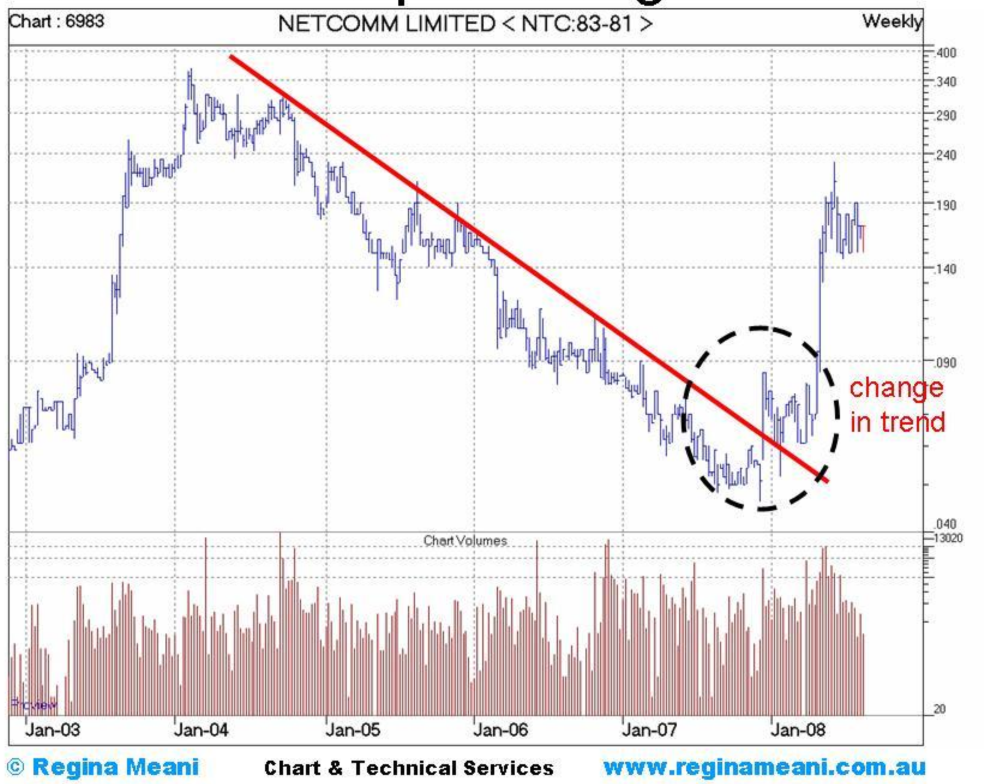
Identifying Trend Changes and using the MACD *written for the ASX,* August 18, 2008

For much of 2008, share markets around the world have been plagued by uncertainty. Negative influences have driven prices down and there is great debate as to whether it is a fully fledged bear market or merely a correction to an ongoing bull trend. There stands the statistics group on one side who believe in the "Decennial Pattern" which touts that the years ending in an "8" since 1900 are up years and they overlay that with the fact the in the US Presidential cycle it is an election year which usually produces an up year. On the other side we have the bears that focus on the fact that the major world markets have dropped around 30% with the Asian markets diving more, particularly china with nearly double that. At the end of the day it doesn't really matter to those who bought in at the recent top in 2007, they are suffering!

The most important factor is to be able to determine when this situation is going to change. Technical Analysts can focus on a number of things. They can start out simply by finding where the prevailing trend is over the longer and shorter-terms. Their next step is to work out whether that trend is likely to continue or change. A way of doing this is to identify, in the case of a downtrend, whether there has been a top formation and if the targets from that pattern have been met. Looking at the momentum which has driven the fall is important and if that is now exhausting and to determine whether the indicators are registering oversold. In times of increased turmoil it is relevant to note that "indicators" are just that an indication or guide and should not be relied upon exclusively.

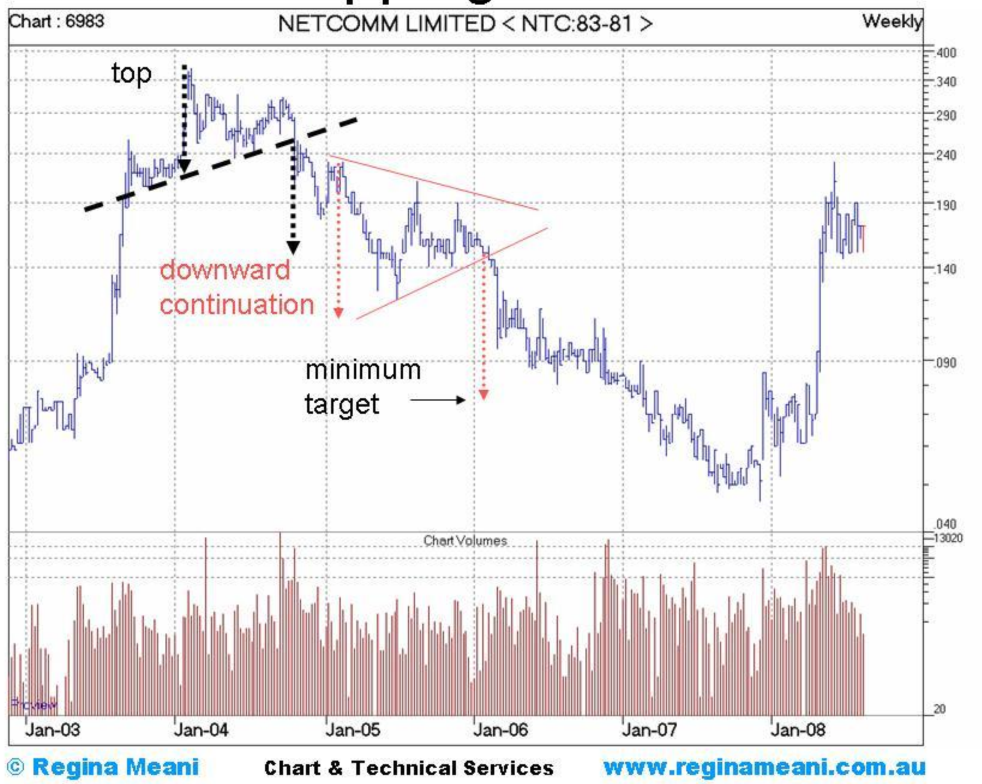
For our case study we have chosen Netcom as the price for this stock topped out in 2004 and the prevailing trend was down until December last year, when others in the market topped. So we may use this company's experience as an example of some of the things we need to look for when the current market influences begin to change. Chart 1 highlights the prevailing downtrend between 2004 and 2007.

Chart 1: The prevailing trend



Next we need to look for what was driving the trend and whether that influence remains. The price topped out in 2004 forming a small head and shoulders pattern, breaking down at 27c in October 2004 with a minimum expectation to 15c. (Chart 2)

Chart 2: Topping out

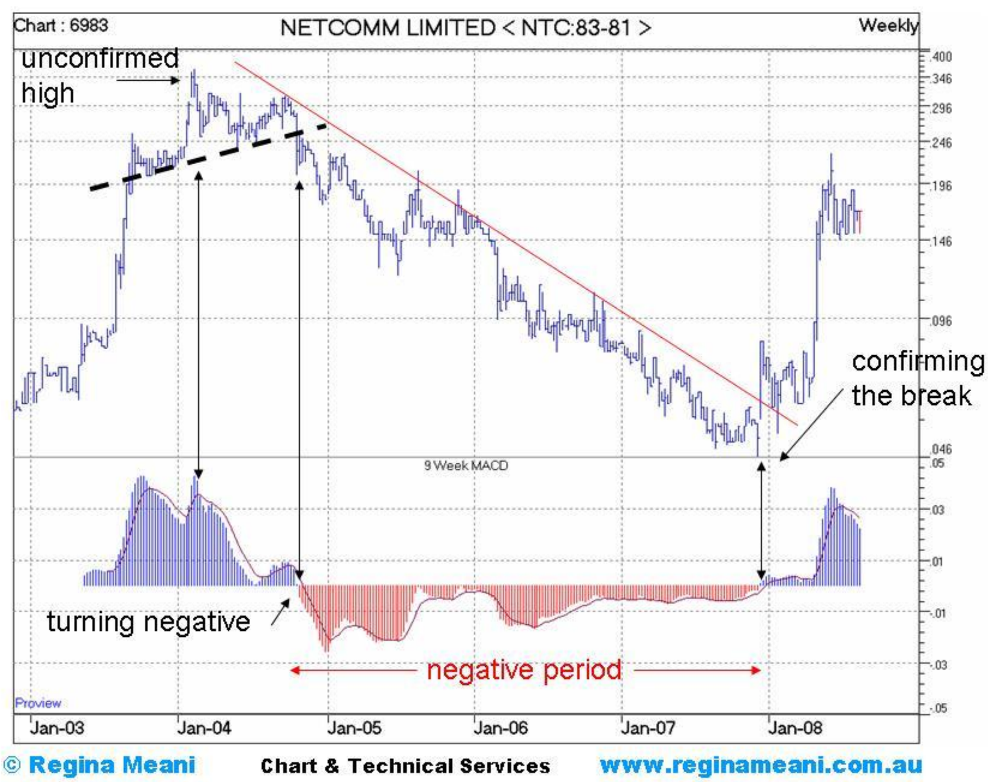


This was achieved in April 2005 with an overshoot to 12c stretching the downward momentum (see Chart 3) and producing a pause phase which allowed a rally back to 21c in August that year before the negative forces resumed to drive the price lower, providing a new downward objective to at least 8c. While momentum slackened around this area it was not enough to implement a change in direction for the stock and the downward trend continued until the price reached 4.6c on December 5, 2007. The following week the price surged to 8.5c bursting through the downtrend with strong volume participation with the momentum indicators simultaneously turning positive.

Using the Moving Average Convergence/Divergence (MACD) indicator we have a clear picture of the positive and negative momentum forces at play. This indicator measures the deviation from the trend by the mathematical interpretation of two moving averages as they continually move towards or away from each other. As the price peaked in 2004, the MACD failed to produce a similar action, halting around its previous peak level and thereby failing to confirm the new peak on the share price. This is termed divergence and is an indication that the momentum driving the current move is waning and perhaps about to change. When the price broke down from the top pattern it was confirmed by the MACD dropping through the zero line signaling a change in the direction of the trend. It is important to note that while the MACD fluctuated it did not turn positive to signal a change in direction until the price broke the trend in December 2007.

While there was not an early warning of a change, there was confirmation which is equally important.

Chart 3: The MACD



Finally we look for what patterns are developing for a reversal process. A Head and Shoulders Bottom began to develop its first shoulder during 2006, the head formed throughout 2007 with the final shoulder completing the phase by April this year. The pattern filled all the criteria required for the phase and on the breakaway rose quickly within a couple of weeks to its minimum expectation to 15c, shooting higher within a momentum thrust to 23c in June gaining an awe inspiring 187% before pausing the new trend.

This is only one example of a combination of technical elements that have come together in the process of determining a bottom and change in trend. There are many other variables in the Technical Analysis armory that are equally useful.

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