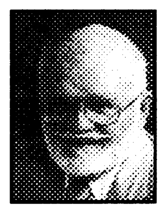
Las Vegas MGM Grand Nov. 1999

TAG21

SELF-MANAGED TRADING WITH STOCHASTICS

COVERING: STOCKS AND FUTURES

GEORGE AND CAIRIE LANE



In this valuable session, George and Cairie Lane will provide in-depth explanations of the theory of momentum and stochastic signals. Using numerous charting examples, they will show you how to use this timing tool to best advantage when trading stocks, futures and indices. They will also discuss where their personal trading styles converge and diverge, and discuss issues and approaches to self-management and discipline—traits necessary to become a successful trader. The Lane's wealth of knowledge and experience makes this session valuable for both novice and veteran traders.

George Lane, known as "The Father of Stochastics," received his training as a broker and technical analyst in New York at E.F. Hutton, learning from legendary analyst Joe Granville. George is an active trader and teaches technical analysis at his school in Watseka, Illinois.

During his forty-year career, George has served as a trader and broker on the floor, taught technical analysis of stocks and commodities, written a daily market letter/hotline, owned a regional brokerage firm with forty-one branch offices, and sat on the board of directors of the Mid-America Commodity Exchange. George was the first broker to raise the price per trade since the Civil War, thus opening the door to the growth of the industry. He helped the Mid Am exchange get started. He created the first association of investment clubs, and owned and expanded one of the first commodity charting services.

Early in his career, George spearheaded a research group that originated a number of technical indicators, most notably the Stochastic Process (Lane's Stochastics). Stochastics are now used to manage billions of dollars in pension and investment funds.

Before marrying George, **Cairie Lane** worked in the public sector as a teacher and social worker. As George's life and working partner, she has gained a thorough knowledge of every aspect of the futures markets and technical analysis. She started by keeping up daily charts and indicators by hand, then worked with TAG's technical team to port the system onto the newly introduced 48k Apple computer. She has since continued to develop her trading-related computer expertise. Cairie partnered with George in running the research department, managing daily hotlines and writing weekly market letters.

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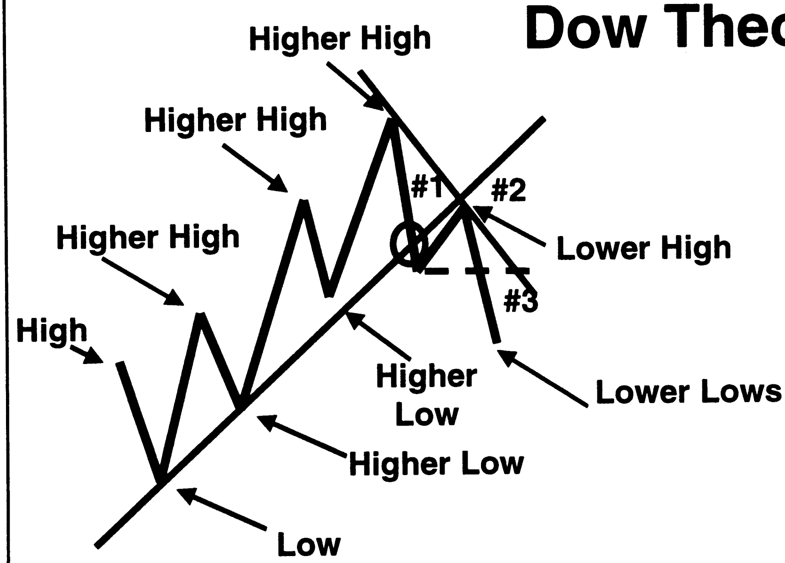
1

Dow Theory



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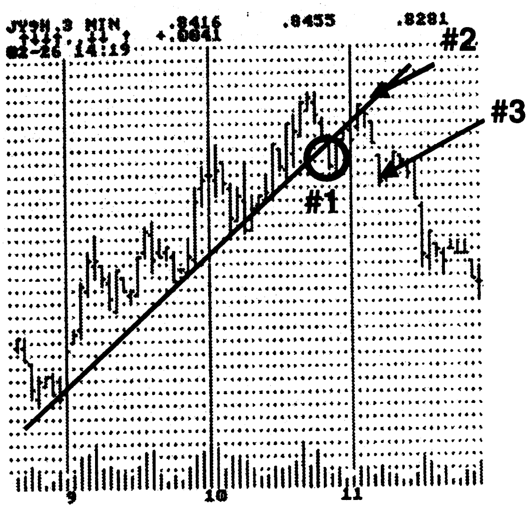
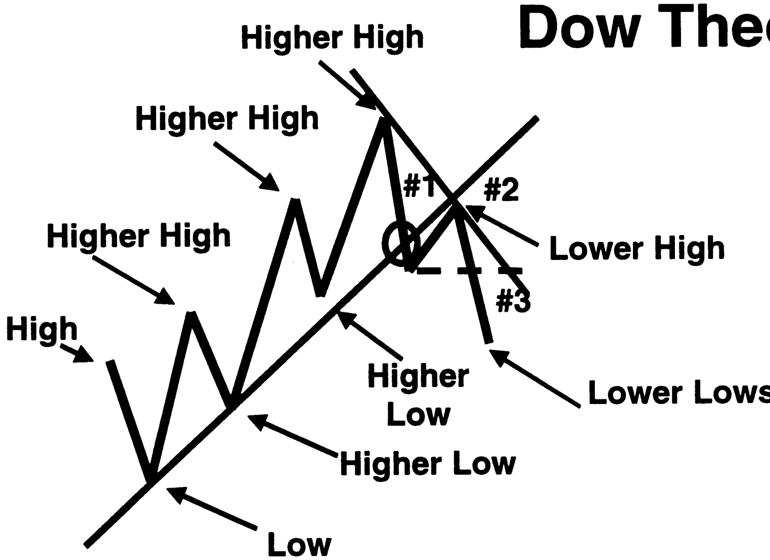
Dow Theory



1

Dow Theory



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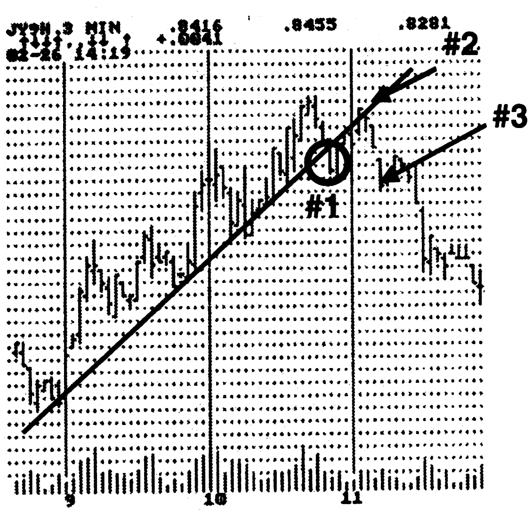
Dow Theory



❧ **Definition**

(from the Greek):

Stochastics is the process of finding the underlying pattern in what appears to be random, or chaotic.

Stochastics is a Momentum Oscillator

<u>The Theory of Momentum</u>

The momentum oscillator measures the velocity of directional price movement.

Momentum always changes direction (trend) before price.

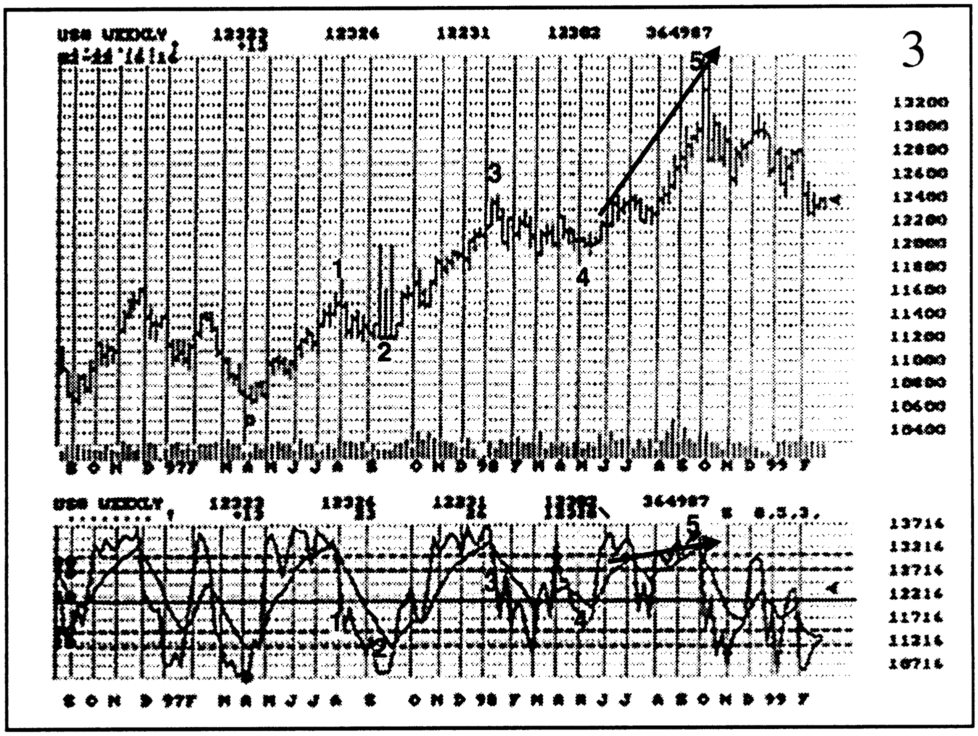
We, therefore, developed an <u>oscillator</u> that would show this tendency through the use of a ratio.
We optimized it, smoothing it twice. Then, we converted it to a (%) percentage oscillator.

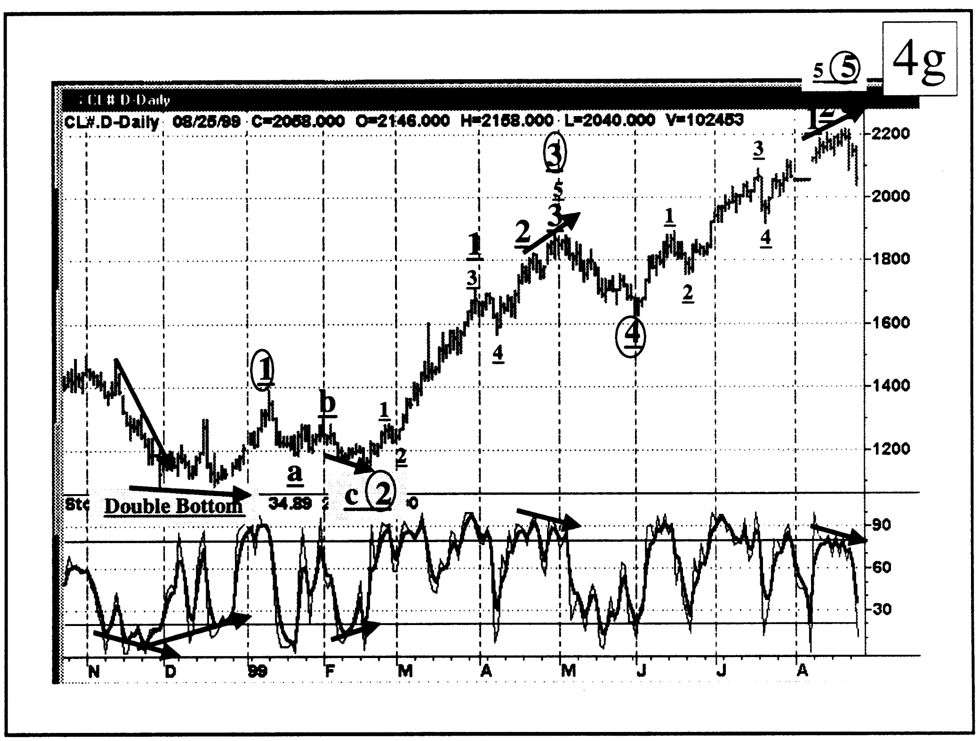
Theory of Stochastics

Stochastics is based on the observation that, as price decreases, Closes tend to accumulate ever closer to their extreme Lows of the daily range.

Conversely, as price increases, Closes tend to accumulate ever closer to the extreme Highs of the daily range.

This concept holds whether you are working in 1-minute, 3-minute, 5-minute, 15-minute, 30-minute, hourly, daily, weekly, or monthly time periods.


3
5
3
1
2
4
S O N D 97 F M A M J J A S O N D 98 F M A M J J A S O N D 99 F


4g
CL#.D-Daily 08/25/99 C=2058.000 O=2146.000 H=2158.000 L=2040.000 V=102453
2200
2000
1800
1600
1400
1200
Double Bottom
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b
c
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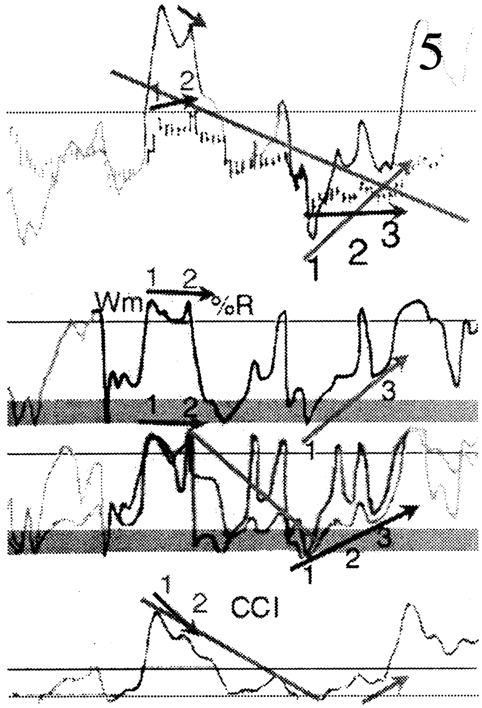
60
30
N D 99 F M A M J J A



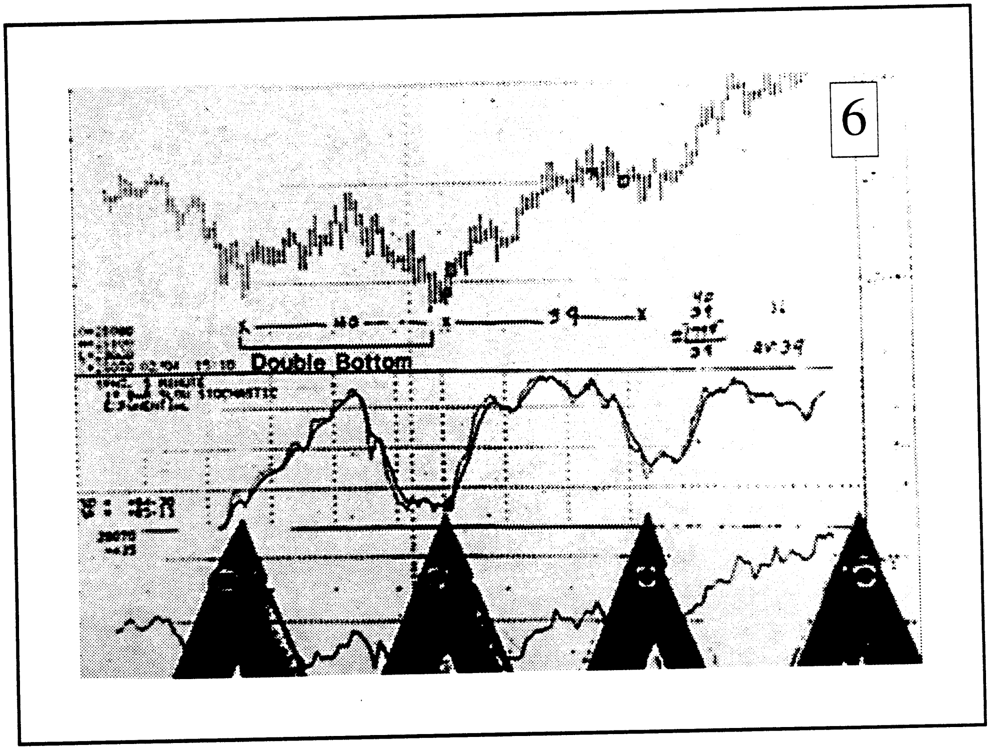
To select the correct periodicity:

1. Study the printout of each of the charts you intend to trade, be it 3-minute, 15-minute, daily, weekly, or monthly charts of the commodity of your choice.

   Decide which you are going to use, based on your own gut level and trading style.

2. Determine the Cycles in the charts you select using an Ehrlich Cycle Finder, or by counting. Pick the optimal Cycle for you — one offering the greatest potential profits commensurate with the greatest risk you can afford moneywise and psychologically.

3. Use a periodicity (number of bars) that is half (50%) of the Cycle you choose to trade. Refine from there.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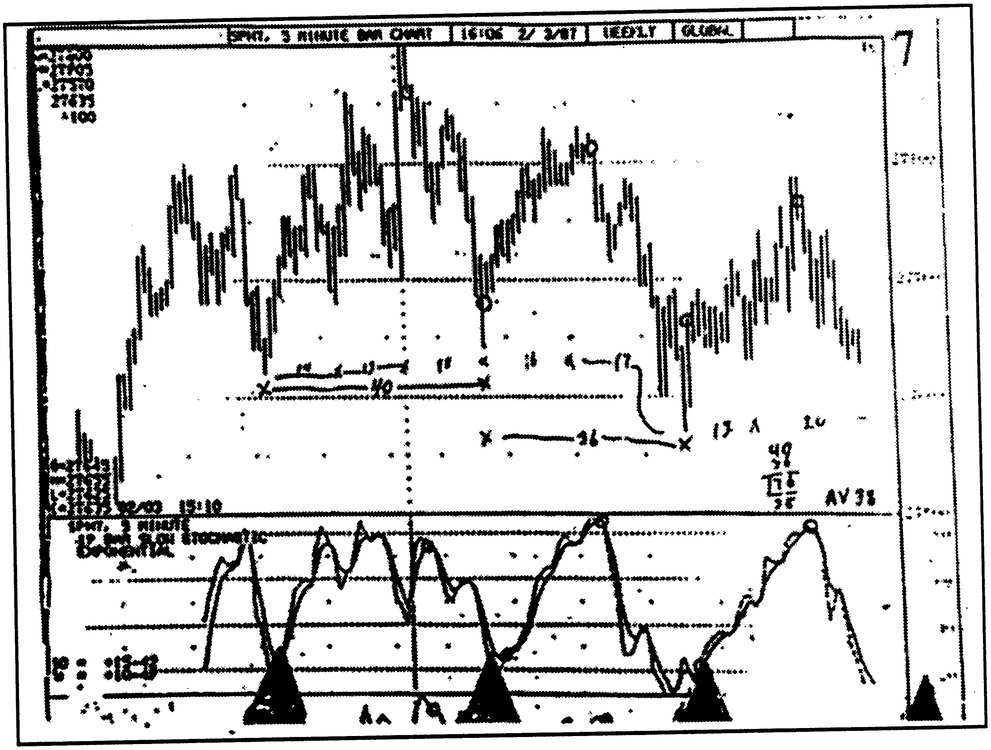
Double Bottom
AV 39

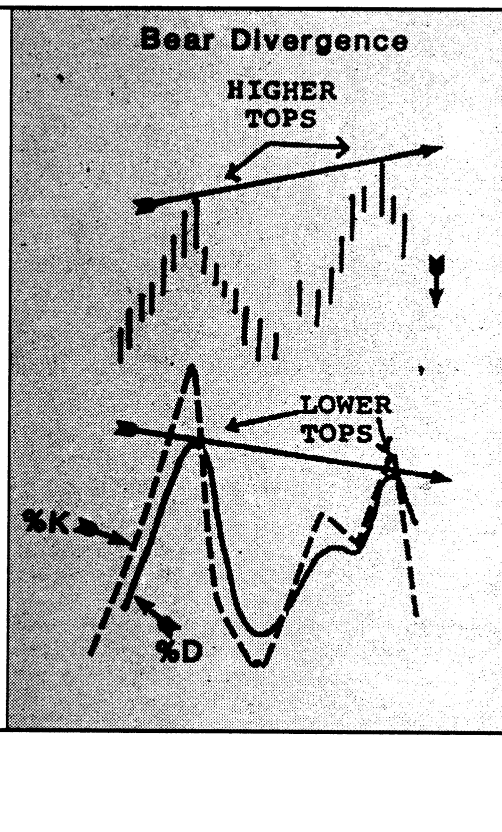

7
AV 38

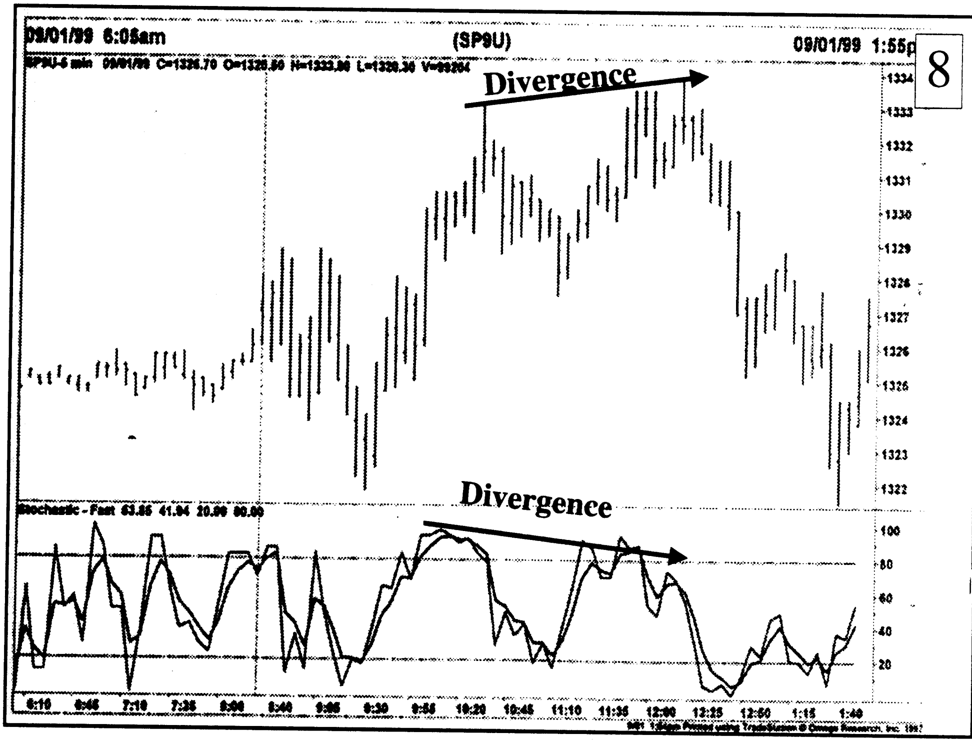
I. Divergence/Convergence

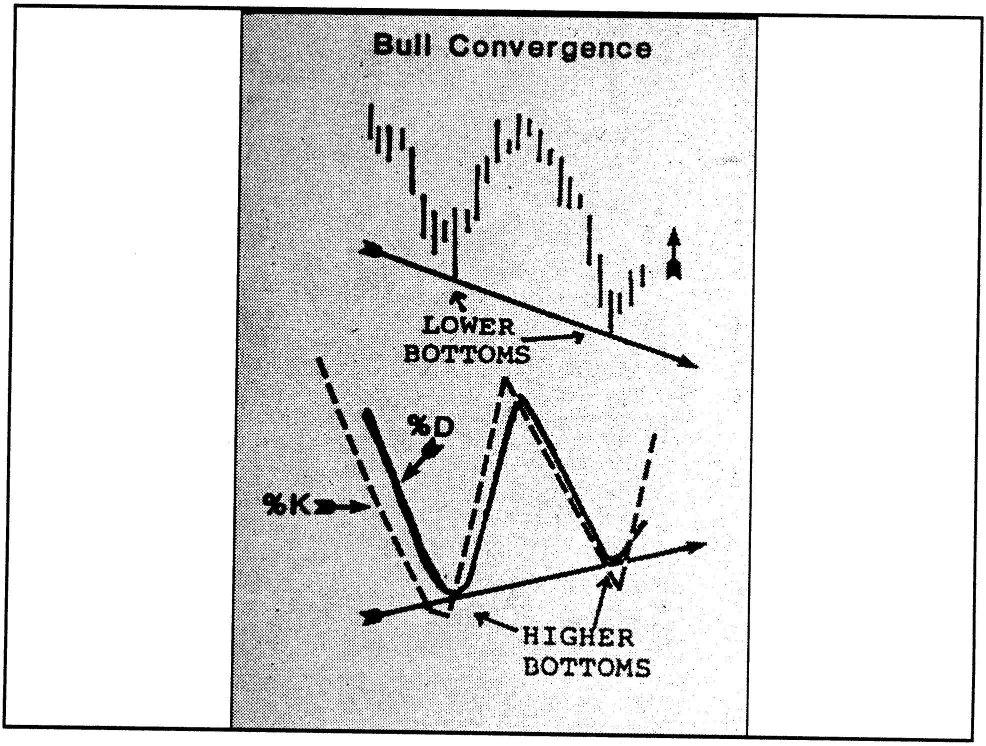
When a stock or commodity has made a High, then reacts, and subsequently goes to a higher High, while the corresponding peaks on %D make a High and then a lower High, a ***bearish divergence*** is indicated.

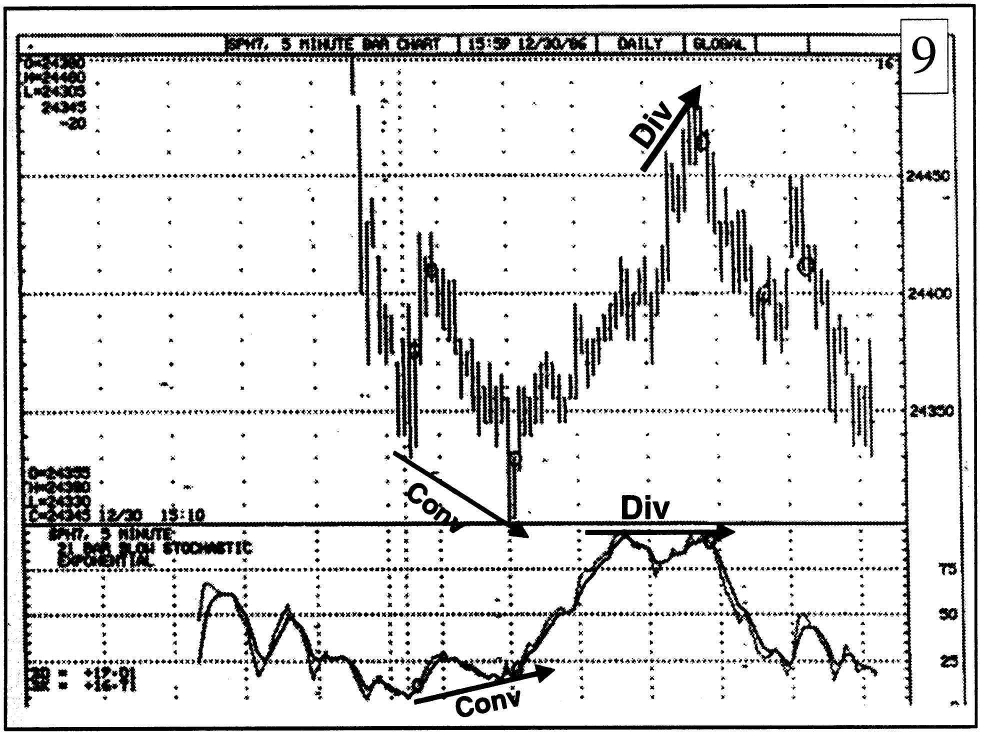
Conversely, when a stock or commodity has made a Low, then rallies and subsequently moves down to a lower Low, while the corresponding low points of %D have made a Low and then a higher Low, you have ***bullish convergence***.

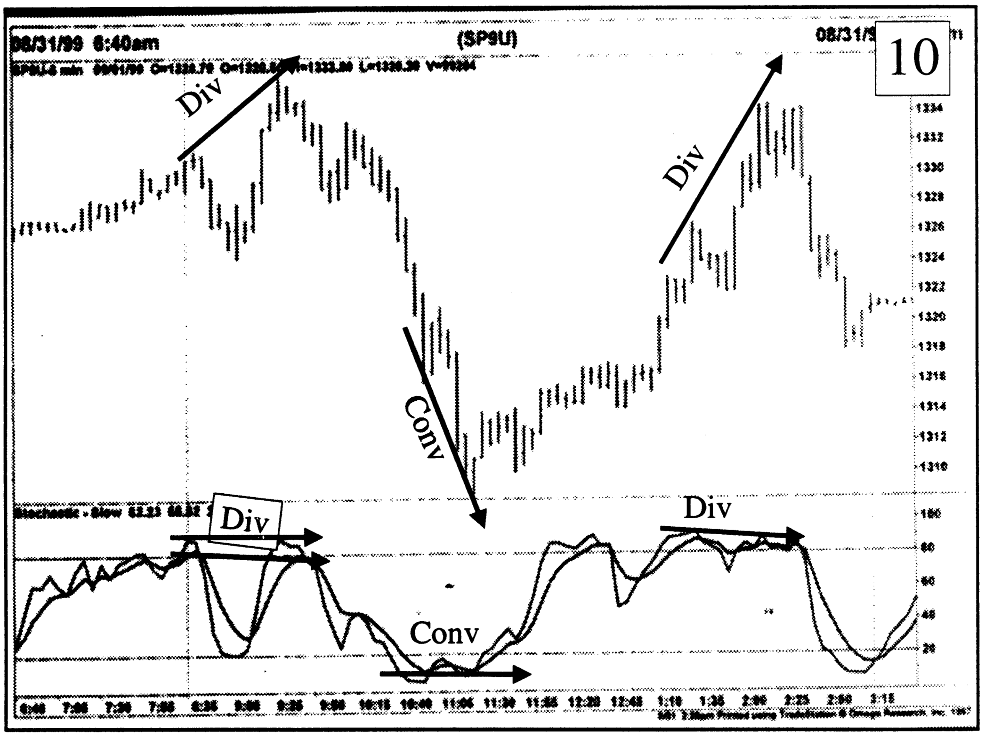
The signal to act comes when %K crosses on the right-hand side of the low point of %D at a Bottom, or on the right-hand side of the peak of %D at a Top.

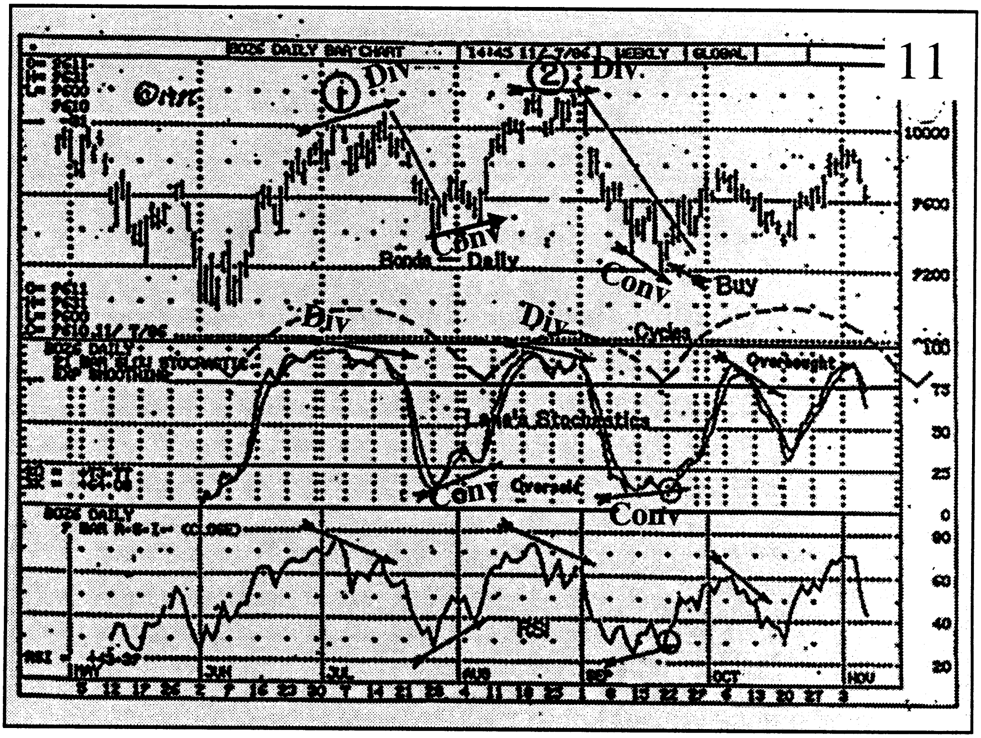


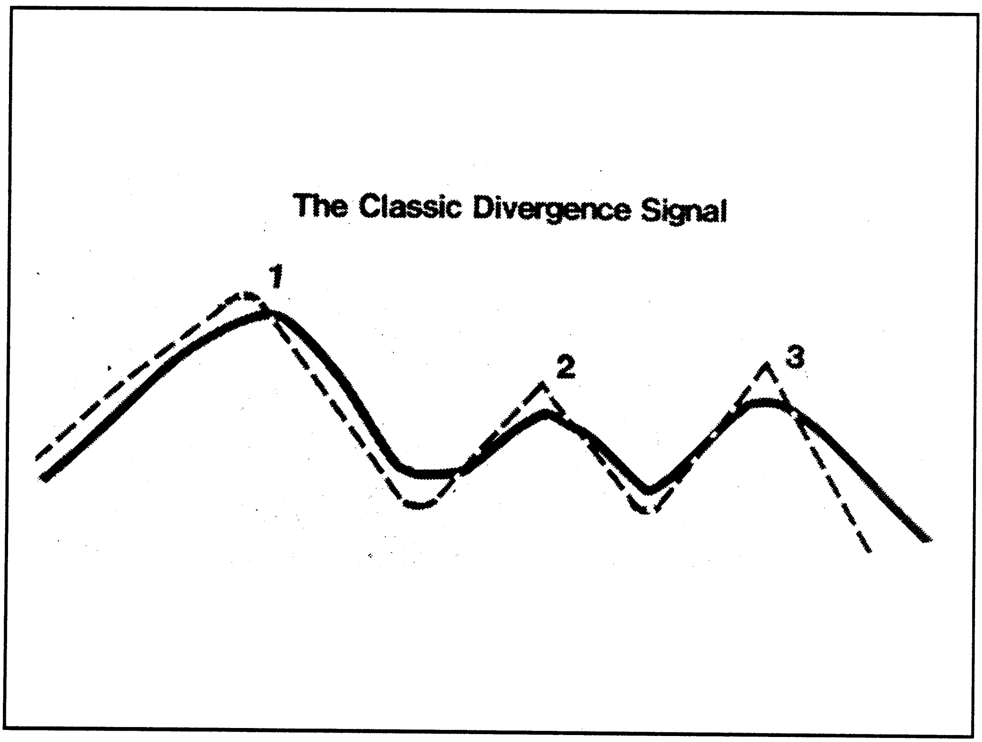

8
09/01/99 6:05am
(SP9U)
09/01/99 1:55p
Divergence
Divergence

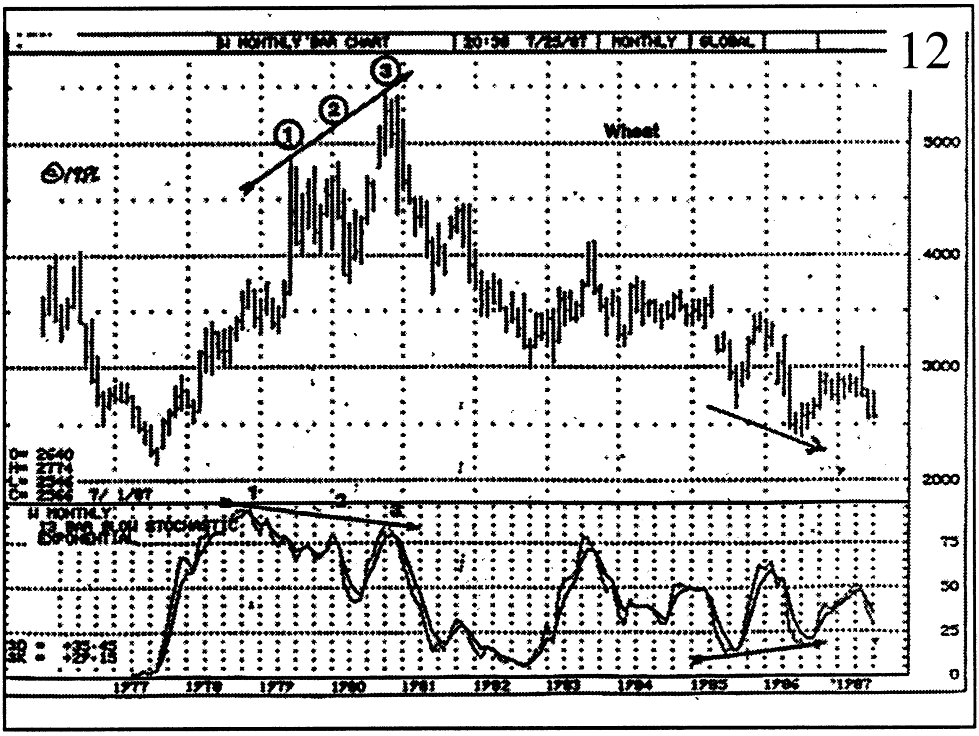

Bull Convergence
LOWER BOTTOMS
%D
%K
HIGHER BOTTOMS


9
SPH7, 5 MINUTE BAR CHART
15:59 12/30/96
DAILY
GLOBAL
Div
Conv
Div
Conv
24450
24400
24350
75
50
25


10
(SP9U)
Div
Div
Conv
Div
Div
Conv


11
Div
Div
Conv
Bonds — Daily
Conv
Buy
Div
Div
Cycles
Overbought
Lane's Stochastics
Conv
Oversold
Conv
RSI
JUN
JUL
AUG
OCT
NOV


The Classic Divergence Signal
1
2
3


12
Wheat
5000
4000
3000
2000
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50
25
0
1977
1978
1979
1980
1981
1982
1983
1984
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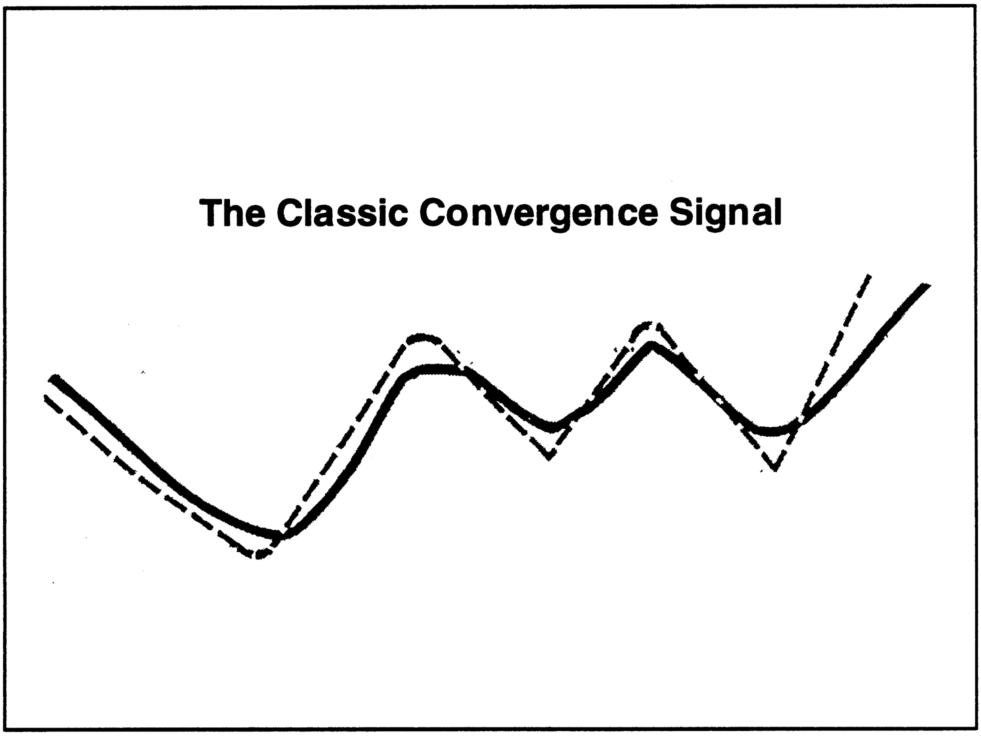
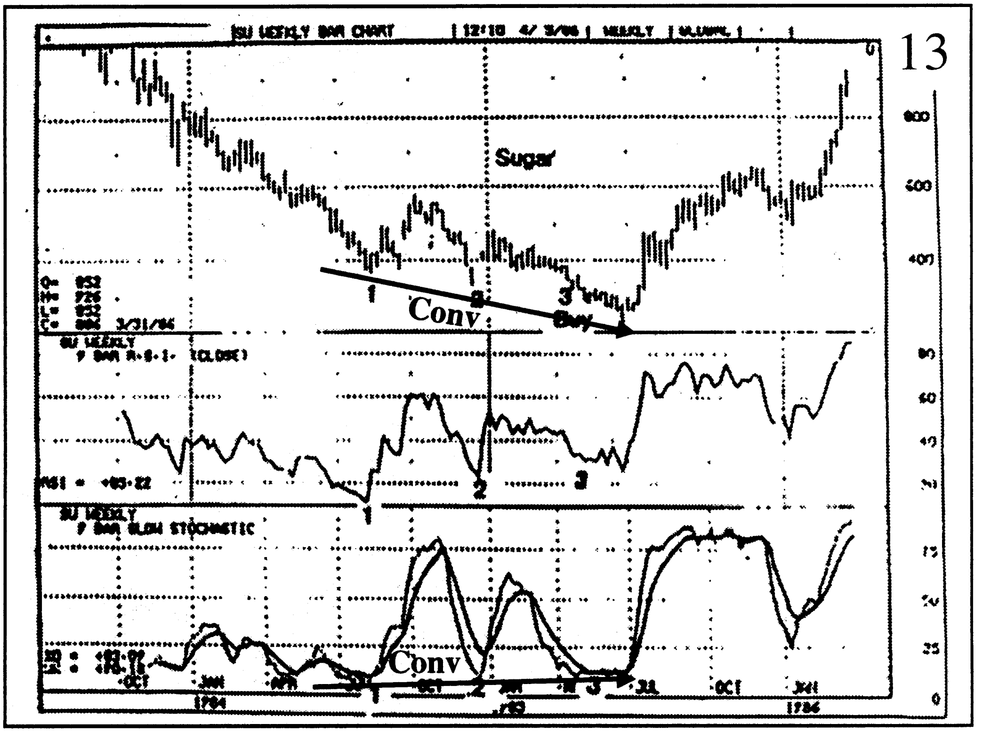
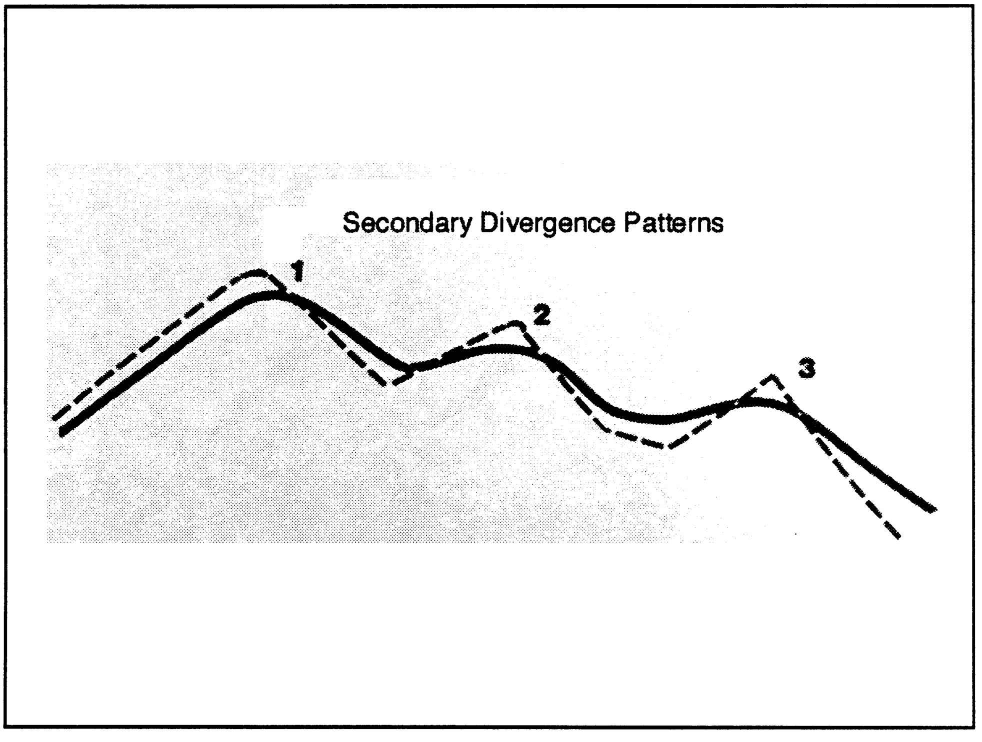
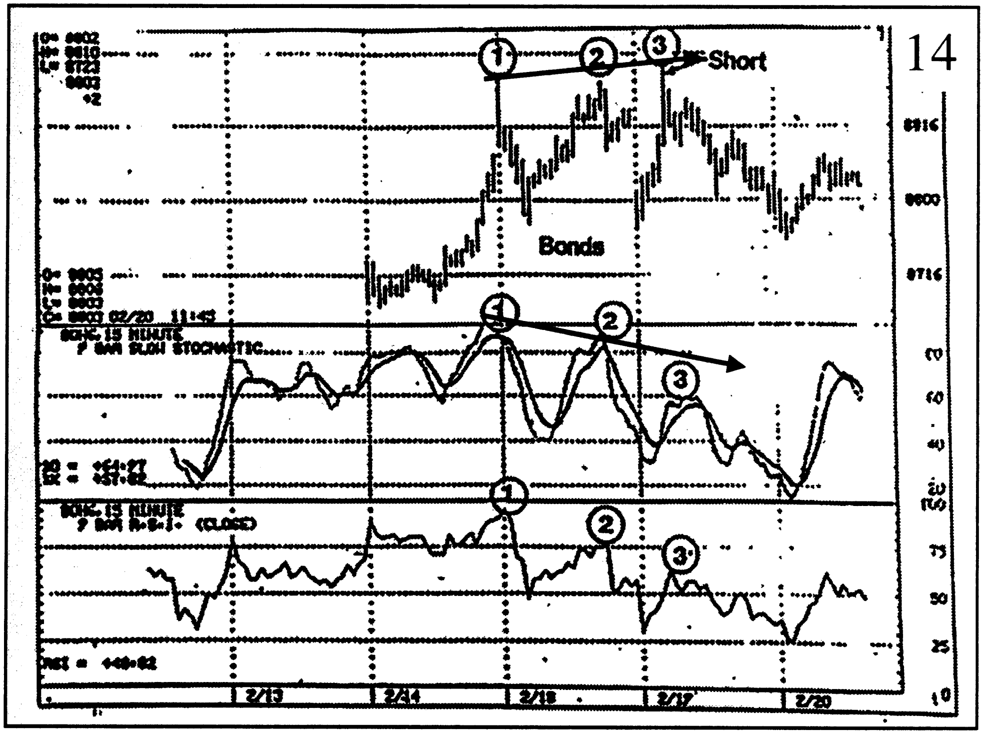
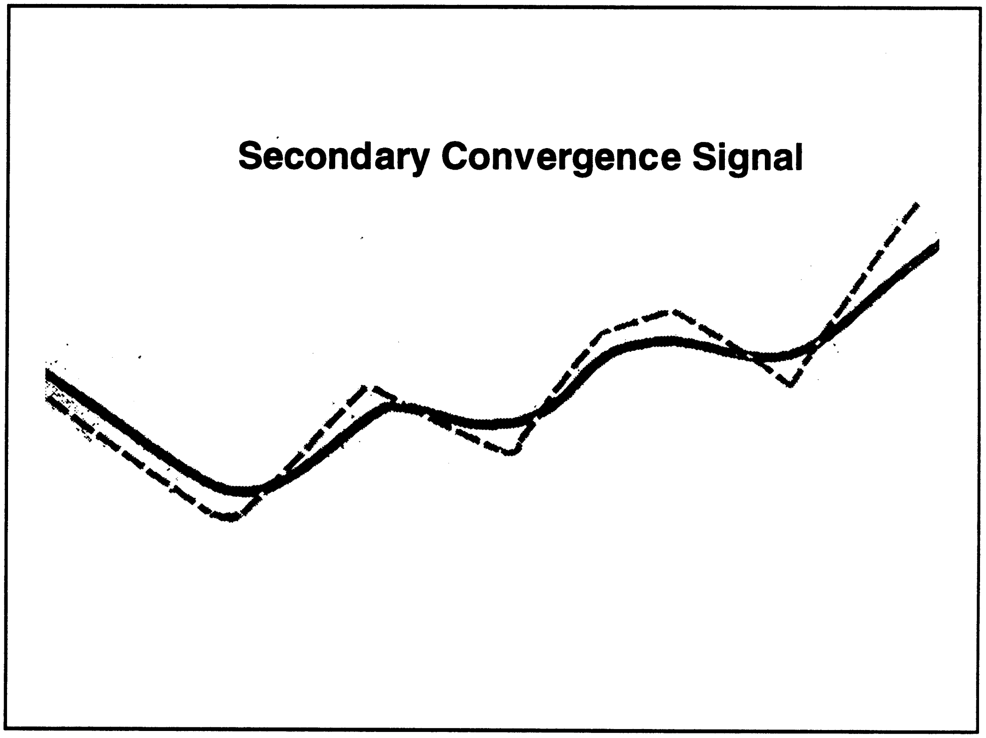
1986
1987

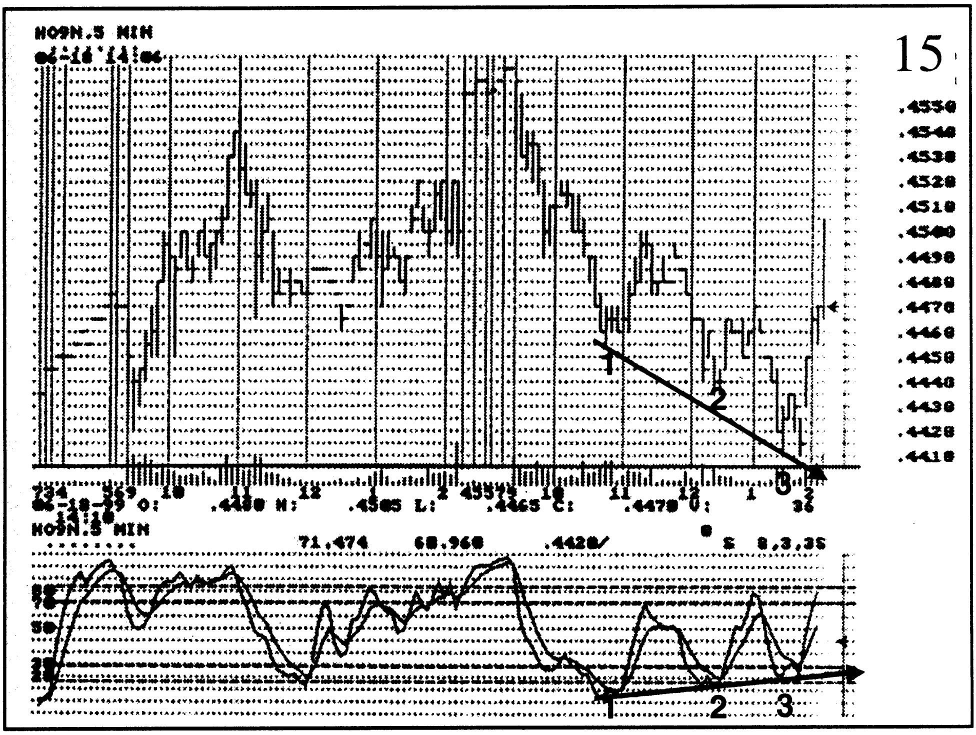

The Classic Convergence Signal


13
Sugar
Conv
Buy
Conv
1
2
3


Secondary Divergence Patterns
1
2
3


14
Short
Bonds
2/13
2/14
2/18
2/17
2/20


Secondary Convergence Signal



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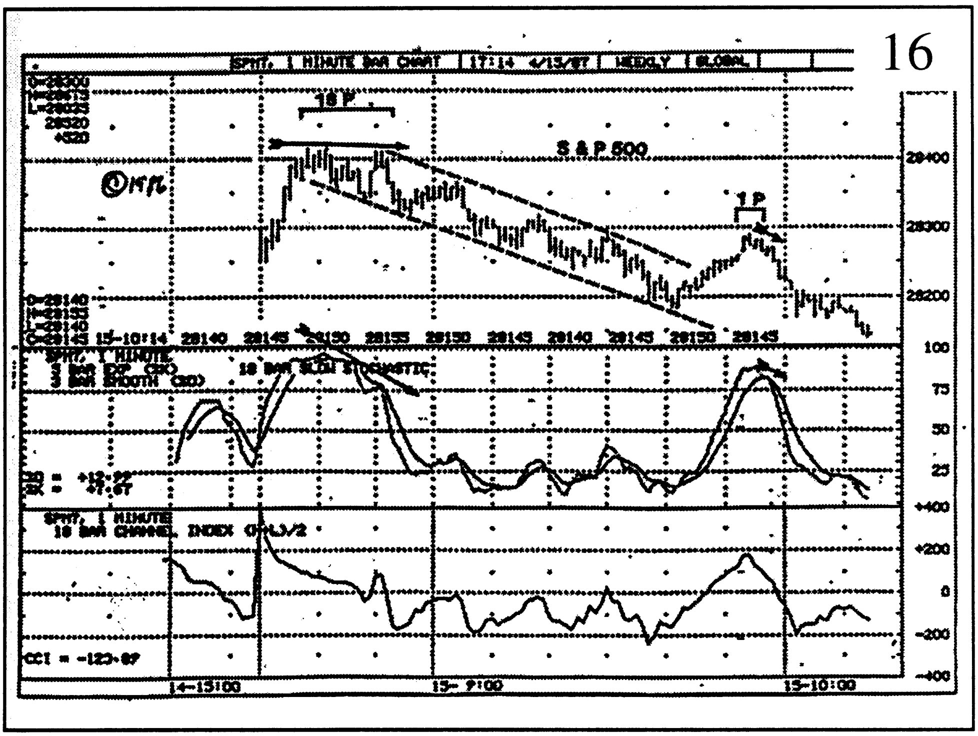

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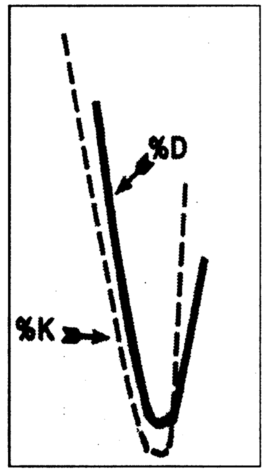
II. Crossovers

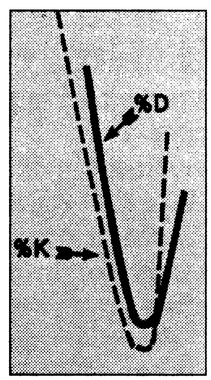
❧ Left-Hand Crossover

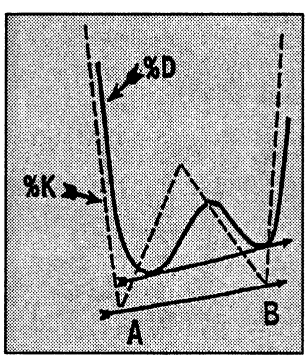
- When a change in trend returns the commodity to the major trend, a "Spike" or "V" Bottom (or Top) will occur.
- At such a Bottom (or Top), a left-hand crossover is acceptable.



Right-Hand Crossover

A right-hand crossover is still the desired signal for Double Bottoms (or Tops) and for "Garbage Bottoms" (or Tops).



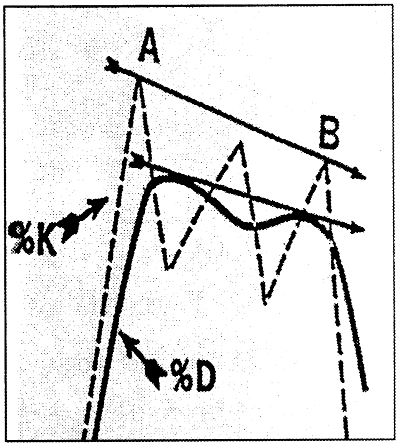


This illustration shows a less than desirable change in trend at Bottom A, but an acceptable right-hand crossover at B, with convergence in both %K and %D.
This pattern usually accompanies a Double Bottom.

Right-Hand Crossover

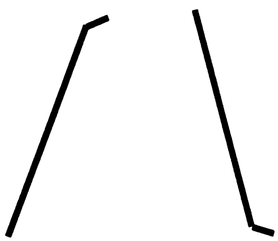
- Congestion Tops are congestion changes in trend.
- Note that Top A is a less than desirable left-hand crossover. However, at B, we have a good, clean right-hand crossover, with convergence in %K and in %D.

Therefore, a left-hand crossover, *when price does not make a Spike*, predicts that the market has more to go before giving the correct right-hand crossover.



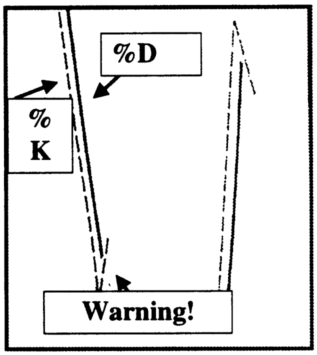
III. Hinge

- A reduction in the velocity of movement in either %K or %D usually indicates a reversal of trend for the next period.



IV. Warning

- When %K has been declining each period and then one period reverses sharply (2-12%), this is a warning that you may have only a few more time periods before a reversal.



V. %K Reaching the Extremes (0% - 100%)

- **In an up market, when %K rises to a value of 100%, *this does <u>not</u> denote an absolute top* in the stock or commodity. <u>It signifies extreme strength.</u>**
- **%K may reach the extreme, decline, then rebound a second time to the extreme before giving a Sell Signal (as in the case of a Double Top).**
- **Reaching 100%, does <u>not</u> mean that the price of the stock or commodity has gone as high as it will go.**
- **In fact, the market may have a reaction, or a hesitation, and then a resumption of the major trend, which is still in force.**
- **There may be substantial upside action remaining at the point where the indicator is just entering the upper band of the Stochastic chart.**
- **%K will continue to flutter along near 100%, giving us...**

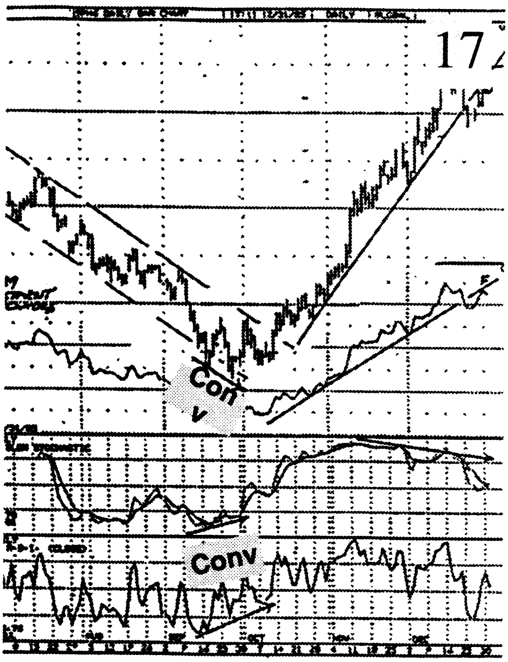
Jake Bernstein's Stochastics Pop!

In a market returning to the major trend, or in an exuberant market, when :

- the short-term trend is up
- the intermediate trend is up
- the long-term trend is up

then...

...the market develops extra push in the direction it's going!



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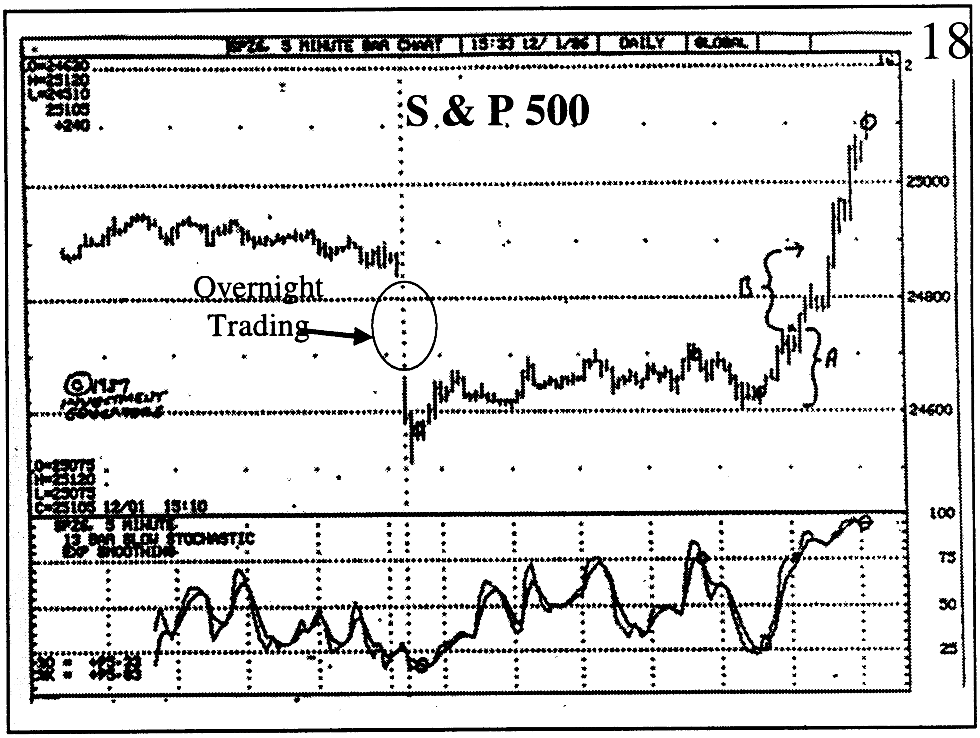
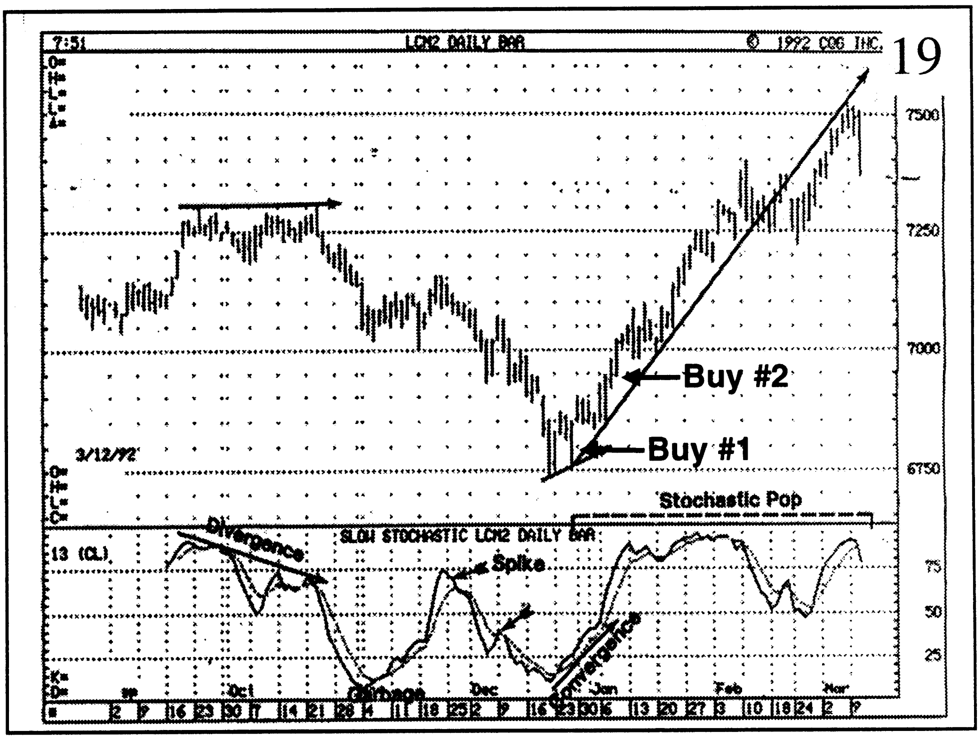

SPZ6 5 MINUTE BAR CHART
S & P 500
Overnight
Trading
A
B
24800
24600
25000
100
75
50
25

19


LCM2 DAILY BAR
© 1992 CQG INC.
7500
7250
7000
6750
Buy #2
Buy #1
3/12/92
Stochastic Pop
SLOW STOCHASTIC LCM2 DAILY BAR
Divergence
Spike
Garbage
Convergence
Oct
Dec
Jan
Feb
Mar

Plan for Taking Profits

Take profits (or move up a tight Stop-Loss) when:

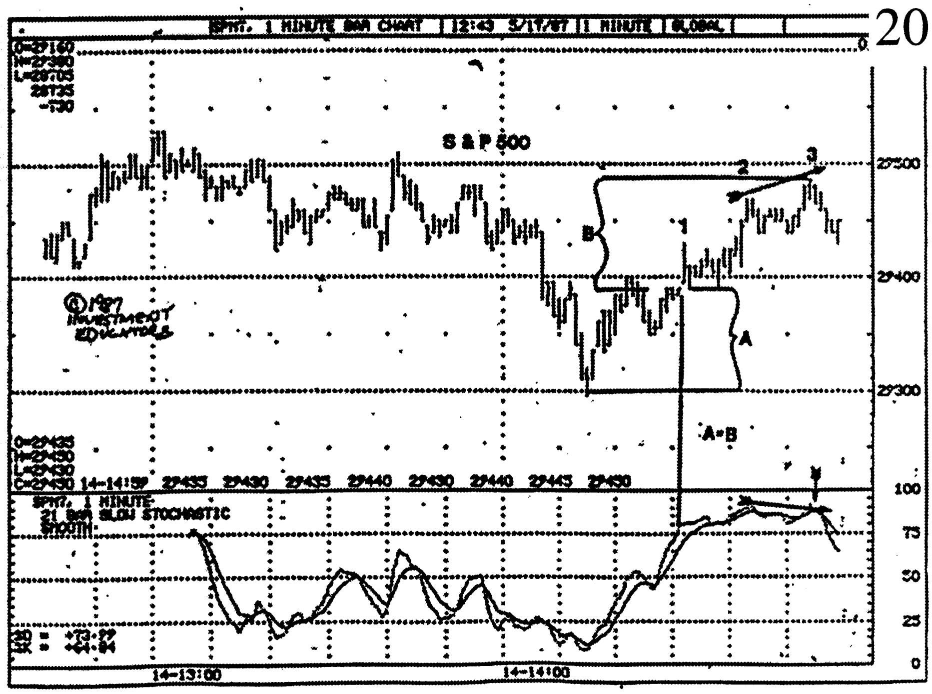
A. the stock or commodity has moved up to a price that's twice the price it had at the 75% level (its 100% swing price objective);

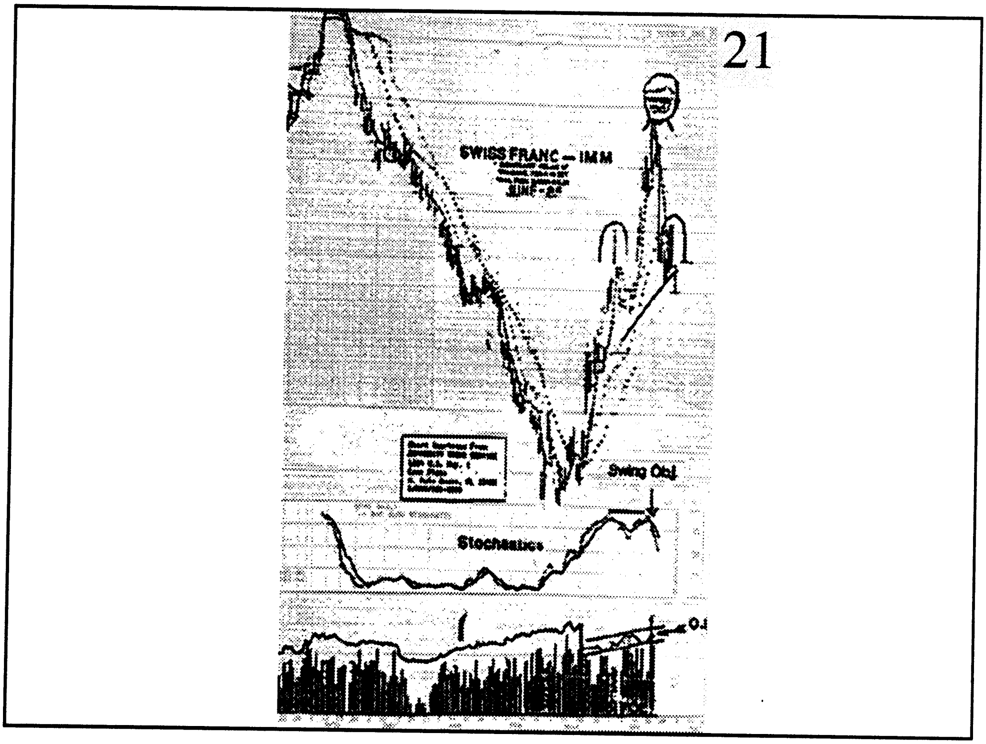
B. when %K falls below 60%;

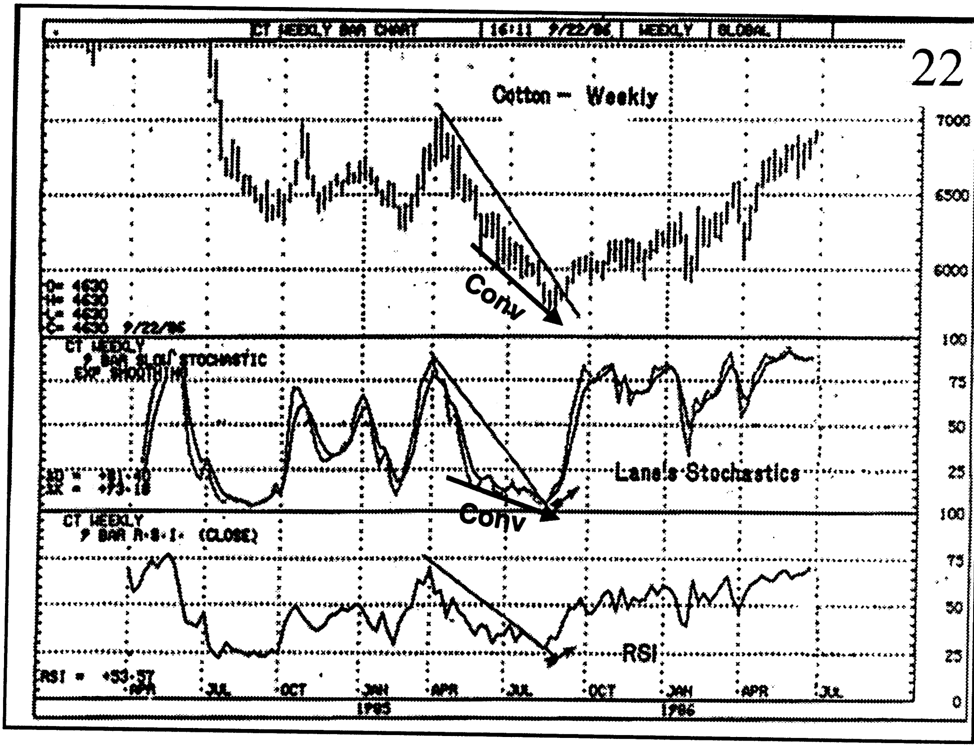
C. when %K crosses below %D;

D. when you have completed a pattern of divergence.

20




21
SWISS FRANC — IMM
Swing Obj
Stochastics
O.I


22
CT WEEKLY BAR CHART
16:11 9/22/86
WEEKLY
GLOBAL
Cotton — Weekly
7000
6500
6000
Conv
O= 4630
H= 4630
L= 4630
C= 4630 9/22/86
CT WEEKLY
9 BAR SLOW STOCHASTIC
Lane's Stochastics
Conv
100
75
50
25
CT WEEKLY
9 BAR R-S-I- (CLOSE)
RSI
RSI = +53.57
APR
JUL
OCT
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APR
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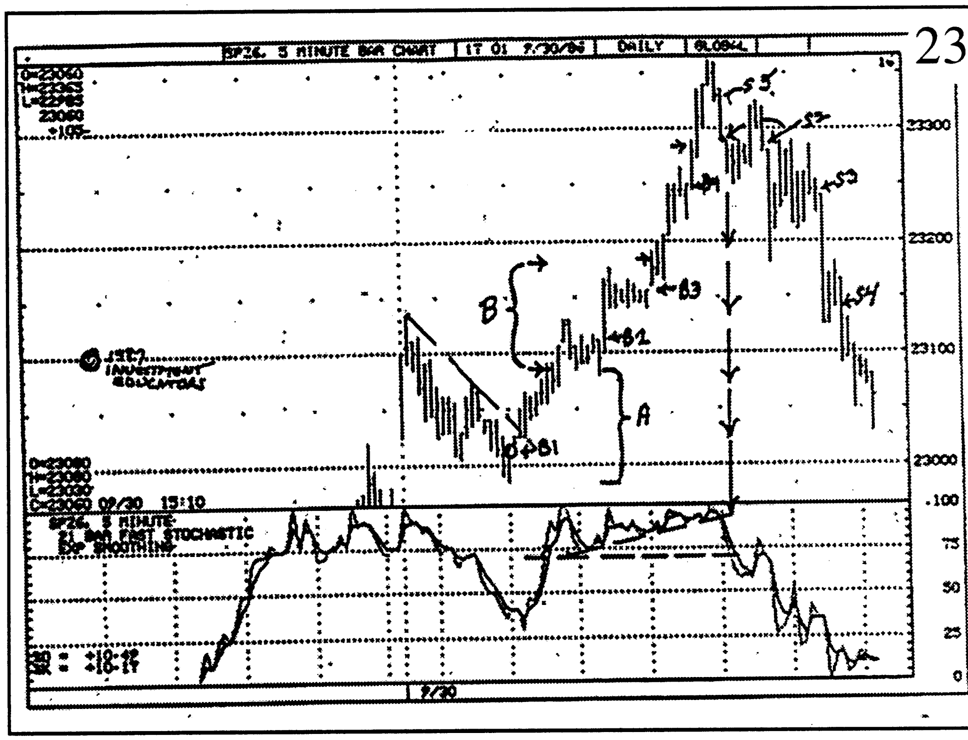
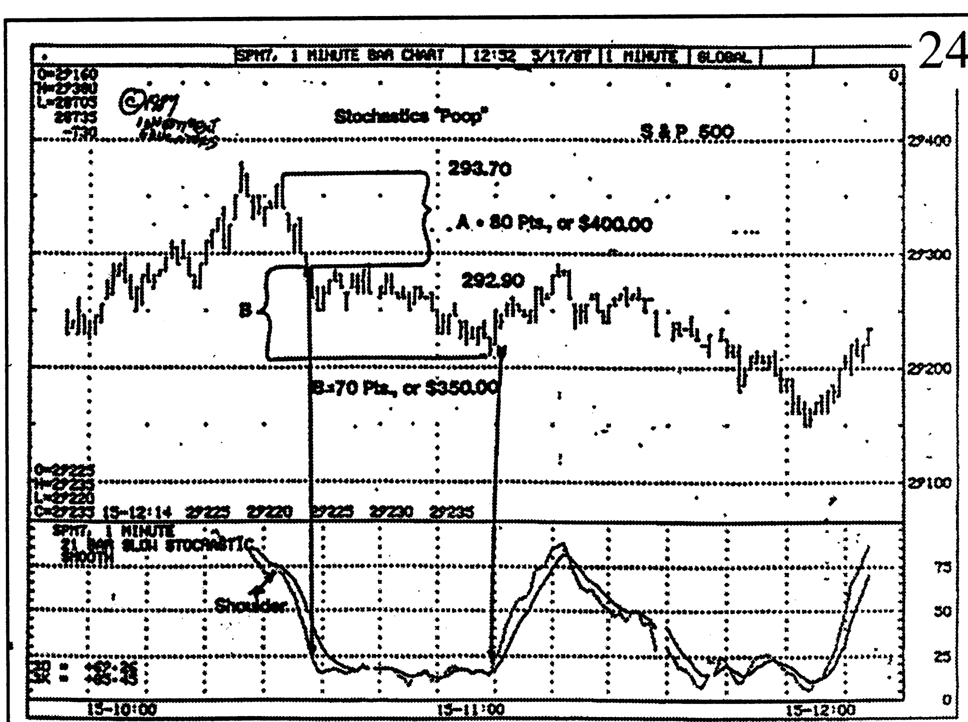
OCT
JAN
APR
JUL
1985
1986
0

23

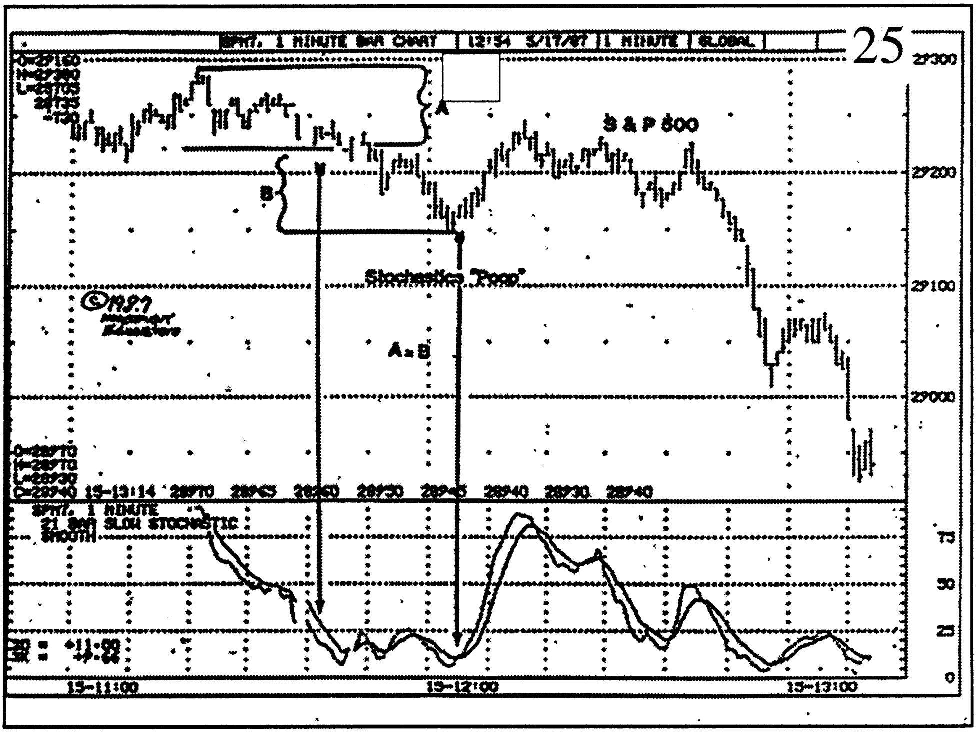


SP26, 5 MINUTE BAR CHART
DAILY
GLOBAL
21 BAR FAST STOCHASTIC
23300
23200
23100
23000
B
A

24



SPH7, 1 MINUTE BAR CHART
1 MINUTE
GLOBAL
Stochastics "Poop"
S & P 500
293.70
A = 80 Pts., or $400.00
292.90
B
B=70 Pts., or $350.00
SPH7, 1 MINUTE
21 BAR SLOW STOCHASTIC
Shoulder
15-10:00
15-11:00
15-12:00



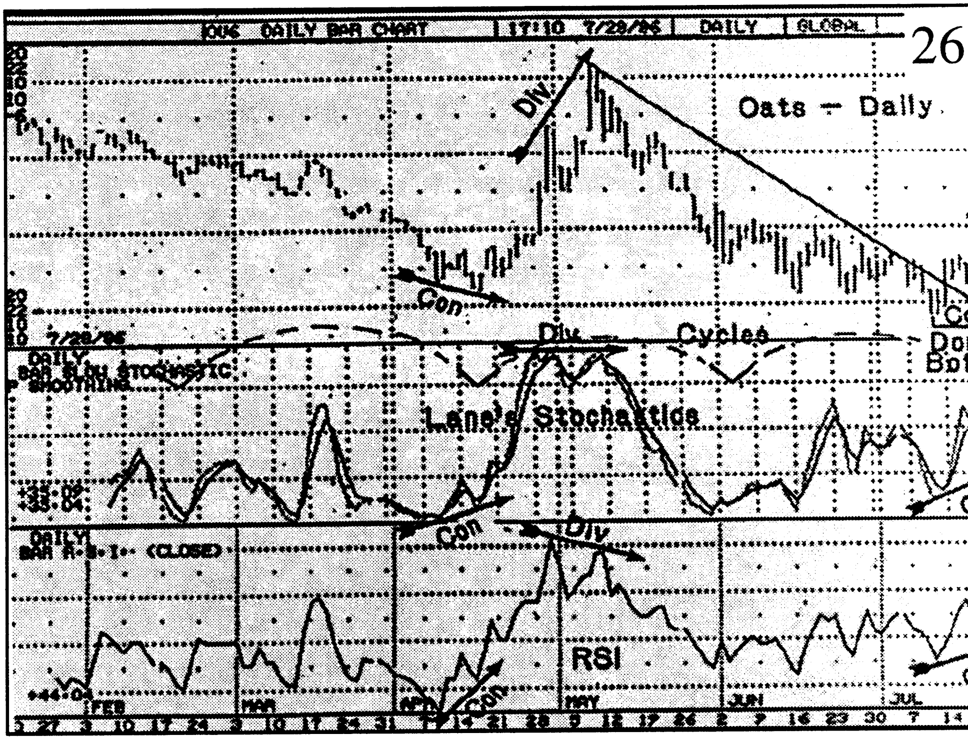
In a "Poop" take profits when:

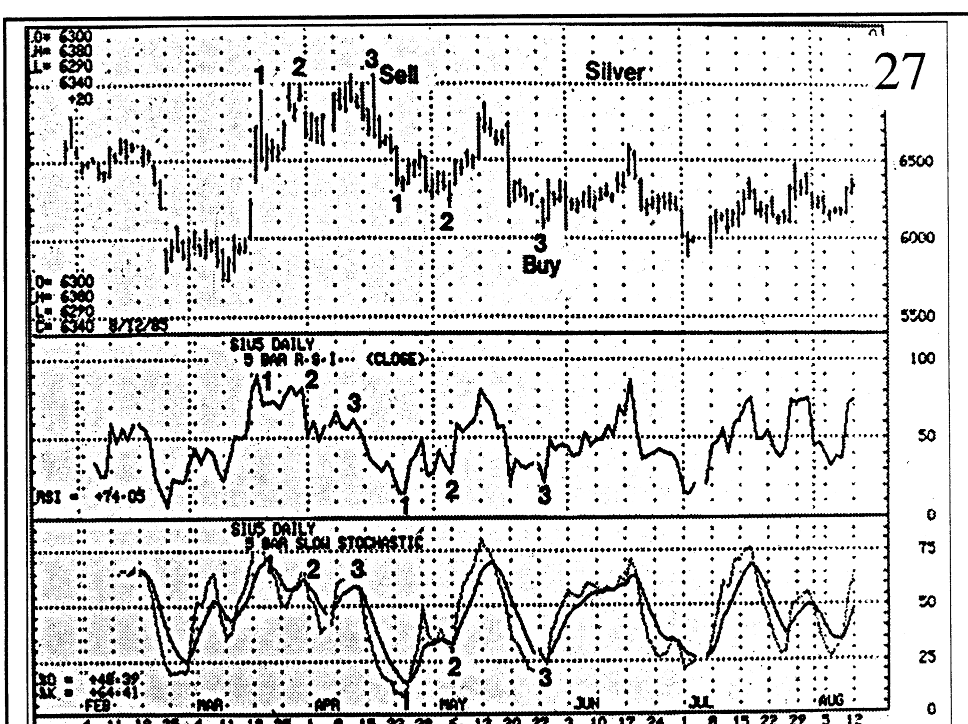
A. The stock or commodity has moved down to a price that is twice as low as it was when Stochastics reahed the 25% level;

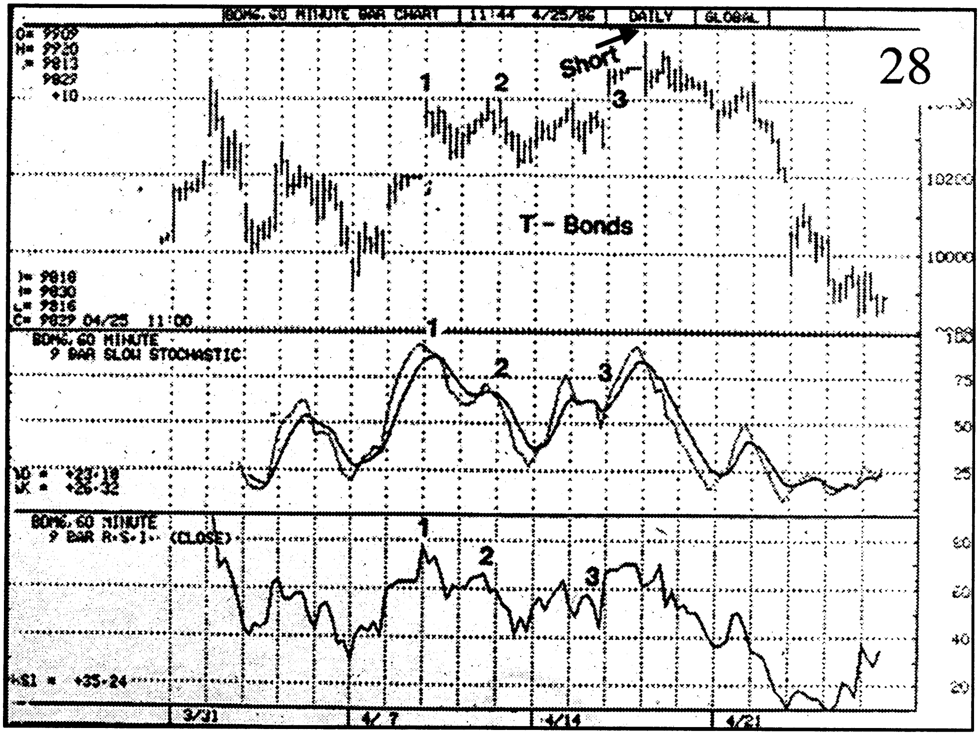
B. %K rises above 40%;

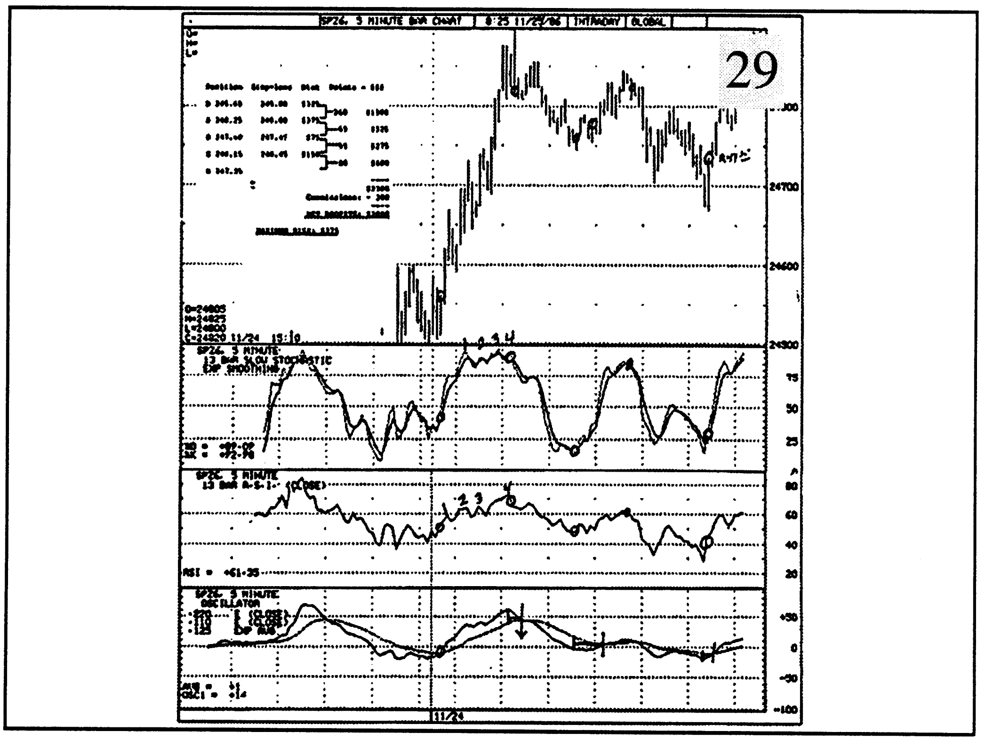
C. %K crosses above %D; or

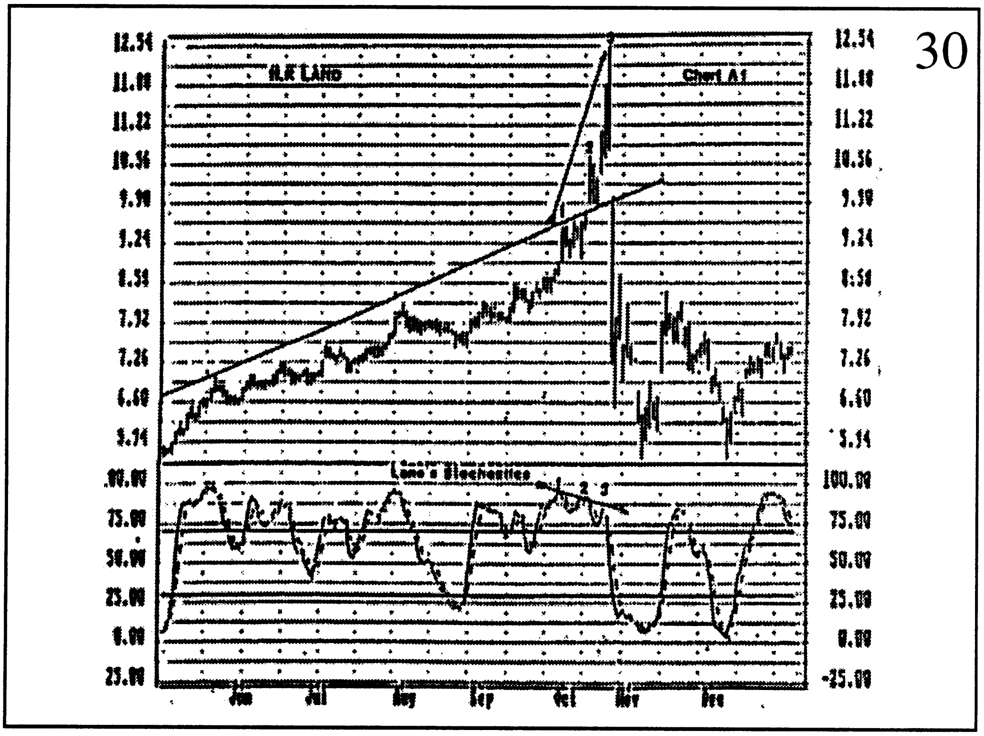
D. at a garbage bottom, the stock or commodity has completed a pattern of convergence

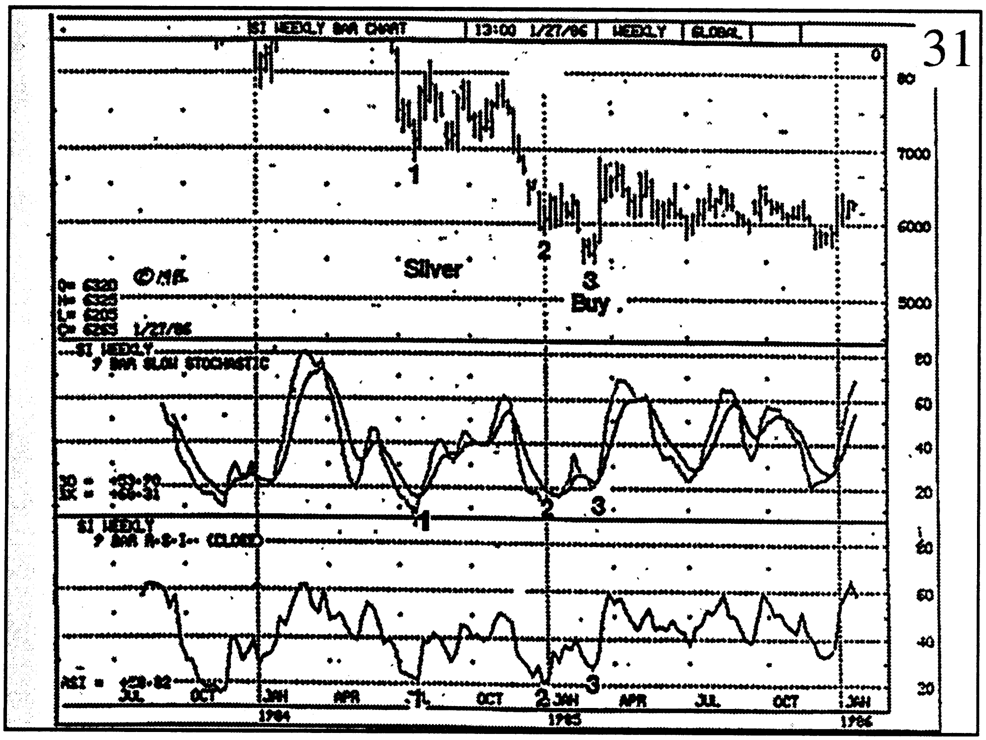

26
Oats - Daily
Div
Con
Cycles
Lane's Stochastics
Div
Con
Div
RSI
Con
Dou
Bot

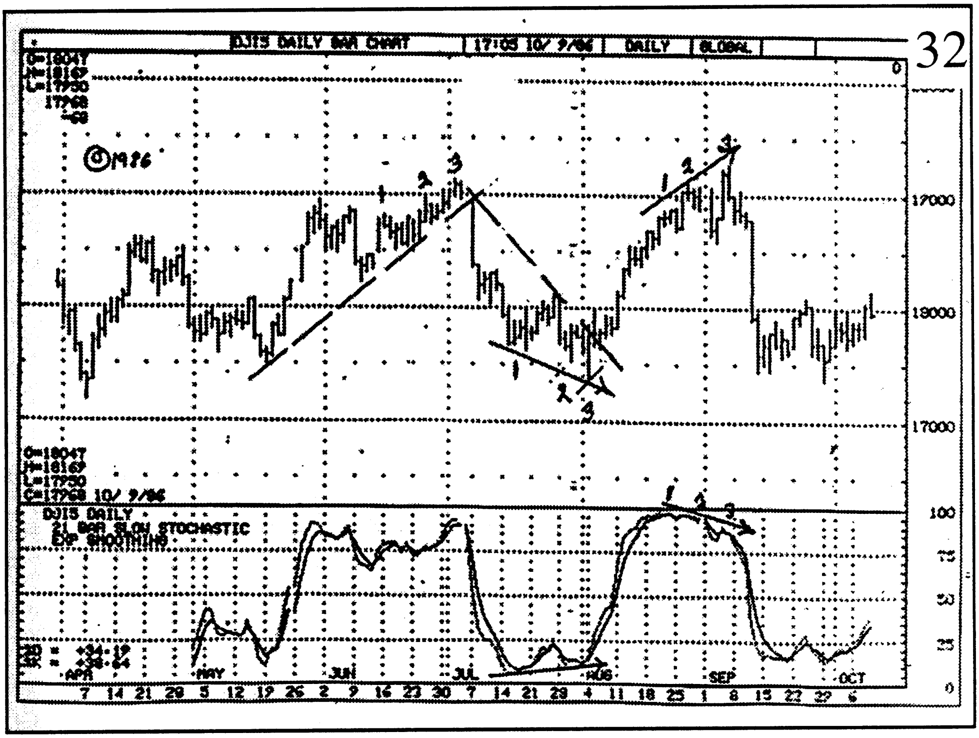

27
Silver
1
2
3
Sell
1
2
3
Buy
SIU5 DAILY
5 BAR R-S-I (CLOSE)
SIU5 DAILY
5 BAR SLOW STOCHASTIC

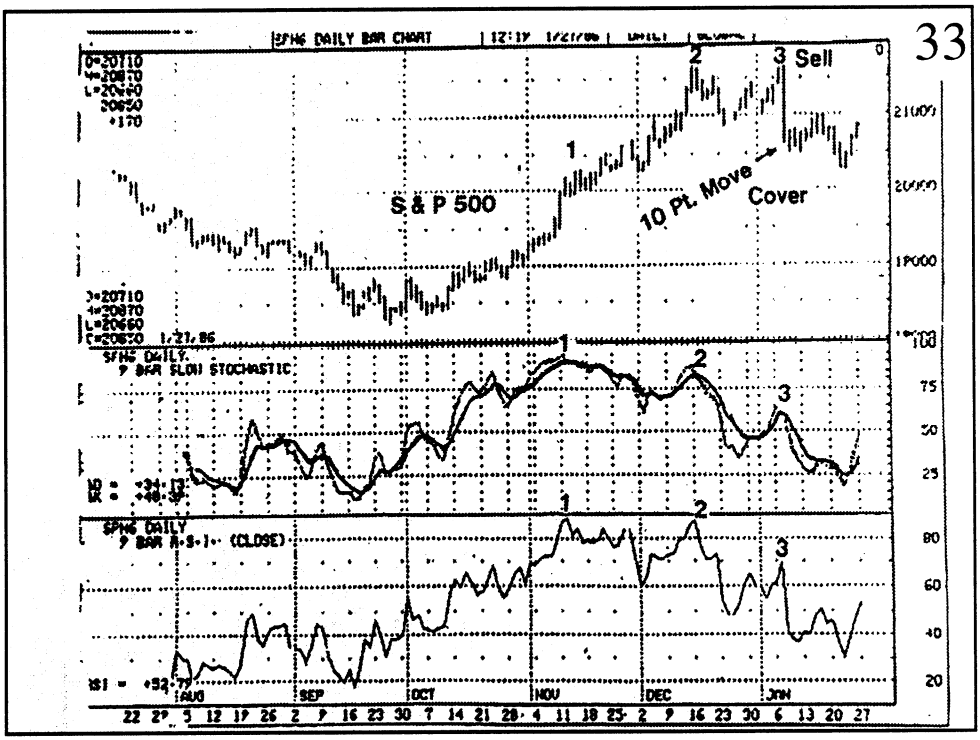

BDM6.60 MINUTE BAR CHART
11:44 4/25/86
DAILY
GLOBAL
28
Short
1
2
3
T- Bonds
BDM6.60 MINUTE
9 BAR SLOW STOCHASTIC
BDM6.60 MINUTE
9 BAR R-S-I- (CLOSE)
3/31
4/7
4/14
4/21

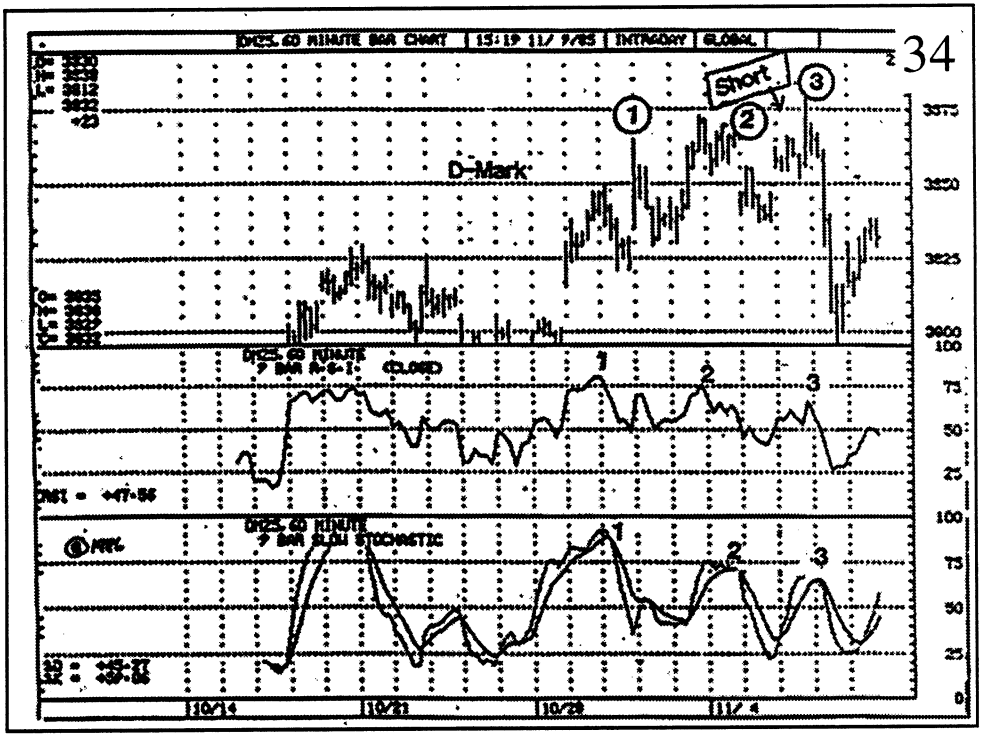

SP26. 5 MINUTE BAR CHART
8:25 11/25/86
INTRADAY
GLOBAL
29
11/24

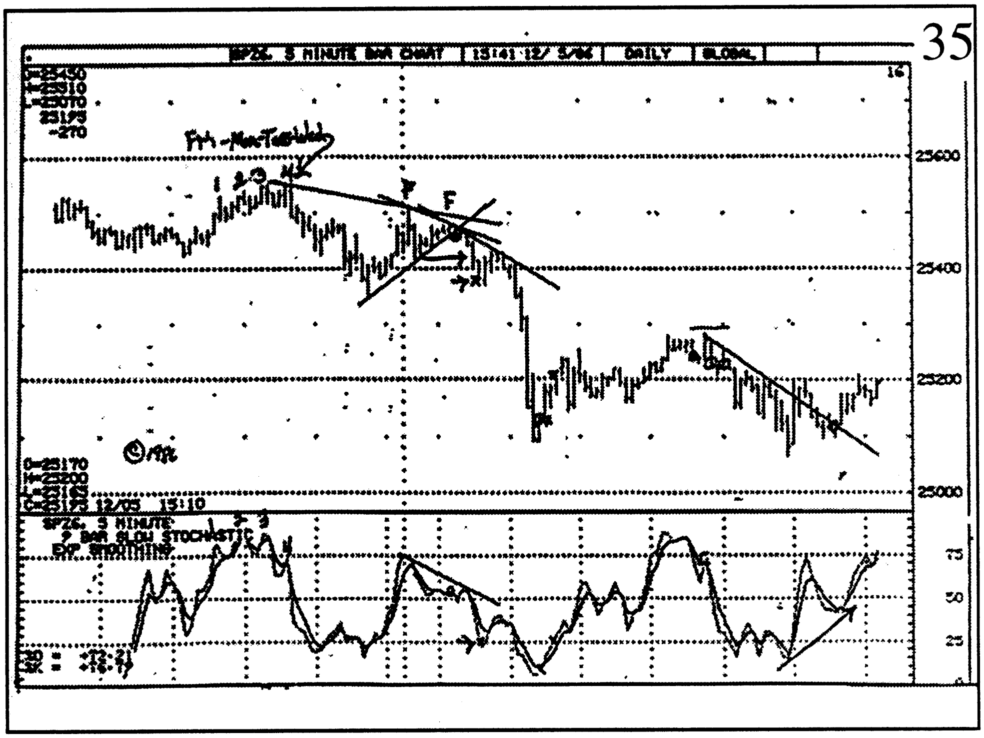

30
H.K LAND
Chart A1
Lane's Stochastics
Jun
Jul
Aug
Sep
Oct
Nov
Dec

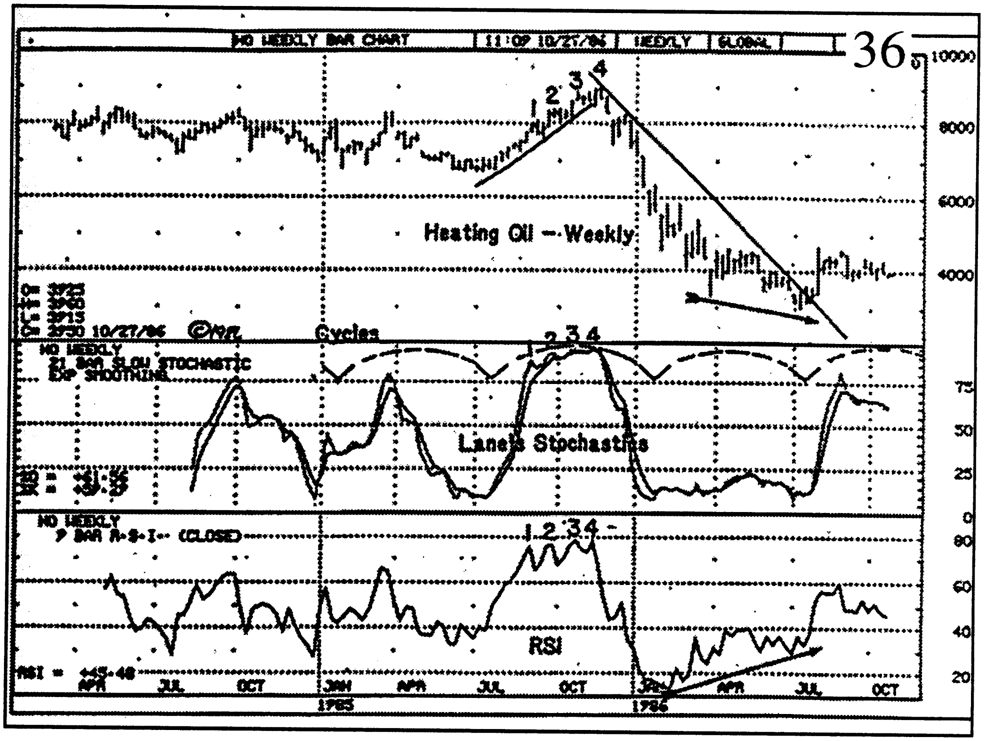

31
SI WEEKLY BAR CHART
13:00 1/27/86
WEEKLY
GLOBAL
Silver
Buy
SI WEEKLY
9 BAR SLOW STOCHASTIC
SI WEEKLY
9 BAR R-S-I-- (CLOSE)
JUL
OCT
JAN
APR
JUL
OCT
JAN
APR
JUL
OCT
JAN
1984
1985
1986

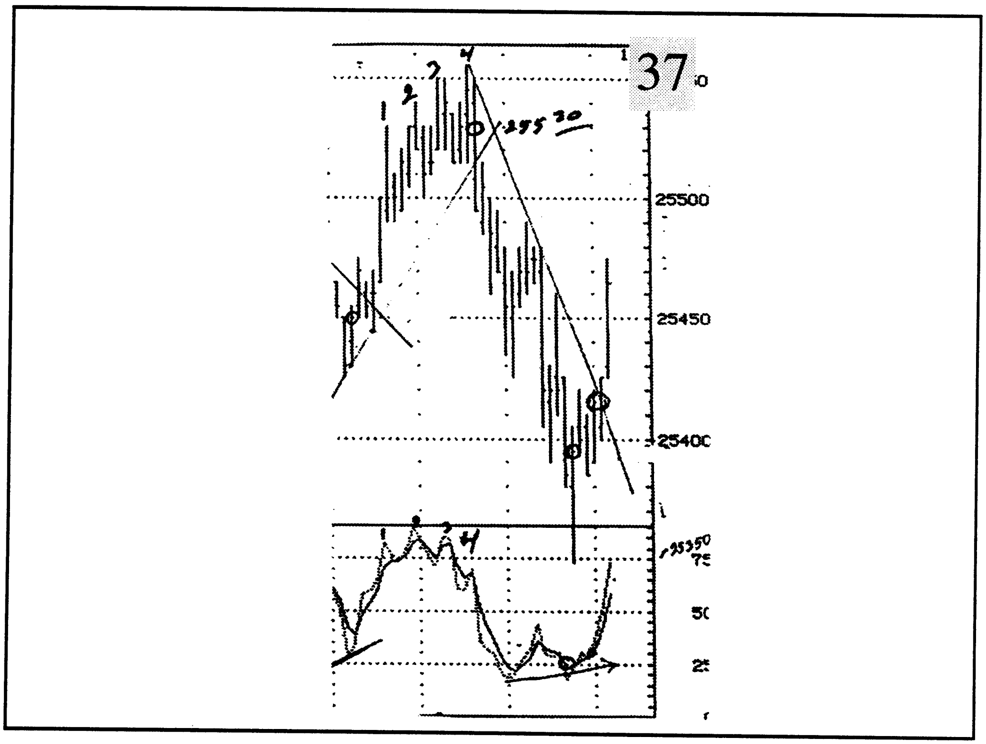

32
DJIS DAILY BAR CHART
17:05 10/ 9/86
DAILY
GLOBAL
©1986
1
2
3
17000
18000
DJIS DAILY
21 BAR SLOW STOCHASTIC
EXP SMOOTHING
APR
MAY
JUN
JUL
AUG
SEP
OCT

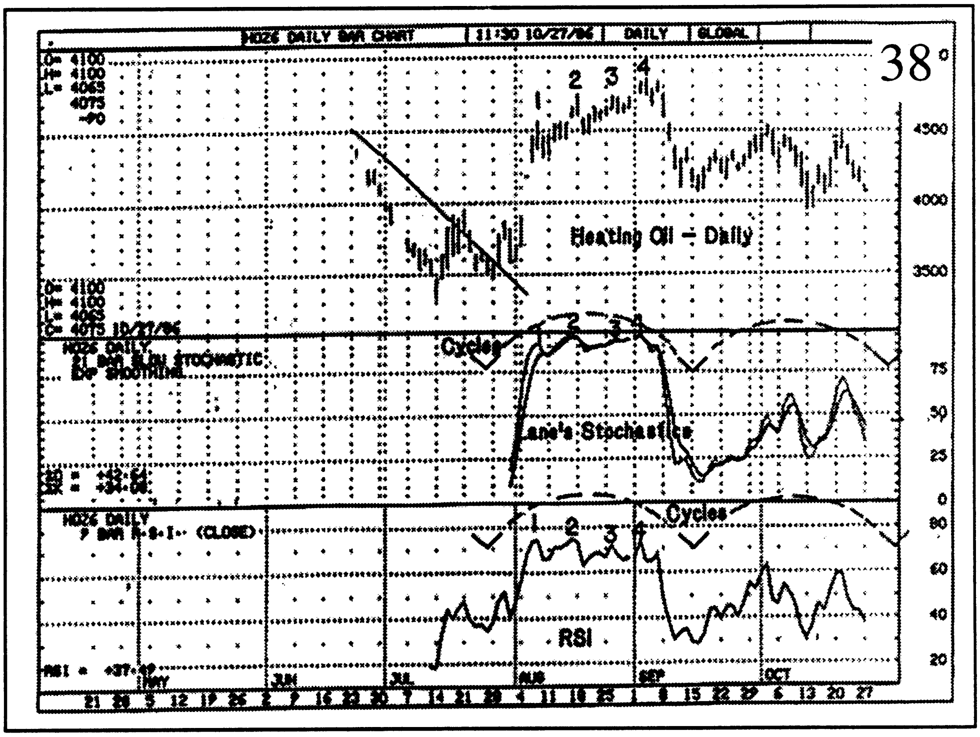

33
SPH6 DAILY BAR CHART
1
2
3 Sell
S & P 500
10 Pt. Move
Cover
SPH6 DAILY
9 BAR SLOW STOCHASTIC
SPH6 DAILY
9 BAR R-S-I- (CLOSE)
AUG
SEP
OCT
NOV
DEC
JAN

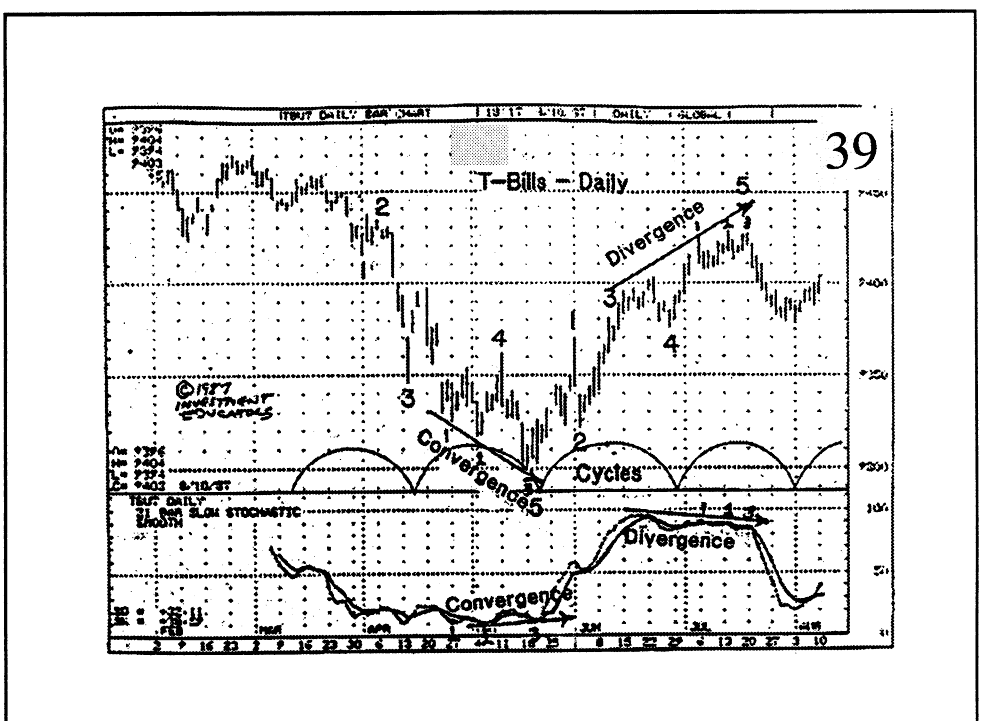

DM25 60 MINUTE BAR CHART
INTRADAY
GLOBAL
34
Short
D-Mark
9 BAR SLOW STOCHASTIC
10/14
10/21
10/28
11/ 4

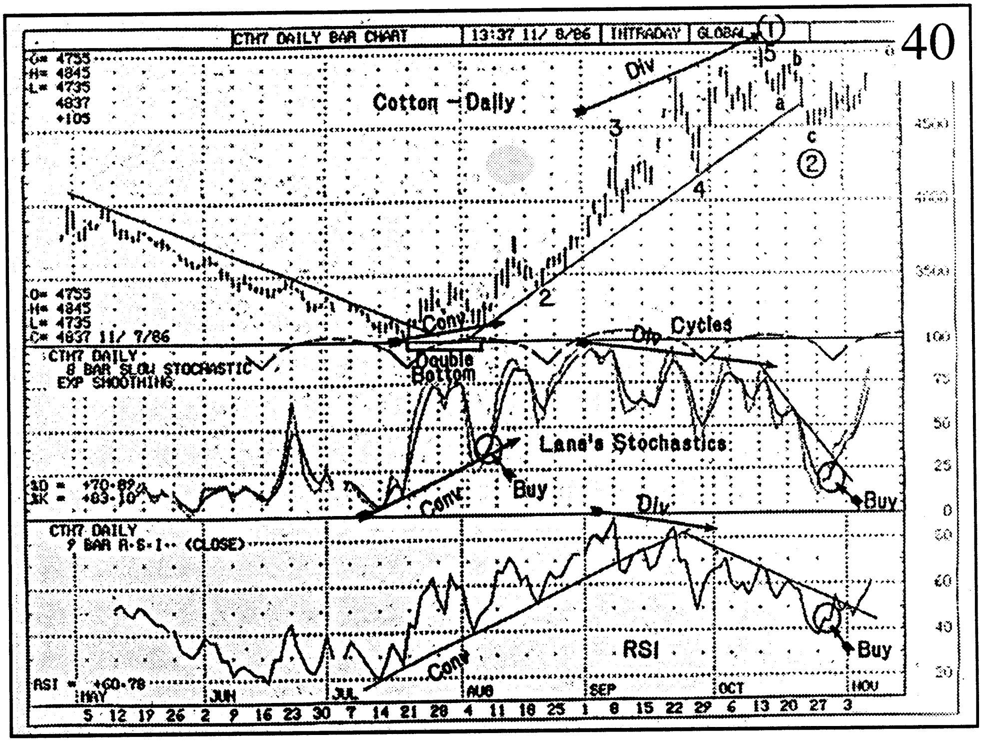

SPZ6 5 MINUTE BAR CHART
DAILY
GLOBAL
35
25600
25400
25200
25000
SPZ6 5 MINUTE
9 BAR SLOW STOCHASTIC
EXP SMOOTHING


HO WEEKLY BAR CHART
11:09 10/27/86
WEEKLY
GLOBAL
36
Heating Oil — Weekly
Cycles
Lane's Stochastics
RSI
1 2 3 4
APR
JUL
OCT
JAN
1985
1986
10000
8000
6000
4000
75
50
25
80
60
40
20

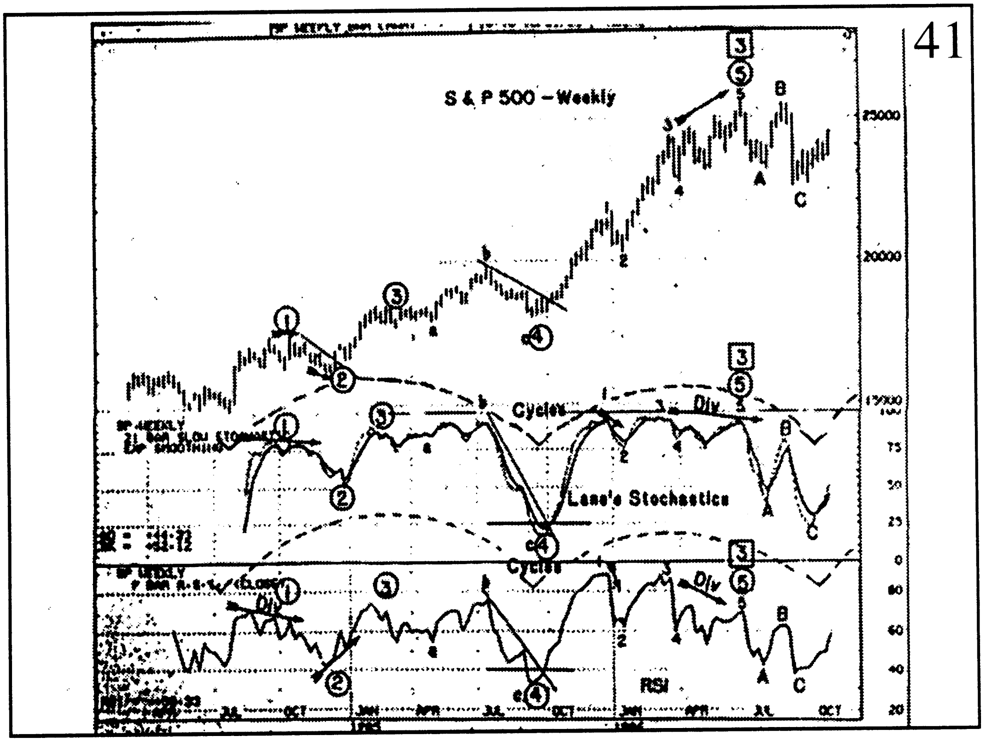

37
1
2
3
4
25500
25450
25400
75
50
25


38°
HOZ6 DAILY BAR CHART
Heating Oil — Daily
Cycles
Lane's Stochastics
RSI


39
T-Bills — Daily
Divergence
Convergence
Cycles



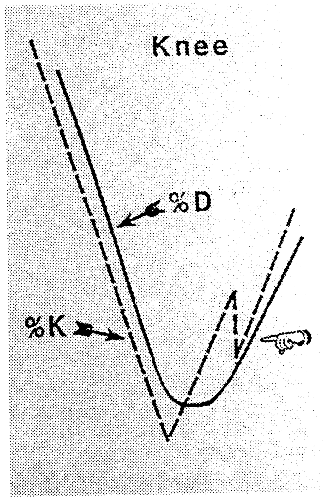
40
CTH7 DAILY BAR CHART
Cotton - Daily
Div
Conv
Double Bottom
Cycles
CTH7 DAILY
8 BAR SLOW STOCHASTIC
EXP SMOOTHING
Lane's Stochastics
Buy
CTH7 DAILY
9 BAR R-S-I-- (CLOSE)
RSI

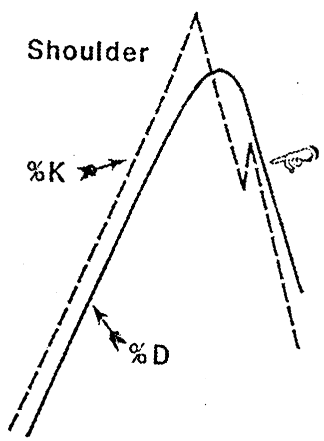


41
S & P 500 - Weekly
Cycles
Div
Lane's Stochastics
RSI

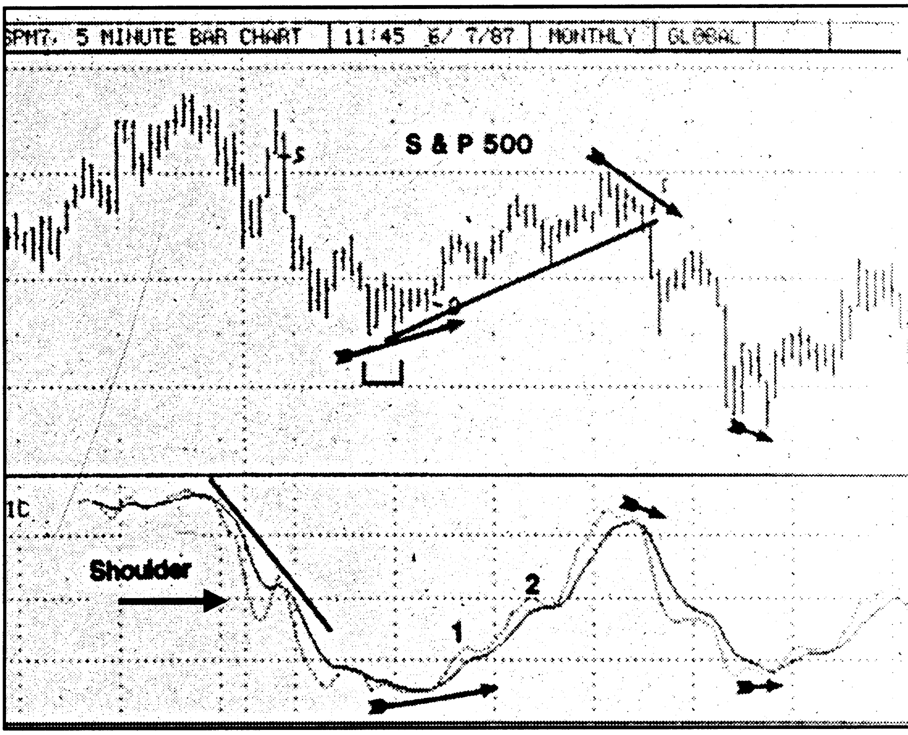
VI. Knees and Shoulders

- In an up market, when %K has crossed up through %D and, then, pulls back a few percentage points the next period, but fails to re-penetrate %D on the downside before turning up, we call this a Knee.
- A <u>Knee</u> is a continuation of upward progression ***denoting strength***.
- %K may be rectifying an earlier left-hand crossover.

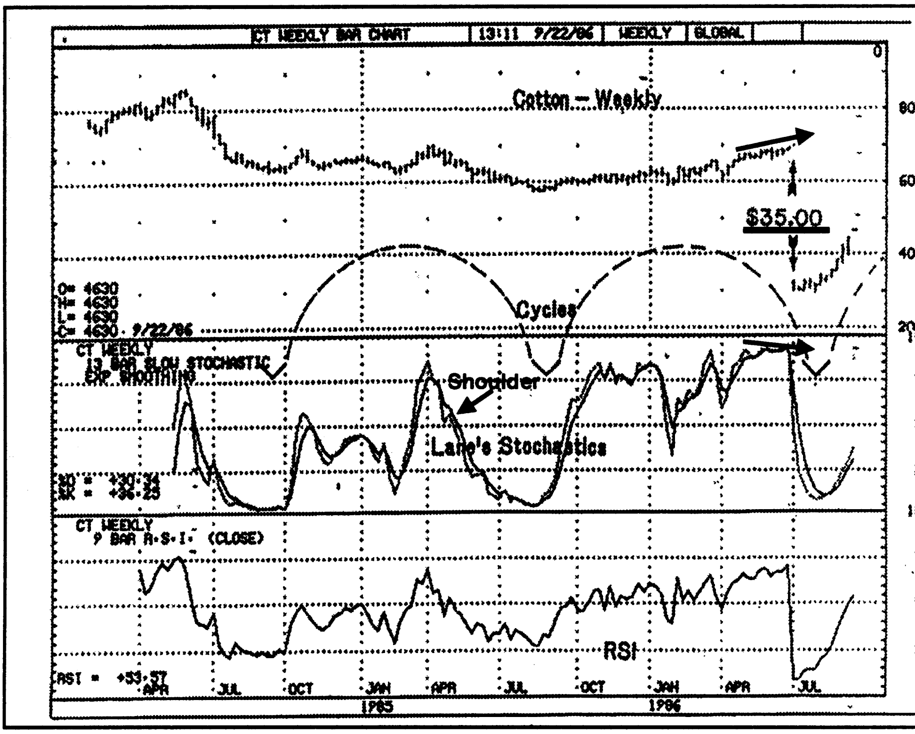




42


SPM7, 5 MINUTE BAR CHART
11:45 6/7/87
MONTHLY
GLOBAL
S & P 500
Shoulder
1
2

43


CT WEEKLY BAR CHART
13:11 9/22/86
WEEKLY
GLOBAL
Cotton – Weekly
$35.00
Cycles
O= 4630
H= 4630
L= 4630
C= 4630 9/22/86
CT WEEKLY
13 BAR SLOW STOCHASTIC
Shoulder
Lane's Stochastics
CT WEEKLY
9 BAR R.S.I. (CLOSE)
RSI
APR
JUL
OCT
JAN
APR
JUL
OCT
JAN
APR
JUL
1985
1986
8000
6000
4000
2000
100
75
50
25
0

VII. Divergence in %K Only

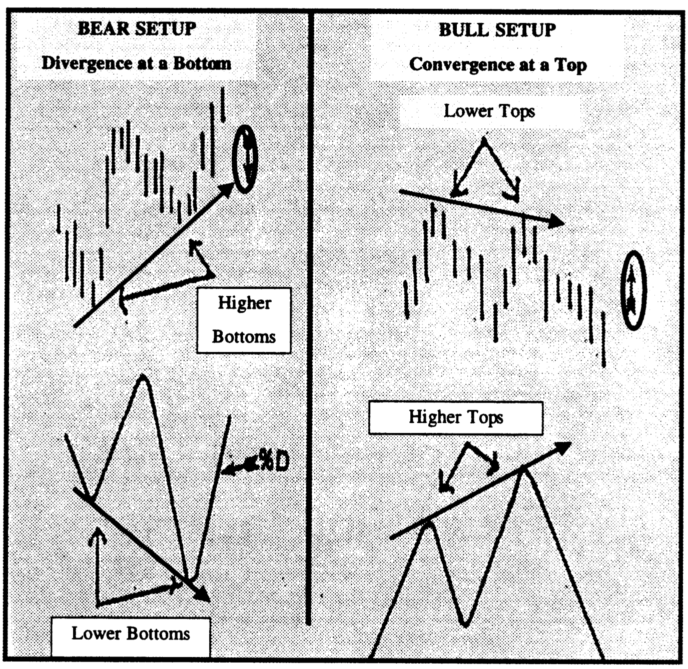
In an uptrending market, when the commodity is reacting against the major trend, one can expect Congestion Tops.

At these times, we may observe divergence in %K only. The significance in this instance is minor.

VIII. Set-up

We have already said the signal we are looking for is divergence at Tops, and convergence at Bottoms.

But what happens if you see the opposite: convergence at a Top, or divergence at a Bottom?



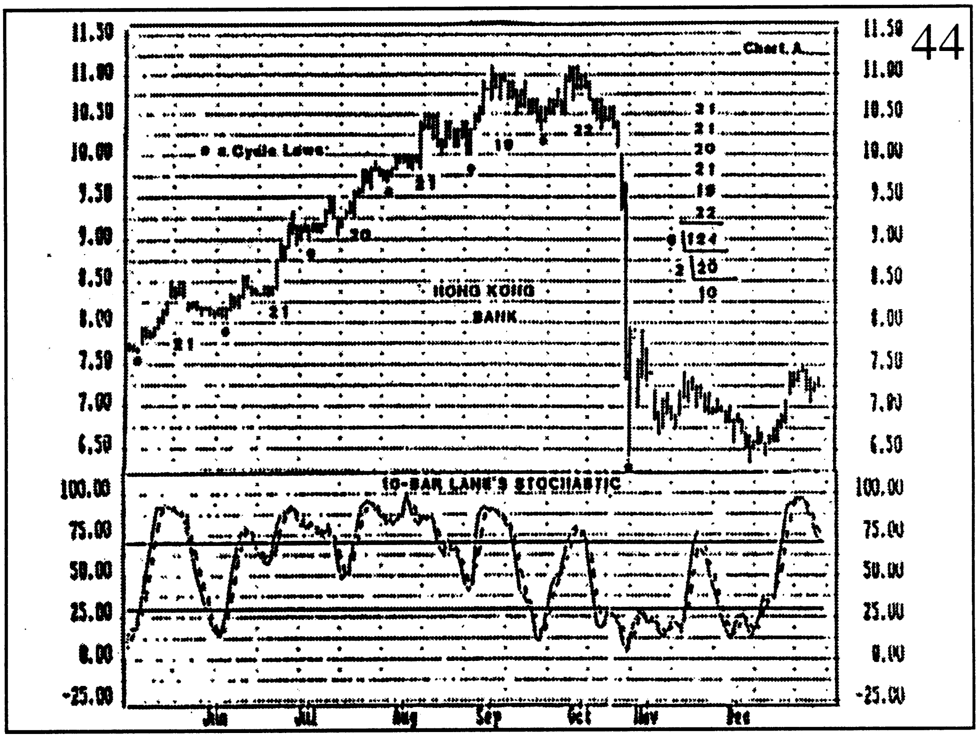


Chart A
HONG KONG
BANK
10-BAR LANE'S STOCHASTIC
Jun
Jul
Aug
Sep
Oct
Nov
Dec

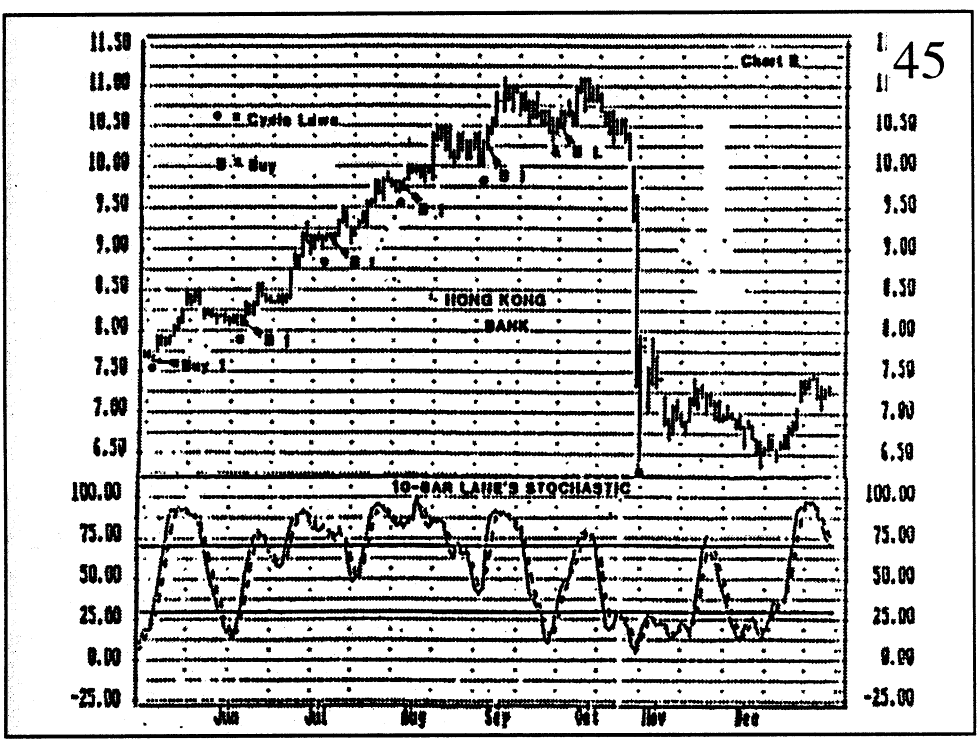
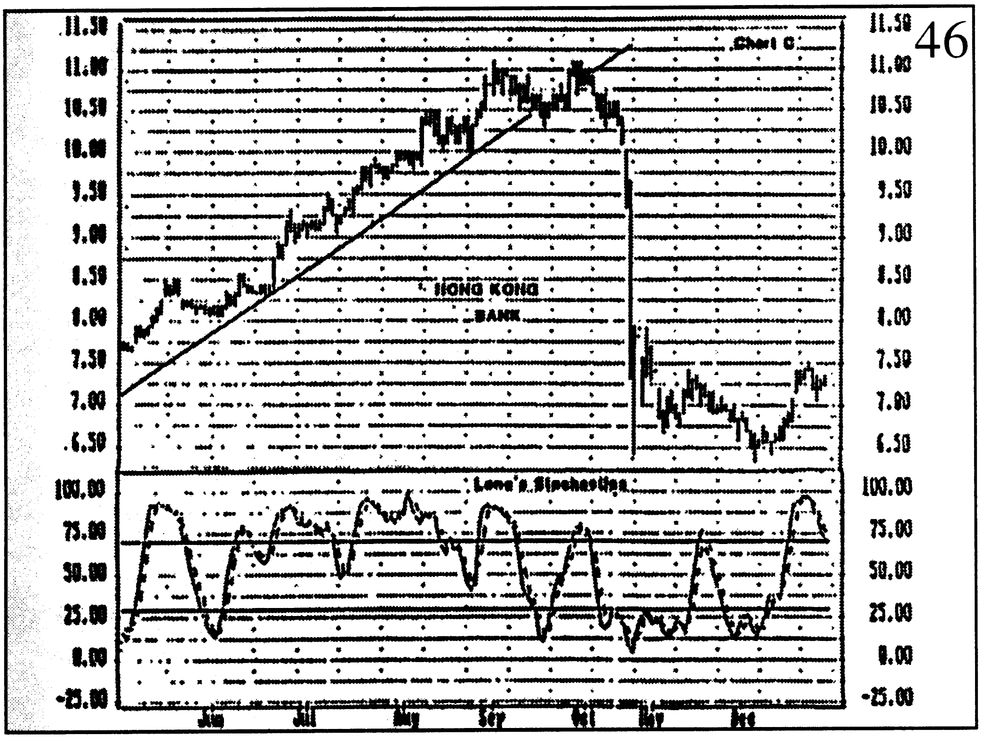
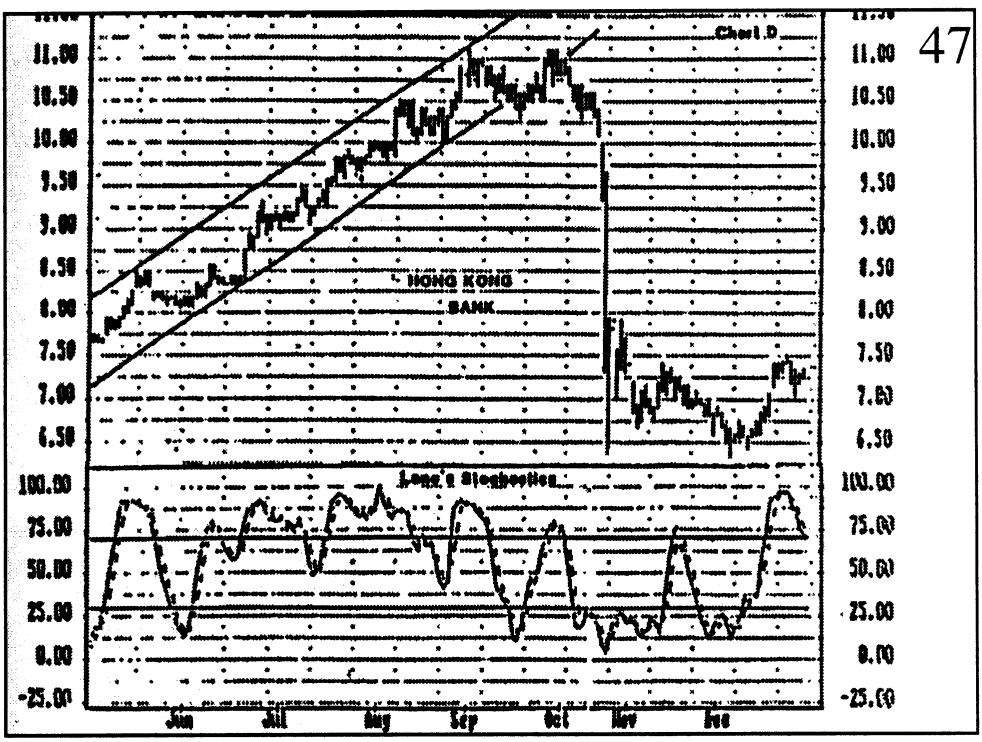
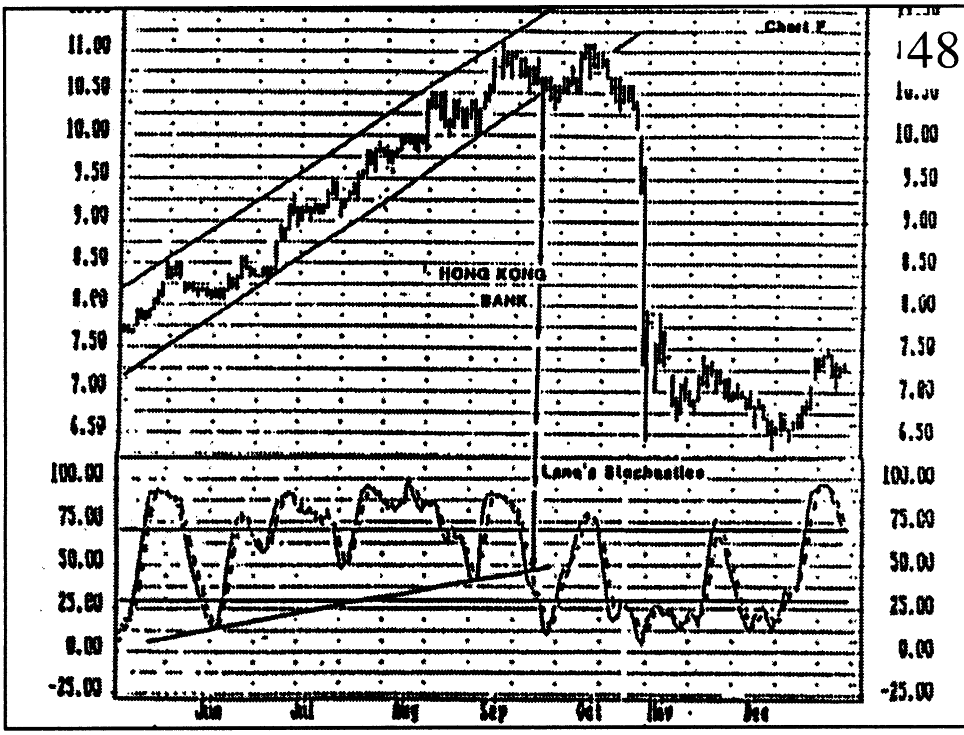
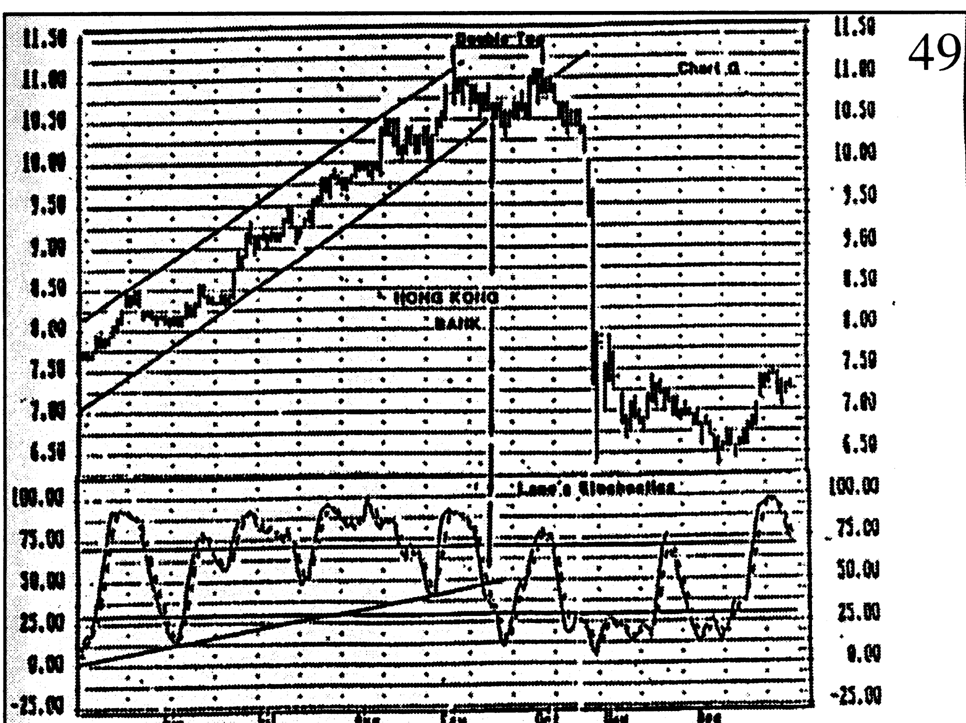


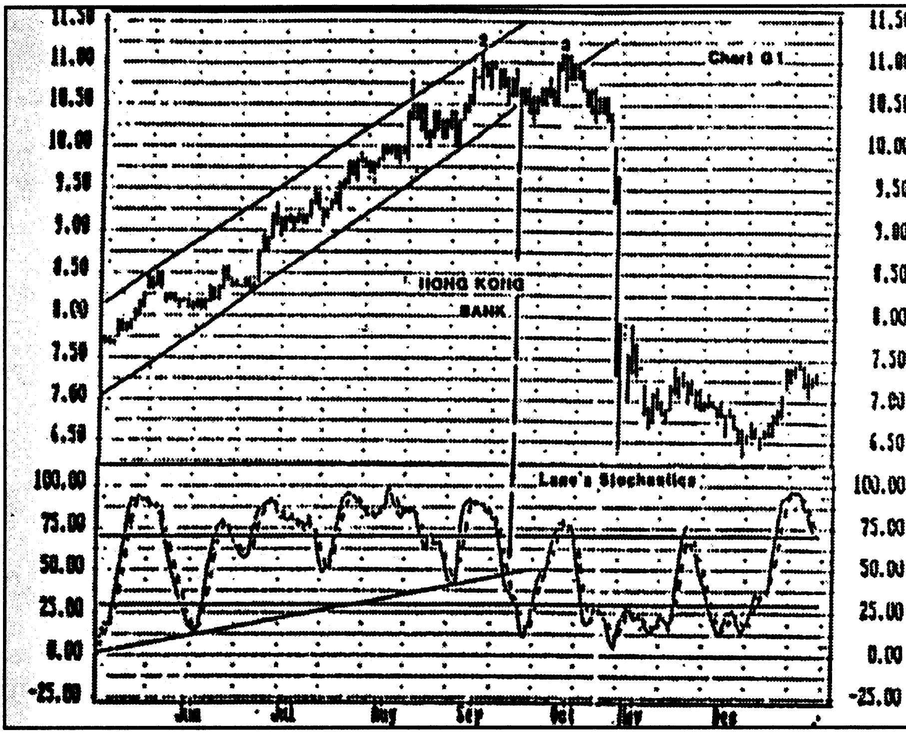
Chart B
HONG KONG
BANK
10-BAR LANE'S STOCHASTIC
Jun
Jul
Aug
Sep
Oct
Nov
Dec

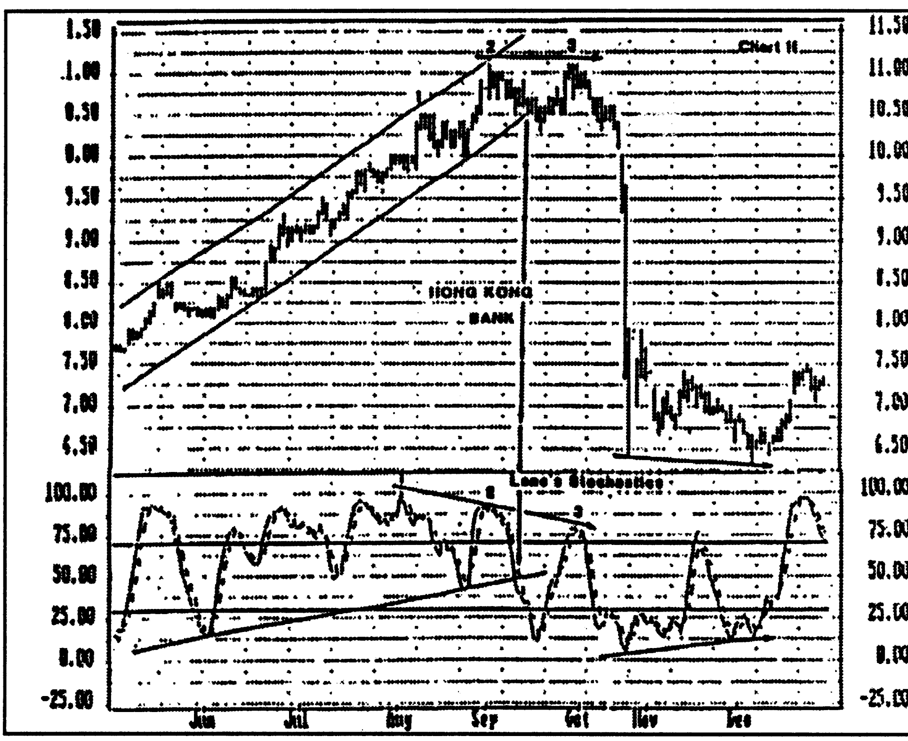

46
Chart C
HONG KONG
BANK
Lane's Stochastics
11.50
11.00
10.50
10.00
9.50
9.00
8.50
8.00
7.50
7.00
6.50
100.00
75.00
50.00
25.00
0.00
-25.00
Jun
Jul
Aug
Sep
Oct
Nov
Dec

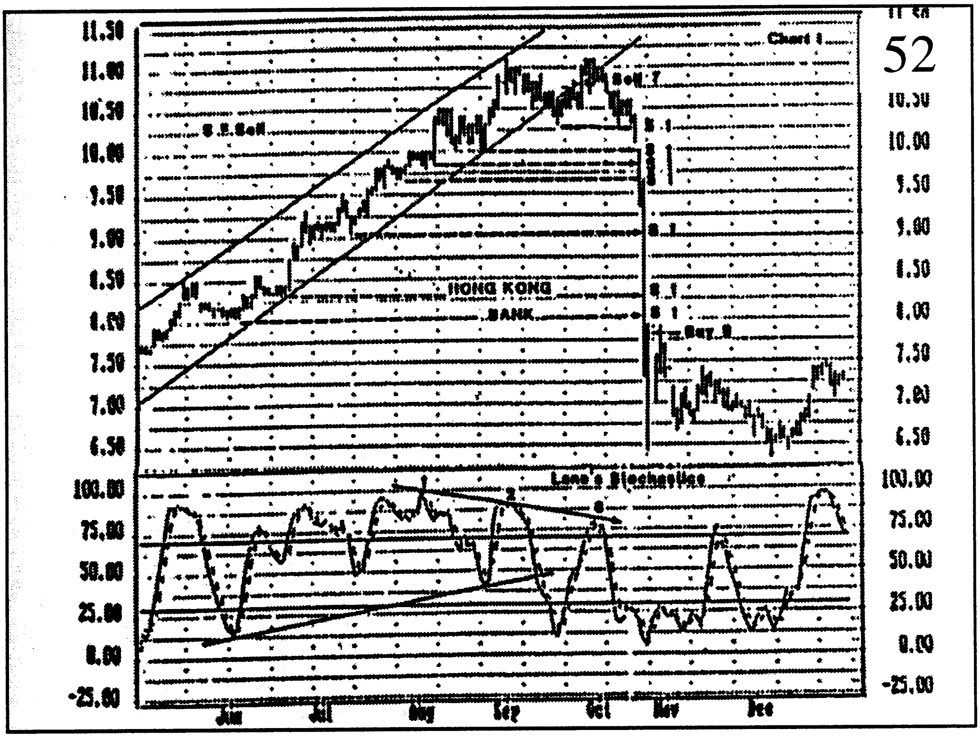

47
Chart D
HONG KONG
BANK
Lane's Stochastics
11.00
10.50
10.00
9.50
9.00
8.50
8.00
7.50
7.00
6.50
100.00
75.00
50.00
25.00
0.00
-25.00
Jun
Jul
Aug
Sep
Oct
Nov
Dec

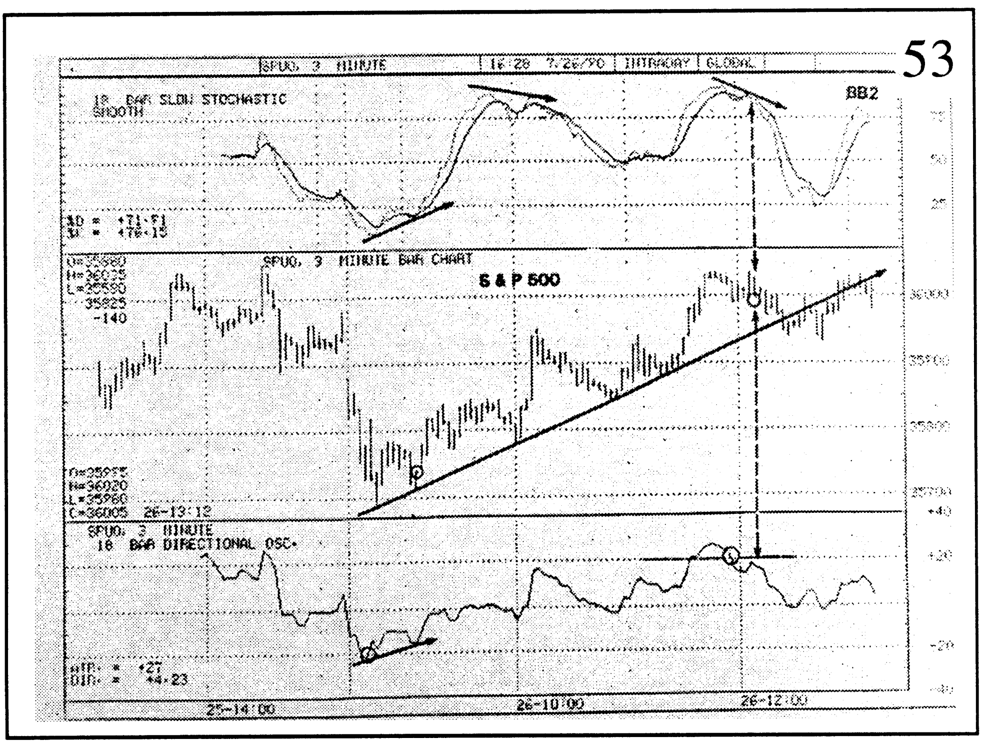

48
Chart F
HONG KONG
BANK
Lane's Stochastics
11.00
10.50
10.00
9.50
9.00
8.50
8.00
7.50
7.00
6.50
100.00
75.00
50.00
25.00
0.00
-25.00
Jun
Jul
Aug
Sep
Oct
Nov
Dec

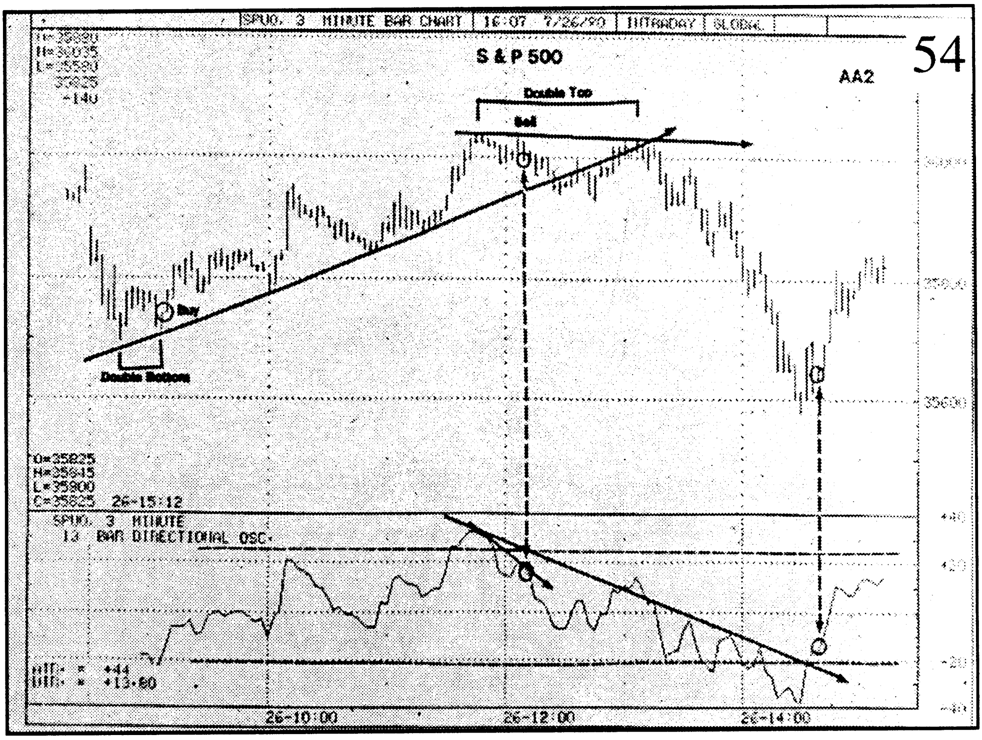

49
Double Top
Chart G
HONG KONG
BANK
Lane's Stochastics
11.50
11.00
10.50
10.00
9.50
9.00
8.50
8.00
7.50
7.00
6.50
100.00
75.00
50.00
25.00
0.00
-25.00
Jun
Jul
Aug
Sep
Oct
Nov
Dec


HONG KONG
BANK
Lane's Stochastics
Jun
Jul
Aug
Sep
Oct
Nov
Dec
50

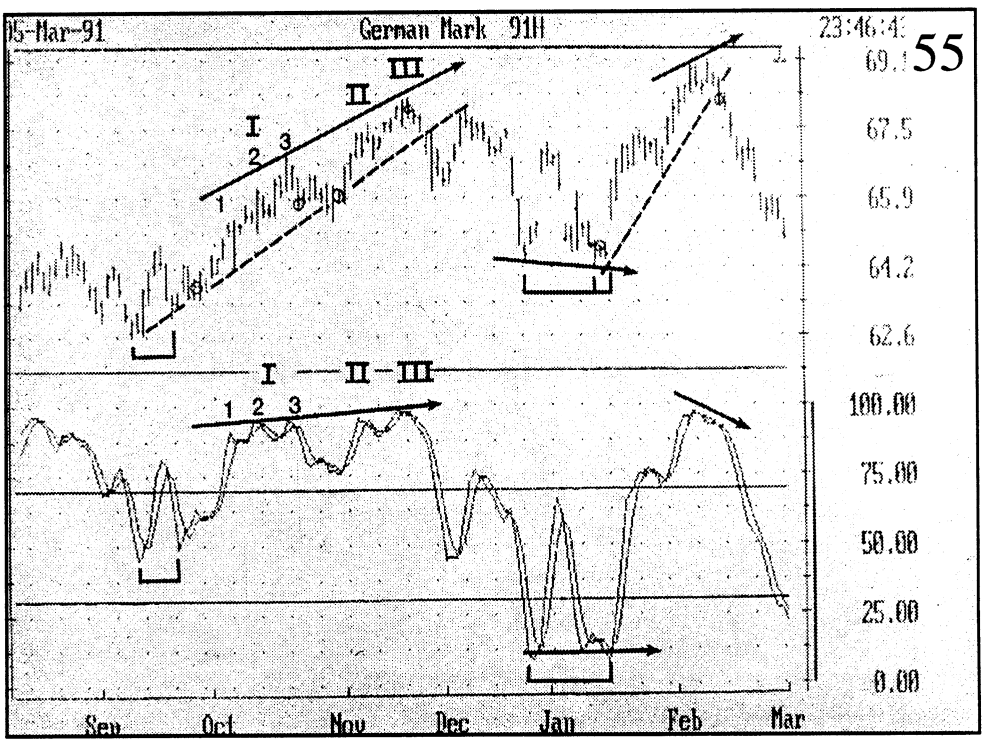

HONG KONG
BANK
Lane's Stochastics
Jun
Jul
Aug
Sep
Oct
Nov
Dec
51


52
Chart I
HONG KONG
BANK
Lane's Stochastics
Jun
Jul
Aug
Sep
Oct
Nov
Dec

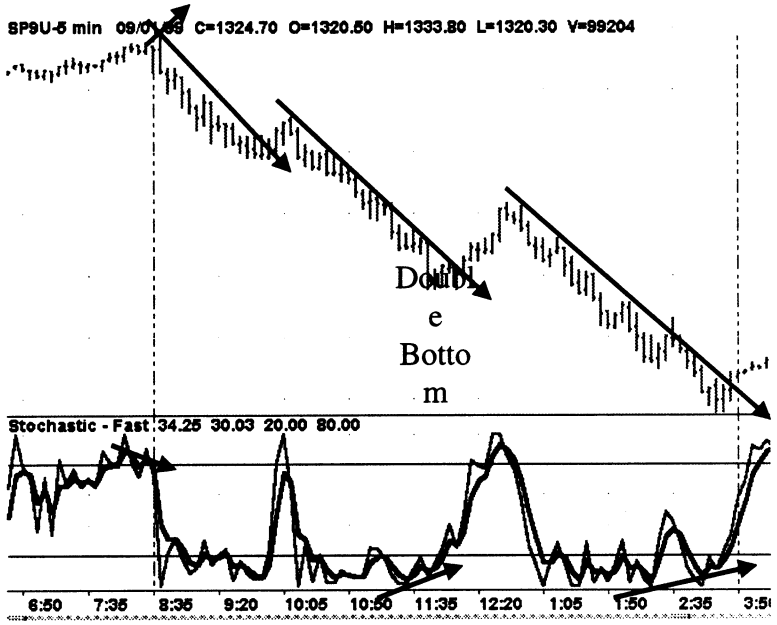

53
SPU0 3 MINUTE
16:28 7/26/90
INTRADAY
GLOBAL
18 BAR SLOW STOCHASTIC
SMOOTH
BB2
SPU0 3 MINUTE BAR CHART
S & P 500
SPU0 3 MINUTE
18 BAR DIRECTIONAL OSC.
25-14:00
26-10:00
26-12:00


SPU0, 3 MINUTE BAR CHART
S & P 500
AA2
Double Top
Sell
Buy
Double Bottom
SPU0, 3 MINUTE
13 BAR DIRECTIONAL OSC.
26-10:00
26-12:00
26-14:00

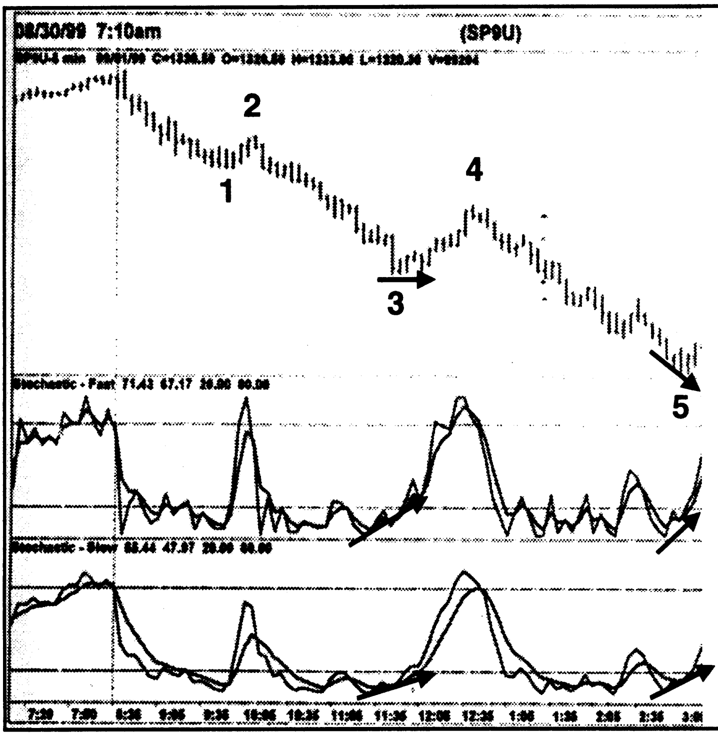
54


05-Mar-91
German Mark 91H
I
II
III
1
2
3
67.5
65.9
64.2
62.6
100.00
75.00
50.00
25.00
0.00
Sep
Oct
Nov
Dec
Jan
Feb
Mar

55

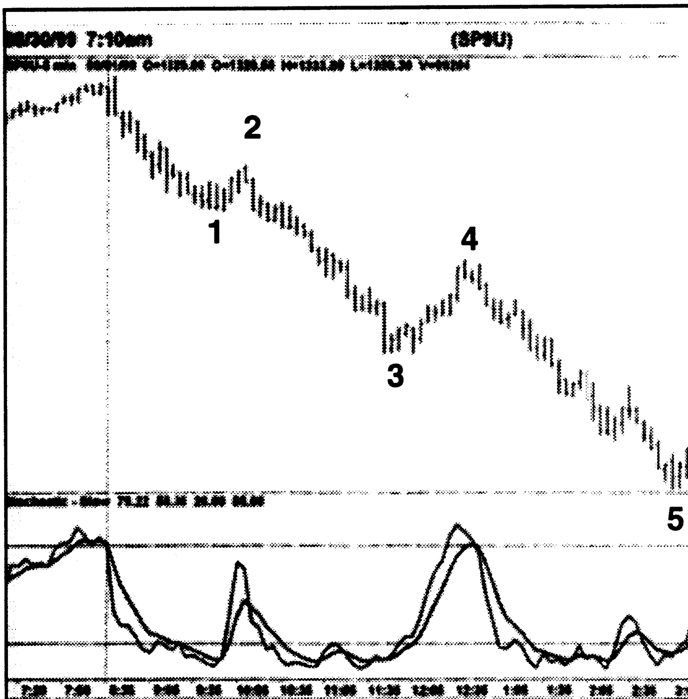


56



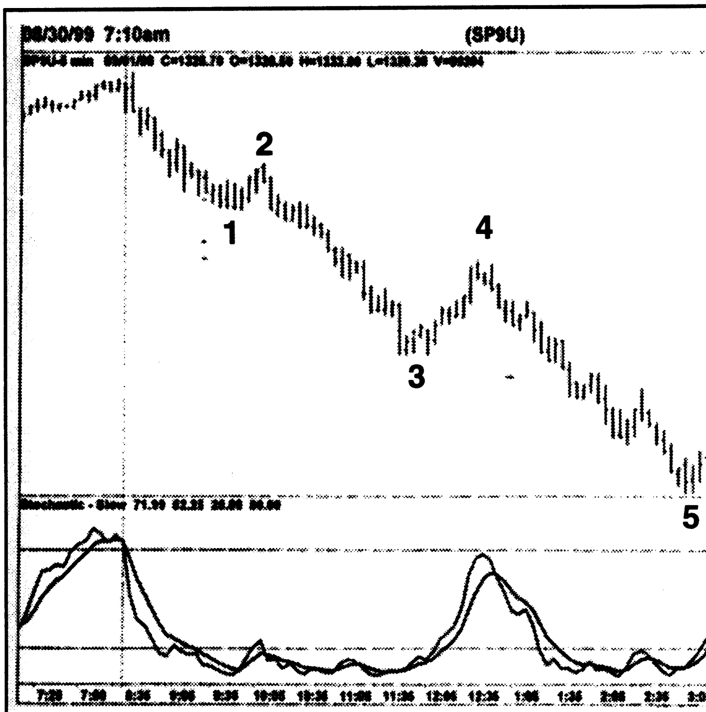
57

Filters



58

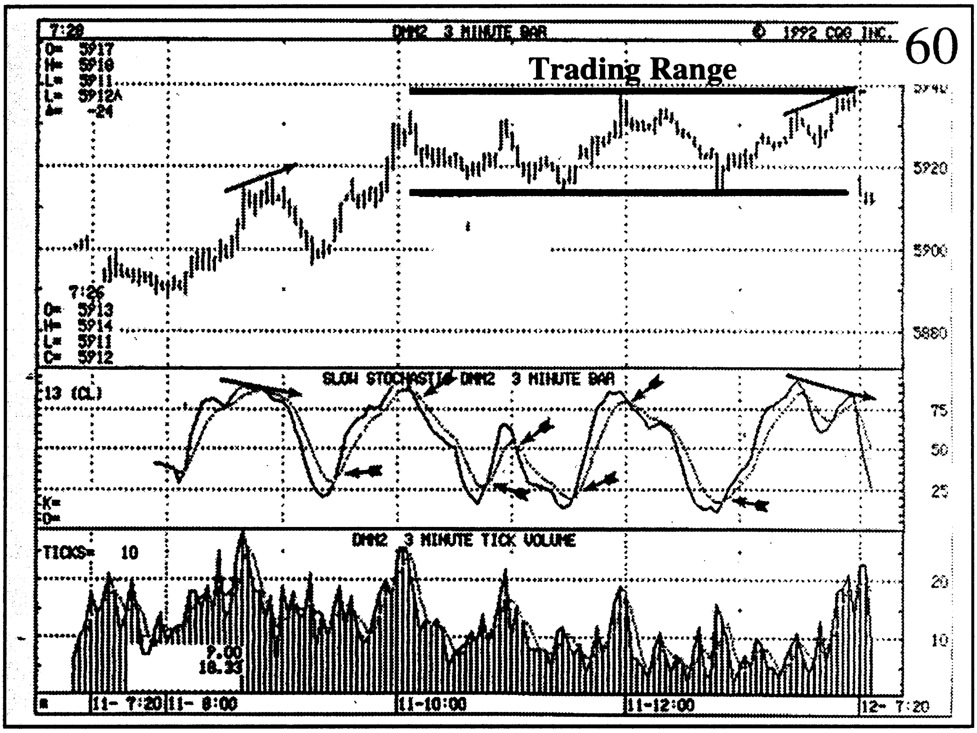
Filters



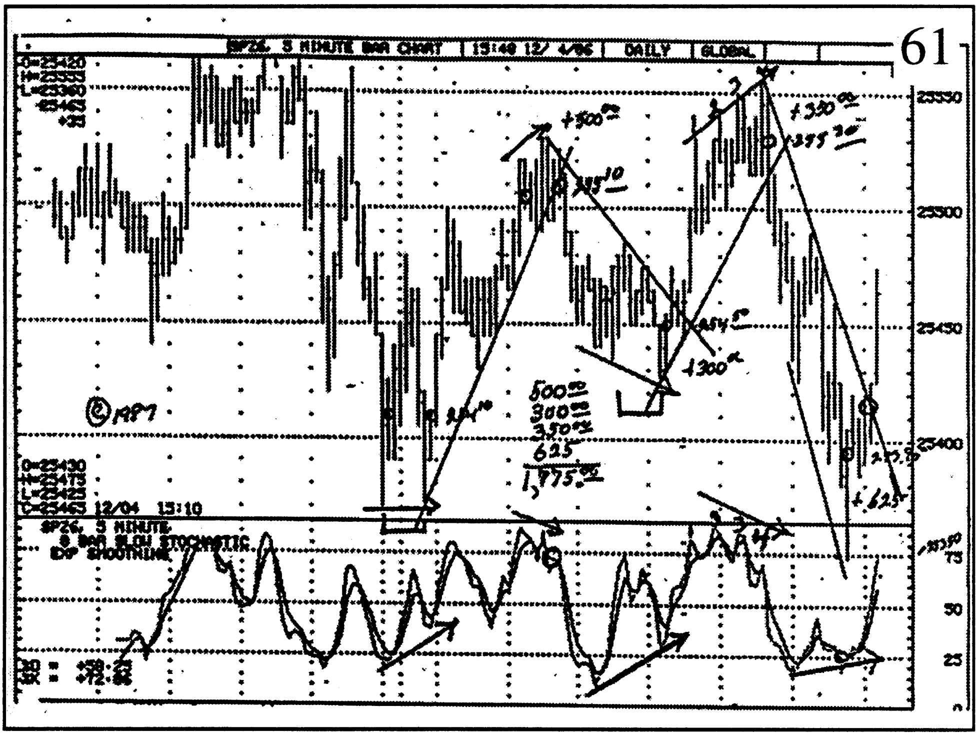
59

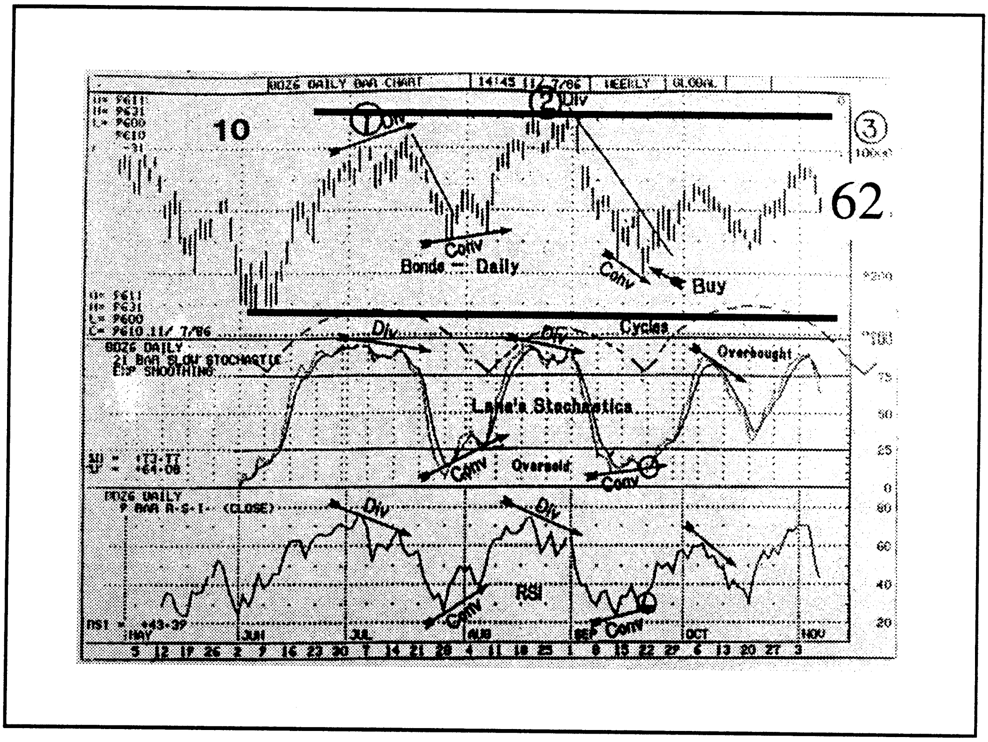
Filters

60

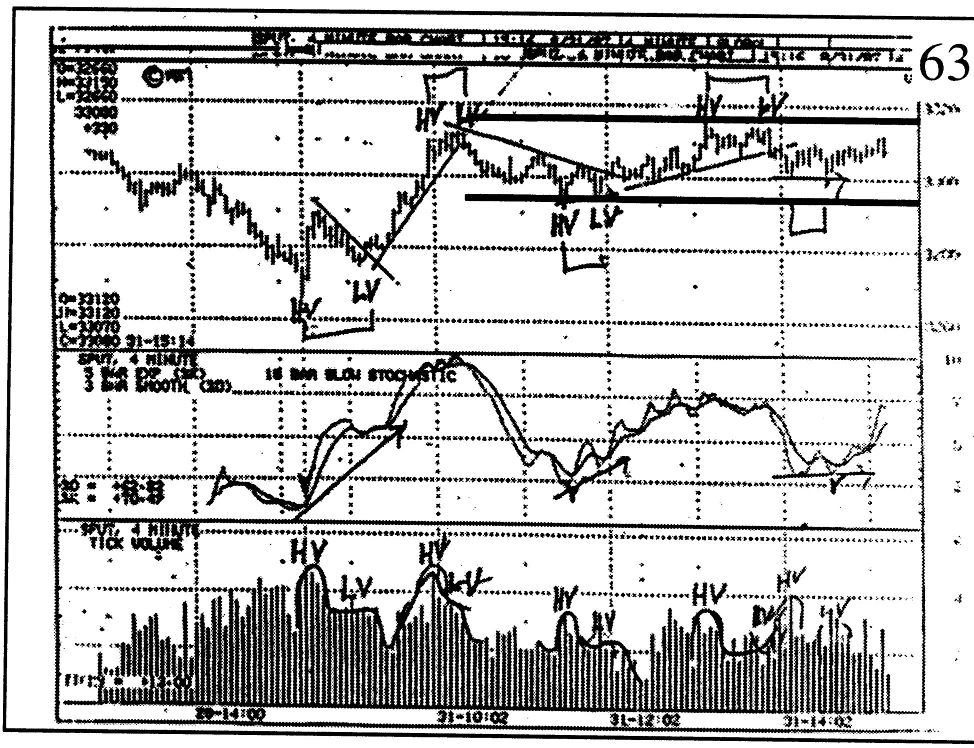

Trading Range
DMM2 3 MINUTE BAR
© 1992 CQG INC.
SLOW STOCHASTIC DMM2 3 MINUTE BAR
DMM2 3 MINUTE TICK VOLUME

61


SP26, 5 MINUTE BAR CHART
DAILY
GLOBAL
SP26, 5 MINUTE
8 BAR SLOW STOCHASTIC
EXP SMOOTHING


BOZ6 DAILY BAR CHART
10
Conv
Div
③
Bonds — Daily
Buy
Cycles
BOZ6 DAILY
21 BAR SLOW STOCHASTIC
EXP SMOOTHING
Overbought
Lane's Stochastics
Oversold
BOZ6 DAILY
9 BAR R-S-I- (CLOSE)
RSI
MAY JUN JUL AUG SEP OCT NOV

62


HV
LV
SPUT, 4 MINUTE
16 BAR SLOW STOCHASTIC
SPUT, 4 MINUTE
TICK VOLUME
30-14:00
31-10:02
31-12:02
31-14:02

63

Filters

1. A trendline
2. A longer-term Stochastic
3. A 38-bar Moving Average
4. Another Indicator (MACD or CCI)
5. A chart of larger degree with Stochastics

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So, you've gotten a computer and gone surfing on the internet. You've visited some great sites — www.INO.com — for instance. You've checked out the charts and seen $$$ in your future! Maybe, you've even purchased one of the software packages for traders with all the charts and indicators you could ever want. Trading made easy, right?

Wrong! The first — and worst — mistake a trader makes is depending on someone, or something, to make his/her trading decisions for him/her. Trusting your financial future to a brain the size of a Pentium III is foolhardy!

If you are to become a successful trader — one who can make a good living in any kind of market, during boom times or bust — first, you must understand the logic behind the market. You need to learn what drives price. Then, you must become a chartist. You need to study chart patterns until the picture speaks volumes to you. Then, you need to understand the indicators your software produces. And, lastly, you must integrate these elements into a trading methodology that you have the discipline to follow.

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