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Nick McDonald is a leading independent trader with a global following via the company he founded, www.tradewithprecision.com. A specialist in technical trading strategy for any market and any time frame, Nick possesses a unique approach to modern technical trading which forms the basis of the strategies that he teaches. Nick is in high demand as a speaker on the global trading circuit with speaking engagements on multiple continents each and every year.

The Path to Trading Success

PART 8: LEADING INDICATORS

The last three articles in this series introduced you to what we consider the most important technical tool; reading price action. Master price action and you will be well on your way to successful trading. In this article we will introduce you to the how we use two very simple indicators as a confirmation tool alongside price action to help us locate only the very highest probability trades.

➔ INDICATOR IMPORTANCE

Many traders place too much importance on indicators and they are often pitched by unscrupulous salespeople as the holy grail to trading. Indicators by themselves, and especially when they are used in the traditional way that many of them were designed, are close to worthless (this will be discussed in detail later in the article).

Indicators should never be used as your primary technical tool and they can only really add value to your trading when used in combination with price action. Using our baking analogy once again; if price action was the cake, indicators are simply the icing on the cake or even the sprinkles on the icing! It's possible to make a very tasty cake without icing but it's very unlikely you will have icing without a cake.

TRADING WITH THE TREND AND MOMENTUM

In its most simplistic form the job of a trend trader is 1) to locate a market which has trend momentum, 2) ensure that the trend momentum looks likely to continue and 3) enter a trade in the same direction of that trend momentum (once a valid trade set up occurs) and stay in that trade for as long as the trend momentum continues.

So how do we go about locating those markets which have the best trend momentum and which look likely to continue trending?

We break trend momentum down into price momentum and indicator momentum. Only those markets which exhibit both price and indicator momentum at the same time will be considered for trading opportunities.

The three previous articles in this series discussed how the author uses price action in order to find the best markets which have price momentum (i.e. a trend based on price action) so the focus of this article will be indicator momentum.

F1) BULLISH CONVERGENCE

Price is making a series of successive higher highs. Both indicators are also making a series of successive higher highs. Both price momentum and indicator momentum are converging. Source: Trade Station

F2) BEARISH CONVERGENCE

Price is making a series of successive lower lows. Both indicators are also making a series of successive lower lows. Both price momentum and indicator momentum are converging. Source: Trade Station

INDICATOR MOMENTUM

As stated earlier the author does not read indicators in the traditional way they were designed (e.g. changes in the RSI direction while it is overbought or oversold) because the signals they generate are lagging. That is, they signal a change in price after that change has actually occurred. This means that traders enter trades far too late and miss the majority, if not all, of the profitable move. Instead the author reads them in a way that transforms them into leading indicators.

A leading indicator signals a potential change in price before that change has actually occurred. Which obviously makes it a far more powerful and profitable tool than a lagging indicator. Do you want to be in before or after price has moved?

The two indicators the author uses to establish whether a market also has indicator momentum are the RSI (Relative Strength Index) and MACD (Moving Average Convergence Divergence). He converts RSI and MACD from lagging indicators into leading indicators by looking for convergence (or lack of) between price momentum and the indicator.

Convergence between price and the indicator means that both are trending in the same direction and in a similar fashion. Bullish convergence occurs when price is making a series of successive higher highs and the indicators are also making higher highs. Bearish convergence occurs when price is making a series of successive lower lows and the indicators are also making lower lows.

If you have a market which is exhibiting price momentum but the indicators aren't keeping up, that is they are diverging from price (i.e. price momentum is going in one direction whereas indicator momentum is going in the other direction) then this can be a potential early warning signal that the trend is running out of momentum. As we want to trade only the strongest trends we will not trade a trend where the indicators are diverging from price.

F3) INDICATOR DIVERGENCE

Price momentum and indicator momentum are diverging. Price momentum is going in one direction whereas indicator momentum is going in the other direction. An early warning sign that the price momentum may be about to change direction.
Source: Trade Station

CONCLUSION

Markets which have both price momentum and indicator momentum in agreement are the strongest trending markets and consequently will present the highest probability trading opportunities. These are the markets that trend traders should be searching for where our leading indicators are pointing towards the price trend continuing in its current direction.

NEXT MONTH

Now that the author has introduced all the technical tools he uses in his trading, the next article will demonstrate how he combines all those technical tools together to create a trading strategy.

> We convert RSI and MACD from lagging indicators into leading indicators.