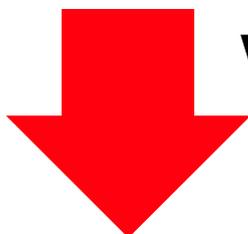




Currencies have long been praised for their capacity to trend, but in today's market, an objective countertrend technique might be a forex trader's most valuable asset. TD Sequential is designed to identify trend exhaustion points and keep you one step ahead of the trend-following crowd.



Countertrend forex trading with TD SEQUENTIAL



BY TOM DEMARK AND ROCKE DEMARK

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here is a market adage that describes the *modus operandi* of almost all currency traders: "The trend is your friend."

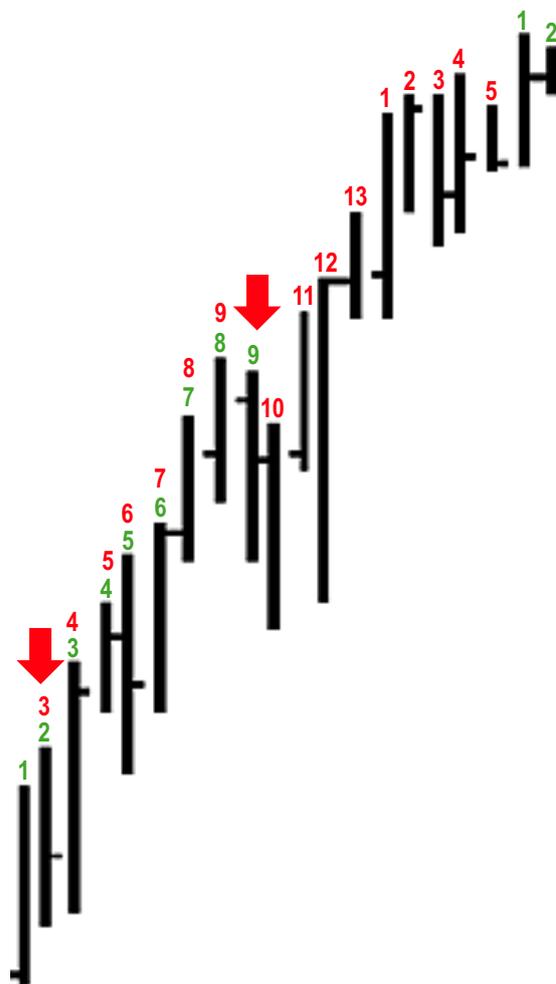
Granted, that is often the case. However, to make it more truthful, we have added the corollary "unless the trend is about to end." This qualifier has never been more appropriate for the forex market than in recent times.

Markets will trend, but research proves this is the exception rather than the rule. Overall, markets trend 25 to 30 percent of the time, which means 70 to 75 percent of the time they move within defined trading ranges.

Historically, currency markets were more likely to trend than traditional commodities, financial, or stock markets because policy decisions made by central banks were coordinated, and these collective actions influenced currency relationships for extended periods of time. In recent years, however, that interdependency has diminished and currency price behavior has mimicked that of other conventional markets.

Psychologically, it is simple to buy an advancing market and sell a declining market. Most traders attempt to operate in harmony with the trend, and the news associated with such price movement serves to reinforce that tendency and provide an excuse for its perpetuation. This is simply human nature — all of us want to be on the side of a winner, and the news accompanying a trend is written to justify its existence. Eventually, however, the trend exhausts itself and, almost by default, it is reversed or, at least, interrupted.

Typically, stock specialists, market makers and brokerage trading desks supply needed liquidity by positioning themselves against the prevailing trend. Their collective countertrend activities are responsible for price exhaustion periods.



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Professional traders

Several currency strategists and traders specialize in applying TD Sequential and other TD indicators to the currency markets.

One is Jason Perl, Global Head of the Fixed Income, Rates and Currency Technical Strategy Group at UBS Investment Bank. He has been using these studies for the past 10 years — identifying, among other events, the USD/JPY top in 1998, the U.S. bond highs in June 2003 and March 2004, the April 2004 Nikkei high and the May 2004 EUR/USD low, using TD Sequential.

Kurt Magnus, head of foreign exchange sales at WestPac Bank, has given numerous seminars on these indicators, as have Bloomberg trading specialists Doug Tengler, Terry Gaut, Paul Salerno, Roderick Bentley, Brendan Scholey, Trevor Neil, Greg Byrnes and David Keller. Other contributors include: from CQG Inc., Stan Yabroff in the U.S. and Shaun Downey in London; from Thomson Financial, Phil Doyle and John Kozey; from Morgan Stanley, Rick Bensignor, head of technical research; Ed Solari, Senior Technical Strategist at the Bank of Montreal; Paul Day at HSBC; Kevin O'Dowd at Legg Mason; Tim McCullough at West LB AD; Lindsay Glass, Blake Berteau and Steve Shirley from Oppenheimer; Chuck Gall from RBC; Dain Rauscher; and from UBS Gerald Chan and Robert HY Lam.

—Tom DeMark

Check out next month's issue for insights on TD Sequential from some of these market professionals.

A tool for identifying the ends of trends

TD Sequential is designed specifically to predict potential price exhaustion and likely price reversals. This methodology is designed to become progressively less bearish as price declines and, conversely, less bullish as price advances, contradicting the behavior of most trend-following traders.

TD Sequential provides much-needed discipline and removes the emotions associated with trend trading. It also gives a distinct edge to traders who operate in size, allowing them to buy when supply is most plentiful and to sell when demand is most aggressive.

Markets move in impulses or waves. No move, either up or down, is uninterrupted. There is a natural rhythm or cadence associated with price movement in any market. This is apparent on any time frame, from one-minute to monthly. This rhythm can be measured and followed according to the tenets of TD Sequential, which has two components: 1) TD Setup, which is momentum-based and compares the closing price with the close four periods earlier and, 2) TD Countdown, which is trend-based and compares the close with the

high or low two periods earlier.

Buy and sell Setups

Buy Setup is a series of at least nine consecutive closes less than the close four price bars earlier. Prior to the first bar of this series, proper "initialization" must occur in the form of a TD Price Flip. This means the close prior to setup close No. 1 must be greater than or equal to the close four price bars earlier; only then can the buy Setup process begin. (Note: For cash currency markets, use the New York close, which is 10 p.m. London time, as the end of the trading day.)

Once a minimum of nine consecutive closes less than the corresponding closes four price bars earlier are fulfilled, these bars are numbered 1 through 9. If that series is interrupted at any time prior to completion, the count is erased and the process must begin anew.

Typically, when a buy Setup is completed and "perfected," price has a tendency to at least react to the upside or move sideways — i.e., after a confirmed Setup, the prevailing downtrend corrects for a period of time. To "perfect" a buy setup, either the low of Setup bar 8, the low of Setup bar 9 or a

subsequent price bar's low must be less than the lows of both Setup bars 6 and 7. Until that occurs, the anticipated price "hiccup," or reaction, is less likely to occur.

A sell Setup is a series of at least nine consecutive closes greater than the close four price bars earlier. Prior to the first bar of this series, a TD Price Flip must occur to initialize the Setup — i.e., the close of the bar immediately before bar No. 1 of the prospective sell Setup must be less than or equal to the close four price bars earlier. If the Setup series is interrupted at any time prior to completion, the bar numbers are erased and the process must start again.

Typically, when a sell Setup is completed and perfected, price has a tendency to at least react to the downside or move sideways for a while. A sell Setup is perfected when either the high of Setup bar 8, the high of Setup bar 9 or a subsequent price bar's high is greater than the highs of both Setup bars 6 and 7. Until that occurs, the anticipated price reaction is less probable.

Countdown

Buy Countdown begins when a buy Setup has completed (once the minimum requirement of nine consecutive closes less than the close four days earlier is fulfilled). Beginning on the ninth Setup bar, a process is applied that compares the close of that price bar vs. the low two bars earlier: If the close is less than or equal to the low two price bars earlier, then a Countdown is recorded.

Just as a buy Setup series' bars are numbered, so too are bars in a Countdown, except in a different color. Once 13 valid Countdown bars have occurred (note: Countdown bars *do not* have to be consecutive), the downside price momentum is likely to be exhausted. Additionally, to ensure the price action is sufficiently low relative to the prior price action, the following qualifier is used: The low of buy Countdown bar 13 must be less than or equal to the close of Countdown bar 8.

There are two events that cancel a buy Countdown prior to completion:

FIGURE 1 — BRITISH POUND

After the sell Setup series (green numbers) that completed in late May 2004, the pound's upward momentum was interrupted for two weeks.



Source: Bloomberg, Inc.

The first occurs if, subsequent to the completion of a buy Setup, a price bar's low and the prior price bar's close are both above the highest price of the entire buy Setup series. In these instances, the buy Setup is cancelled and you must begin to look for a new Setup series. The second cancellation occurs when a contradictory sell Setup appears before the completion of the Countdown.

Because of additional selling from a new group entering the market, a downtrend will unexpectedly intensify from time to time. If the selling becomes sufficiently intense for an extended period of time to produce a new buy Setup that extends past the minimum nine to at least 18 consecutive closes less than the close four bars earlier — prior to the completion of the Countdown or prior to a subsequent

close greater than or equal to the close four price bars earlier — the Countdown process will "Recycle".

Sell Countdown inverts the rules for a buy Countdown: It begins once the minimum sell Setup requirement of nine consecutive closes greater than the close four bars earlier is fulfilled for a sell setup. Beginning on bar 9 of the Setup, a series of closes (which do not have to be consecutive) greater than or equal to the high two price bars earlier must occur. The rules for cancelling a sell Countdown are inverted as well.

On the daily time frame, completed Countdown "13s" coincide with a market's top or bottom approximately four or five times a year. On shorter time-frame charts, the number of Countdown 13s will increase commensurately.

Trading forex with TD Sequential

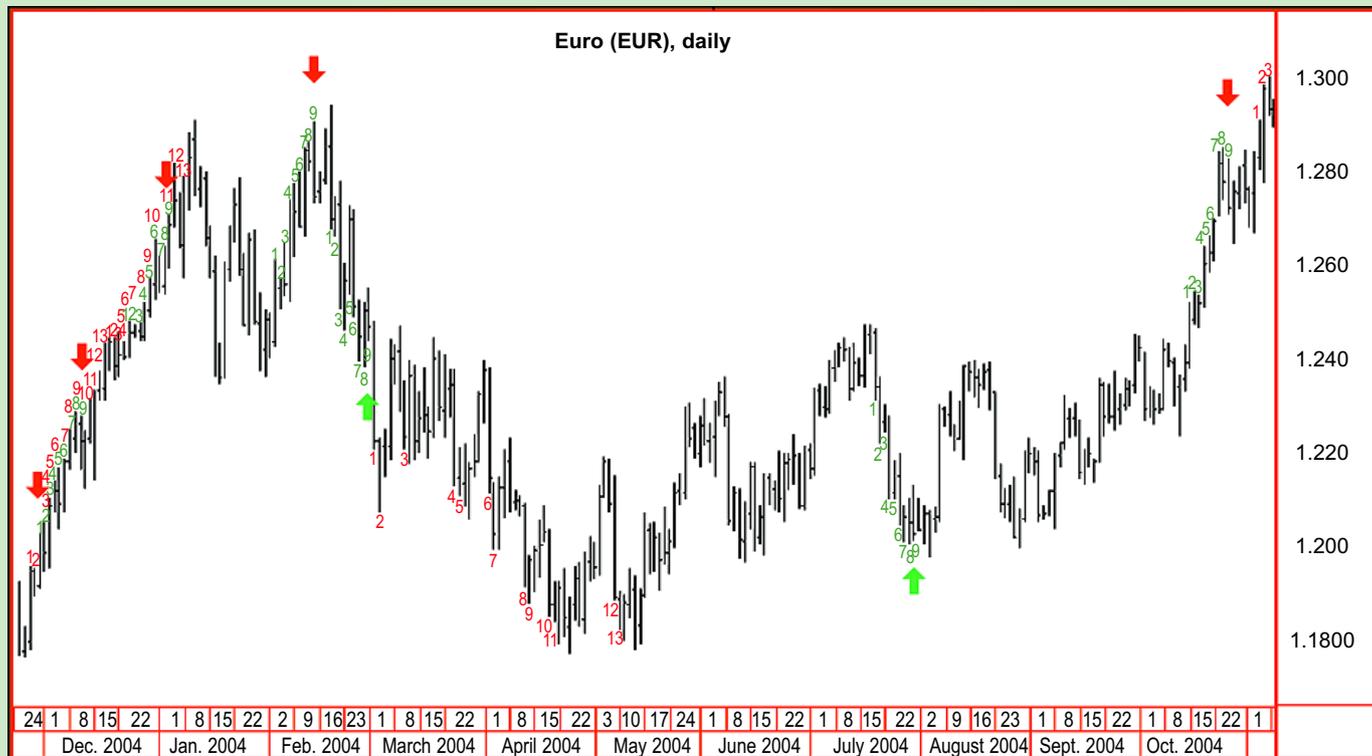
The following daily charts illustrate
continued on p. 32

Historically, currencies have tended to trend because coordinated policy decisions by central banks influenced currency relationships for extended periods of time. In recent years, however, that interdependency has diminished and currency price behavior has mimicked that of other markets.



FIGURE 2 — EURO

Although both the sell Countdown in early January and the buy Countdown in mid May marked trend reversals, price tested the 13 price level in each case and then made secondary Setup 9 series.



Source: Bloomberg, Inc.

the application of TD Sequential to cash currency trading.

Figure 1 (see p. 31) of the cash British pound (GBP/USD) shows a sell Setup series (green numbers) that completed in late May 2004; the red arrow above the "9" indicates the sell Setup was "perfected." Notice the upside progress was interrupted for 11 trading days after this bar, as price moved sideways and then declined.

The Countdown process then began, with the qualifying bars labeled

numbers). This sell Setup was not perfected until the high close (day 12 of the Countdown) because days 8 and 9 of the sell Setup were below Setup day 7, and the high of Setup day 7 was not exceeded until two days after the sell Setup day 9, which happened to be the Countdown "12" day, and the highest close of the rally.

In late July a buy Setup was perfected on day 8; a short-term rally ensued, followed by a buy Countdown. Note the Countdown 12 bar appeared in

however, downside pressure subsided and the market rallied.

Figure 2 of the euro/U.S. dollar (EUR/USD) illustrates a sell Countdown in early January and a buy Countdown in mid-May. Although both Countdown 13s marked trend reversals, price tested the 13 price level in each instance and then recorded secondary Setup 9 series. Both Setup 9 series were perfected, which served to reinforce the original 13's.

Also, the Setup 9/Countdown 13/Setup 9 series that completed at the late-July bottom was particularly interesting because it defied conventional technical wisdom, which at that point interpreted the trend as bearish on the daily, weekly and monthly time frames. In October, another perfected Setup 9 appeared that stalled the uptrend for a few days, after which the market entered the Countdown process.

In Figure 3 of the Australian dollar/New Zealand dollar cross rate (AUD/NZD), four of the five Setup series have arrows that coincide with

Operating against the trend is often difficult because it contradicts human nature.

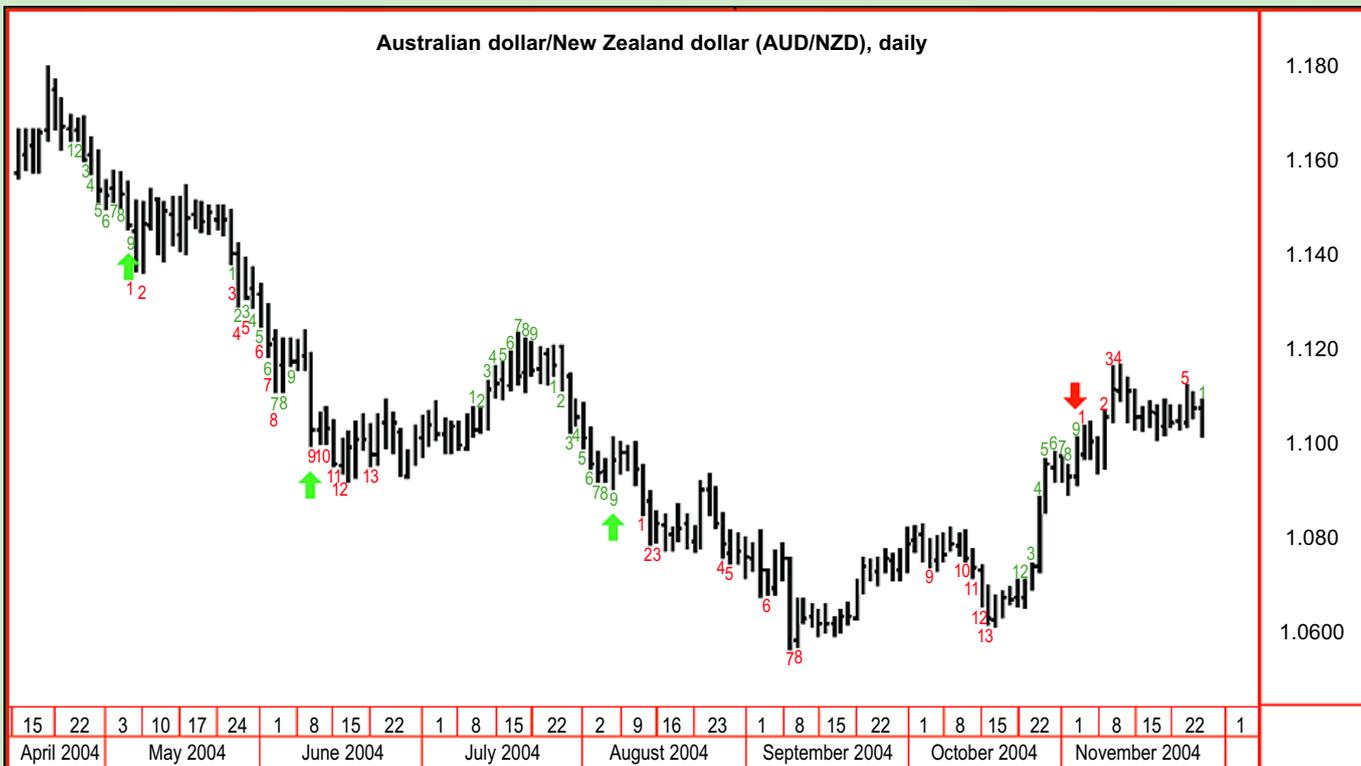
with red numbers. The peak of the rally was marked by a Countdown "13" and exhausted the upside for this market.

Notice another sell Setup developed simultaneously with this Countdown (the second series of green numbers, below the red Countdown

mid September, followed by five asterisks before the Countdown 13 bar occurred. Each asterisk day would have been a "13," but that designation was deferred because the lows of these bars were not as low or lower than the close of Countdown bar 8. Once a valid Countdown 13 bar occurred,

FIGURE 3 — AUSTRALIAN DOLLAR/NEW ZEALAND DOLLAR

The two Countdown 13 bottoms were immediately followed by profitable upside price moves.



Source: Bloomberg, Inc.

either a short-term price reversal or price consolidation. The two Countdown 13 bottoms had immediate upside price responses that proved to be profitable moves.

Forecasting trends instead of following them

The advantage of using TD Sequential instead of conventional trend-following methods is that you can buy into weakness and sell into strength (and do so in size). When following trends, entry competition produces slippage and price gaps that cut into performance.

Operating against the trend is often difficult because it contradicts human nature. However, these examples show there are distinct advantages to doing so, and TD Sequential is an indicator designed specifically to accomplish this goal. 📍

For information on the author see p. 8.

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Related reading

“Tom DeMark: Objectively speaking”
Active Trader, November 2001.
 An extended interview with Tom DeMark.

“Demarking trend exhaustion zones”
Active Trader, July 2002.
 This article illustrates how to use Tom DeMark’s TD Sequential and TD Combo indicators to identify trend-exhaustion zones.

“Absolute price projections”
Active Trader, July 2004.
 Tom DeMark applies objective price projection tools to historical price examples results to generate a stock market a forecast.

“DeMark variation”
Active Trader, September 2001
 This is a Trading System Lab based on a simple pattern, named TD Carrie, described by Tom DeMark in his book *New Market Timing Techniques*.

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