Books & Trades # 204

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Normal and Abnormal Prices … Classes … Specials

Dear Trader,

The great investor Warren Buffett is fond of saying that when you buy a stock you become a partner of a manic-depressive fellow he calls Mr. Market. Each day Mr. Market runs up to you and offers to buy your shares or sell his shares to you. You should ignore him most of the time because he is crazy. Occasionally Mr. Market becomes so depressed that he offers you his shares for a song – and that's when you should buy. At other times he becomes so manic that he offers an insane price for your shares – and that's when you should sell.

Buffet's idea is brilliant in its simplicity, but emotionally hard to implement. Mr. Market sweeps most of us off our feet because his mood is very contagious. Most people want to sell when Mr. Market is depressed and buy when he is manic. To be a successful trader, you have to stand apart from the crowd. You need objective criteria to decide how high is too high and how low is too low. Buffett makes his decisions on the basis of fundamental analysis and a fantastic gut feel. We can use a technical tool called an envelope or a channel for catching price extremes.

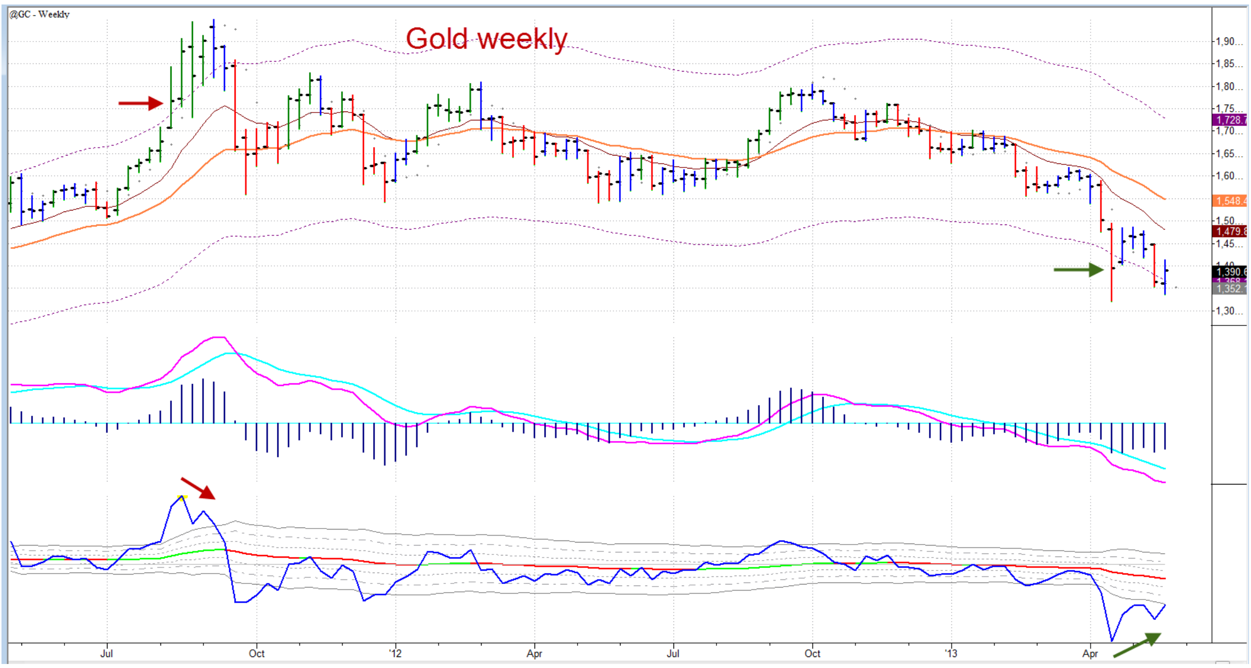
We plot channels or envelopes parallel to a moving average on a price chart. If you use a pair of moving averages, plot the channel parallel to the slow one.

Upper Channel Line = EMA + Channel Coefficient * EMA
Lower Channel Line = EMA – Channel Coefficient * EMA

You need to adjust your channel coefficient for any security until that channel contains approximately 95 percent of all price data for the past 120 bars, which is approximately six months on a daily chart. Selecting a channel width is similar to buying a shirt. Even without knowing your exact size, you can keep trying on shirts until you find one that you can button on your chest without it feeling too loose or too tight, while the length of sleeves is such that only your wrists stick out of them. Only the extreme prices can protrude outside of a well-drawn channel.

If prices touch the upper channel line, you see that mass bullishness is being overdone and it is time to think about selling. When everyone turns bearish but prices touch the lower channel line, you know that it is time to think about buying instead of selling. Channels help traders remain objective when others get swept up in bullish or bearish hysteria.

Channels work great in all timeframes, including weekly, daily and intraday. Let's use recent action in gold as an example.

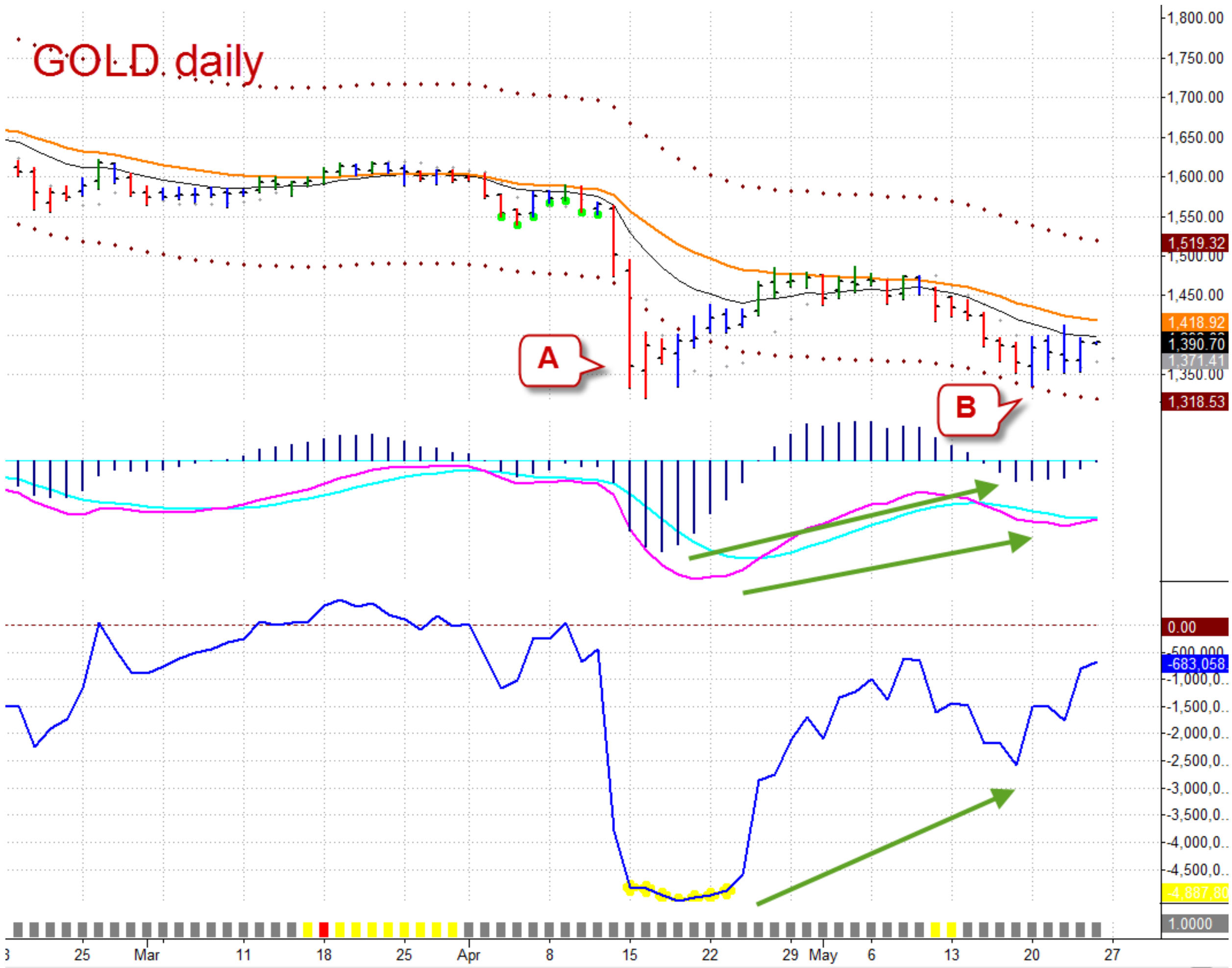


Click [here](#) to enlarge the chart (only when you're online)

On this weekly chart, the horizontal red arrow near the left edge shows where gold blew out of its channel in 2011. It closed at $1,756 that week and continued to boil for a month before collapsing, but a savvy trader knew that price action above the upper channel was not sustainable – it was the time to sell, not to buy.

Turn now to the right edge of the weekly gold chart, where a horizontal green arrow shows where gold dropped below its lower channel line in April 2013. It continued to hover near the lows for five more weeks, as bears kept huffing and puffing.

Notice Force Index divergences: bearish in 2011 and bullish now. Technical indicators often, although not always, produce symmetrical signals at tops and bottoms.



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Turning to the daily chart of gold, we see its recent drop below the lower channel line in April in area A, followed by a pullback to the value zone between the two EMAs. As prices slowly sink to retest the channel in area B, all indicators trace bullish divergence patterns, telling us that the power of bears has been spent. The channel helps us position ourselves against the fearful and depressed crowd. Curiously enough, similar patterns are seen on intraday charts.

When I taught an intensive workshop in Taiwan a few weeks ago, many participants who use local software kept asking how to select "channel coefficients." They had to do by trial and error, using high and low percentages to obtain channels that would hold 95% of recent data. Those percentages vary between securities and timeframes.

Fortunately, one of my Camp participants, a brilliant programmer in Chicago named John Bruns, had created what he calls an Autoenvelope. His program automatically creates a perfect channel for any security in any timeframe. We've included Autoenvelope in all our elder-disks – for TradeStation first, followed by Metastock, TC2000, and all the other programs LISTED on our website.

Whatever method you use for drawing your channels, those lines will help you see when the market is manic or depressed – and put yourself in opposition to the crowd at key turning points.

Traders' education

Please visit our website for more information on these events

June 5 & 12, Webinar –"Current markets with Dr Elder." Enter Dr. Elder's trading room from your own computer and watch him review stocks and futures, including your picks if you wish.

June 26, 2013 – a full-day intensive class in **Sydney** "The essential skills of a pro trader"

Best wishes for success!

Dr. Elder and Team at elder.com