C H A P T E R *20*
Expert Trend Locator

The Need for XTL

eSignal does an excellent job in identifying Elliott Wave counts. When combined with studies such as the Profit Taking Index, Wave Four Channels, Trend Channels etc., a very effective mechanical trading strategy is available to eSignal users. This mechanical strategy focuses mainly on:

• Trading the Wave Four to Wave Five segment in Type One trades
• Trading the end of Wave Five in Type Two trades

While this has been very productive, we still lacked a mechanical-type entry into some of the massive Wave Three swings generated in the market. So far, this was accomplished by staying in Type Two Trades entered at the end of a Wave Five and waiting for the Wave Three to develop. On numerous occasions, many of our users requested that we come up with a technique that allows early entries in Wave Three swings.

After some extensive research, we released the Joseph Trend Index in 1995. The JTI was designed to confirm Wave Three swings once the swing matured. It performed this task by producing an exponential curve in Major Wave Three swings. However, in some cases, the confirmation was accomplished a little too late for the user to take full advantage of the entire Wave Three swing, specifically in terms of an early entry.

The Theory Behind XTL

If you carefully look at any chart, you will find periods where the market tends to trade back and forth without any clear direction with swings that reverse at random. Looking back, many of these swings can be classified as noise. When the market is trading sideways in this manner, the XTL will indicate this **noise** by printing the bars as **black**. When the XTL senses an impending **uptrend**, it will mark the bars in **blue**. When a **downtrend** is expected, the bars will be marked as **red.**

The objective is to identify when the market is trading in a random fashion and when it is trading in a Major Trend. There are two additional requirements:

1) The Major Trend Mode has to be detected at any early stage so one can trade it.
2) Minimize the false signals.

We developed a Statistical model that checks for randomness in a given set of data. The model is somewhat similar to the Runs Test for Randomness (found in Advanced Statistical books). Our Statistical model calculates a value between 0 and 1 for any given run of data. (0 being completely random and 1 being completely biased). In addition to this, we also developed a way to measure a threshold level. If our test for Randomness for a given set of data exceeds this threshold level, we conclude that the market is potentially running or trading with a bias in the early stages of a Major Trend.

When an Upward bias or Uptrend is detected, the bars are displayed in **blue**. When a Downward bias or Downtrend is detected, the bars are displayed in **red**. If the Trend is neither up nor down, the bars are displayed as usual in **black**.

Figure 20-1: Merril Lynch, Daily   **Figure 20-2: PHLX, Daily**

Portability

Any study is valid only if it is portable to other markets. The Statistical model we developed for the XTL meets this criterion. It works on all markets (Stocks and Futures) and for any time frame without any modification.

Compatibility with Elliott Wave Analysis

Almost all Wave Three swings generate strong and extended momentum to be classified as a Major Trend. In a majority of the cases, the XTL can identify the Major Trend at the early stages of a Wave Three. Since the XTL is a Statistical model and does not use Elliott Wave logic, it provides an independent confirmation and early entry tool for Wave Three type swings.

Designated Use for XTL

Perhaps the single most valuable use for the XTL is to identify the early stages of a Wave Three type rally or decline. Elliott Wave analysis alerts the user of a potential change in Trend and the XTL detects or identifies this change in Trend. Thus the combination of Elliott Wave analysis and the XTL provides the added luxury of both anticipating and confirming the Trend.

On the next several pages, we will discuss how to use the XTL and explain some of the recommended trading rules. We suggest you use the Training Mode (End-of-Day Program only) and test our recommended ideas on various markets. Then form a plan that fits your trading style.

Settings for XTL

There is only one user setting (input) required for calculating the Expert Trend Locator (XTL) study. This is the number of bars of data used to test for Randomness. The default setting is 35 periods and we highly recommend this. Using a 35-period setting reduces the number of false break out signals. However, using a 21-period setting allows the XTL to identify the Major Trend at a much earlier stage.

Thus, while the 35-period XTL offers less false signals, the 21-period XTL identifies the Major Trend one or two bars earlier.

Which setting (35-period or 21-period) you use is your personal preference. To decide the best setting, use the training mode to backtest on past data and find the setting that suits your style of trading.

How to Use XTL

Since XTL is a tool that identifies Major Trends, you can use it in a number of ways to enhance your trading. From our testing we have found the following method to be very reliable. When there is no Major Trend, the bars are plotted as regular bars in **black**. As soon as a Trend is detected, the color of the bar is changed to **blue** (Uptrend) or **red** (Downtrend).

The first bar that changes the color is called the First Breakout Bar.

Add half the length of this Breakout Bar to obtain a Buy Level.
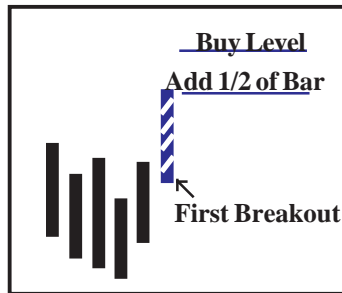
Figure 20-3a: Breakout Bar

Buy (go long) when the market penetrates the Buy Level, provided the following holds true:

a) XTL does not detect and display a bar with the opposite trend color. In Figure 20-3a, the buy was generated with an Uptrend signal. Therefore, you should not see any red color bars prior to the prices penetrating the Buy Level. Neutral (black) bars are okay and do not alter the strategy.

b) The Stop is not taken out.

We suggest adding 1/2 the length of the Breakout Bar. Please feel free to backtest, using the Training Mode and find a length you are most comfortable with. For aggressive entries, you could even set the Buy Level just above the high of the Breakout Bar. You could enter the market with a Buy Stop at the selected level.
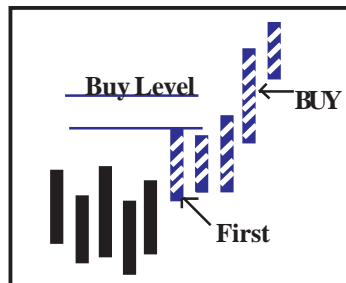

Figure 20-3b: Breakout Bar

In the following examples, we are adding ½ the length of the Breakout Bar for the entry.

In this Ball Corp. Daily chart as of Jan 28th of 2002, the XTL has detected a potential run in the market. The bar is displayed in **blue** showing an uptrend. This bar is also called the First Breakout Bar. Now add ½ the length of the Breakout Bar to obtain the Buy Level.
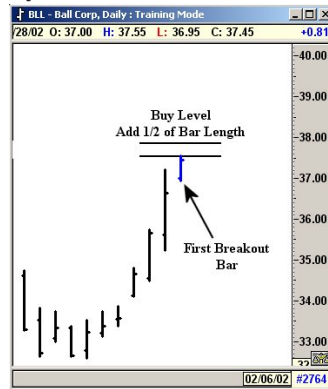

Figure 20-4: Daily Chart, Ball Corp.

Since the First Breakout Bar, the market did not take out the stop, and the market traded above the Buy Level; enter the market in a **long** position. There are a number of ways to enter. The most ideal would be to enter on a Buy Stop at the Buy Level.

Note: Prior to trading through the Buy Level, Neutral (**black**) bars may be displayed. Black bars do not alter the trading strategy.

Figure 20-5: Daily Chart, Ball Corp.

Taking Profits

Where one takes profits is different from trader to trader. However, once you have some decent profits in the trade, we suggest you use eSignal's built-in Regression Trend Channel. You can use them on the Auto mode or simply originate it from the previous pivot. These channels are excellent for bracketing a trending market.
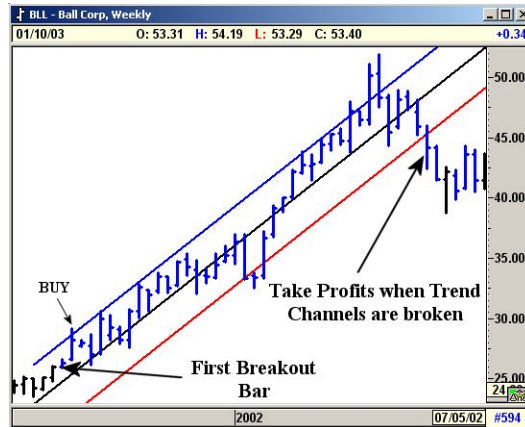

Figure 20-6: Weekly Chart, Ball Corp.

One of the major strengths of the Regression Trend Channel is to bracket a trending market. When a trending market breaks the channel, this usually indicates the end of the Trend. With this in mind, we suggest that profits should be taken when the prices break the channels.

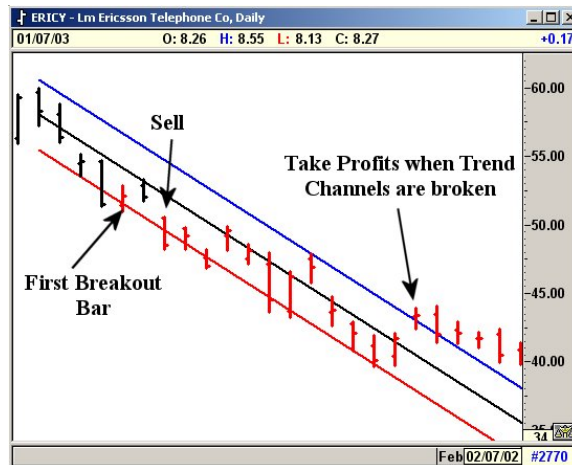The XTL can also be used to identify Major Downtrends.

Figure 20-7: Daily Chart, Ericsson Telephone Co.

Trade Continuation

When using the Regression Trend Channels to protect profits, you may from time to time be stopped out of a market that continues to Trend in the direction of your original trade. When prices break the Trend Channels, it usually indicates the end of the current Trend or at least a temporary change in direction (bias).

Figure 20-8: 60-Minute Chart, S&P Cash

It is extremely hard to forecast whether a breaking of a Trend Channel is an actual Trend change or just a temporary change. Therefore, we recommend taking profits. If the original Trend continues, you can still get back in as shown below.

As long as the Major Trend displayed by the software does not change, you can re-enter the market in the original direction when prices break the newly drawn Trend Channels. In this case, the bars should not change from Downtrend (**red**) to Uptrend (**blue**). Neutral (**black**) bars are okay and do not alter the strategy. The new Trend Channels are drawn from the previous pivot.
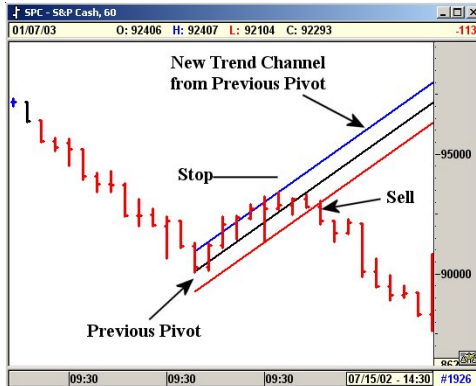

Figure 20-9: 60-Minutes, S&P Cash

Guidelines for Trade Continuation

The Major Trend displayed by eSignal should not change. For example, in a downward   trending market, the bar colors should be red (Down) or black (Neutral) and should **not** change to blue (Up), indicating a possible change in bias (Uptrend). The opposite applies to a market in a rally phase.

Once a Pivot is established, draw Trend Channels from this pivot as shown in Figures 20-8 and 20-9. You could also use the Auto Channels feature in eSignal (please note that the Auto Channels key-off the most recent pivot selected by the user—Major, Primary, etc.; you may have to adjust this setting to get the proper results).

Once the prices break the newly drawn Trend Channel in the direction of the original trend, a new trade can be established with a stop above/below the previous pivot (see Figure 20-10, below).
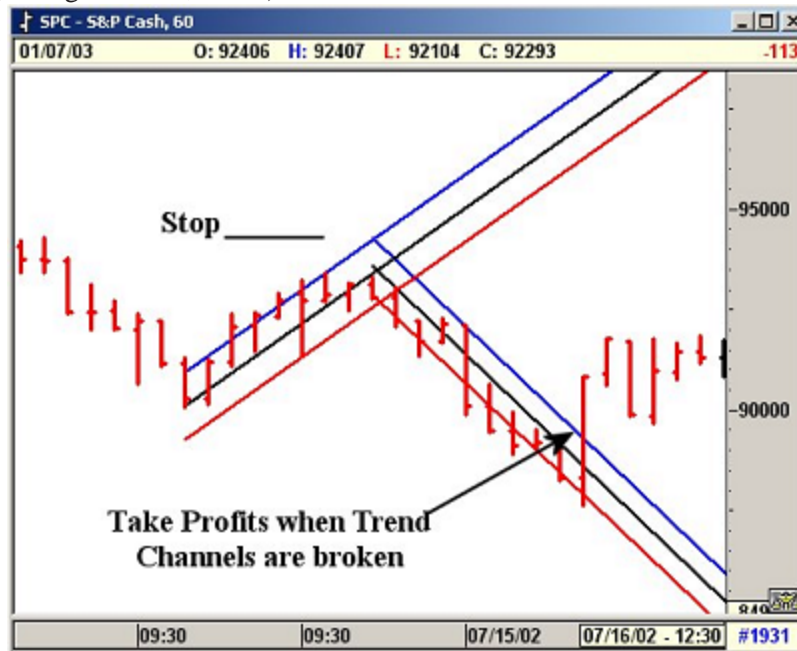

Figure 20-10: 60-Minute Chart, S&P Cash

New Trade

Once you re-enter the market, treat this as a new position. When the trade becomes profitable, use the Regression Trend Channel to protect profits.