a timing decision on entering with more cash or switching to a money market fund unless you prefer to sit through the kind of decline that started in the first quarter of 2000. It is beneficial to have a handle on how the equity markets react in the business cycle and that means keeping close contact with the CRB, bonds and US Dollar. (I will give you a better checklist that will help in another section.)

RSTs

CBOE Volatility Index (VIX)
Daily chart
10-day SMA
18.06
14.87
14.01
72.64
VIX is -11.0% below 10-day SMA
Stochastic(8(3),3)
20.00
19.00
18.00
17.00
16.648
16.00
15.00
14.00
82.93
69.91
60.00
40.00
20.00
27
3
10
17
24
1
Dec
8
15
22
29
5
Jan 2004
12
20
26
2
Feb
© 2004 Quote LLC

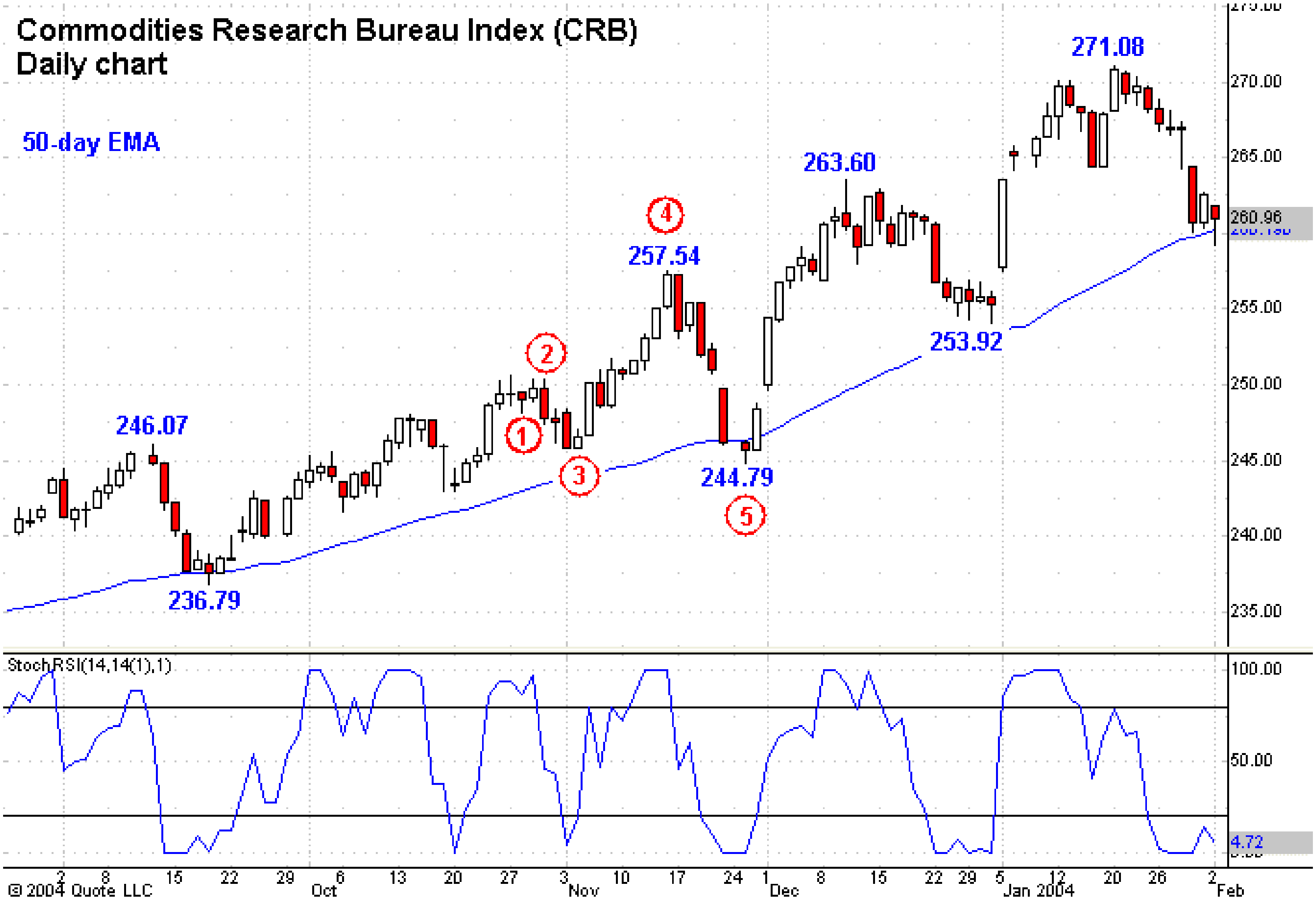
RSTs

This first chart is the CBOE volatility index ($VIX). It gives you an RST setup as the VIX trades and closes above 14.87. If the VIX is rising, you would look for short setups in the major indices, as it has an inverse relationship. The SPX hit its rally high the next trading day at 1155.38 and declined to 1122.38 in two days as the VIX rose to 18.06. The VIX reversed down, and the SPX was trading at 1141 as the VIX hit 16.38.

From my experience, and as you can see, the 8,3,3 slow stochastic complements the VIX price action, and in fact, I also use it on all of the intraday charts. I put the 10-day SMA on this chart for those of you that follow the CVS strategy that is explained in Larry Connors' work on the TradingMarkets site. At the 14.01 low, the VIX was -11.6% below the 10-day SMA, which is used in the strategy.

Key Point: The VIX is an excellent tool and should be used as more weight of the evidence with sequence and the primary reversal patterns. It is one more tool of confirmation.

RSTs



Commodities Research Bureau Index (CRB)
Daily chart
50-day EMA
246.07
236.79
257.54
244.79
263.60
253.92
271.08
1
2
3
4
5
Stoch RSI(14,14(1),1)
260.96
4.72
© 2004 Quote LLC
Oct
Nov
Dec
Jan 2004
Feb

RSTs

The next RST chart is the CRB with a 50-day SMA and a 14-period stochRSI, which is also a good indicator for most markets. I used the simple MA because that is what the CRB has been in sync with. Normally on daily charts I will use a 20-, 50-, 89- and 200-day EMA setup and no simple MAs, but if it's a volatile market, you will sometimes see a significant difference between the EMAs and SMAs, but mostly in the 200-day. (Be aware of both to see which one is in sync, but it is most often the EMAs, which are my primary.)

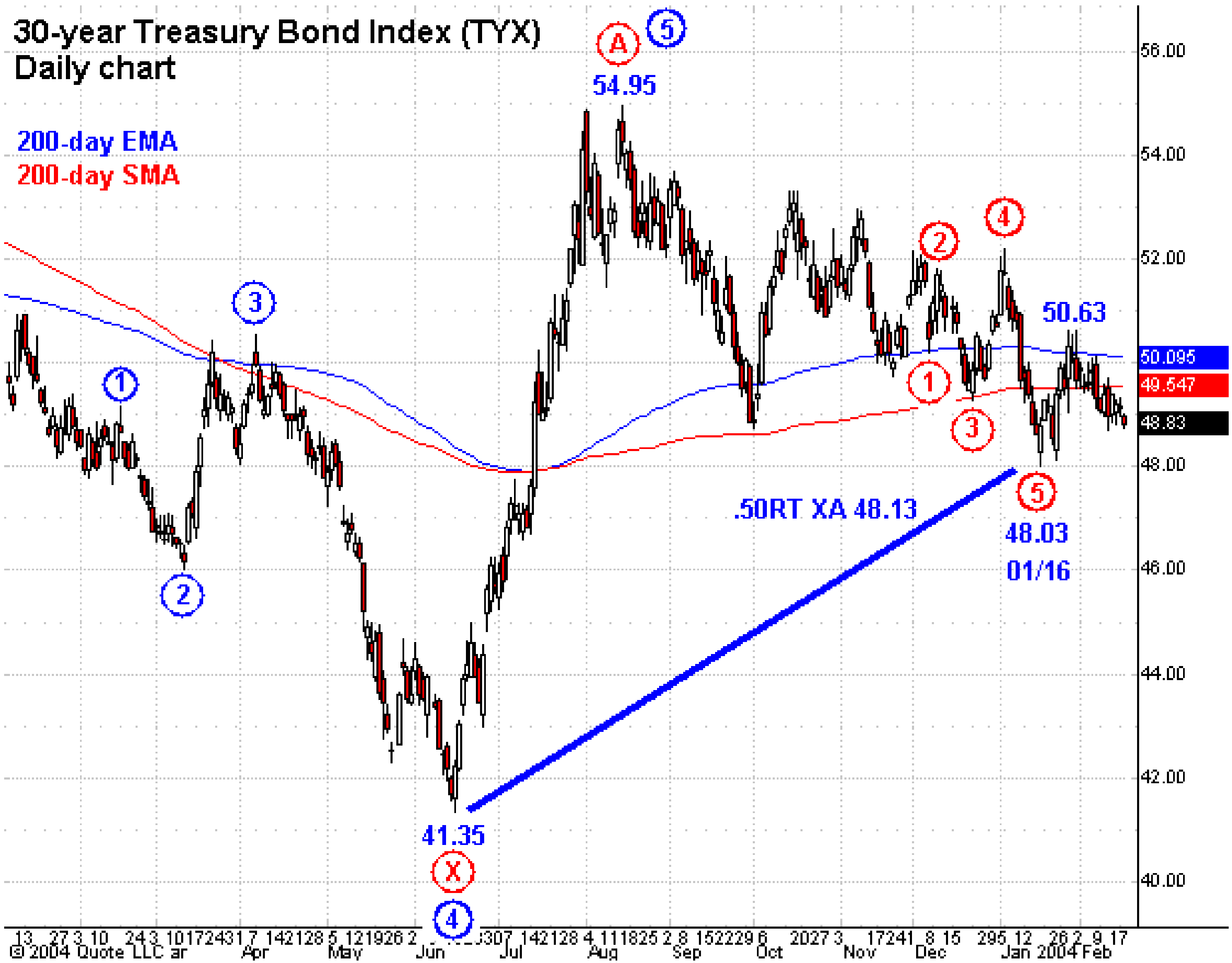
The RST was a retracement to a rising 50-day EMA with a narrow-range bar 244.79 low. RST entry was the next day.

Narrow-range bars with an increase in volume most often precede a change in direction, as you can see on the previous retracement to 236.79 and the one to 253.92. We don't know how the current situation plays out yet.

The stochRSI (14) is in sync with price on all of the retracements.

Key Point: Oversold retracements in a rising trend are high-probability entry points, and you had the RST setup here, so it was a very powerful entry.

RSTs



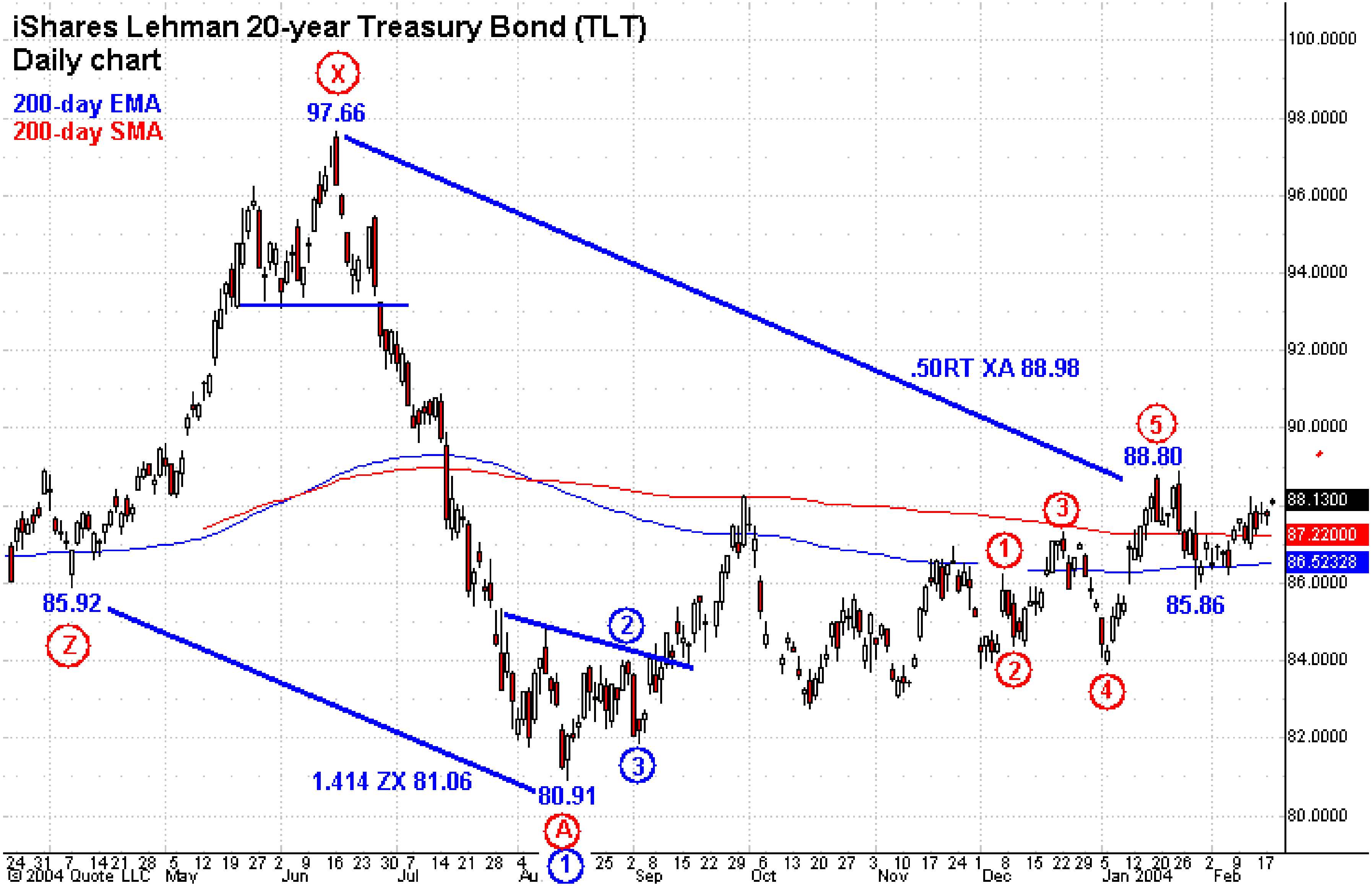
30-year Treasury Bond Index (TYX)
Daily chart
200-day EMA
200-day SMA
54.95
A
5
3
1
2
4
X
41.35
.50RT XA 48.13
1
2
3
4
5
48.03
01/16
50.63
50.095
49.547
48.83
56.00
54.00
52.00
48.00
46.00
44.00
42.00
40.00
© 2004 Quote LLC
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan 2004 Feb

RSTs

We will now move to the Bond market, and the first chart is the TYX long-term bond yield chart. (54.95 is 5.495% yield.)

After a significant rise in rates, 41.35 to 54.95, the TYX makes a .50RT (from an RST pattern) to the XA leg with a 48.03 low on 01/16. This is an RST setup at the .50RT level with good economic reports coming out daily. This is your setup to the short bonds.

RSTs



iShares Lehman 20-year Treasury Bond (TLT)
Daily chart
200-day EMA
200-day SMA
X
97.66
.50RT XA 88.98
5
88.80
3
1
2
4
85.86
85.92
Z
1.414 ZX 81.06
80.91
A
1
2
3
100.0000
98.0000
96.0000
94.0000
92.0000
90.0000
88.1300
87.22000
86.52328
86.0000
84.0000
82.0000
80.0000
© 2004 Quote LLC
May
Jun
Jul
Au
Sep
Oct
Nov
Dec
Jan 2004
Feb

RSTs

If you don't trade the bond futures, then you would use the TLT iShares which trade on the Exchange and most of the time with excellent symmetry, as you can see on the TLT chart above. The TYX gave you an RST pattern indicating that rates might reverse back up from 48.03.

At the same time, as you would expect, the TLT price chart gives you an RST sell pattern after the 88.80 - 88.90 highs. The RST was at the .50RT zone, as it should be, because it is the same thing, except that TYX is a yield chart and TLT a price chart (price down, yield up).

Bonds have great symmetry and are better to trade as a position rather than day trade. Puts and calls work just fine, or if you have the capital, TLTs. If stocks are strong in an economic recovery, then interest rates will soon start to rise, so one could be long index proxies and short TLTs.

Consider the symmetry after the TLT made a classical H&S top, then declined to the 80.91 low, which is the 1.414 Fib extension of the ZX leg. That set up an inverse H&S pattern, which was also a 1,2,3 higher bottom, and the rally began. Notice that there are both a 200-day EMA and SMA. The previous two retracements before the 88.80 RST sell setup were in sync with the 200-day EMA.

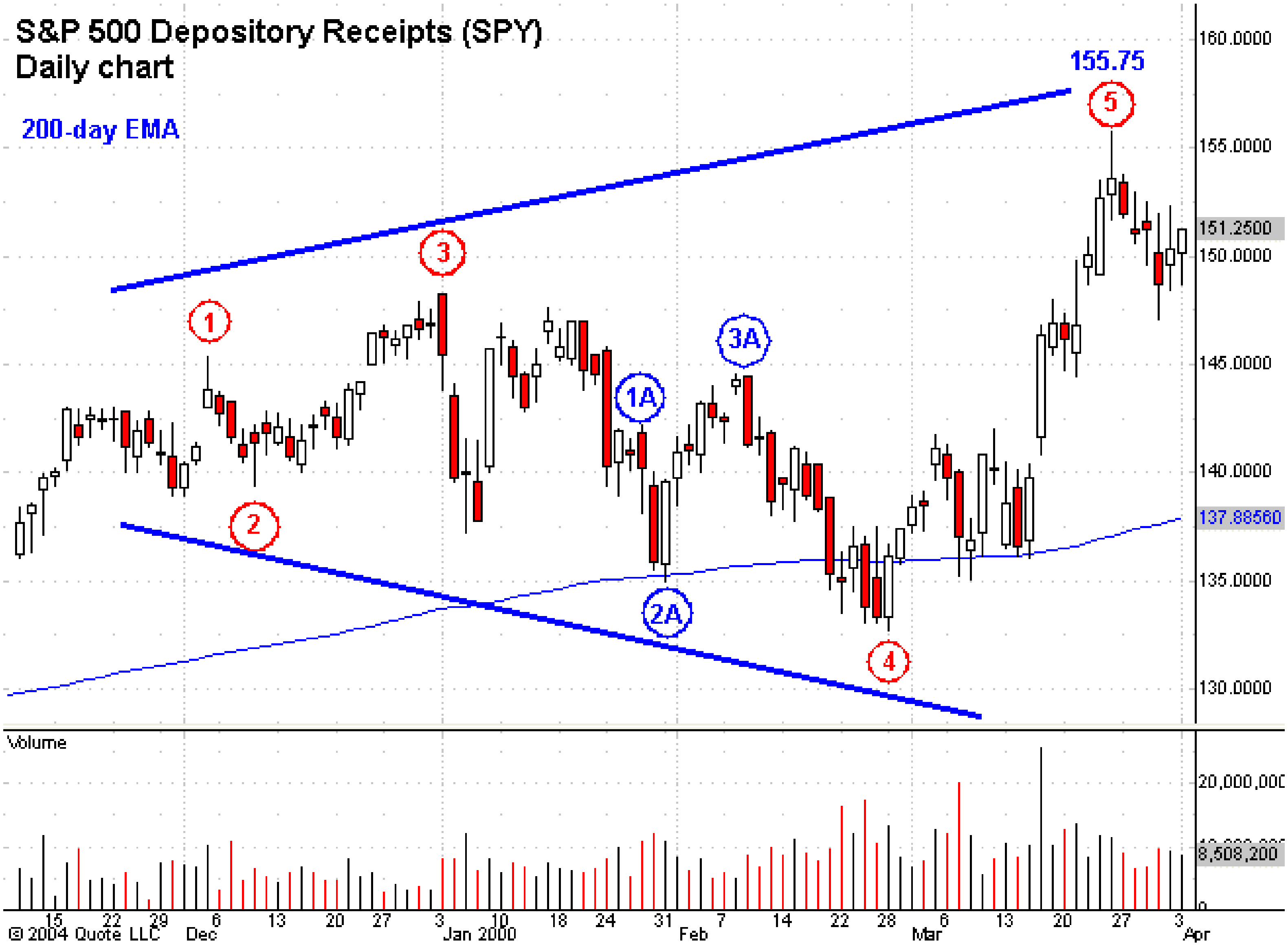
RSTs

The first thing I look at on a chart is whether there is an RST in progress, and then where will the next one set up based on the most recent high and low. After some practice and repetition, you will see a chart exactly as I do, and the RSTs will jump out at you.

RSTs

When a major index, like the SPX, forms an RST, it is only because there are many individual stocks in the index that are doing the same, as it would be with ETFs and HOLDRs. On daily charts, there will not be as many RSTs in the index as there are in individual stocks, FOREX, etc., but when you do see them, they are usually at very significant turning points, as you will see on the following charts. Just worry about seeing the symmetry of the pattern. They are not outlined with other sequence tools, but are at some significant turning points.

RSTs



S&P 500 Depository Receipts (SPY)
Daily chart
200-day EMA
155.75
1
2
3
4
5
1A
2A
3A
160.0000
155.0000
151.2500
150.0000
145.0000
140.0000
137.88560
135.0000
130.0000
Volume
20,000,000
8,508,200
0
15
22
29
6
13
20
27
3
10
18
24
31
7
14
22
28
6
13
20
27
3
Dec
Jan 2000
Feb
Mar
Apr
© 2004 Quote LLC

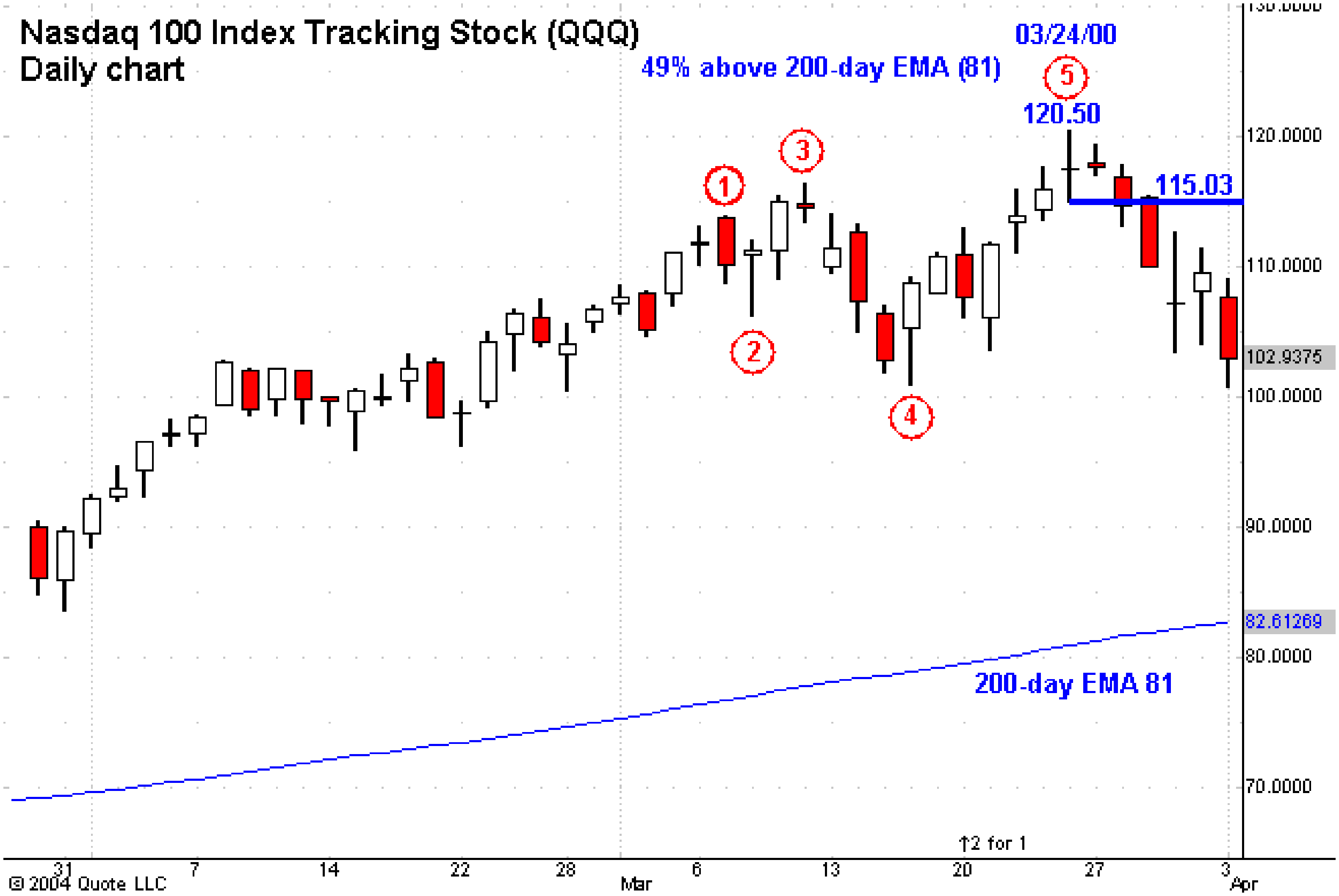
RSTs

RST sells

1. SPY 03/24/00 top

On this chart, I labeled the five swing points that show the larger symmetry, but there is a shorter RST pattern with the 1 point in the last week of January, which is indicated by 3A, 2A and 1A. The shorter pattern has enough symmetry, but when you have a larger one with good symmetry, it is a strong confirmation.

RSTs



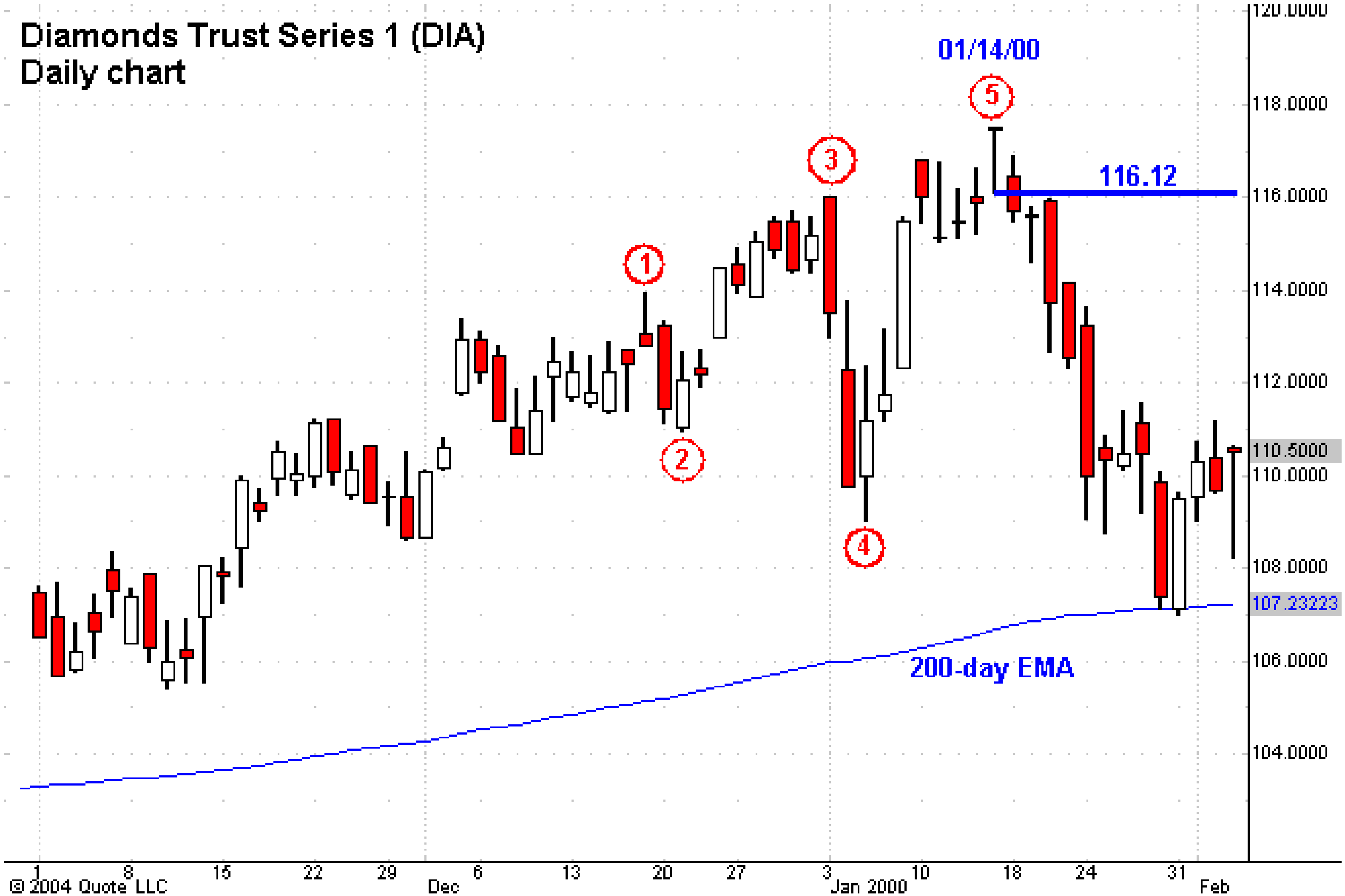
Nasdaq 100 Index Tracking Stock (QQQ)
Daily chart
49% above 200-day EMA (81)
03/24/00
120.50
115.03
1
2
3
4
5
200-day EMA 81
120.0000
110.0000
102.9375
100.0000
90.0000
82.61269
80.0000
70.0000
↑2 for 1
31
7
14
22
28
Mar
6
13
20
27
3
Apr
© 2004 Quote LLC

RSTs

2. QQQ 03/24/00 top

The QQQs RST top had excellent symmetry and was in a technology bubble and extended 49% above the 200-day EMA. Stocks will always be more extended than an index, but this bubble was an exception.

RSTs



Diamonds Trust Series 1 (DIA)
Daily chart
01/14/00
1
2
3
4
5
116.12
200-day EMA
120.0000
118.0000
116.0000
114.0000
112.0000
110.5000
110.0000
108.0000
107.23223
106.0000
104.0000
1
8
15
22
29
6
13
20
27
3
10
18
24
31
Dec
Jan 2000
Feb
© 2004 Quote LLC

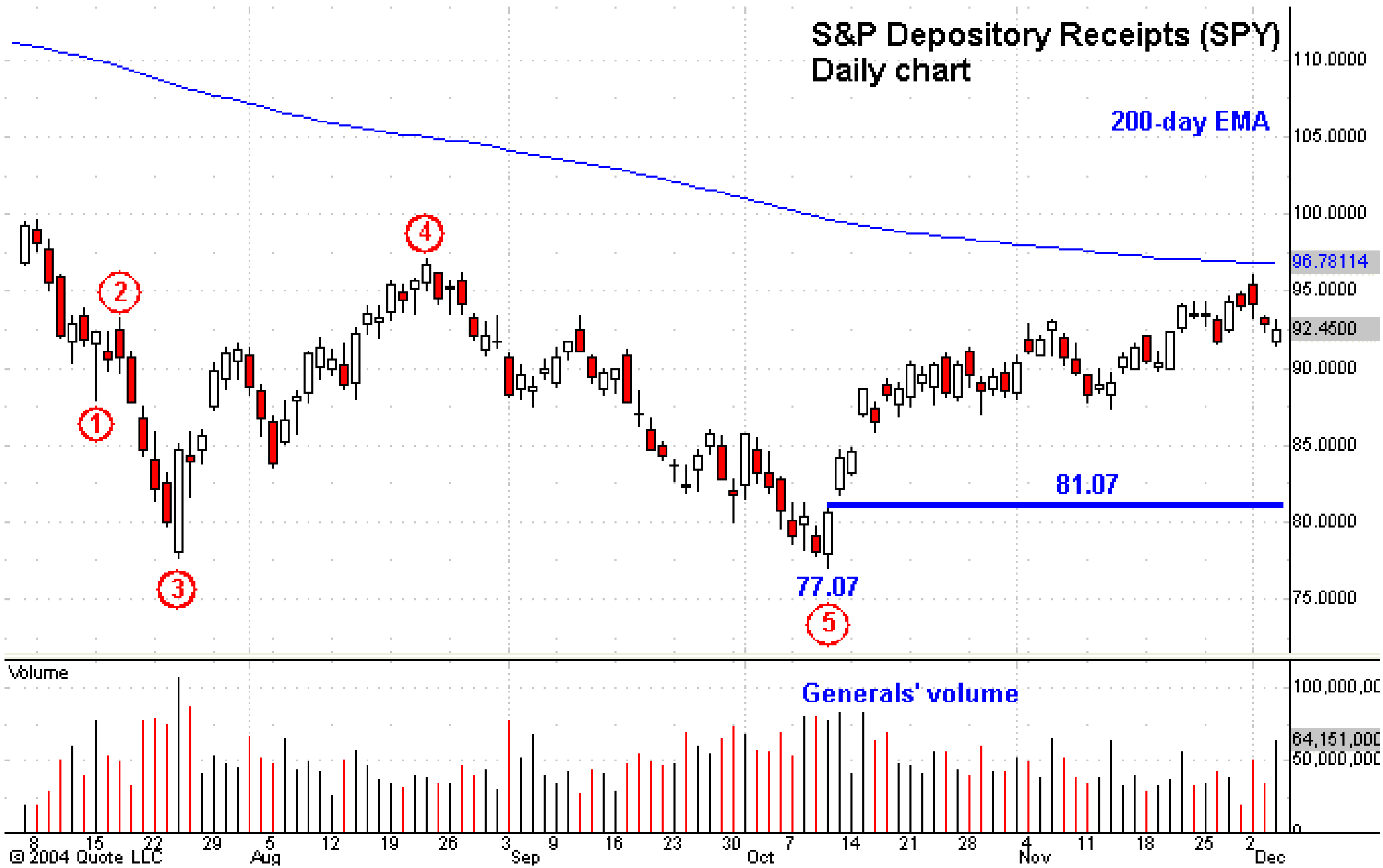
RSTs

3. DIA 01/14/00 top

The Dow was the first major index to top, and this DIA RST sell pattern had good symmetry.

RSTs

Now that you caught the bull market top, let's see how the bottom played out.

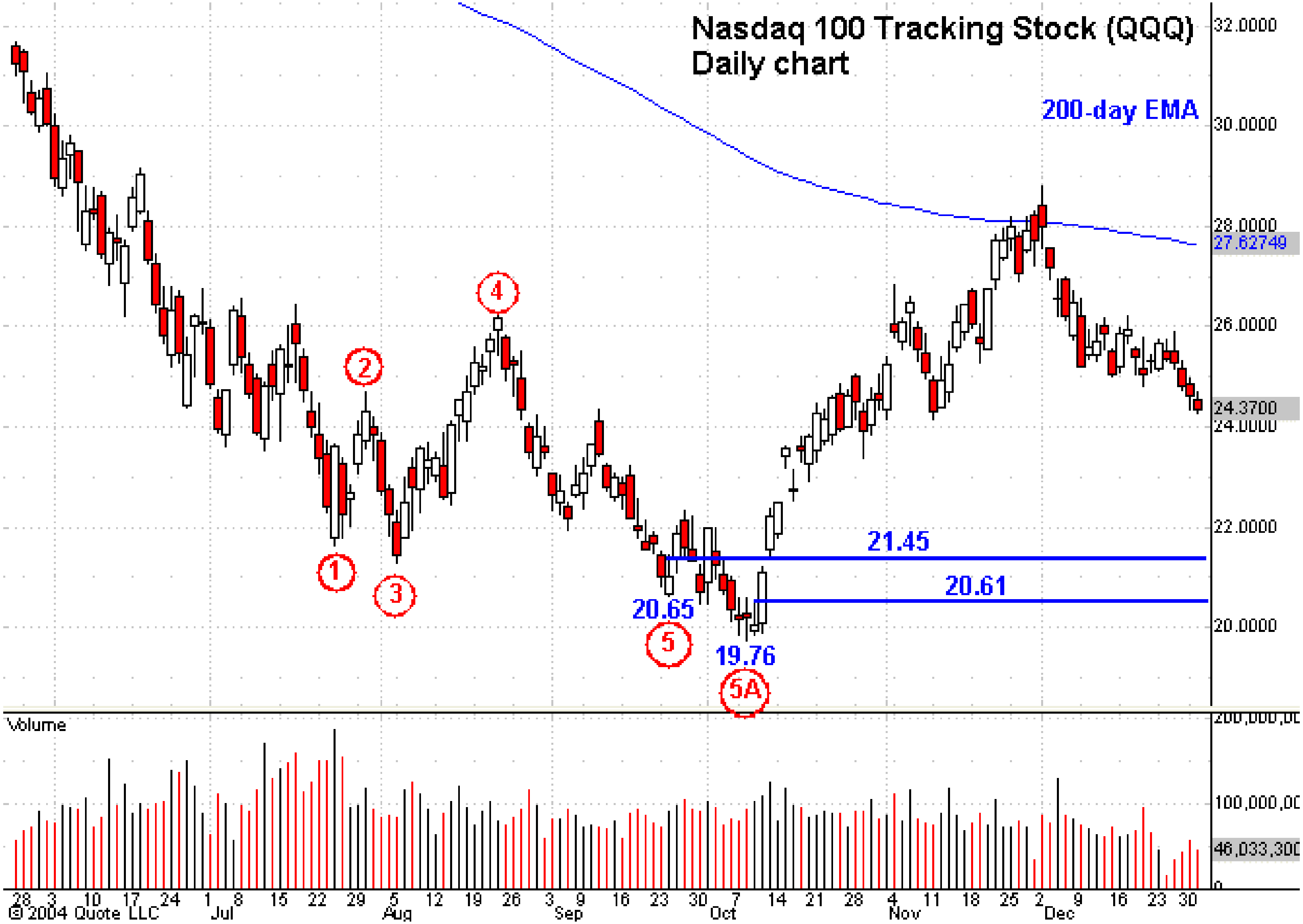


RSTs

4. SPY 10/10/02 bottom

The SPY bottom was a wide-range reversal bar with a volume spike that reversed three closes and the previous day's high, while closing in the top of the range. The next day gapped, and again three days later. As you will soon see, there were positive divergences in indicators like stochastics, RSI, momentum, etc., and major sequence tools in play, but for now, see the pattern itself at a significant turning point which is now the bear market low for the move.

RSTs



Nasdaq 100 Tracking Stock (QQQ)
Daily chart
200-day EMA
1
2
3
4
5
5A
21.45
20.61
20.65
19.76
32.0000
30.0000
28.0000
27.62749
26.0000
24.3700
24.0000
22.0000
20.0000
Volume
100,000,00
46,033,300
0
28 3 10 17 24 1 8 15 22 29 5 12 19 26 3 9 16 23 30 7 14 21 28 4 11 18 25 2 9 16 23 30
Jul
Aug
Sep
Oct
Nov
Dec
© 2004 Quote LLC

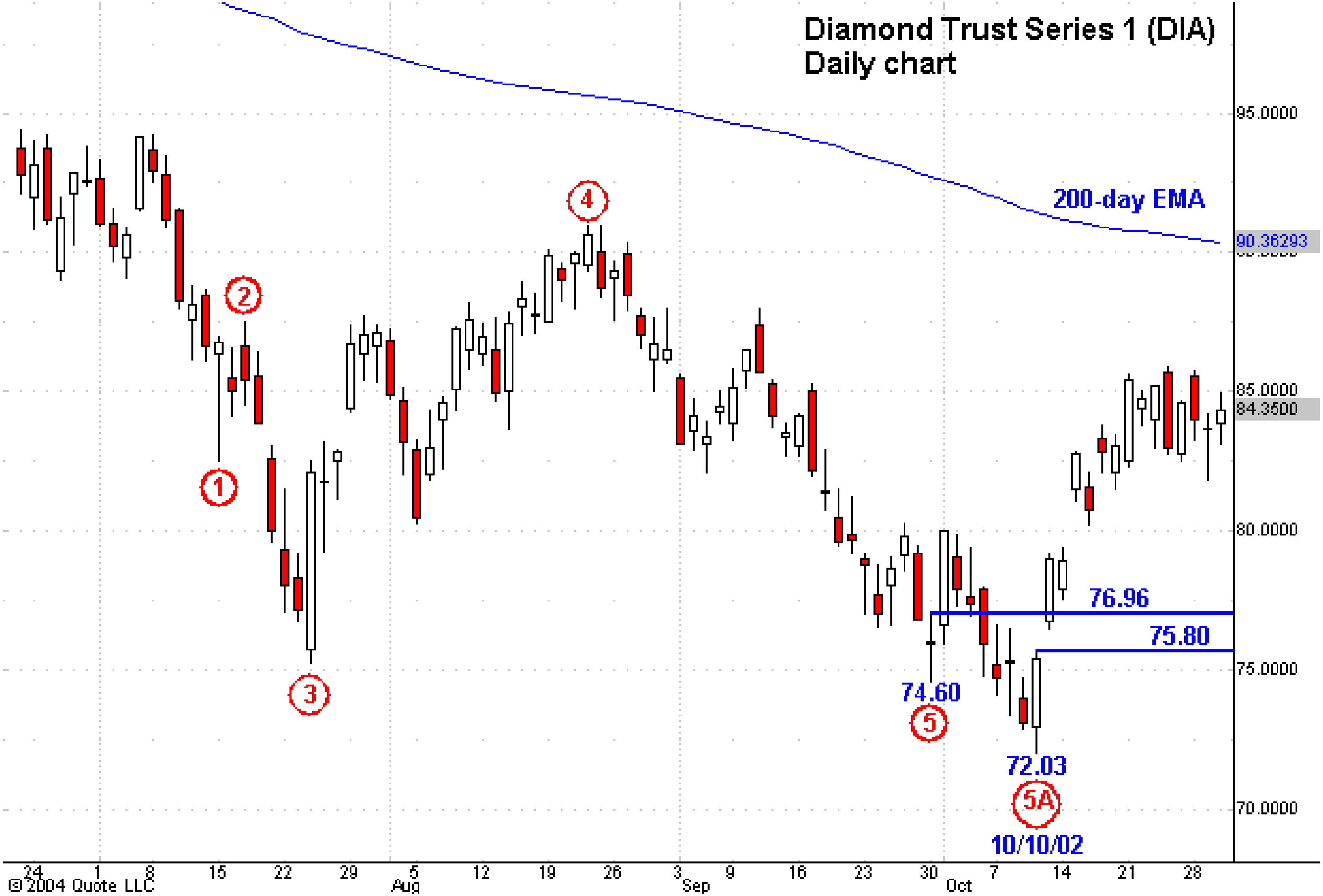
RSTs

5. QQQ 10/08/02 bottom

The QQQ had dropped like a knife as the bubble accelerated to the downside. This set up an RST with entry above 21.45. At that point, the SPY had not made a lower low, which it did later at 77.07, nor had the DIA. That didn't mean that the SPY and DIA would not make 1,2,3 higher bottom lows because they had retraced enough to their July lows. As it turned out, you see that the QQQ made another 5 point below 20.65 which set up a second entry above 20.61. Price was about -32% below the 200-day EMA.

Key Point: The QQQs gave you trade-through entry on both 5 points, which is always better than any gaps.

RSTs


Diamond Trust Series 1 (DIA)
Daily chart
200-day EMA
90.36293
95.0000
85.0000
84.3500
80.0000
75.0000
70.0000
1
2
3
4
5
5A
76.96
75.80
74.60
72.03
10/10/02
24
1
8
15
22
29
5
Aug
12
19
26
3
Sep
9
16
23
30
Oct
7
14
21
28
© 2004 Quote LLC

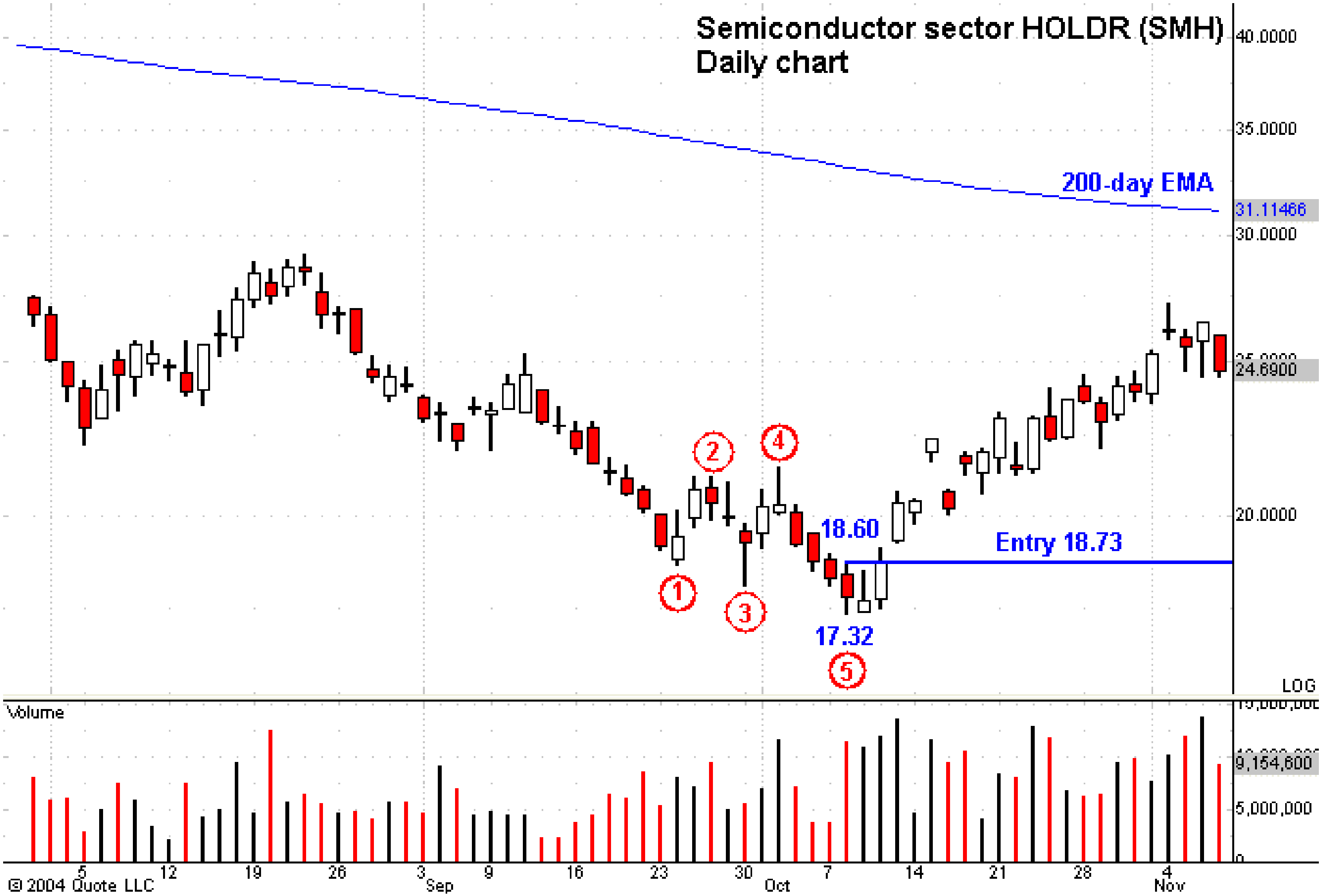
RSTs

6. DIA 10/10/02 bottom

The DIA, like the QQQ, made a second entry 5 point. The first entry ran three points to 80, then reversed down to 72.03, giving you second entry above 75.80. When price gaps on the second entry, it usually means it will succeed, but it must be accompanied by a significant increase in volume.

Key Point: When in doubt, always take the trade-through entry when you are making a decision in the major indices.

RSTs



Semiconductor sector HOLDR (SMH)
Daily chart
200-day EMA
18.60
Entry 18.73
17.32
1
2
3
4
5
40.0000
35.0000
31.11466
30.0000
24.6900
20.0000
LOG
Volume
9,154,600
5,000,000
0
5
12
19
26
3
Sep
9
16
23
30
Oct
7
14
21
28
4
Nov
© 2004 Quote LLC

RSTs

7. SMH 10/09/02 bottom

The SMH was -48% below its 200-day EMA and formed a very symmetrical RST buy pattern with trade-through entry on the close above 18.60, which was 18.73. It was gap up after that, but you didn't mind because you were on the train. In the early part of a recovery, the semis will usually be the leading sector. This entry was after two narrow-range big-volume days which often means a change in trend is near. When there is narrow range and big volume, it can only mean some Generals have joined the demand side of the equation. The next two big-volume bars after the low resolved the situation.

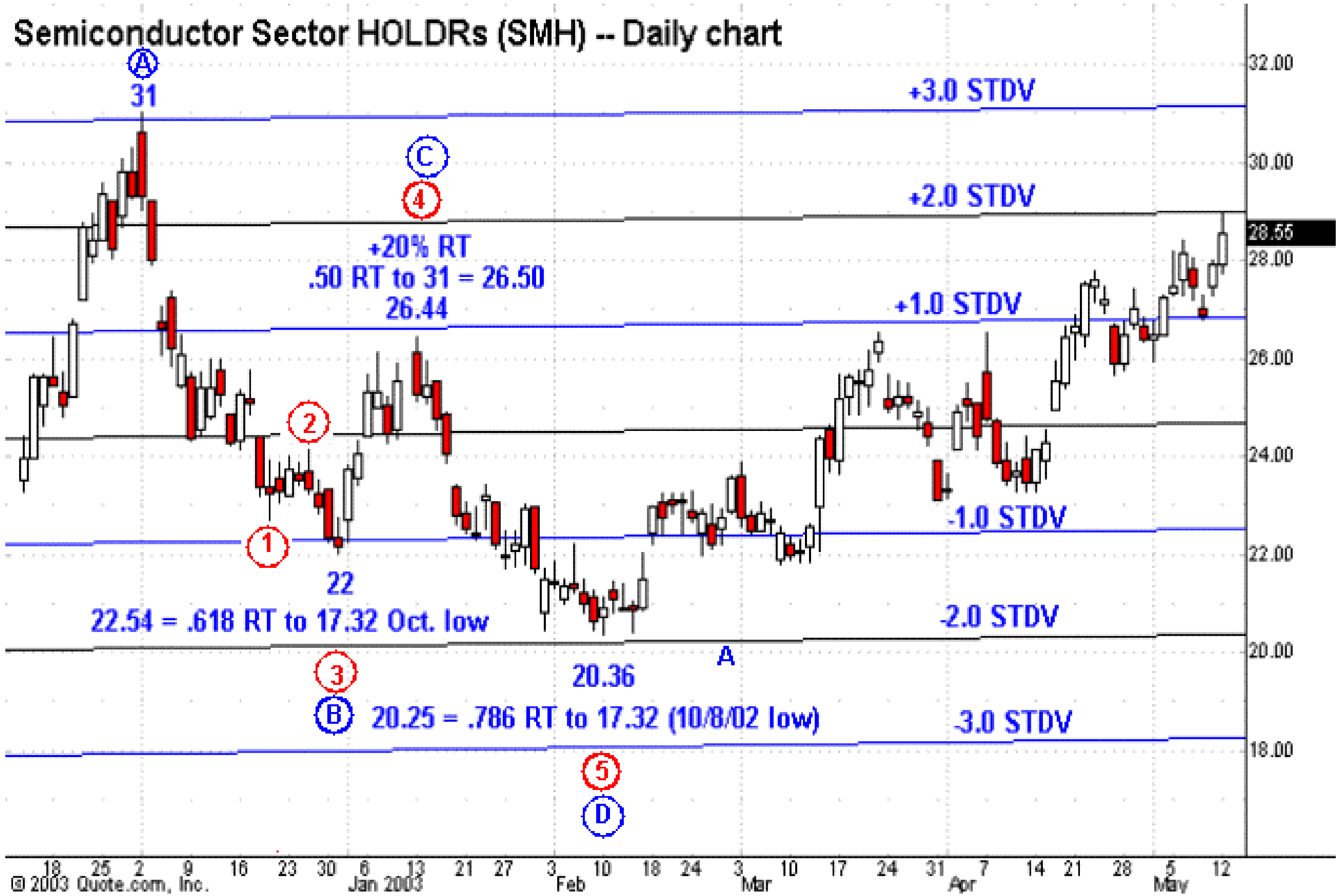
RSTs

The best way for you to learn and believe in sequence trading is repetition. There will sometimes be a repeat of the same chart, but I will add more sequence to it, and that will reinforce your learning and make you start thinking on a relative basis, meaning everything has some kind of relationship.

RSTs

There is always more than one sequence tool in play, so it doesn't matter that we are in the RST section because you will see Fibonacci, volatility, etc., in any section.

RSTs



Semiconductor Sector HOLDRs (SMH) -- Daily chart
A
31
+3.0 STDV
C
4
+2.0 STDV
+20% RT
.50 RT to 31 = 26.50
26.44
+1.0 STDV
2
1
22
22.54 = .618 RT to 17.32 Oct. low
-1.0 STDV
-2.0 STDV
A
3
20.36
B
20.25 = .786 RT to 17.32 (10/8/02 low)
-3.0 STDV
5
D
32.00
30.00
28.55
28.00
26.00
24.00
22.00
20.00
18.00
18 25 2 9 16 23 30 6 13 21 27 3 10 18 24 3 10 17 24 31 7 14 21 28 5 12
Jan 2003
Feb
Mar
Apr
May
@ 2003 Quote.com, Inc.

RSTs

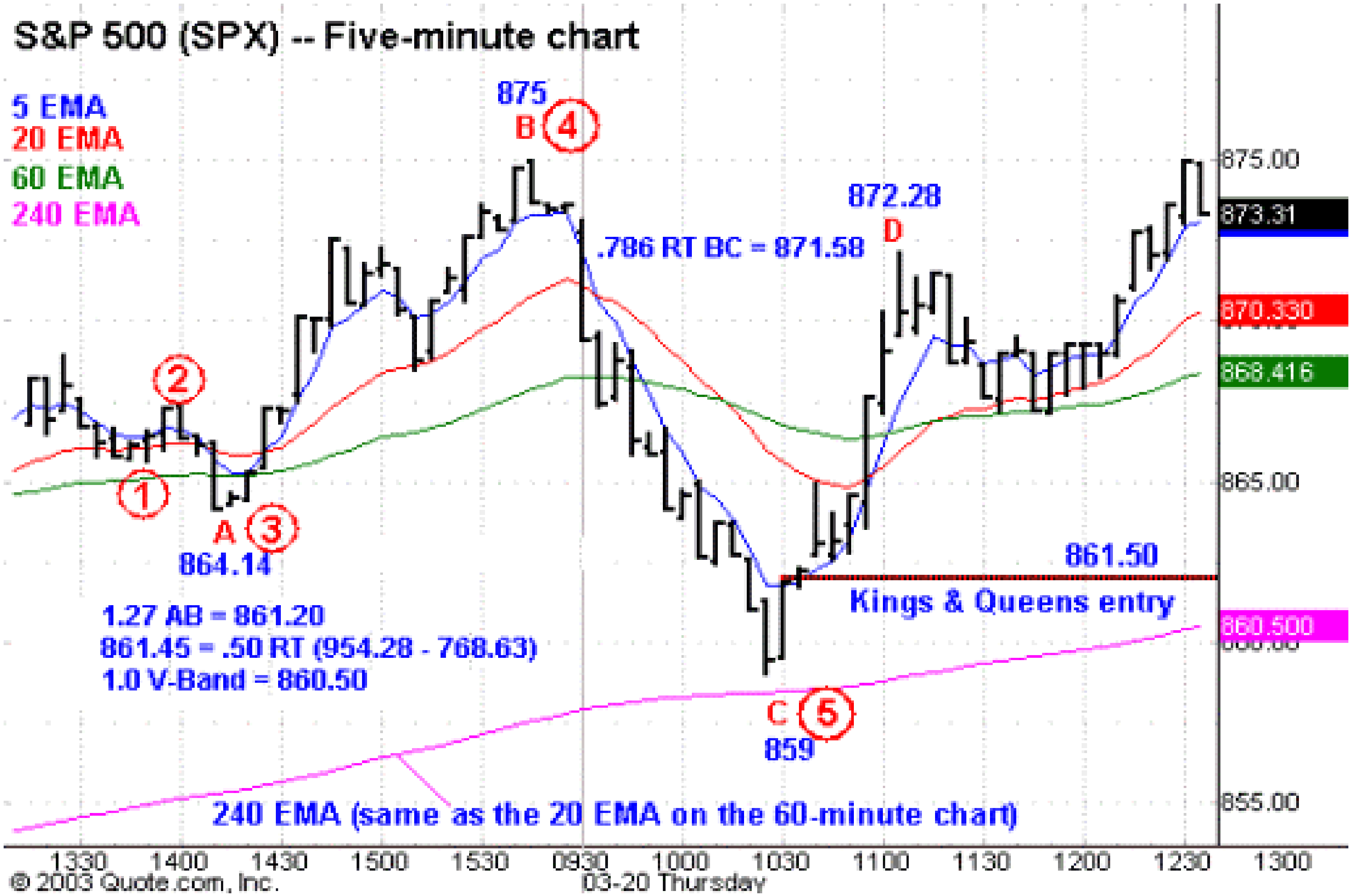
The first chart is the SMH's February 2003 retracement to the 17.32 October 2002 low. The 17.32 low, as you have seen, was a very symmetrical RST buy pattern that was extended almost to the 3.0 STDV band. The SMH had rallied from the 17.32 October 2002 low to 31 and then reversed and declined in parallel line (AB=CD) sequence.

The initial decline was to 22 (AB) vs. the 22.54 .618RT to the 17.32 low. There was a good 20% rally to 26.44 and .50RT to 31, which is 26.50. That was the BC leg. The CD leg was a -29% decline from 26.44 to 20.36, which is the .786 retracement (20.25) zone to the 17.32 low. As you see on the chart, the .786 retracement was to the 2.0 STDV band and exactly where the RST buy pattern set up. There was also confluence with the 1.272 Fib extension of the BC leg, which was 20.79. Whether it was trader or investor, it didn't matter because you had the important sequence tools to make a high-probability decision.

Key Point: In this example, you had Fib retracements and extensions. There was an RST buy setup at the .786 retracement to a significant low and that was at the extended 2.0 STDV band.

RSTs

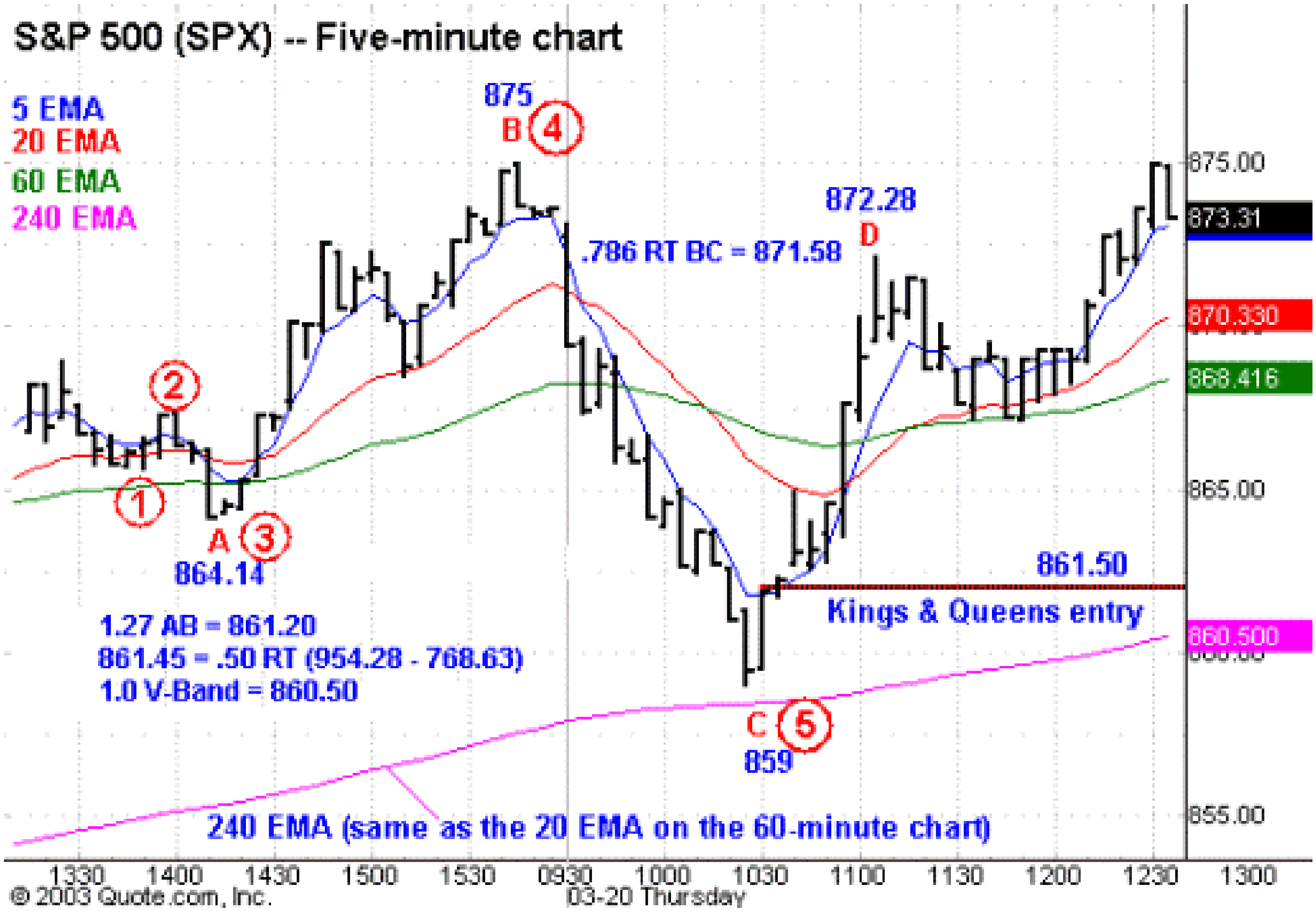
The following SPX five-minute chart will give you more insight into the sequence thought process.



RSTs

This chart shows you that the last leg up on Thursday (AB) ended with the 875 high. Getting prepared for the next day, I want to know the Fib extension levels above 875 if the SPX rallies early on Friday and also any retracement levels to past significant highs. The next thing I do is frame the Fib retracement levels to 864.14 and also the Fib extensions below 864.14 in case of a stronger decline. You would also check the retracement levels below 864.14. I start every day with the volatility band levels on my desk, so no problem there.

RSTs



S&P 500 (SPX) -- Five-minute chart
5 EMA
20 EMA
60 EMA
240 EMA
875
B 4
872.28
D
.786 RT BC = 871.58
2
1
A 3
864.14
1.27 AB = 861.20
861.45 = .50 RT (954.28 - 768.63)
1.0 V-Band = 860.50
861.50
Kings & Queens entry
C 5
859
240 EMA (same as the 20 EMA on the 60-minute chart)
875.00
873.31
870.330
868.416
865.00
860.500
855.00
1330 1400 1430 1500 1530 0930 1000 1030 1100 1130 1200 1230 1300
© 2003 Quote.com, Inc.
03-20 Thursday

RSTs

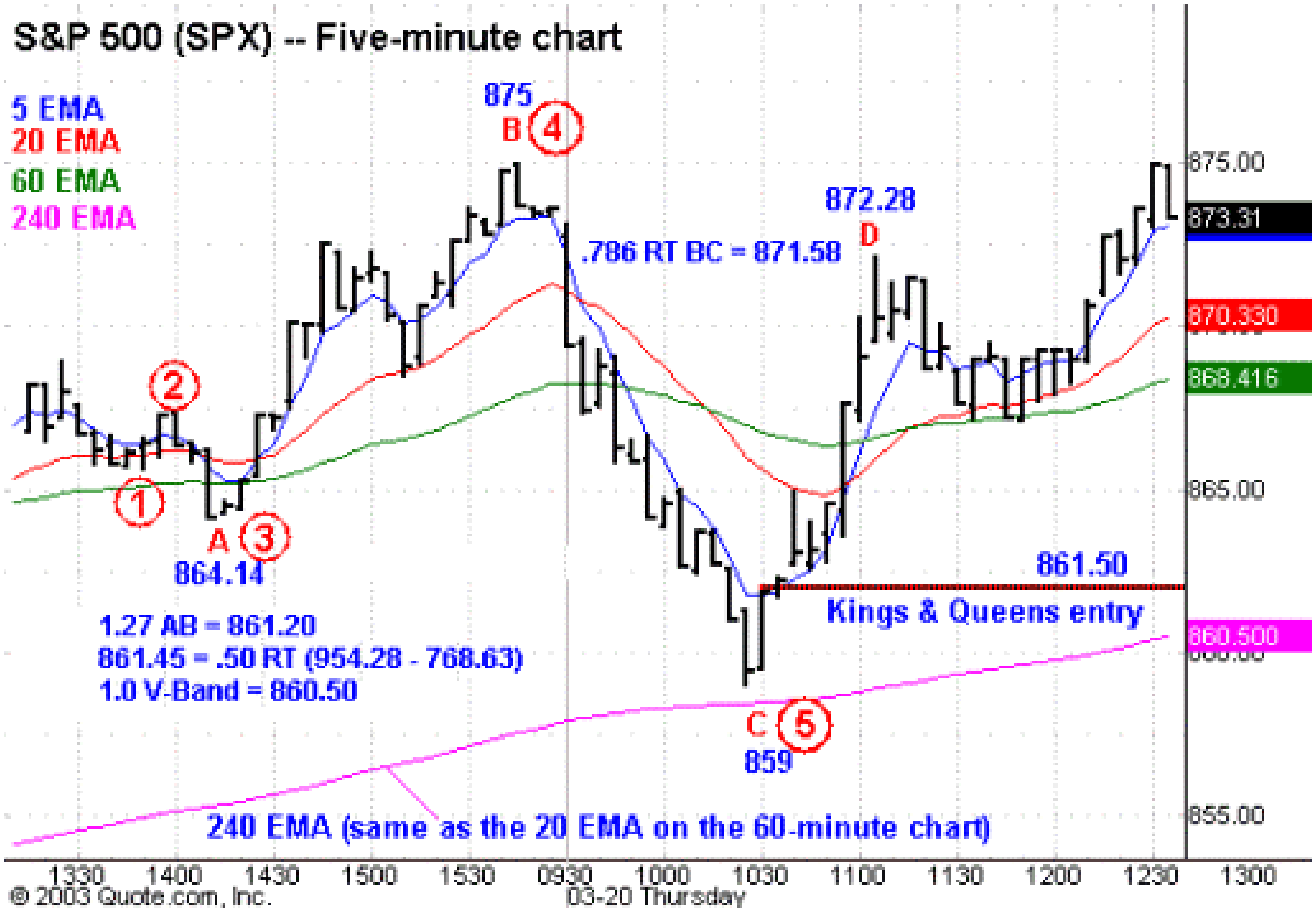
I am now ready for the opening, and I don't care which way it goes, but I know my levels, so I just have to concentrate on price action approaching the levels.

Thursday opened trading straight down, taking out the 864.14 low, but we were ready, correct? Price hit 859 right at the 240 EMA and reversed on the next bar, which reversed two closes and the previous high.

There was excellent confluence at this level. There was a 1.27 Fib extension of AB at 861.20. The .50RT to 768.63 (954.28 was the rally high off the October low). Next, we had the 1.0 VBand at 860.50, and last, but not least, the powerful RST setup right at the zone of excellent confluence.

There was a reversal-bar entry above 861.50 (see Kings and Queens in the Trap Door section), or else you could have taken entry earlier if you felt the dynamics were quickly changing to the upside because the confluence was excellent with the initial stop below 859. (You would trade either the futures or SPY.)

RSTs


S&P 500 (SPX) -- Five-minute chart
5 EMA
20 EMA
60 EMA
240 EMA
875
B 4
872.28
D
.786 RT BC = 871.58
2
1
A 3
864.14
1.27 AB = 861.20
861.45 = .50 RT (954.28 - 768.63)
1.0 V-Band = 860.50
861.50
Kings & Queens entry
C 5
859
240 EMA (same as the 20 EMA on the 60-minute chart)
875.00
873.31
870.330
868.416
865.00
860.500
855.00
1330
1400
1430
1500
1530
0930
1000
1030
1100
1130
1200
1230
1300
© 2003 Quote.com, Inc.
03-20 Thursday

RSTs

After you took the RST entry, you framed the retracement levels to 875 for future exit of the trade. Price traded up to the .786 retracement level to 875 on thrust and then made a three-bar reversal, and you had to exit on at least half or all of your position.

As it turned out, the SPX pulled back to the 60 EMA and continued to advance, but you didn't care because you had taken out 8 or 9 points depending on your entry vs. the small initial stop risk.

Key Point: The purpose is to show you the sequence symmetry, but there are many times when you got stopped out on your initial entry and then get a second entry at the confluence zone, which you should not be afraid to take. Losing trades are a fact of life, or else they would not call it trading. Learn your sequence and you will be on the right side a majority of the time.

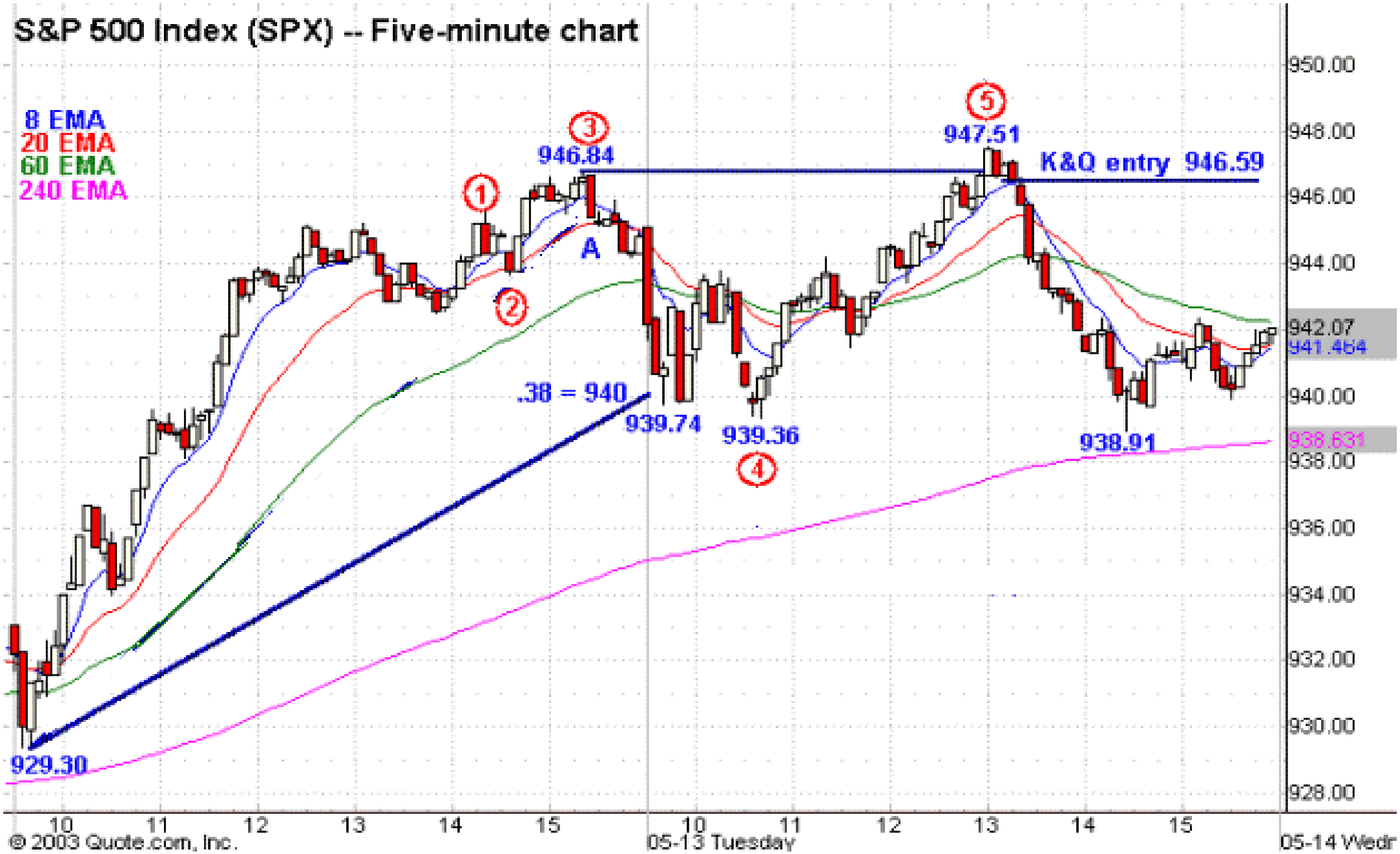
RSTs

The following SPX daily chart shows you the time symmetry between the 08/22/02 965 top and the 12/02/02 954.28 top.

RSTs

On this chart, you can see the SPX made an RST bottom off the 788.90 March 2003 retracement to the October 2002 769 low. This RST was also midway between the 2.0 and 3.0 STDV bands. There was also a positive divergence in primary momentum indicators. May 15 was the 2.618 ratio date between the tops and on 05/13, the SPX 947.51 close was right at the 2.0 STDV band.

RSTs

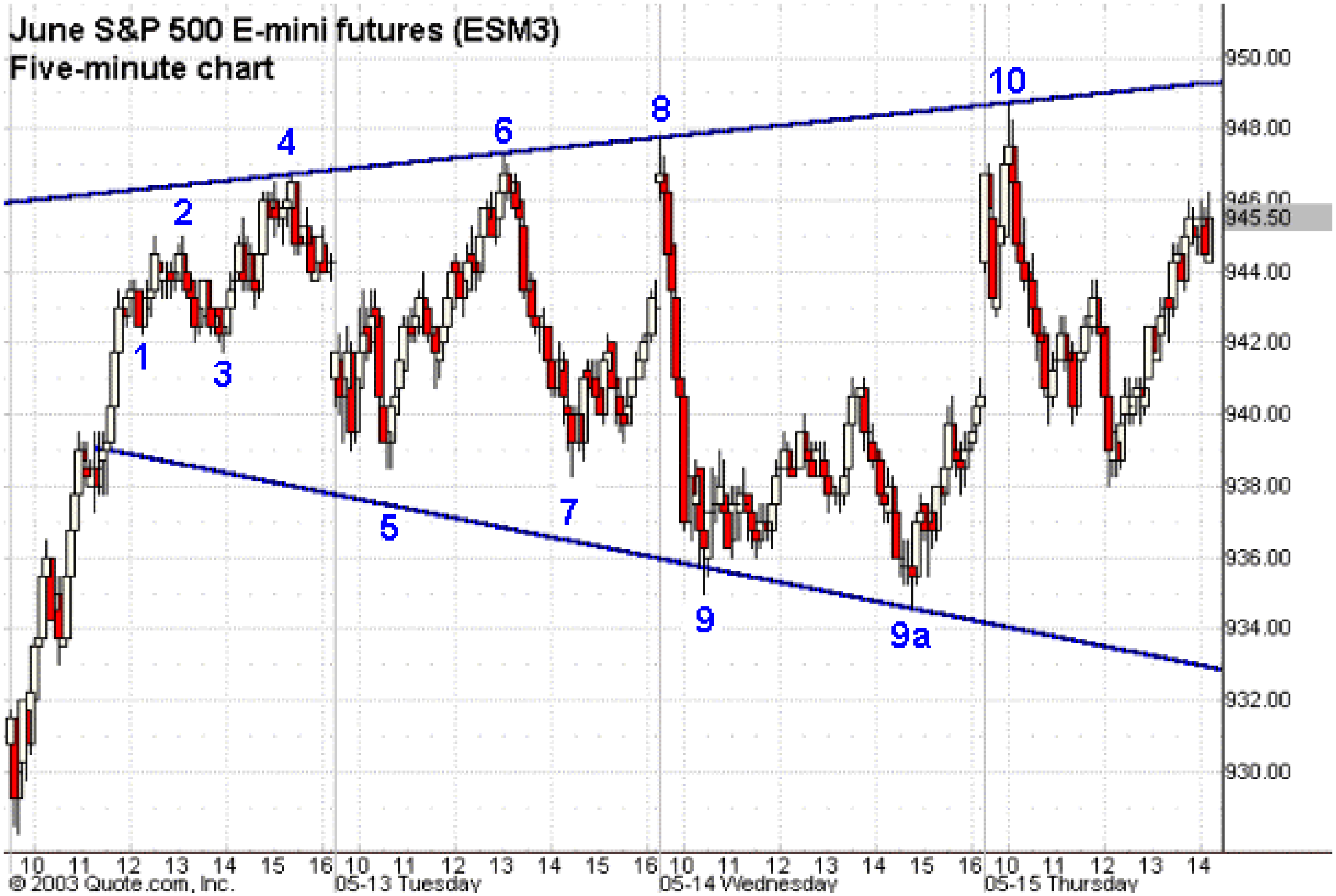


S&P 500 Index (SPX) -- Five-minute chart
8 EMA
20 EMA
60 EMA
240 EMA
1
2
3
946.84
A
5
947.51
K&Q entry 946.59
.38 = 940
939.74
939.36
4
938.91
929.30
950.00
948.00
946.00
944.00
942.07
941.464
940.00
938.631
938.00
936.00
934.00
932.00
930.00
928.00
10
11
12
13
14
15
05-13 Tuesday
05-14 Wedr
© 2003 Quote.com, Inc.

RSTs

This SPX five-minute chart shows you the RST sell entry on 05/13 with entry below 946.59. You had a 2.0 STDV and 2.618 ratio time zone in the daily chart, so you were ready for an entry, and you got it with the RST.

RSTs



June S&P 500 E-mini futures (ESM3)
Five-minute chart
1
2
3
4
5
6
7
8
9
9a
10
950.00
948.00
946.00
945.50
944.00
942.00
940.00
938.00
936.00
934.00
932.00
930.00
10 11 12 13 14 15 16 10 11 12 13 14 15 16 10 11 12 13 14 15 16 10 11 12 13 14
© 2003 Quote.com, Inc.
05-13 Tuesday
05-14 Wednesday
05-15 Thursday

RSTs

The next S&P 500 E-mini five-minute chart clearly shows the expanding volatility and the kinds of trades that the RST can give you. There is symmetry in the markets. Note that 9a was a second-entry 5 point on the same day.

RSTs

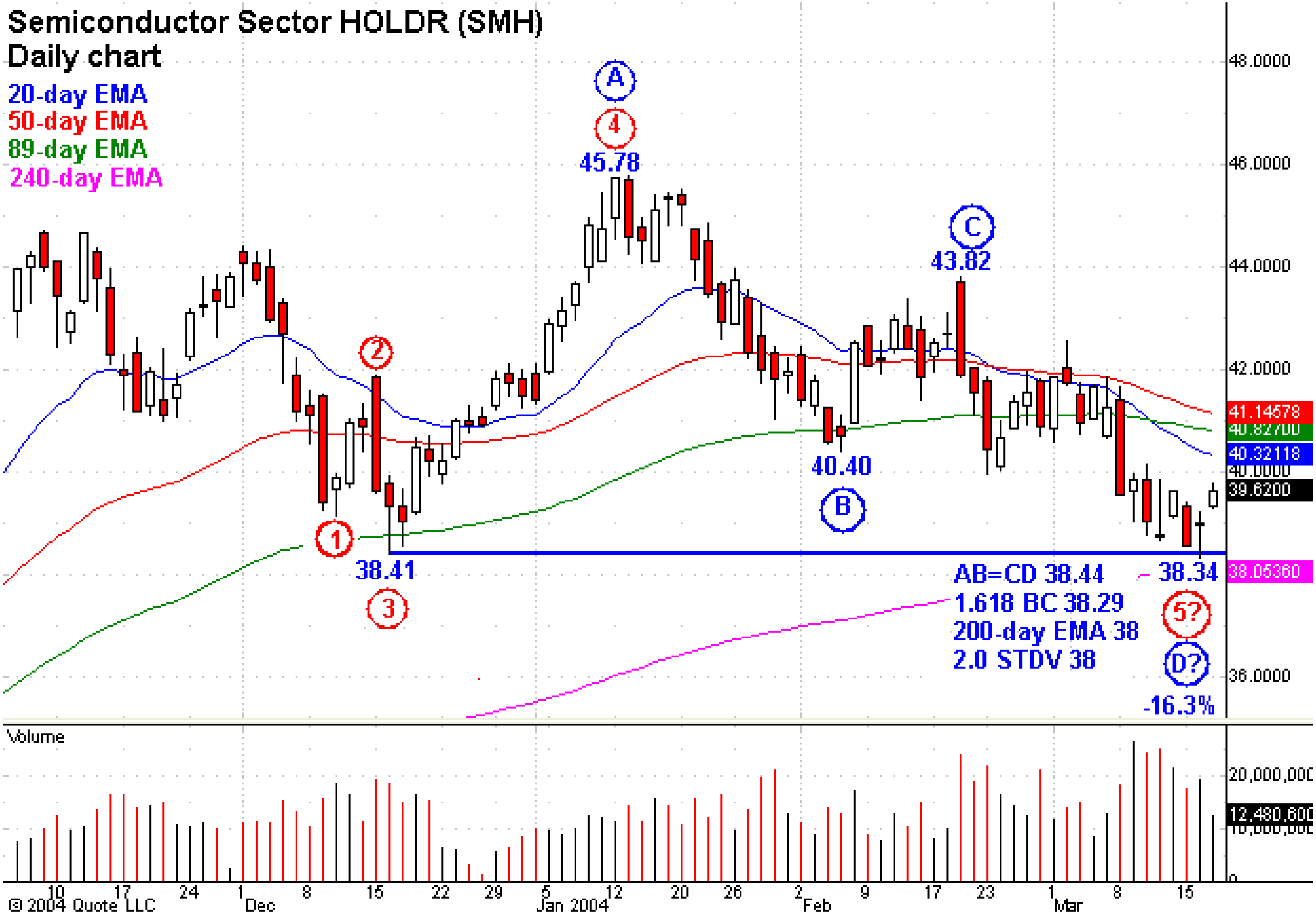
You should take some time to study as many charts as you can, but you have a good foundation in the primary sequence tools right now to be very successful, provided you keep your emotions out of it and control your risk.

RSTs

Here is an excellent example of the RST early entry and follow-through trade.

There will be times that you anticipate an excellent potential RST daily chart setup, and then there is a gap above/below the signal bar, which takes away a good initial trade-through entry. Earlier in this section, I said if you also daytrade and there is a good intraday entry above/below the signal bar high/low, you can take it and keep it if it closes above (in this example) the signal-bar high, i.e., if the high is 40 and you enter and the stock closes at 40.75, you have gotten in early, rather than on the 40.75 close. Very often, if there is follow-through the next day, price might gap open above 40.75, making your profit cushion larger.

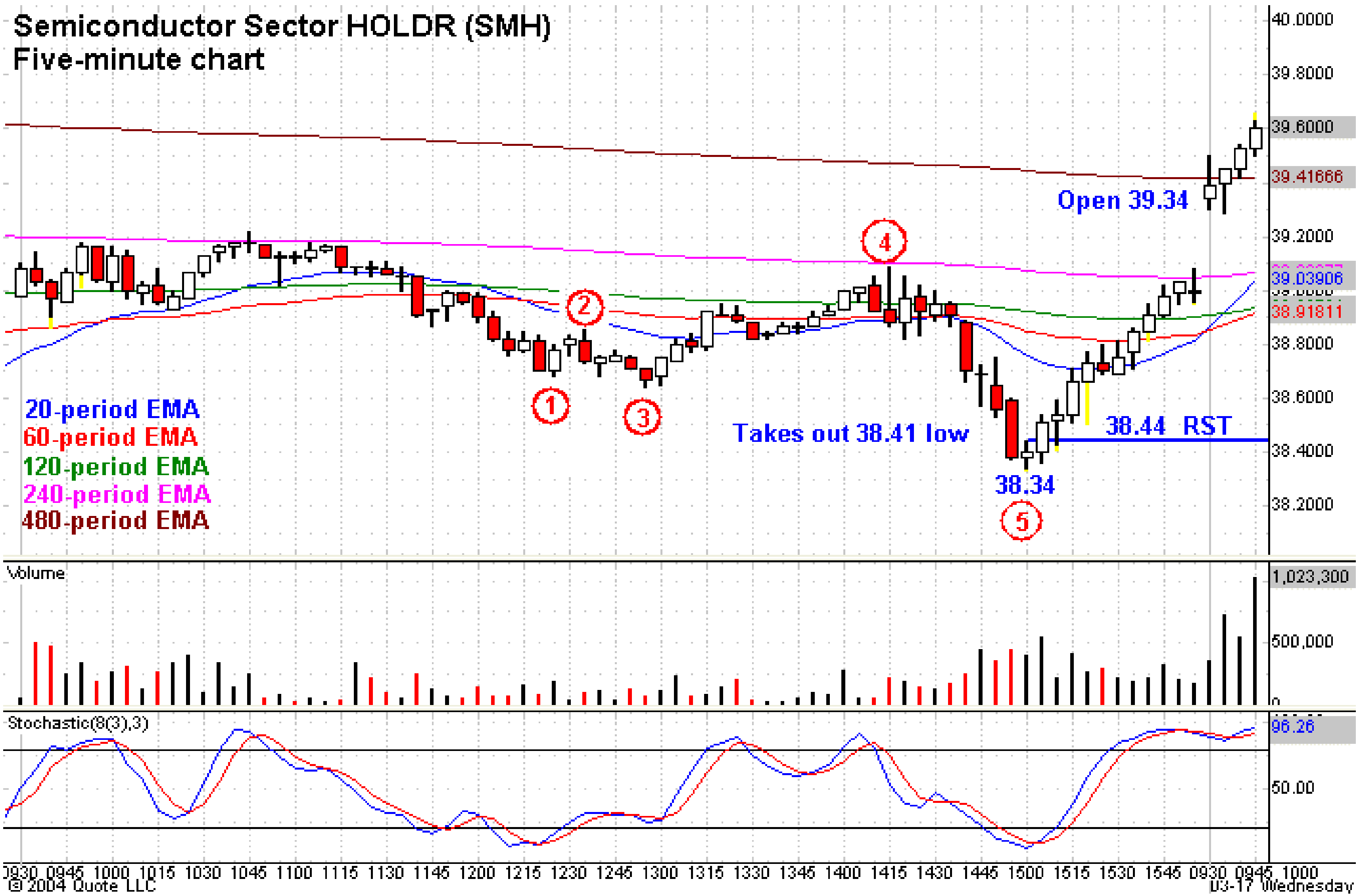
RSTs


Semiconductor Sector HOLDR (SMH)
Daily chart
20-day EMA
50-day EMA
89-day EMA
240-day EMA
A
4
45.78
C
43.82
2
1
38.41
3
40.40
B
AB=CD 38.44
1.618 BC 38.29
200-day EMA 38
2.0 STDV 38
38.34
5?
D?
-16.3%
48.0000
46.0000
44.0000
42.0000
41.14578
40.82700
40.32118
40.0000
39.6200
38.05360
36.0000
Volume
20,000,000
12,480,600
10,000,000
0
10
17
24
1
Dec
8
15
22
29
5
Jan 2004
12
20
26
2
Feb
9
17
23
1
Mar
8
15
© 2004 Quote LLC

RSTs

This SMH RST trade is a good example to understand the nuance. Take a look at this SMH daily chart, and you can see that when the 38.41 low was taken out, that a potential RST buy pattern could form. The 38.34 low was a -16.7% retracement from the 45.78 high and right to a strong sequence zone with the confluence outlined on the chart (all of which you had anticipated in advance).

RSTs

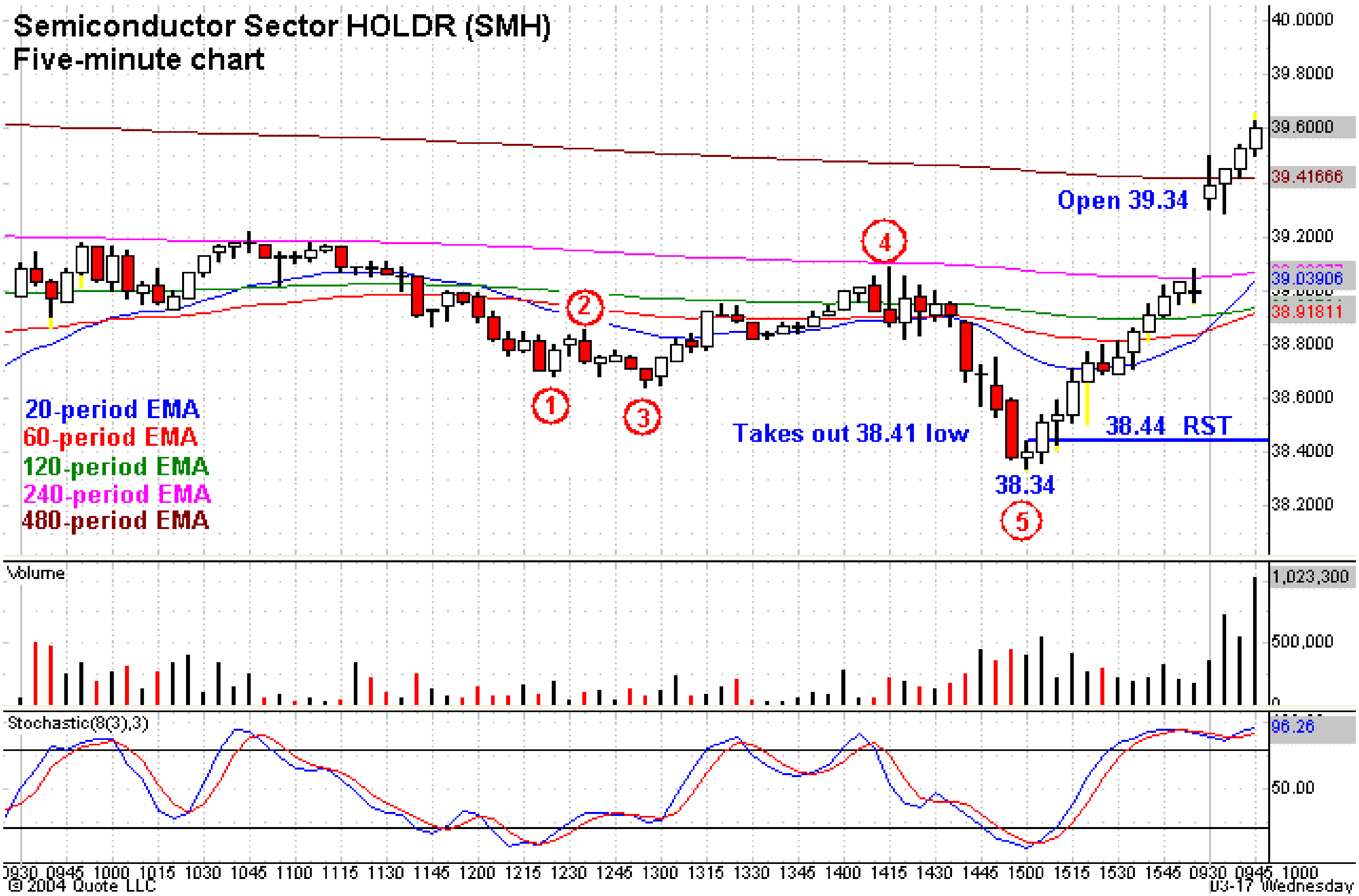

Semiconductor Sector HOLDR (SMH)
Five-minute chart
20-period EMA
60-period EMA
120-period EMA
240-period EMA
480-period EMA
1
2
3
4
5
Takes out 38.41 low
38.34
38.44 RST
Open 39.34
40.0000
39.8000
39.6000
39.41666
39.2000
39.03906
38.91811
38.8000
38.6000
38.4000
38.2000
Volume
1,023,300
500,000
0
Stochastic(8(3),3)
96.26
50.00
0930 0945 1000 1015 1030 1045 1100 1115 1130 1145 1200 1215 1230 1245 1300 1315 1330 1345 1400 1415 1430 1445 1500 1515 1530 1545 0930 0945 1000
© 2004 Quote LLC
03-17 Wednesday

RSTs

To see what I mean, we have to move to the five-minute SMH chart on the same day as the 38.34 low. It is important to note that the RST entry on the daily chart would be above 39.22, the high of the 38.34 low bar.

On this chart, there is an RST buy setup after the 38.41 low, which was a narrow-range doji bar on good volume. Entry was on the 3:05 p.m. ET bar (had enough time left) above the 38.44 high, and the trade ran +1.7% to 39.08 and closed at 39. This is where you must make a decision on whether you should keep the position overnight, anticipating the 39.22 RST daily chart entry the next day. You had a good profit cushion, and it is the SMH, so company-specific news is not a major factor to worry about, plus you went long in a significant sequence zone. To keep it is an aggressive decision that some traders can make depending on your experience, and it is correct based on the sequence.

RSTs



Semiconductor Sector HOLDR (SMH)
Five-minute chart
20-period EMA
60-period EMA
120-period EMA
240-period EMA
480-period EMA
Open 39.34
Takes out 38.41 low
38.44 RST
38.34
1
2
3
4
5
Volume
Stochastic(8(3),3)
40.0000
39.8000
39.6000
39.41666
39.2000
39.03906
38.91811
38.8000
38.6000
38.4000
38.2000
1,023,300
500,000
0
96.26
50.00
0945 1000 1015 1030 1045 1100 1115 1130 1145 1200 1215 1230 1245 1300 1315 1330 1345 1400 1415 1430 1445 1500 1515 1530 1545 0930 0945 1000
© 2004 Quote LLC
03-17 Wednesday

RSTs

However, a better decision over time and many similar trades would be to take your profits from your RST entry above 38.44 and go out flat with a nice profit in the bank. This would give you a good chance of taking entry above 39.22 the next day, or maybe even lower on another intraday setup. As I finish this example on 03/17/04, the SMH opened at 39.34 and traded up to 39.65 with an intraday low of 39.29 so far at 11:00 a.m. Regardless of how it turns out, you must realize that decisions are made all the time, and in this case, you could have made either one.

For an IRA add-to-position in the SMH, I prefer the first decision, simply because you were buying it regardless of the RST in the sequence zone, but the RST made it even better.

Key Point: Position traders should always check for early entry from intraday setups.

RSTs

RST Follow-up Entry

In the previous example, there was daily chart confluence for the SMH and then you took the early RST long entry above 38.44, which ran to 39.08, +1.7%, and closed at 39. The next day it opened at 39.34.

RSTs

On the daily chart, there was also a 1.618 Fib extension of the leg from 40.40 to 43.82, which was 38.29.

After the SMH opened at 39.34, the next day it traded in a loose Slim Jim from 39.65 - 39.40. If the dynamics were good at the time, you might have taken a breakout trade in the afternoon, but you also had to be thinking about the "523" trend (120-minute chart) at the time. You had taken a retracement trade on the daily chart, and the early entry long above 38.44 on the five-minute chart. The daily chart was a retracement in the longer-term uptrend and takes precedence, but the "523" trend was down with the 5 EMA below the 20 EMA, which was below the 34 EMA.

RSTs

The next chart shows the following RST sell pattern two days later.

RSTs

You can see on this chart that the RST sell pattern occurred right at the 816 EMA (34 EMA on the 120-minute chart), which traded down to the .618 retracement to the 38.34 low before reversing up to 39.31.

Key Point: If you took the initial RST buy entry above 38.44 as a position trade and wanted to stay with it because your stop had been moved to breakeven, it was mandatory that you take the RST sell entry below 39.72 as a daytrade, and you might have even taken the long after the 38.80 .618 retracement zone. If you took either/both of the follow-up daytrades, you should have gone out flat with money in the bank so as not to increase the size of your initial position taken above 38.44.

RSTs

Semiconductor Sector HOLDR (SMH)
Five-minute chart
Slim Jim
1
2
3
4
5
39.72 RST
Open 39.34
20-period EMA
60-period EMA
120-period EMA
240-period EMA
480-period EMA
816-period EMA
.618RT 38.34 = 38.90
38.80
39.31
40.0000
39.8000
39.67898
39.6000
39.4000
39.36005
39.20837
39.17594
39.10654
39.0600
39.0000
38.8000
Volume
1,000,000
500,000
245,200
0
10
11
12
13
14
15
03-18 Thursday
© 2004 Quote LLC

RSTs

You kept the initial position size, so risk was the same, but you actually reduced your cost basis because of the profitable daytrade that you took in a declining "523" trend situation with the RST sell pattern at the 34 EMA (816). This is why being both a position trader and daytrader can be so beneficial.

Sure, the daytrade could be a loser, but it is small because your initial stop was just above the 39.80 high and 34 EMA (816), which was no more than .10. I like those kinds of risk/rewards when you have a $1.20 - $1.30 profit cushion and you take a good RST sell trade risking just .10 with a good risk/reward and high probability.