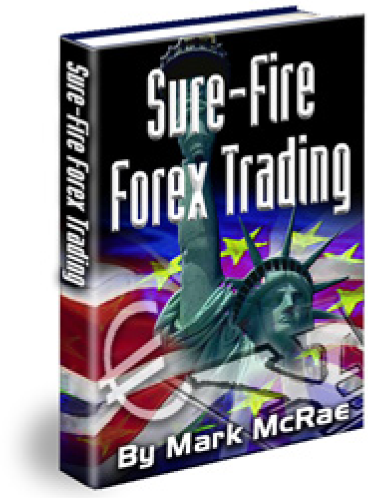

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The ADX (Average Directional movement Index) Indicator

The ADX is part of the direction movement system introduced by J.Welles Wilder in his book New Concepts in Technical Trading Systems. It comprises of the Directional Movement lines – the plus DMI line and the minus DMI line – and the ADX line (the Average Directional Movement Index)

ADX is created with reference to both positive and negative directional movement and identifying sustained movement in one direction. When this occurs ADX will rise (irrespective of whether the trend is higher or lower). Trend direction is identified by whether positive movement (DMI+) is above or below negative movement (DMI-). Once ADX rises above a certain level a trend can be said to have been established.

Although the average directional movement index (ADX) isn't used as frequently as some of the popular technical indicators the ADX line has definite advantages because it filters out a lot of the false oscillator signals which are frequently given early in a move.

A trader can stay with trending positions longer by following the simple guidelines for the ADX line. A climb by the ADX line above 40 followed by a downturn, signals an imminent end to the current trend (whether up or down).

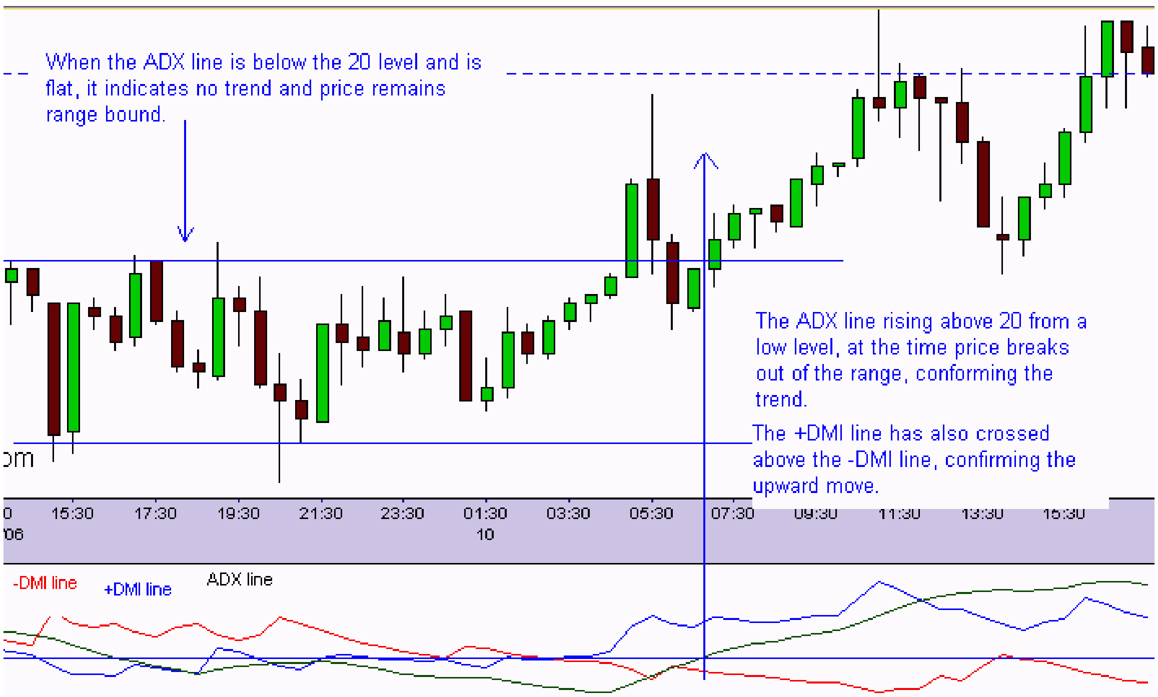
The ADX is less helpful during sideways markets. During extended consolidation periods the ADX line will slip toward 10. When ADX approaches 10, a major move is usually about to take place. But the ADX line doesn't tell you which direction it will go. You have to rely on other indicators for the probable direction of the next move.

In short, if the market is trending, the ADX line should be rising. During an extended consolidation period the ADX line will slip toward a low number.
To sum it up –

- When the ADX starts rising from a low level it signals the beginning of a trend.
- The trend is confirmed when the ADX has risen above the 20-25 value and the +DMI line has crossed the –DMI line (in case of an uptrend)
- When the ADX has reached an overbought level of 40-50 and starts consolidating or turning down it can signals the end of the current trend.
- The decline of the ADX signals the consolidation or indecision of the market.

The optimum use of this indicator would be to consider trades only when the ADX has started to rise from a low level, as it indicates that a sideways basing pattern has been formed and trends usually emerge from extended sideways periods giving highly profitable trades.

The chart example shows how the ADX effectively indicates a range bound area and the breakout forming the subsequent trend.



Trading with the trend ADX Strategy

The currency markets are known to trend well. At the same time, catching a trend and staying with it, is not as easy as it seems.

Price always moves in wave motion, forming impulsive and corrective waves and many a times a major retracement could be interpreted as a reversal, only to see the trend continue.

The market saying of “trading the pullback” would fit this situation well.

Hence, if we can identify a strong trend and correctly interpret the corrective waves of the trend as a retracement, it would make trading more profitable.

With this in mind, we shall make a system that gives us the ability to trade pullbacks in the direction of the main trend by combining 2 technical indicators.

The advantage is that the unique characteristic of each, gives us the combined interpretation that we are looking for.

The first indicator is the ADX with the standard setting of 14. It is a trend indicator, which identifies a sustained movement in one direction. Once the ADX rises above a certain level a trend is said to have been established. You stay with trending positions longer, simply by observing that the ADX is not declining. An ADX reading of above 30 indicates that a strong trend is in place and we shall use this parameter for our strategy.

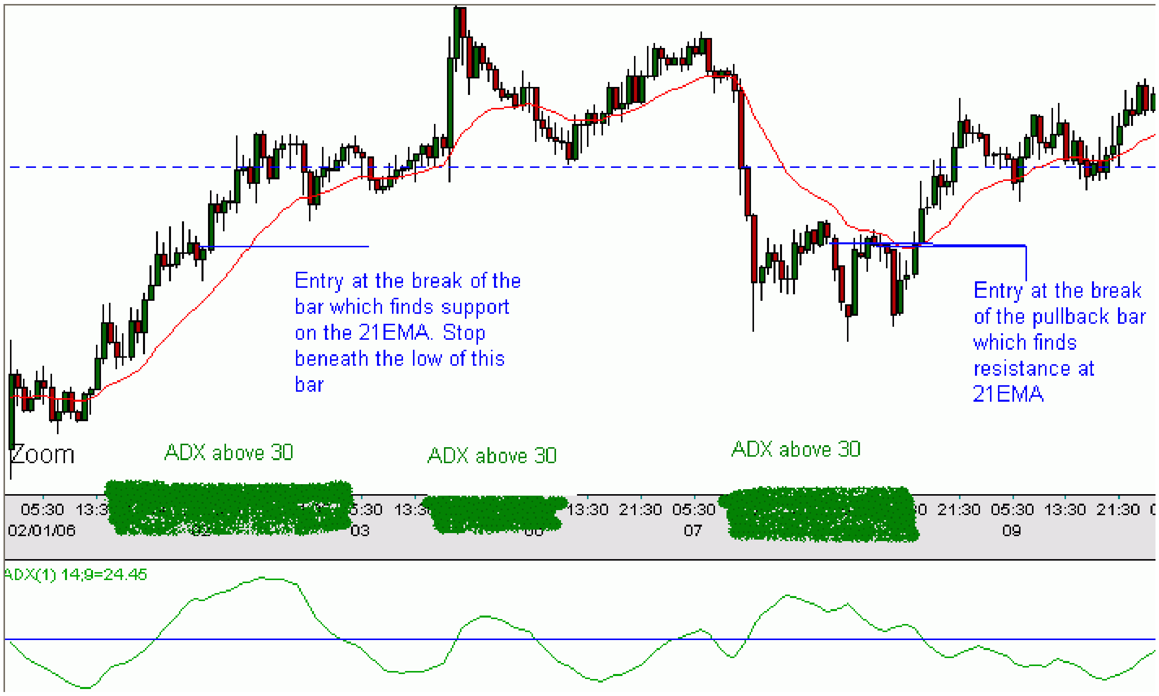
The second indicator is the Exponential moving average with a look back period of 21. The basic use of the EMA 21 is that it often acts as a dynamic barrier of support and resistance. In an uptrend price will remain above the 21EMA and more often than not, find support on the average in a continuing trend.

By combining these unique characteristics of the above two indicators we now define our parameters for the system. We will define a long trade and the same rules apply for a short trade by reversing the parameters.

Initially an ADX reading of above 30 is needed, which indicates that a strong trend is in place.

Once this parameter has been met and price retraces back to the 21 EMA we have a buy signal.

We enter the trade on the break of the high of this pullback bar, and place the stop below the low of the entry bar. The exit would be when prices cross the 21EMA down.

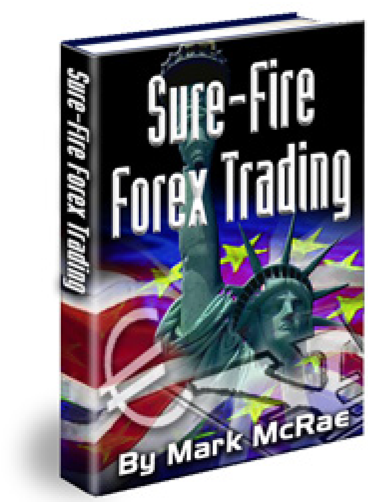


And as we can see in the chart we have both long and short trades completed successfully.

It is a very simple strategy with a high probability of success. Since we are going with the trend we are waiting for price to confirm our trades.

The basic drawback is that it works only in trending markets and should not be used when price is range bound.

Good Trading
Mark McRae



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