

**CHAPTER 1****Order  
from Chaos**

**H**ave you ever looked at one of those pictures that at first glance seem to be only a hodgepodge of colors, dots, and shapes splashed randomly across the page? Initially, the picture doesn't excite you. However, if you stare at it long and hard enough, it starts to blur and you begin to see an actual picture within the picture. Slowly, a 3-D image begins to take shape and emerge from within the mass of colors and shapes. Once you have seen the image, it is much easier to see each subsequent time you look at the picture. It always seems that there is one person who can see the image immediately. For others, even though it takes more time and effort, the image finally appears. And then there are those people who just can't see it or just don't want to put in the effort.

Initially, a price chart is similar to that hodgepodge picture. It is really nothing but a series of lines and numbers illustrated in a visual form. At first glance, it may not reveal a lot of information. However, with study and experience, a clear picture begins to appear out of this clutter. Price trends start to be seen and chart patterns begin to be identified. With sufficient experience, one can use this information to predict future price movements.

Although the price fluctuations may seem random, they are the result of many forces working together in a very efficient manner. Out of this apparent disorder, one begins to see a market that is moving in a very deliberate pattern, driven by buyers and sellers with different opinions about future prices.

One February afternoon in 1999, I was on a flight traveling from Denver to New York City to attend a meeting with representatives of the New York Mercantile Exchange. I was serving a second term as president of the National Introducing Brokers Association at the time. As I often do during long flights, I pulled out my stack of commodity futures price charts and began to calculate Reversal dates, using a technique that I had developed a few years earlier. Even though the Reversal dates had served me well, I always felt there was more to the picture than I was seeing. I decided to apply a couple of theories that I had been mulling over. After some time, a pattern that I hadn't noticed before began to unfold as clear as day. There on the chart was a distinctive, repetitive pattern. All of a sudden it was very simple.

How many times have you looked at a great idea and been amazed at its simplicity? That is how I felt when I finally noticed what I now call the Reaction cycle. I tried it on numerous other charts and found that it still worked. After testing this new discovery on several commodity charts, I decided to test it on some stock charts. To my amazement and delight, it worked just as well. I became very excited because for the first time I was truly able to understand market behavior.

I now possessed the tool that would allow me to identify the beginning of a major trend, to identify when and where the center of the trend should occur, and to determine the price level and time frame when the trend would be exhausted.

Most of the current technical analysis is just a rehash of discoveries introduced years ago by great trading legends such as W. D. Gann, R. N. Elliott, Allen Andrews, and others. Although their trading approaches were different, the premise of their methodologies was the same. They all believed that there were natural cycles circulating throughout the markets.

Yes, the factors of supply and demand do play a key role in market behavior. However, they do not play the role that most people think. You see, the simplistic law of supply and demand is constantly subjected to a force that is equally powerful, very hard to measure, and infinitely less logical. That force is human emotion. As a result of two emotions that are as old as humanity (greed and fear), most traders have a tendency to overreact to market conditions. When things are going well, traders succumb to greed and overbuy in an effort to maximize profits. When the market is not going their way, fear kicks in, followed by a flurry of selling. These two opposing market forces have been around since the market began and will continue to always be a large factor. Supply and demand may change, but human emotions remain constant.

## **PRICES LEAD FUNDAMENTALS**

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The statement that prices lead fundamentals has probably shocked or upset many traders. The fact is that I believe price leads fundamental news in the marketplace. Markets seem to top just when the fundamental news is the most bullish and bottom out when the news or reports are the most bearish. I'm unable to count the number of times traders have asked me, "How can the market be trading higher? We just had a very bearish report." The answer is simple: The price has already discounted the fundamental news. Successful traders are already looking into the future, while novice traders are still trying to trade off past news.

I am not saying that fundamentals do not influence market prices. In fact, they can have a dramatic effect on prices. Market fundamentals of supply and demand are the ultimate decision makers in the marketplace. These forces will move the markets over the long term, while the technical side provides entry and exit signals in the short term.

## **TECHNICAL ANALYSIS—WHAT IS IT?**

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Technical analysis is devoted to the internal studies of the markets and not the fundamental (or outside) forces that influence market movement. It looks at the forces that lie within the particular market activity. These forces are generally considered the human qualities and emotions.

It is not important how much a commodity should be worth, but rather how much people are willing to pay for it and the intensity of their belief. In a market based on supply and demand, the intensity of emotion will reveal which one is more powerful—those demanding the commodity or those supplying it.

Each individual has his own reason for buying or selling a commodity. (We do not need to know the reason.) Whatever the reason, it is reflected in the price action with the strongest hand leading the change.

Technical analysis is the study of the actions and net results of all outside influences. The relationship of the two competing forces of supply and demand is reflected in the market by the characteristics of the price action, the nature of the activity, when the action appeared, and how much time it takes to unfold.

The law of supply and demand should and does apply to all free markets. However, sometimes government regulations interfere for short intervals with supply and demand. But, as always, after this interference fails, the markets are given back to the people and the natural laws that govern them.

I find it interesting when a market makes an unexpected large move for no apparent reason, only to be verified by some fundamental news released at a later date.

Jesse Livermore, a famous speculator, once wrote,

*Remember there is always a reason for a stock acting the way it does. But also remember the chances are you will not become acquainted with the reason until some time in the future, when it is too late to act on it profitably.*

## UNIVERSAL LAWS OF PRICE ACTION

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It is obvious that universal laws govern all aspects of nature, from the changing seasons to the rise and fall of the tides and right down to the smallest atom of the universe. We accept this to be true. Therefore, can we accept the premise that these laws may affect the actions of man and that under certain conditions he will have similar or repetitive reactions? If this holds true in the markets, then price patterns will repeat themselves as traders react to current patterns in the same way they did to past patterns. Therefore, the past can illuminate the future.

Every trade needs three things in order to successfully identify a correct signal—*time, price, and pattern*. When all three components come together, great things can happen. If you can improve the timing of your entry price, it will enhance *any* trading method. That is what the Reversal date indicator and the Reaction cycle will do for you. *It will tell you the precise day a market will likely react and the level the market needs to be at for it to react. It will even tell you what the market must do to confirm the trade signal.*

This is all based on the market theory that *for every action in the markets there is an equal and opposite reaction*. This means that if you can find the right *action* point in the market, you should be able to predict the *reaction*. Amazingly, you can predict to the exact day when the market will likely reverse. *The key to all of this is the ability to find the end of the initial Action and the beginning of the Reaction.*

This may sound like a complicated and difficult task, especially to those not well versed in technical analysis. However, in reality it is very simple and easy to learn. This methodology is entirely based around one chart pattern that I call the *Reaction swing*. The Reaction swing is the first thing we will learn, as it will lay the groundwork and allow everything else to simply fall into place.

There are many things that help a trader become more successful.

These include commonsense rules and sound techniques. However, I believe that two things are critical and must be possessed before anyone begins to trade in the market. These two things vital to any trader are *knowledge* and *confidence*—knowledge of how the markets work and confidence in the trading approach one has chosen to use. In this book, I give you the knowledge so you know how to identify when a major move in the market is about to begin or end, how to understand what the market is telling you, and how to react to the well-defined patterns. However, you will have to build your own confidence. This is critical because without confidence in your ability to use it, knowledge is useless. Confidence comes from study and practice. The more you see the market react as you anticipate, the more you will believe.

## **TECHNICAL INDICATORS**

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There are many technical tools available to traders today—so many, in fact, that it can be confusing for traders as they scamper from one new indicator to the next in an effort to find the one just right for them. New technology has made it easy to develop and test new indicators and has led to a surge of new systems available to the public. It was widely anticipated that new technology would open up the floodgates of prosperity to whoever was willing to pay the price for the system. However, the floodgates did not burst open. The computer made it easier, but not necessarily better.

This overdependence on computer systems is keeping people from learning the basics of trading. To be a successful trader, you need to get back to the basics and learn the characteristics of the market. All markets display certain inherent behavior. Learning to identify and exploit this behavior is essential in becoming a successful trader. It enables you to anticipate the market's movement and react in a purposeful way. Rewards still come to those who are willing to work hard, learn the markets, and anticipate and react to changes quickly. Unfortunately, traders who look for the easy way to riches end up losers. A trader will experience real success only by learning the skills to trade, not by buying the latest system.

## **LAGGING BEHIND**

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I started trading in the early 1980s simply by learning to use basic trend line and classic chart patterns, such as head and shoulders, flag and pennant

formations, and others. These patterns have been used by traders for years (long before I came along), and still remain very popular today.

Like most traders who initially taste some success, I became thirsty for more knowledge. Therefore, I went in search of more advanced indicators because I was convinced that they would make me more successful. I began to learn more about momentum indicators, such as the Relative Strength Indicator (RSI), stochastics, and moving averages. The purpose of these indicators is to measure the strength of the market and predict when the market is losing or gaining momentum.

Although these indicators have their uses and are very good at supplying valuable information, they should not be used on a stand-alone basis, as their calculations are all based on past information. Consequently, they will often trigger buy or sell signals after the market has already made a substantial move. This causes traders to enter a market when it is overbought or oversold and ready for a correction. The traders then have to decide whether to exit their trades or to sit through what they hope is only a small price correction.

Using these indicators did give me a good idea about the overall trend and strength of a market. This fit well with the teachings found in the majority of the trading books I had read. The so-called trading experts insisted that the only way to be a successful trader was to “take it out of the middle.” They described the danger of trying to enter at tops or bottoms, stating that the only safe and sane time to enter a trade is after the trend is established and well on its way. Even though there is a lot of wisdom in this trading philosophy, I always felt like I was starting a 100-yard dash 10 yards behind everyone else.

Using these traditional technical indicators made it easy enough to enter a market in an established trend. However, I had to sit through some large price fluctuations and take on more risk than was necessary. The more I read and the more I traded, the more I knew I wanted to find a different way to analyze the markets. I wanted to find a methodology that would allow me to maximize profits and to reduce risk. This would require a way to enter a trade earlier and exit later or, in other words, catch the turns and improve my timing in the market.

## **THE SAME, ONLY DIFFERENT**

I figured that if I was reading all this information about the right way to trade, then other traders were probably reading and using the same information. We were probably studying the same chart patterns and using the same technical indicators. If the saying was true that “80 percent of traders

lose money,” I didn’t want to look at the market in the same way the 80 percent looked at the market. Therefore, I knew that to truly understand the market, I’d have to start looking at it differently and begin thinking outside the box. I would no longer be able to be content to simply follow the mainstream and trade lagging and late indicators.

This statement reminds me of the picture that was shown to my class when I was in grade school (I’m sure just about everyone has seen this picture). It was a black-and-white drawing of either an old lady in a feathered hat or a young woman with a fancy hairdo (depending how you looked at the picture). When the teacher asked each of us to describe the drawing, some of my classmates said they saw the older lady in the feathered hat while others said it was the young woman. It was only after the teacher pointed out the two different images that we could see both the old lady and the young woman. Naturally, a small percentage of the students could never see either image.

This is a good illustration of how several people can look at the same information and come to many different conclusions. This is actually desirable in the market because it requires different opinions to function. However, I wanted to be able to see the market from a different perspective than the mass majority of traders. Therefore, I had to look outside the box.

In 1989, I had just moved to Eugene, Oregon, from southern California, where I had been working for a large brokerage firm. While in California, I had written some articles on my research about using technical analysis in conjunction with seasonal tendencies in the market. These articles caught the attention of a firm in Chicago. The firm was so impressed with my unique research that they soon asked me to join their research facility in Eugene, Oregon. It was an offer I couldn’t refuse.

This firm’s research facility was so state-of-the-art for 1989 that it even had its own computer programmer. If I had an idea, Nick, the programmer, would write a program to test the idea.

It was during this time that I stumbled across a significant finding in the markets. I was conducting some extensive research that used cycles to help identify more precise entry and exit points in a seasonal move. While doing this research, I found that one price pattern kept giving me precise turning points in the market. This finding required me to think outside the box because this new way to measure cycles was completely different from the commonly accepted practice in 1989. This recurring price pattern in the market that I uncovered would become the foundation of my Reversal date trading indicator.

From this initial discovery, the Reversal date indicator has evolved into a complete study of the natural movements of the markets. One thing that all the established trading experts had in common was the belief in

**8**

## ORDER FROM CHAOS

the concept of time and price working in harmony with the markets. The Reversal date indicator takes this idea one step further as it incorporates price patterns with time and price for an additional confirmation of a trade signal.

This technical approach offers the three key components that I believe are essential for any trade signal—time, price, and pattern. If you can improve the timing of your entry price, you will enhance any trading method (whether it is for stocks or commodities). To be successful in the markets, you don't need extensive knowledge about all the markets you trade or even access to inside information. What you do need and what will go a long way in helping you become a successful trader is to develop a thorough understanding of market behavior.