

Predictive Indicators for Effective Trading Strategies

By John Ehlers

INTRODUCTION

Technical traders understand that indicators need to smooth market data to be useful, and that smoothing introduces lag as an unwanted side-effect. We also know that the market is fractal; a weekly interval chart looks just like a monthly, daily, or intraday chart. What may not be quite as obvious is that as the time interval along the x-axis increases, the high-to-low price swings along the y-axis also increase, roughly in proportion. This "spectral dilatation" phenomena causes an undesirable distortion, one that has either not been recognized or has been largely ignored by indicator developers and market technicians.

So, we have two challenges to address. 1) How to best smooth the data, and 2) how the fractal nature of the market distorts indicator interpretation.

To address the smoothing problems I will show you a stunning new filter from my aerospace analog filter design experience translated to a digital filter useful for traders. To address the mitigating the effects of the fractal structure of the market I will show you the effects of a new filter seldom used in trading. By removing the noise and the indicator distortion I will then show you the core concept of getting consistent short term trading winners.

MARKET DATA STRUCTURE

There have been many academic studies about the market data structure. Figure 1 captures the significant factors found in these studies. The horizontal axis is in terms of frequency, so that a frequency of 10^{-1} means a cycle having a 10 bar period and a frequency of 10^{-2} means a cycle having a 100 bar period, etc. The vertical scale is the power in the wave.

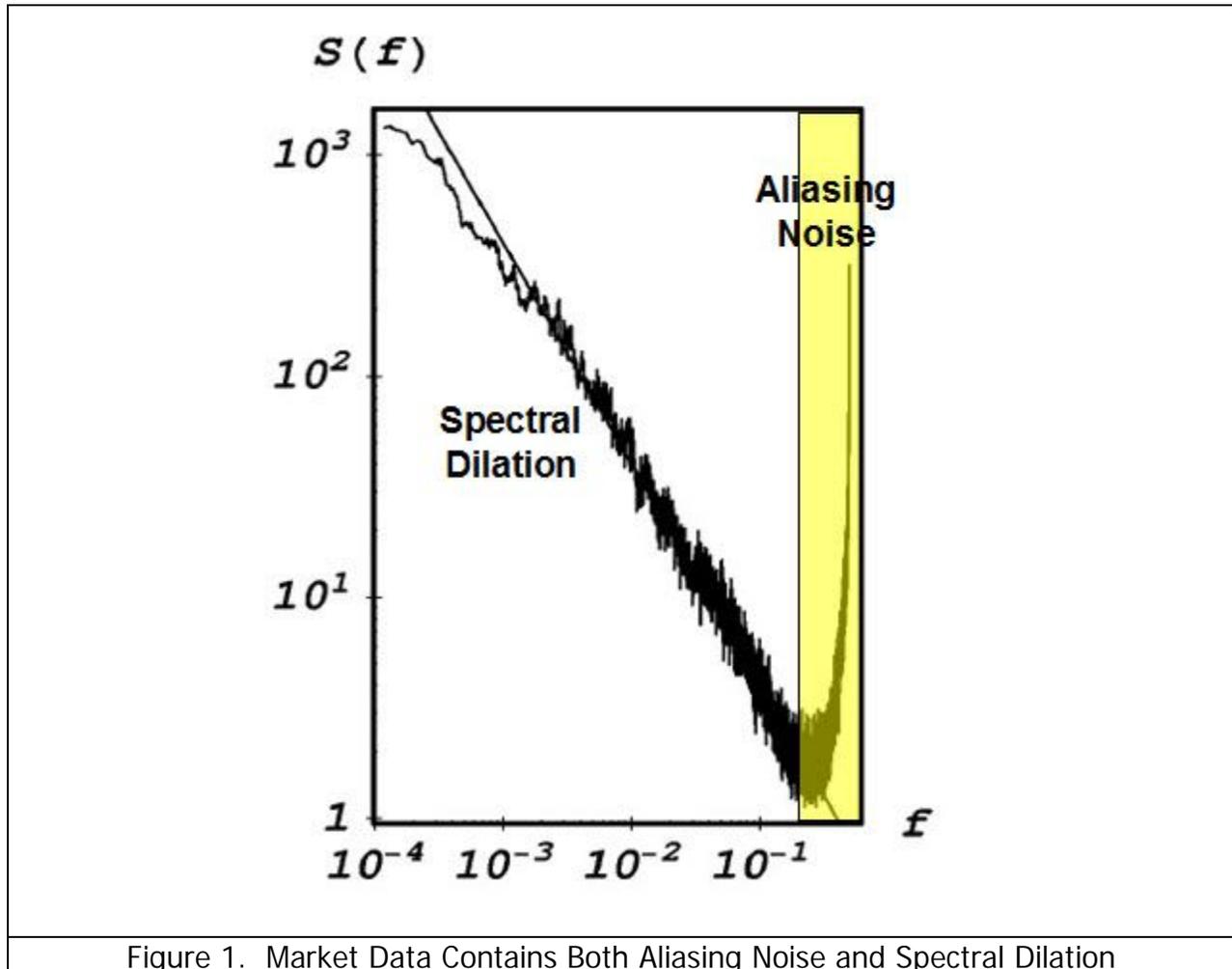
Aliasing noise has the largest amplitude at the higher frequencies (i.e. the shortest cycle periods). This is the noise that must be removed by smoothing.

Starting at periods somewhat shorter than a 10 bar cycle, a longer wave has more power in it than a shorter wave, which means the wave amplitude is larger for the longer wave. I call the shape of this Wave Amplitude versus frequency Spectral Dilation.

Spectral Dilation increases at the rate of approximately 6 dB per octave. This means that each time the cycle period is doubled, the wave amplitude in that longer wave is also doubled.

Although I knew about Spectral Dilation I was shocked to find that the phenomenon exists all the way down to shorter cycle periods – even below a 10 bar cycle period. At this point Spectral Dilation intercepts the aliasing noise resulting from using sampled

data. If we just want to eliminate Aliasing noise, we do not need a smoothing filter longer than a 10 bar cycle period. In fact, using a smoothing filter longer than 10 bars attenuates the data we are trying to use in trading.

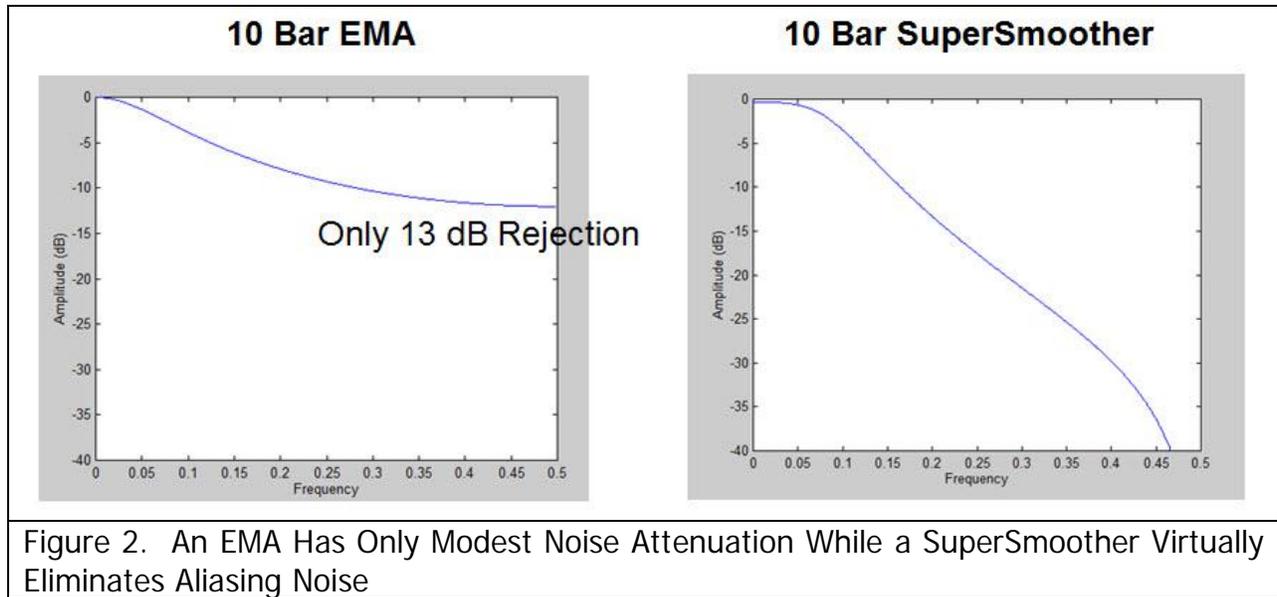


SMOOTHING FILTERS

Most traders use a moving average for smoothing. The problem is that a moving average is just not a very efficient filter. In order to get the amount of smoothing desired, the moving average length must be made longer. But making the average length longer also causes more lag, with the result that the smoothed trading signals are not timely for a good trade. I have compared a 10 bar Exponential Moving Average (EMA) with my SuperSmoother filter set to a critical period of 10 bars for an apples-to-apples comparison in Figure 2. The horizontal scale is in terms of frequency, so that 0.1 corresponds to a 10 bar cycle period and .5 corresponds to a 2 bar cycle period. 0.5 is called the Nyquist frequency, and is the highest possible frequency component using daily sampled data.

The EMA only reduces the amplitude at the Nyquist frequency by 13 dB. On the other hand, the SuperSmoother filter theoretically completely eliminates components at the

Nyquist Frequency. The added benefit is that the SuperSmoother filter has significantly less lag than the EMA.



Code Listing 1 gives the EasyLanguage code to compute the Super Smoother filter. The a1 and b1 variables are computed for the 10 bar critical period. These are then used to compute the c1, c2, and c3 coefficients of the filter. If the reader is translating to another computer language, please note that the trigonometric arguments are in degrees whereas they are in radians in most other languages. Also please note the notation [N] is the value of that variable “N” bars ago.

Code Listing 1. EasyLanguage Code to Compute the SuperSmoother Filter

```
{
    SuperSmoother filter
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}
Vars:
    a1(0),
    b1(0),
    c1(0),
    c2(0),
    c3(0),
    Filt(0);
a1 = expvalue(-1.414*3.14159 / BandEdge);
b1 = 2*a1*Cosine(1.414*180 / BandEdge);
c2 = b1;
c3 = -a1*a1;
c1 = 1 - c2 - c3;
Filt = c1*(Close + Close[1]) / 2 + c2*Filt[1] + c3*Filt[2];

Plot1(Filt);
```

Having solved the problem of dealing with Aliasing Noise, we can now turn our attention to Spectral Dilation.

SPECTRAL DILATION

Most trading oscillators and “detrenders” perform basically the same way as a one pole HighPass filter because they only have one difference term in their calculation. For example, the difference term of a Stochastic Indicator subtracts the lowest closing price over the length of the indicator from the current closing price. The result of performing as a one pole HighPass filter is that the attenuation scales as 6 dB per octave for frequency components smaller than the critical frequency.

But if Spectral Dilation is increasing the amplitude at the rate of 6 dB per octave and the oscillator is reducing the amplitude due to filtering at the rate of 6 dB per octave, the net result is that the longer period waves are not filtered out. The only effect of the single pole filter (or conventional indicator) is to flatten and equalize the Spectral Density. Figure 3 shows the output of a single pole HighPass filter that is smoother with a SuperSmoother.

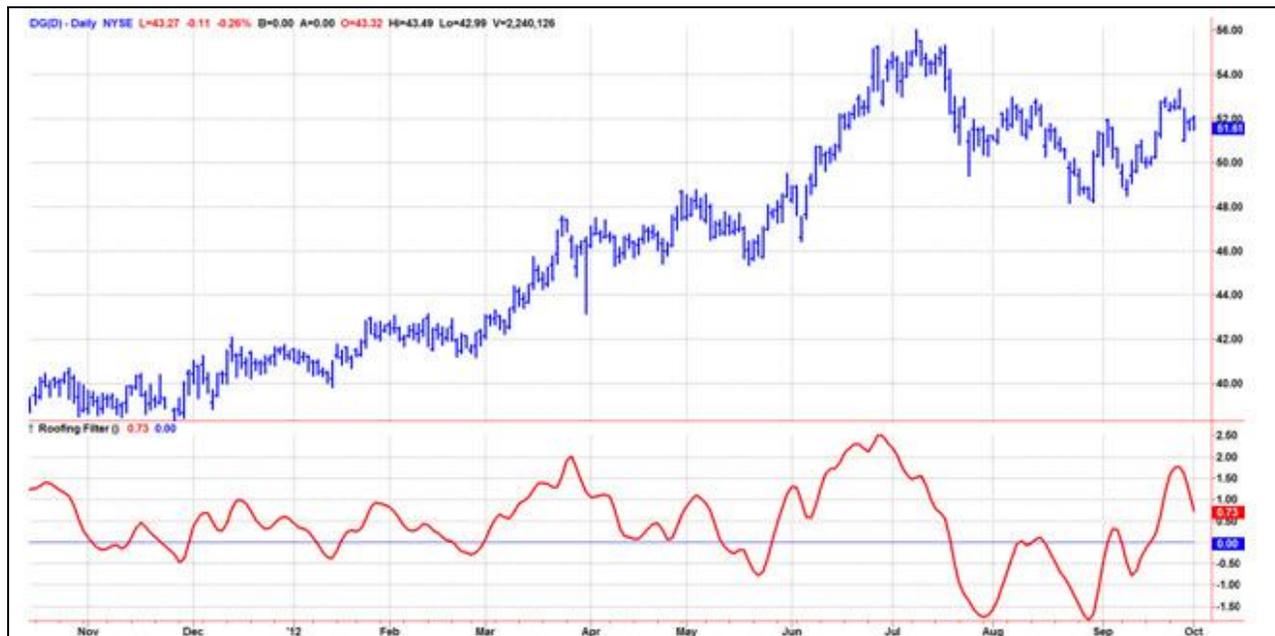


Figure 3. A Single Pole HighPass Filter (or Oscillator) Does Not Remove Low Frequency Components, Resulting in the Output Failing to Have a Zero Mean

If the high pass filter complexity is increased to a two pole HighPass filter, then the filter response increases to 12 dB per octave, enabling the effects of Spectral Dilation to be removed. The result of using the two pole HighPass filter is compared to the response of the original one pole HighPass filter in Figure 4.

The original one pole HighPass filter output is shown as the red dashed line and the two pole HighPass filter output shows the effects of Spectral Dilation have been removed. Now the output has a zero mean, allowing for a more accurate assessment of the turning points without the distortion of the long period offsets. In addition the waveform generally has less lag when longer wave components are removed.



Figure 4. A Two Pole HighPass Filter Removes the Effects of Spectral Dilation. This Gives the Oscillator a Zero Mean to Accurately Assess Turning Points and Generally Reduces Indicator Lag.

The combination of a two pole HighPass filter and a SuperSmoother filter can be used to precondition data before any additional calculations are performed. Since this filter combination limits the range of cycle periods in the output, it is called a "Roofing Filter" because it provides a roof over further calculations. The EasyLanguage code to compute the Roofing Filter is given in Code Listing 2.

Code Listing 2. EasyLanguage Code to Compute the Roofing Filter

```
{
    Roofing filter
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}
Vars:
    alpha1(0),
    HP(0),
    a1(0),
    b1(0),
    c1(0),
    c2(0),
    c3(0),
    Filt(0),
    Filt2(0);

//Highpass filter cyclic components whose periods are shorter than 48 bars
alpha1 = (Cosine(.707*360 / 48) + Sine (.707*360 / 48) - 1) / Cosine(.707*360 / 48);
HP = (1 - alpha1 / 2)*(1 - alpha1 / 2)*(Close - 2*Close[1] + Close[2]) + 2*(1 -
alpha1)*HP[1] - (1 - alpha1)*(1 - alpha1)*HP[2];
//Smooth with a Super Smoother Filter
a1 = expvalue(-1.414*3.14159 / 10);
```

```

b1 = 2*a1*cosine(1.414*180 / 10);
c2 = b1;
c3 = -a1*a1;
c1 = 1 - c2 - c3;
Filt = c1*(HP + HP[1]) / 2 + c2*Filt[1] + c3*Filt[2];

Plot1(Filt);
Plot2(0);

```

In Code Listing 2, the variable alpha1 is computed for the HighPass critical period of 48 bars. The HighPass filter will pass all spectral components having periods less than 48 bars. The SuperSmoother filter passes all spectral components having period greater than 10 bars. The end result of the Roofing filter is that cyclic components having periods between 10 bars and 48 bars will be passed from the input to the output. If the reader is translating to another computer language, please note that the trigonometric arguments are in degrees whereas they are in radians in most other languages. Also please note the notation [N] is the value of that variable "N" bars ago.

The impact of using the Roofing filter before computing a Stochastic is shown in Figure 5. Clearly, the conventional Stochastic tends to hang near the upper bound when the prices are in an uptrend. Since this characteristic is caused by Spectral Dilation, the tired old explanations of how to use %K, %D, and when to enter a short position at the end of a trend are just plain silly. When the Roofing filter precedes the Stochastic, as shown in the second subgraph of Figure 5, the longer period waves have been removed and the swing waves are obvious by inspection.

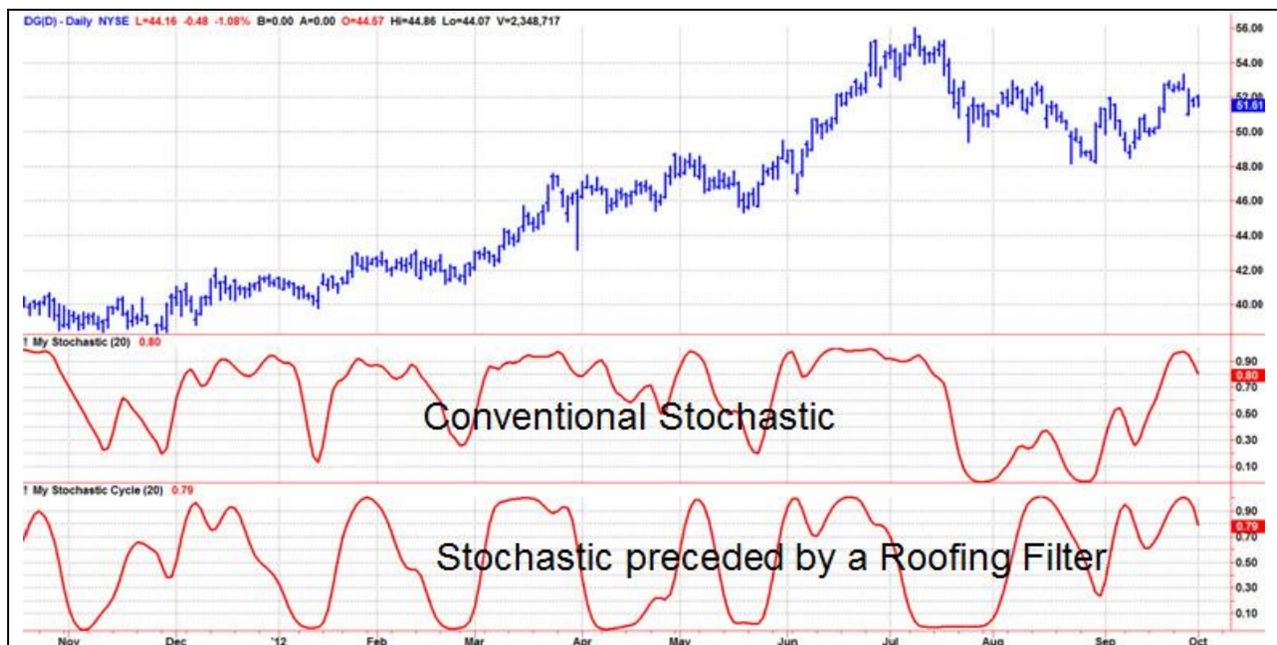


Figure 5. A Roofing Filter Preceding a Stochastic Removes Spectral Dilation Distortion

EFFECTIVE SHORT TERM TRADING STRATEGIES

Having successfully dealt with the Aliasing Noise issues as well as Spectral Dilation in the price data, we now have the tools to address trading strategies.

Conventional wisdom dictates that a long position trade be entered after the oscillator indicator has reached a minimum and turns up. The thinking here is that the indicator is so unreliable that confirmation of the price movement must be obtained before the trade is made. We can test this hypothesis. I am going to describe a trading strategy using the Stochastic preceded by a Roofing filter of Figure 5. I want to emphasize this is not an explicit trading system, it is only a demonstration of a strategy. The strategy using confirmation is to buy when the indicator has reached a minimum value and then crosses over the 20% level. Also confirmation is used to sell short when the maximum value has been reached and then crosses below the 80% level. The equity curve applying this simple rule to the Stochastic oscillator on 10 years of S&P daily Futures data is shown in Figure 6. Clearly, one would not want to trade this rule in real life.



Figure 6. Consistent Losses are Incurred When Trading the Stochastic Oscillator Using the Conventional Rule of Waiting for Confirmation.

The basic reason the confirmation strategy does not work is lag. If you are using an oscillator indicator, you are probably trying to make short term swing or momentum trades. You are most likely trying to trade a monthly cycle because that is a prevalent component in the data, since most companies have to make their numbers by the month. Therefore, you probably have 10 bars in an up-move to be long, and 10 bars in a down-move to be short or flat. All indicators have lag, even the SuperSmoother filter. A quick assessment gives several bars of lag to the SuperSmoother filter, several bars lag in computing the Stochastic, about 3 bars waiting for confirmation, AND then you have to wait another bar after confirmation to make your trade entry. Add all these lags together and you find you have about 8 bars total lag after the prices reached their swing low. The 10 bar up-move is almost over before you make your entry. Then, to exit the trade, you have the move against you for about 8 bars. This is why the wait for confirmation strategy cannot ever work for short term trading.

On the other hand, if we have removed the effects of Aliasing Noise as well as Spectral Dilation from the indicator we can conquer lag by anticipating the cyclic turning points. In other words, we have established a predictive and forecasting indicator. For example, to anticipate the turning point using the Roofing filter and Stochastic indicator, we would take a long position when the indicator crosses below the 20% level, BEFORE the indicator reaches its minimum value. Accordingly, we would take a short position when the indicator crosses above its 80% level, BEFORE the indicator reaches its maximum value. Doing just this, with no other rules, we obtain the equity curve shown in Figure 7 when trading the S&P daily Futures over the last 10 years. Clearly, anticipating the turning points works! I want to emphasize again, that this is not a complete trading system. Rather, I have just demonstrated the efficacy of anticipating the indicator turning points.

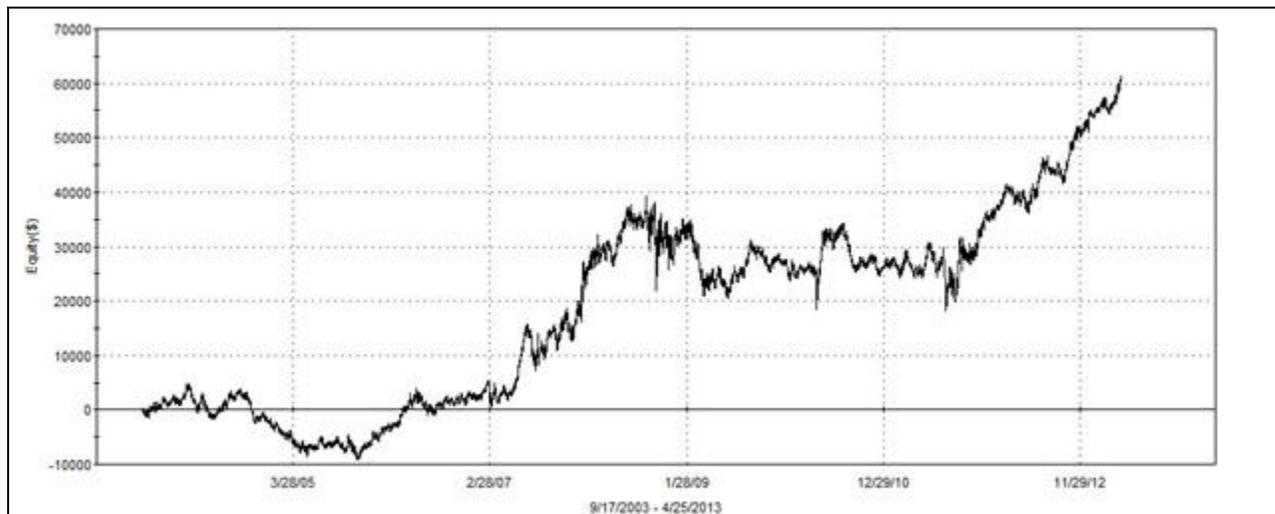


Figure 7. Consistent Winners Occur When Trading the Stochastic Oscillator by Anticipating the Indicator Turning Points.

STOCKSPOTTER.COM

The concept of anticipating the cyclic turning point is used at StockSpotter.com. Figure 8 shows the Swing Trade Setup Analyzer. Two indicators form the basis of the predicted turning points, the MESA Cycle indicator and the MESA Momentum indicator. Note that both indicators have a zero mean and are also very smooth, showing that the effects of Spectral Dilation and Aliasing Noise have been removed. The MESA Cycle is virtually in synchronization with the cyclic moves in the price data, with troughs indicated by green bars and peaks indicated by red bars. The MESA Momentum behaves analogously to the Stochastic. That is, it has some lag. A swing trade setup occurs when the MESA Cycle indicator reaches a trough within the last few days and the MESA Momentum indicator is declining or at a minimum.

Figure 8 is not a cherry-picked example. You can analyze any stock for FREE at StockSpotter.com using the Swing Trade Setup Analyzer for yourself. In fact, there are several more valuable indicators there for FREE. StockSpotter.com also features scanners that identify a variety of trading situations. Premium members receive explicit buy and sell signals at the end of the trading day for exercise at the market on the

open of the next trading day. All signals are given IN ADVANCE and then the hypothetical trading performance is transparently tracked and reported. Please give StockSpotter.com a try.



Figure 8. The MESA Cycle and MESA Momentum Indicators in the Swing Setup Analyzer Combine to Predict Price Turning Points.