

IMPRESSIVE SIGNALS FROM DEMARK

Kurt Magnus, head of foreign exchange sales at Westpac bank in London, discusses Tom DeMark's (TD) Sequential Indicator™, his preferred technique for timing position taking in the FX markets.

The technical analysis indicators developed by Tom DeMark enjoy a reputation for reliability amongst its small group of market users that exceeds that of the average price or volume indicator. DeMark remains one of the lesser known market indicators and is seldom covered in technical analysis syllabi or textbooks. This is largely because DeMark availability has been confined to the professional market and its reputation has spread mainly by word-of-mouth.

Kurt Magnus is a DeMark devotee and applies it to all his FX trading and strategy decisions. "Probably only around 3% of London traders use DeMark", he says. "This is because they take time and effort to master and have to be uploaded onto your screen. This is an inconvenience. Consequently, DeMark enjoys a certain degree of exclusivity and so is not yet part of mainstream technical analysis theory".

Magnus and his team deal only in foreign exchange although there is also a small fixed income desk at Westpac in London specialising in the Australian and New Zealand bond markets. For obvious reasons, the Australian dollar features highly in Magnus' daily trading but he considers that DeMark remains reliable, no matter how obscure the currency cross he may be dealing. "I recall that a recent backtest of the Sequential signals showed them to be





Kurt Magnus

around 70% accurate. DeMark is essentially a risk-reward strategy and its stop-loss positioning means that even when the indicators occasionally underperform, losses are cut to a minimum. In my experience, the TD Sequential Indicator is more than 70% reliable; it is closer to 90%.”

The DeMark Sequential Indicator

Magnus uses Bloomberg charts whose software automatically recognizes and displays TD Sequential Indicators as prices change from day to day. The Sequential is perhaps the most commonly used DeMark indicator and has an impressive record of identifying and anticipating turning points across the FX, bond, equity and commodity markets. Furthermore, the indicators provide signals not only on a daily, weekly and monthly basis but also intraday.

The Sequential Indicator identifies when a trend is becoming, or has become, exhausted. On daily charts, for example, DeMark identifies precisely which day to enter into a new position or liquidate an existing one. This total absence of ambiguity with regard to market timing makes the Sequential stand out. Using the indicator does require a leap of faith however, as signals often appear prematurely. As such, a buy signal may appear before a down-trend has completed so the trader →

may have a nervous ride before the market finally turns. Magnus warns that it is crucial the indicator is properly understood. "Unless you understand exactly the maths behind the signals, you can make costly errors. There are only two guys in the London FX market who can explain these signals with authority. Jason Perl at UBS in London and I often talk to make sure we get it spot on."

Setups

The TD Sequential Indicator consists of two patterns, a TD Setup and a TD Countdown. Setups are the shortest in duration, lasting for exactly nine price bars when completed. For example, a buy Setup exists when there have been nine consecutive price bars in which each bar's close is lower than the close four price bars earlier. When a price bar closes below that of four price bars previously a '1' appears below the bar. If the next price bar also closes below that of four bars earlier a '2' appears and so on. These appear in Figure 2 in green, a chart of EUR/USD from February to May '04. If before price bar 9 is reached a price bar fails to close below that of four bars previously then the Setup is abandoned and the numbers are automatically deleted. Once nine consecutive price bars have been completed the trader will be looking for a "perfected" Setup; one that is now valid for trading. A buy Setup is perfected when the low of either price bar 8 or 9 is less than the lows of both price bars 6 and 7. Perfected sell Setups look for a high of either price bar 8 or 9 that is greater than the highs of both



Figure 1. is a daily chart of the Dow from mid-2003 showing how the DeMark Sequential Indicator appears with price bars. The numbers in green and red represent TD Setups and TD Countdowns respectively. The purple dotted lines are the DeMark stop loss levels automatically generated by the software.



Figure 2.

“CONVENTIONAL INDICATORS ARE TYPICALLY TREND FOLLOWERS WHEREAS DEMARK IS DESIGNED SPECIFICALLY TO ANTICIPATE TREND REVERSALS.” TOM DEMARK

price bars 6 and 7. Figure 2 clearly shows perfected sell Setups in February and April marked with a red arrow.

Countdowns

A TD Countdown occurs after a completed Setup. A buy Countdown consists of thirteen price bars whose close is lower than or equal to the low two bars earlier. The corresponding numbers appear below the price bar. Unlike the Setup, a Countdown doesn't have to

consist of consecutive days. The Countdown is a bigger pattern than the Setup in that it can take months for a Countdown to form and often signifies a larger market move once the trend changes. Like the Setup, the Countdown also has "perfection" criteria. For a buy Countdown this requires that the low of price bar 13 be less than or equal to the close of price bar 8. Similarly, sell perfections require that the high of price bar 13 be greater than

or equal to the close of price bar 8. Figure 3 illustrates how signals have been generated in EUR/USD since June 2003 using Countdowns. The buy signal generated in September '03 and sell signal in February '04 anticipated large market moves which included completed, yet unperfected Setups.

Stop losses

The placing of stop loss levels is a crucial component of the Sequential Indicator and they are generated automatically only after the completion of a Countdown. For a buy signal, their level is calculated by identifying the lowest price bar of the entire Countdown (whether numbered or not) and then subtracting the low of that price bar from its high, or the prior price bar's close, whichever is the greater. This value is in turn subtracted from the low of that same price bar and the critical stop loss level is established. The stop loss is only executed when there is a close above the stop loss level followed by a close below it. The next price bar must also open below the stop loss →

| | TD Setup | TD Countdown |
|-------------------|---|---|
| Duration | 9 price bars | Unlimited |
| Buy signal | 9 consecutive price bar closes that are less than the close 4 price bars earlier | 13 price bars where each close is less than or equal to the low 2 price bars earlier |
| Perfection - buy | The low of either price bar 8 or 9 must be less than the lows of both price bars 6 and 7 | The low of price bar 13 must be less than or equal to the close of price bar 8 |
| Sell signal | 9 consecutive price bar closes that are greater than the close 4 price bars earlier | 13 price bars where each close is greater than or equal to the low 2 price bars earlier |
| Perfection - sell | The high of either price bar 8 or 9 must be greater than the highs of both price bars 6 and 7 | The high of price bar 13 must be greater than or equal to the close of price bar 8 |

Table 1.

“IN MY EXPERIENCE, THE TD SEQUENTIAL INDICATOR IS MORE THAN 70% RELIABLE; IT IS CLOSER TO 90%.”

KURT MAGNUS, WESTPAC

but must also have a low that is below its open. Magnus concludes, “There is some debate as to what close should be used in determining the stop loss level as this can have some impact on overall profits and losses. In my view, the London rather than the New York close is more valid because of the greater liquidity in the London market, at least as far as foreign exchange is concerned.”

Including the Sequential Indicator, there are 17 TD indicators in total. Tom Demark told *The Technical Analyst*, “The DeMark indicators are proprietary market timing tools that are really only available to professional investors. These indicators are not to be confused with conventional technical analysis that relies more upon subjective interpretation of price charts. Rather, they are quantitatively derived and grounded in market psychology and are totally objective. Many traders, even if they are fundamentalists, rely upon the indicators to time their trading decisions. Conventional indicators are typically trend followers whereas DeMark is designed specifically to anticipate trend reversals.”

Tom DeMark is president of Market Studies and has been involved in the investment industry for over 30 years. He has served as a consultant to the Soros Group, JP Morgan, Citicorp and Goldman Sachs among others. In the 1980s he was executive vice president of hedge fund Tudor and for the past eight years has been a special consultant and partner to SAC Capital. www.tomdemark.com



Figure 3.