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Harmonic Trading of the Financial Markets: Volume Two

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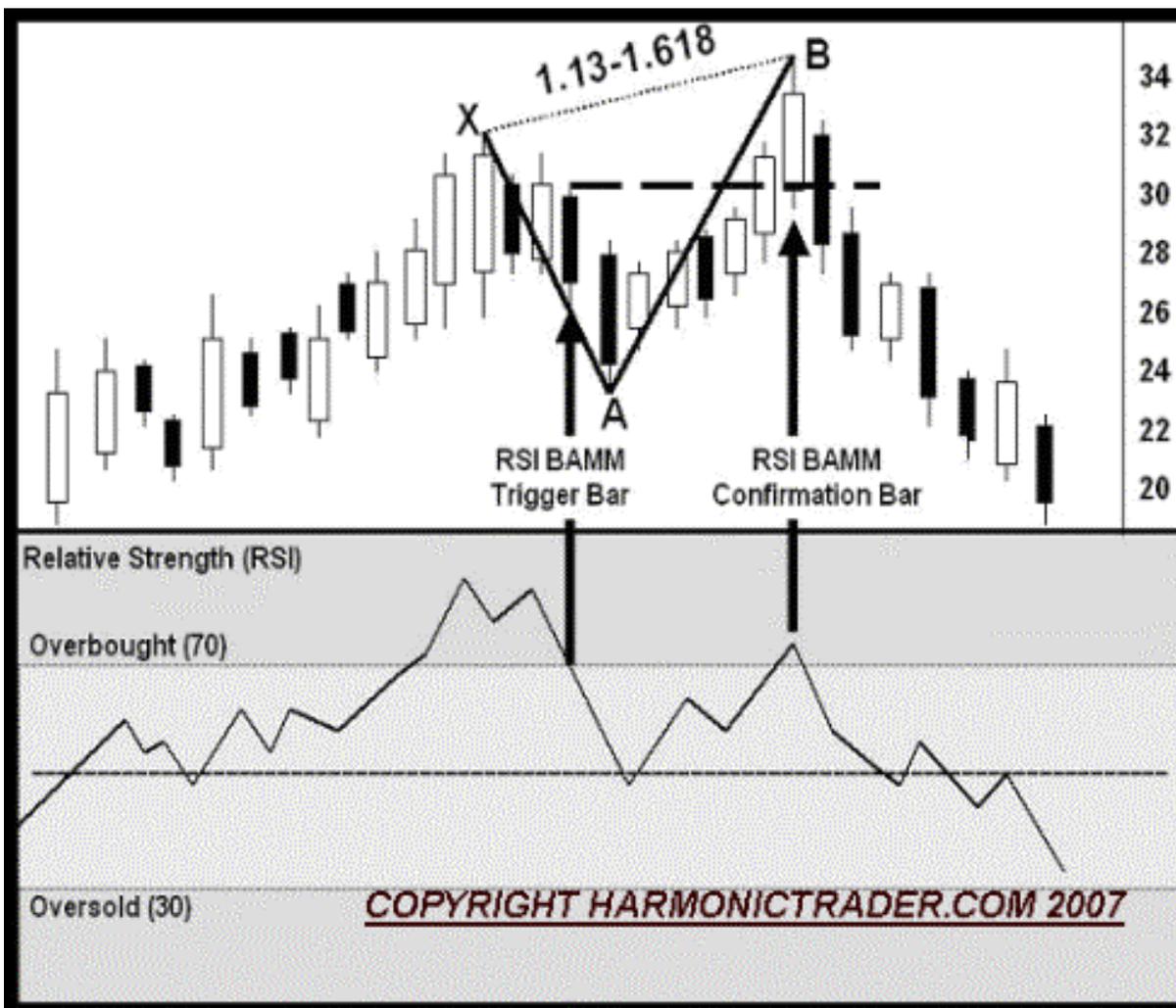
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Bearish RSI BAMB

The Bearish RSI BAMB begins with a complex reading above 70. Referring to the RSI BAMB illustration below, the entire process requires several elements to validate this specific scenario. Although the entire illustration might seem a bit overwhelming upon first examination, this represents the ideal RSI BAMB model. I recommend that you thoroughly study this material before employing these strategies in your live trading.



Each step will be broken down to illustrate the ideal RSI BAMB model. Obviously, the ideal situation does not occur every time. It is important to remember that the real application of the RSI BAMB principles will require a degree of flexibility. The ideal model does present all of the critical elements that explain clearly the effectiveness of this strategy. It will take a period of study to fully comprehend all aspects of the RSI BAMB approach. In much the same manner that the initial rules of harmonic pattern identification and differentiation may have seemed overwhelming, the RSI BAMB rules – albeit a bit complex upon first study – provide a coherent and comprehensive method for accurately measuring potential areas of divergence. It is essential to maintain the patience to execute only those trades that possess all required elements that validate a trade signal based upon the rules of the RSI BAMB set up.

Again, it is important to remember that this illustration represents an *ideal model* and a technical framework to provide a set of guidelines that attempts to quantify precise technical events and to optimize overall trading decisions. However, the RSI BMM strategy in combination with harmonic patterns effectively validates Potential Reversal Zones and improves the overall accuracy of the entire Harmonic Trading approach.

Step 1: Initial RSI Test of Extreme Bearish Limit.

In the Bearish RSI BMM scenario, the first step is to identify price action that possesses a Relative Strength (RSI) reading in the extreme zone above 70. It is important to note that the 70-level for the overbought limit, as well as the 30-level to define the oversold area, were first outlined by Wells Wilder in his book, *New Concepts and Trading Systems*. In addition, a 14-period average is calculated from his approach.

Step 2: Complete a Bearish M-Type Complex RSI Structure

The initial focus should be on the formation of the indicator readings in the entire extreme range rather than looking for a specific numeric level. As I outlined earlier in this chapter for the bullish scenario, it is important to differentiate the two types of indicator structures that form at RSI extremes.

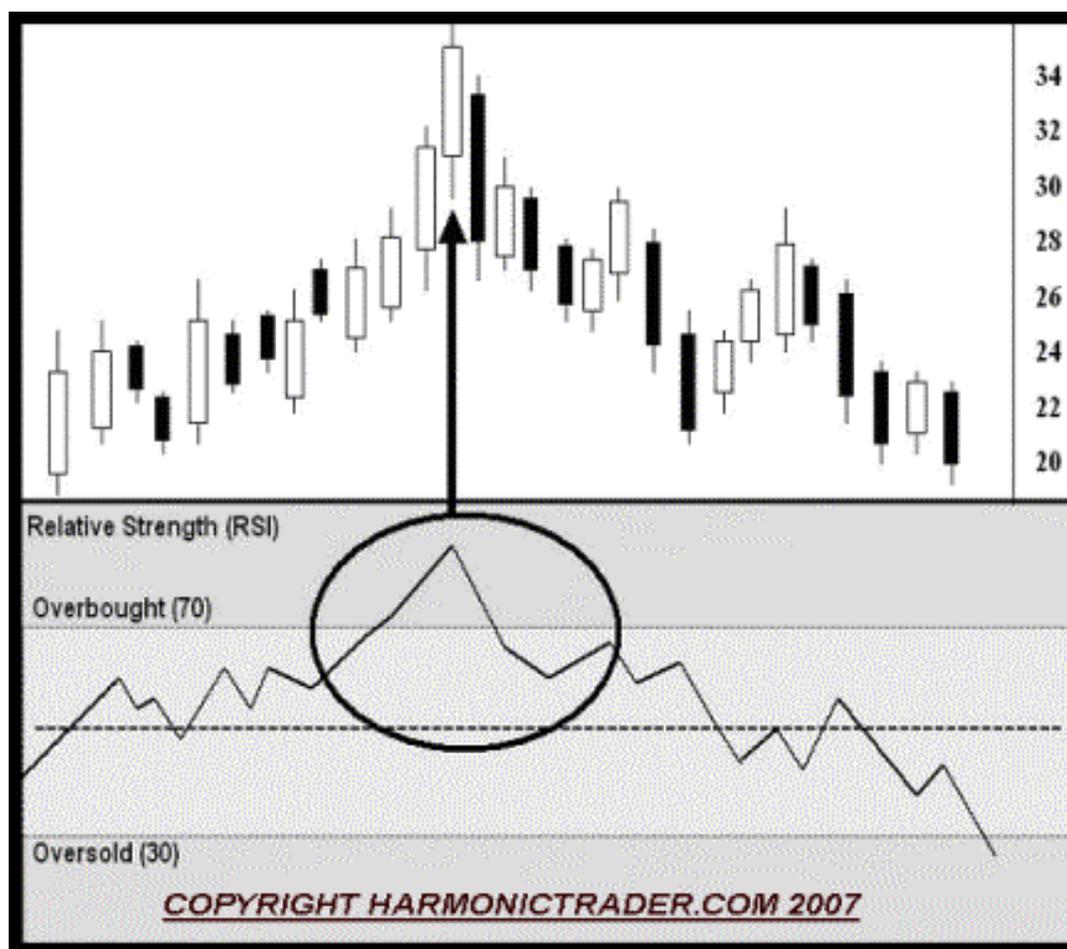
Two Types of Bearish Indicator Structures

In much the same vein as harmonic patterns, it is important to classify the general types of indicator structures that form in overbought RSI area. Although each type could be assigned more specific classifications, indicator readings form either an impulsive or a complex structure. Typically, most bearish RSI readings that are above 70 will be impulsive in nature and do not yield the required structure to be considered as a valid set up. However, valid complex structures that are correctly identified offer a tremendous technical advantage because this situation is especially unique and represents a vital potential reversal area within the overall trend of the price action.

Sometimes, a complex RSI BMM formation can be frustrating because the setup may not ideally unfold following the initial trigger. This can be particularly frustrating when a potential set up is followed for quite some time and fails to adhere to the RSI BMM model. In the same manner that not all patterns form ideally, it is important to wait for only those situations that clearly provide all the required elements to validate the set up. Regardless, the primary focus of the initial step is to identify a complex the RSI BMM M-type structure in the extreme area.

Bearish Impulsive Indicator Structures

A bearish impulsive indicator structure reflects price action that is experiencing a quick test of the extreme overbought resistance area that typically reverses quickly without any consolidating price action. Since the price action commonly reverses sharply in these cases, the indicator reading rolls over and sinks below the extreme limit under 70 typically within 1 or 2 price bars of the first overbought reading. Although such impulsive formations may test the extreme bearish RSI level, it is important to focus on the nature of the indicator structure and not necessarily the exact numeric reading (as long as it is above the 70-limit). The exact indicator level is critical in quantifying the extreme state of RSI but the general indicator formation is the critical factor, as it serves as the essential trigger to validate a potential trade opportunity.



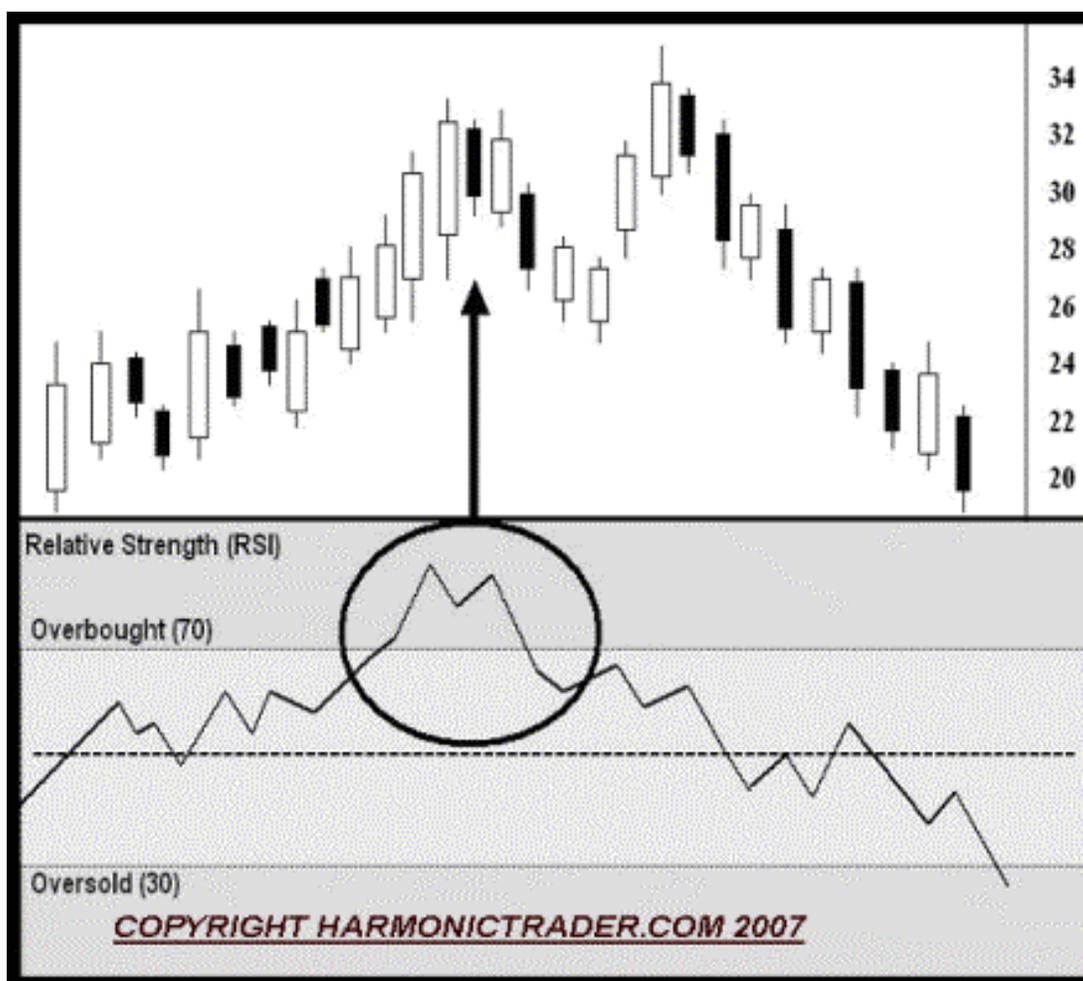
Impulsive structures can be effective technical measures as they can serve to confirm bearish patterns and other trading signals. But, it is important to note that the signals generated from extreme RSI readings do not constitute a comprehensive approach to trading the market. In fact, I believe that this is a common misconception for Relative Strength and most other technical indicators and oscillators.

In my opinion, such technical measures must be utilized as a complimentary methodology rather than as an exclusive approach. A Relative Strength reading above 70 does not automatically signify a trade opportunity. In fact, certain extreme impulse structures can signal significant continuations of the predominant trend. These strategies will be covered later in the

book. For now, it is important to keep in mind that the general types of structures. Furthermore, as is the case with all technical indicators, other methods must be employed to validate any potential trade opportunity on a multiple confirmation basis.

Bearish Complex Indicator Structure

A complex structure represents an indicator formation that initially exceeds the 70-level and forms an M-type structure entirely in the extreme area. The complex structure remains above the extreme 70-limit longer than an impulsive formation and it should be distinct from other types of indicator readings.



Despite representing a more significant technical condition than an impulsive formation, the bearish complex structure is typically an early trading signal. In fact, it is common for price action to accelerate to the upside while the complex formation of the RSI reading completes. Furthermore, the initial reaction to the complex RSI structure may not seem to indicate a change in trend due to such strong price action. Despite this perceived strength, the validity of the entire RSI BMM technique is not determined until the M-type structures has entirely formed in the overbought area above 70. Although the advanced concepts will be clearly presented later in this chapter, it is important to keep in mind that a complex indicator reading is merely the

starting point for the entire approach not the defining event of the methodology.

As the illustration shows, the initial test of the complex indicator formation typically experiences an acceleration of the predominant trend. Despite the perceived strength of the rally, the complex formation establishes the beginning of the most critical aspect of the entire RSI BMM methodology – divergence.

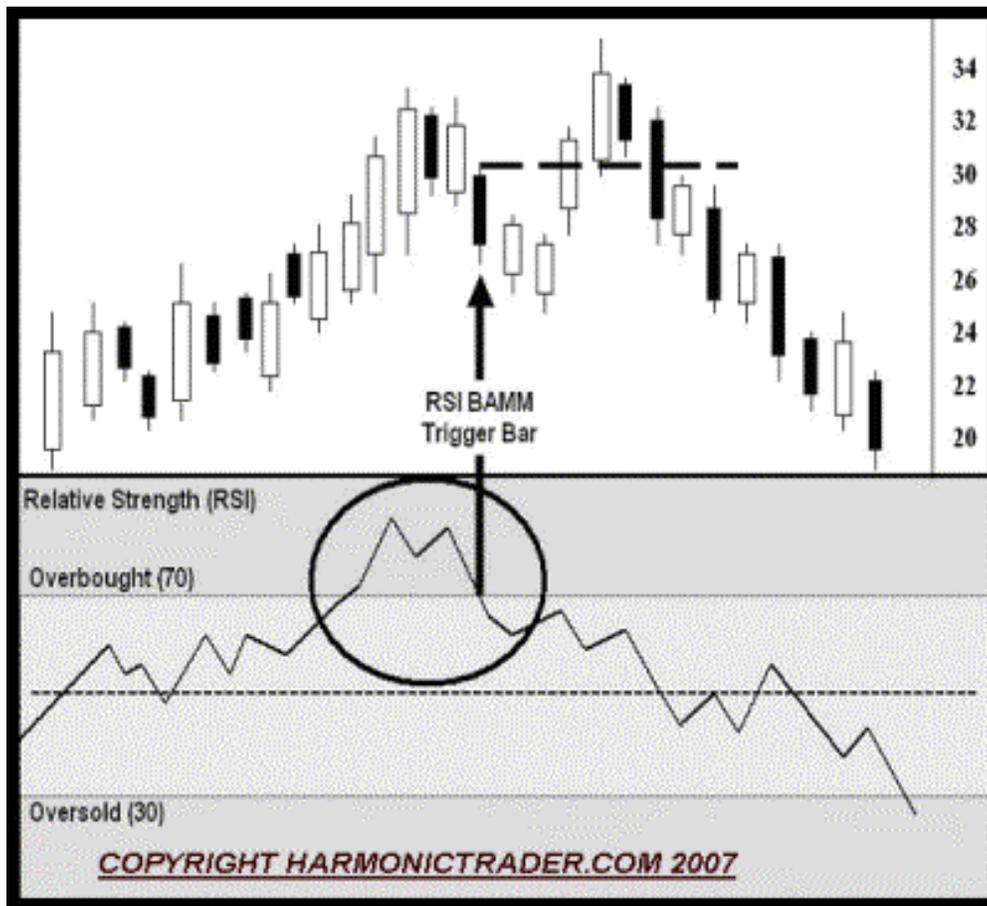
The bearish divergence occurs when the Relative Strength Indicator reading weakens while the price action continues to rally. Although the price action may seem to be maintaining its current uptrend, valid complex RSI structures usually trigger a reversal sooner rather later and mark a critical area for a potential change in the overall direction. Although a few other elements must fall into place for the RSI BMM to be validated, the complex RSI structure is the starting point for entire process. Most important, this is an early signal and it is critical to wait for the M-type structure to break under the 70-line. After the RSI formation has been completed, the other considerations of potential pattern completions and specific RSI BMM harmonic measurements can be projected to determine the optimal reversal area. This leads us to our next step, which is the defining and the measuring of the price level for that triggers this breakdown.

Step 3: Define the RSI Trigger Bar

After defining the complex RSI formation, the next step requires a measurement of the price area where the M-type indicator structure has completed. The price bar that causes the complex RSI indicator reading to complete and to decline below the extreme 70-limit is known as the ***RSI BMM Trigger Bar***.

After identifying the RSI BMM Trigger Bar, it is critical to mark the top of this price bar by drawing an extended line from the peak, projecting the resistance from the peak to the right of the chart, as is illustrated in the diagram. This RSI BMM Trigger Bar resistance level serves as a minimum technical area for the corresponding retest and the anticipated execution area of the completion of the final phase of the RSI BMM.

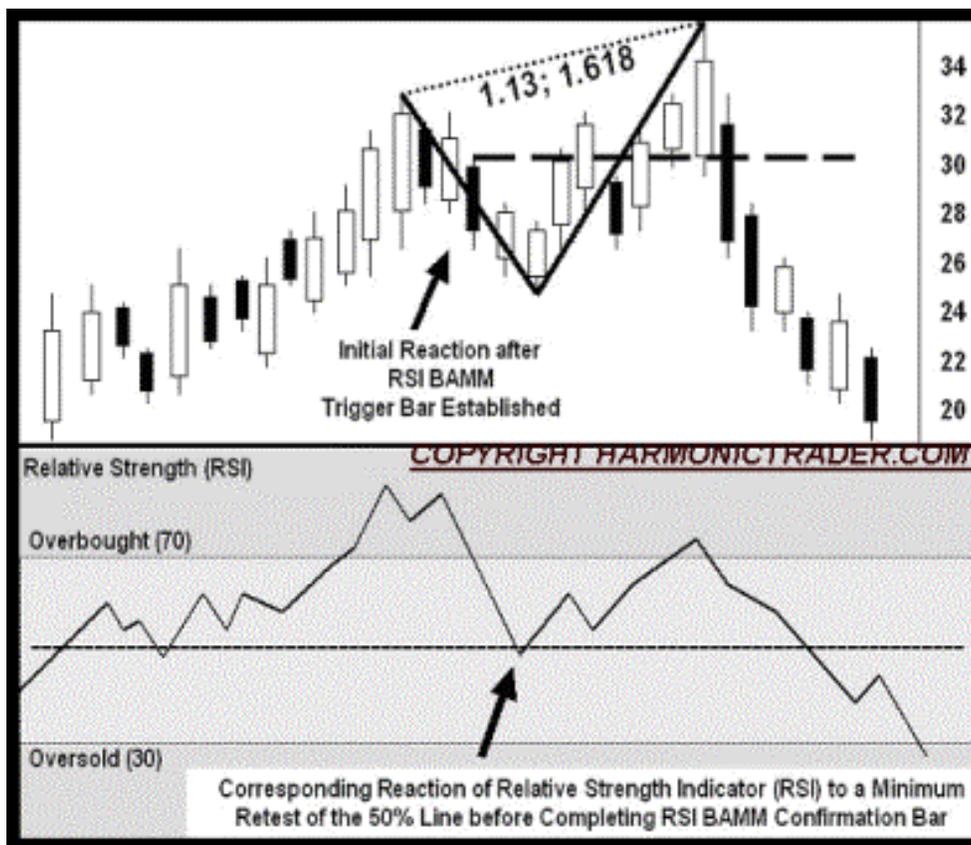
From a general perspective, the RSI BMM Trigger Bar denotes the starting point for the critical divergence phase that the entire methodology is attempting to define and to quantify. Again, the completion of the complex RSI indicator structure is only the starting point of the process. Although there are strategies that I will present later in this chapter to capitalize on the initial indicator breakdown, from a broader perspective the RSI Trigger Bar can reveal a great deal about the validity of the set up and the state of the potential price action. For now, the most critical element of the RSI BMM approach begins after the indicator has reversed from the overbought reading by completing the complex M-type structure.



The position of the Bearish RSI Bamm Trigger Bar in relation to the prior extreme high point is critical. Although its significance will be further explained later in this section, it is important to remember that the RSI Bamm Trigger Bar typically will be the price bar that is the prior peak of the current move or within a few intervals of the extreme high. This is critical and the Trigger Bar's position will determine the execution area for the corresponding retest and completion of the RSI Bamm.

Step 5: Reaction of RSI and Price

The initial breakdown of the RSI and price following the completion of the complex indicator formation represents the first phase of the approach. In an ideal RSI Bamm scenario, the price and indicator decline in tandem.



Frequently, the initial breakdown offers a distinct trading opportunity but these strategies will be covered a bit later in this chapter. For now, the initial breakdown requires a few elements to set up the completion of the RSI Bamm.

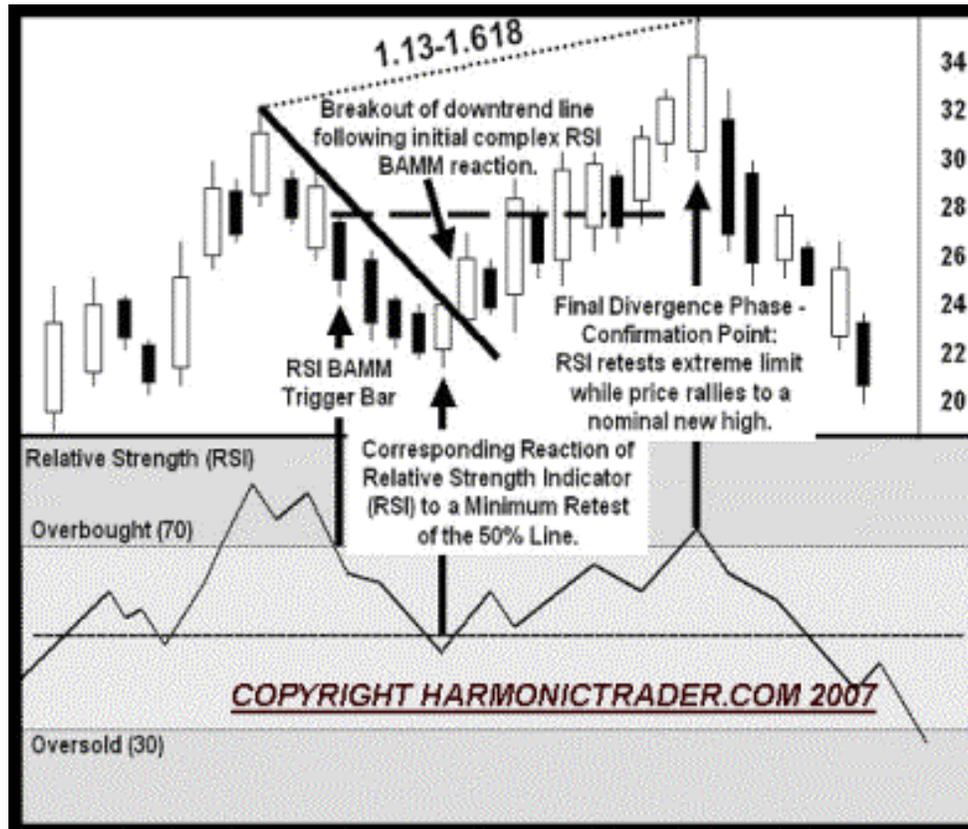
Specific Type of Retest

There are a few technical events that must occur on this initial Trigger Bar reaction. Namely, the RSI reading **MUST** decline to at least the 50-level as the price nominally reacts. Although there is room for interpretation as the RSI reading may exceed the 50-level on this initial reaction, it serves as a minimum requirement that precedes the corresponding retest of the resistance area established by the RSI Bamm. Again, this specific type of retest offers other short-term trading opportunities that I will explain a bit later in this chapter. But, the important aspect of this element of the process establishes the final divergence phase of the entire approach.

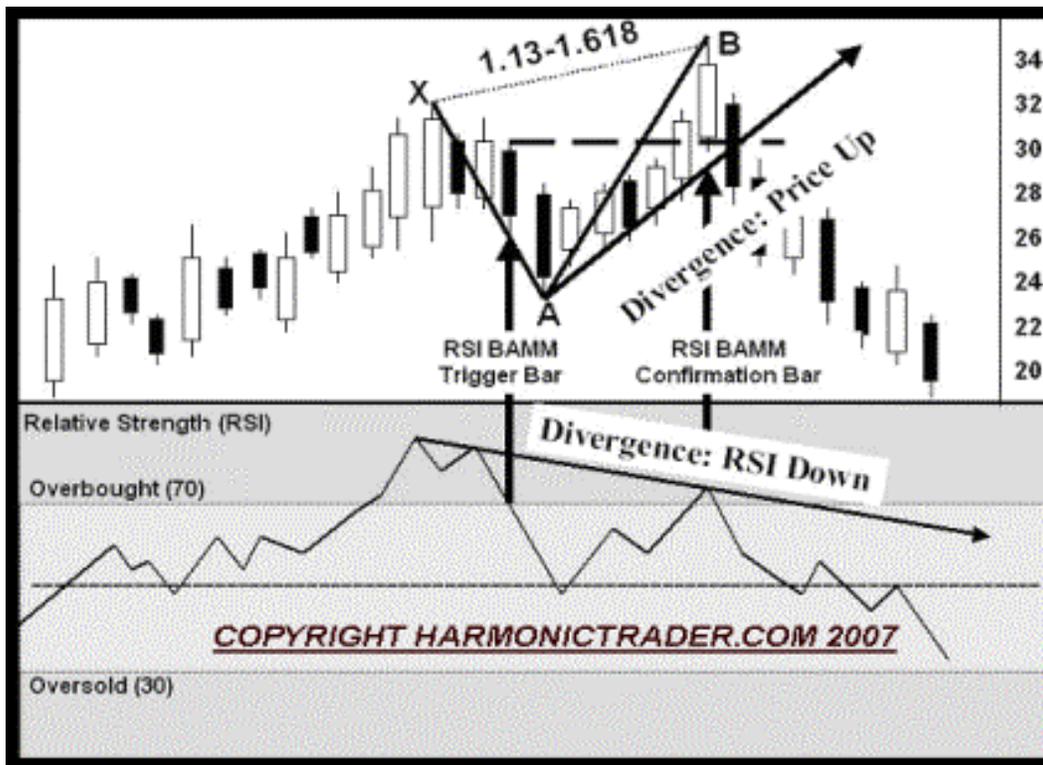
Step 5: The Final Phase - Divergence of RSI vs. Price

The final divergence stage begins after the RSI reading pulls back to at least the 50-line and the short-term price breaks out from the downtrend line of the initial reaction. It is important to remember that the horizontal line drawn from the peak of the RSI Trigger Bar to the right of the

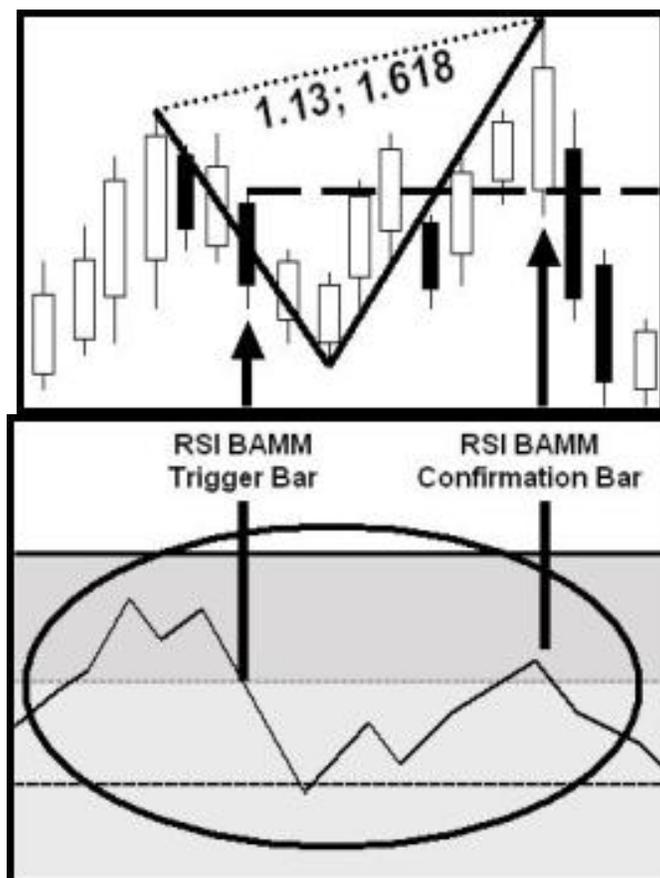
chart defines the minimum resistance level for the completion of the RSI Bamm and the eventual entry of the trade.



This is a situation where the Relative Strength Indicator reading is providing an early signal to the end of the predominant trend. Although this signal may be the end of the trend technically, the price action typically experiences one last rally to retest the resistance area established by the complex RSI structure. This final stage of the retest reveals a great deal about the strength of the predominant trend and the validity of the signals generated by the complex RSI structure. In essence, the price action diverges in a “last gasp” from the indicator reading. The price action will nominally exceed the prior high of the area marked by the complex RSI structure. This final stage of the entire setup reveals the extent of divergence, where the internal reading of the trend indicates a reversal hand while the price continues to rally.



The critical point of the divergence can be seen in this snapshot of the illustration where the trend of the price action continues up (notice uptrend arrow) while the trend of the RSI reading fails to continue higher, typically completing an impulsive structure.

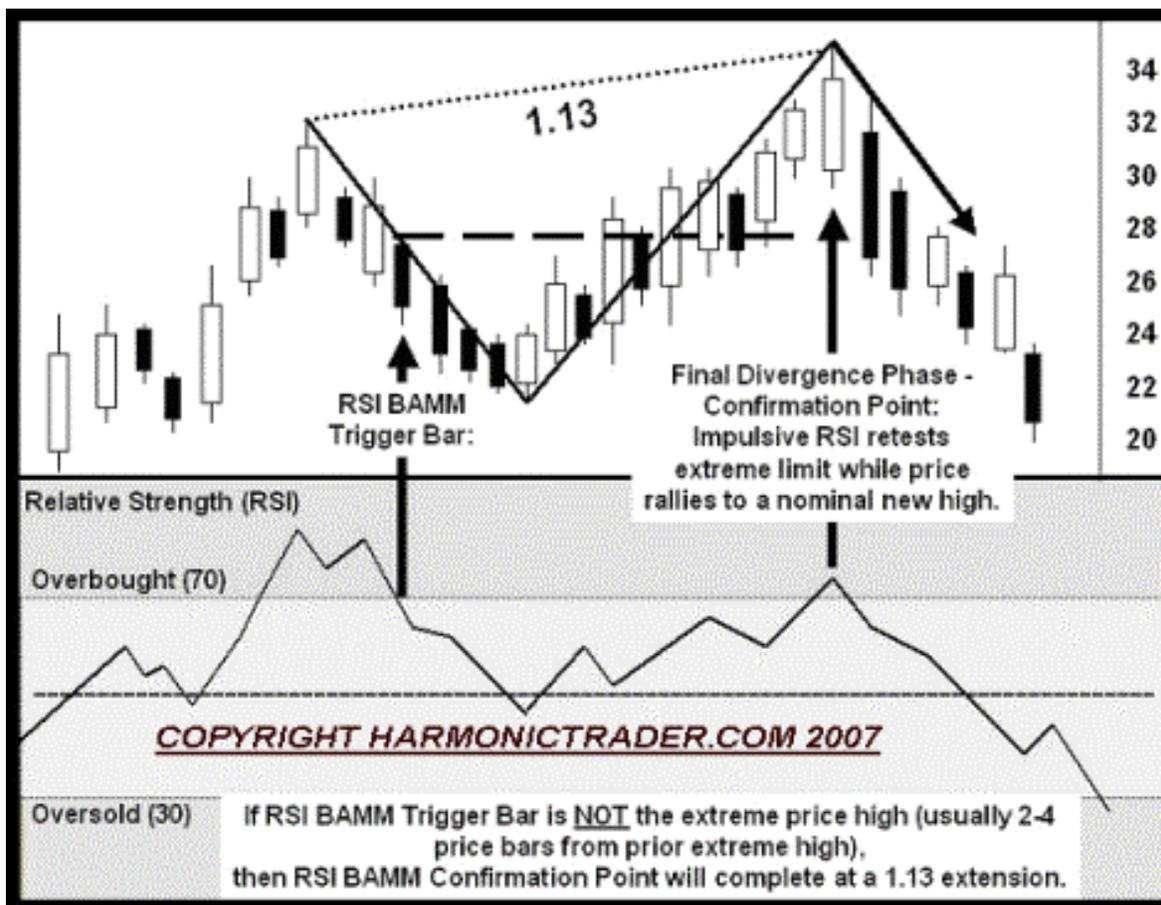


If the RSI structure is a valid resistance signal indicating a reversal at hand, typically the price action will reverse quickly after exceeding the initial prior high level. Although I will outline the advantages of utilizing Harmonic Trading techniques of pattern recognition and Fibonacci measurement strategies with the RSI BAMB, it is important to examine this technical phenomenon on its own before trying to understand other complementary methods. Most important, this area of divergence where the price and the relative strength readings move in opposite directions serves to quantify the critical reversal levels.

Establishing the RSI BAMB Confirmation Point: 1.13 vs. 1.618

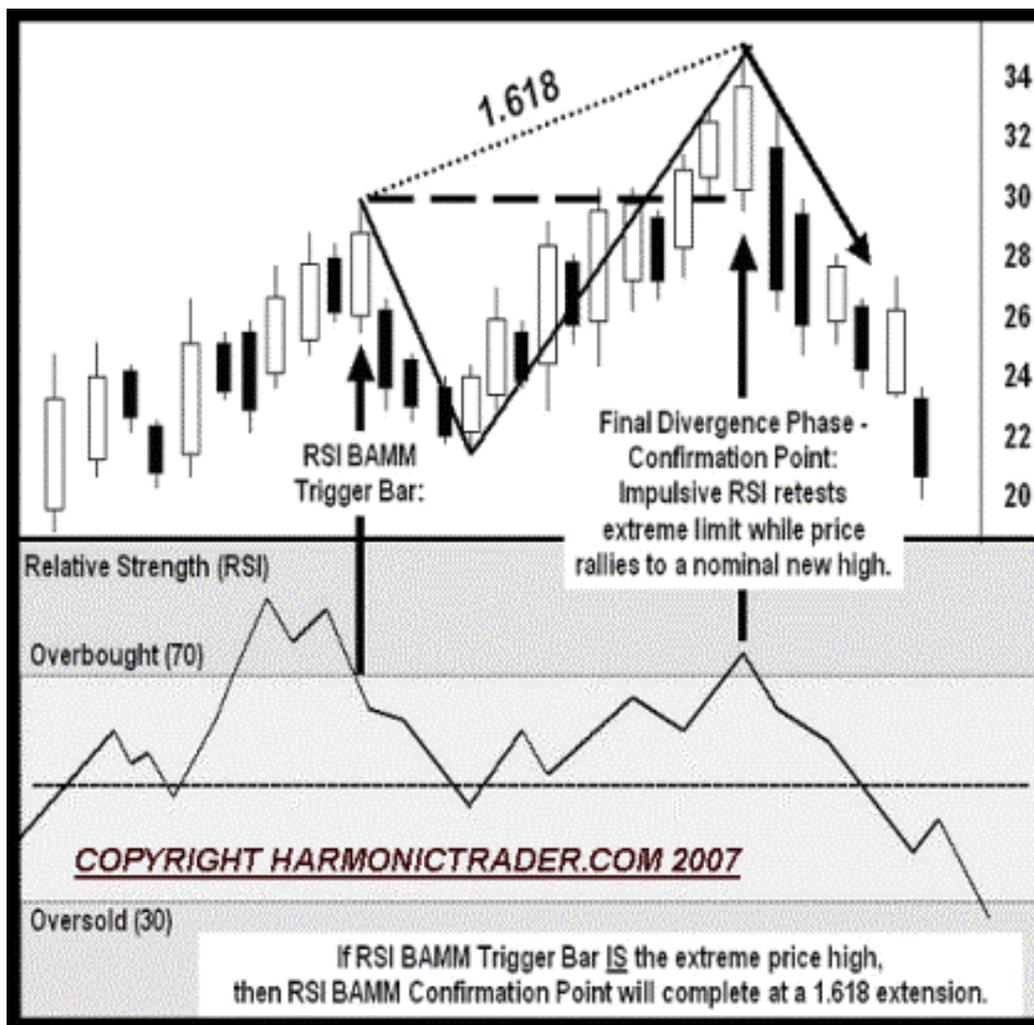
In the development of the RSI BAMB, I was challenged for quite some time to discern the correct extension to employ for the confirmation point. Although the difference between 1.13 and 1.618 may appear small, in real trading situations this gap frequently can be quite expensive. With respect to the primary tenets of Harmonic Trading and pattern identification, exact specification of technical measurement techniques is required to yield the most accurate information regarding the validity of any trading opportunity. Although these are general rules, I noticed a difference in the ultimate extension of the final divergence phase of the RSI BAMB depending upon the position of the Trigger Bar relative to the prior high. If the RSI BAMB Trigger Bar is a few price bars (typically 2-4) from the prior high, the execution of the trade will occur at the corresponding 1.13 extension. However, a RSI BAMB Trigger Bar develops at the extreme high for the move will result in a 1.618 extension at the confirmation point.

1.13 Extension @ RSI BAMB Confirmation Point



Although the general rule regarding the confirmation point extension differentiates the 1.13 and 1.618 ratios, the focus of the Trigger Bar should be on the extreme prior peak. Essentially, if the RSI Bamm Trigger bar is NOT the high price bar, the 1.13 extension is utilized to quantify the execution area for the trade.

1.618 Extension @ RSI Bamm Confirmation Point



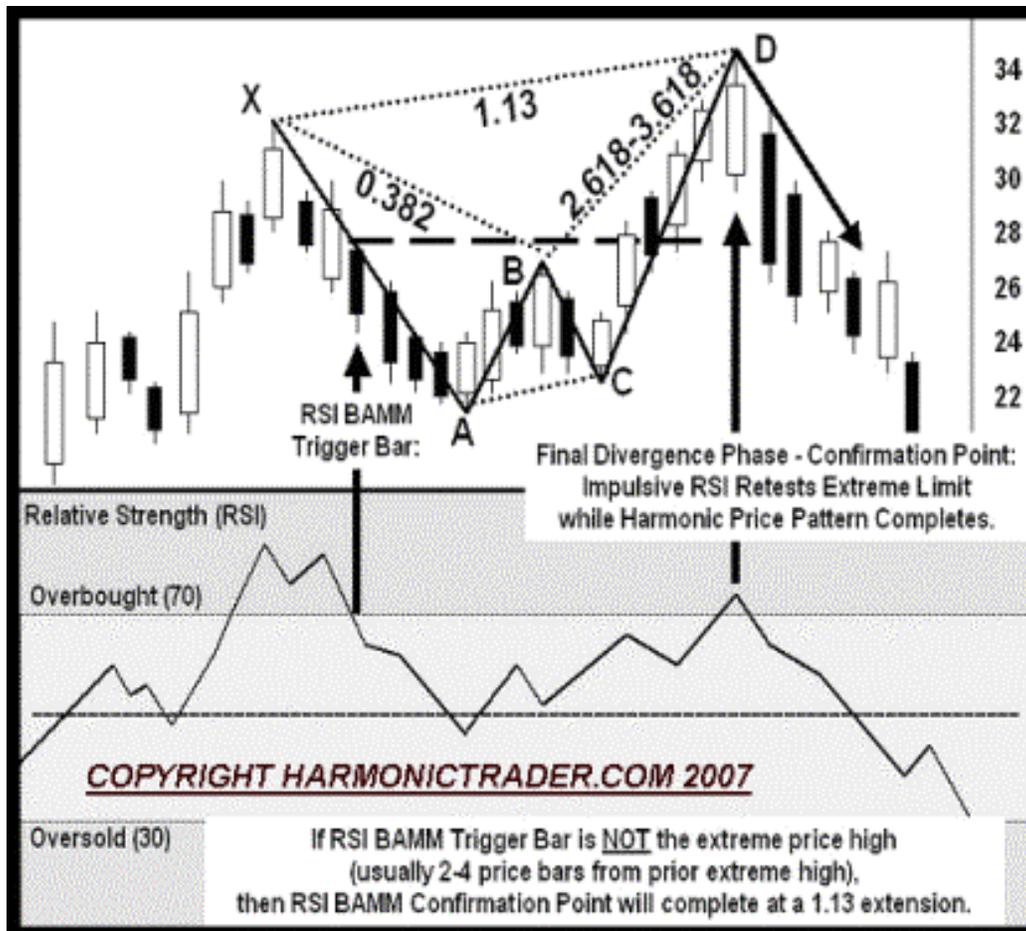
In either situation, the general rule for the confirmation point extension must focus of the location of the Trigger Bar as it relates to the extreme prior peak. If the RSI Bamm Trigger bar IS the high price bar, the 1.618 extension is utilized to quantify the execution area for the trade.

Step 7: Pattern Completion at the RSI Bamm Confirmation Point

After establishing the necessary steps to define the final divergence phase of the RSI Bamm, the integration of harmonic patterns at the confirmation point represents the ultimate advancement of the entire Harmonic Trading methodology. Although the RSI Bamm confirmation point is generally differentiated by location of the Trigger Bar as it relate to the prior high, the price area of execution the trade is defined by the completion of a distinct harmonic pattern in its Potential Reversal Zone (PRZ). The following illustrations show the entire RSI Bamm methodology with various harmonic patterns at the confirmation point.

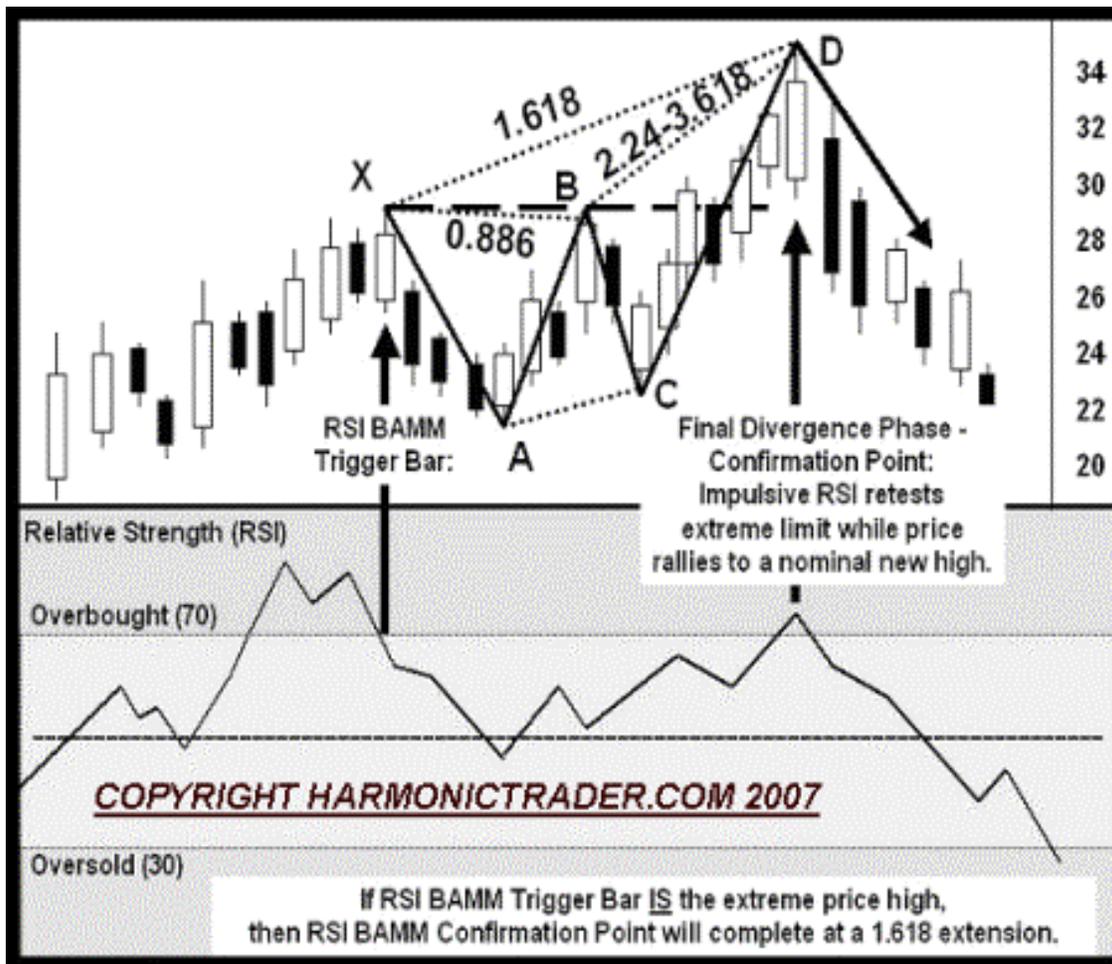
Intermediate RSI Bamm Trigger Bar Signals 1.13 Extension

Although the position of the RSI BAMB Trigger Bar in relation to the prior high defines the execution area of the completion of the RSI BAMB, the formation of distinct harmonic patterns during this final divergence stage is the penultimate confirmation signal for the execution of the trade.



The pattern's Potential Reversal Zone (PRZ) combined with the RSI BAMB extension provides significantly more accurate technical evidence of a probable reversal at hand. In the case of the 1.13 extension, the Alternate Bat is typically the most likely harmonic pattern to complete in this situation. Although other retracement patterns like the Gartley or the Bat may form in conjunction with a 1.13, the position of the RSI BAMB Trigger Bar will typically be 5 or more price bars from the prior high, as I will show a bit later in this chapter.

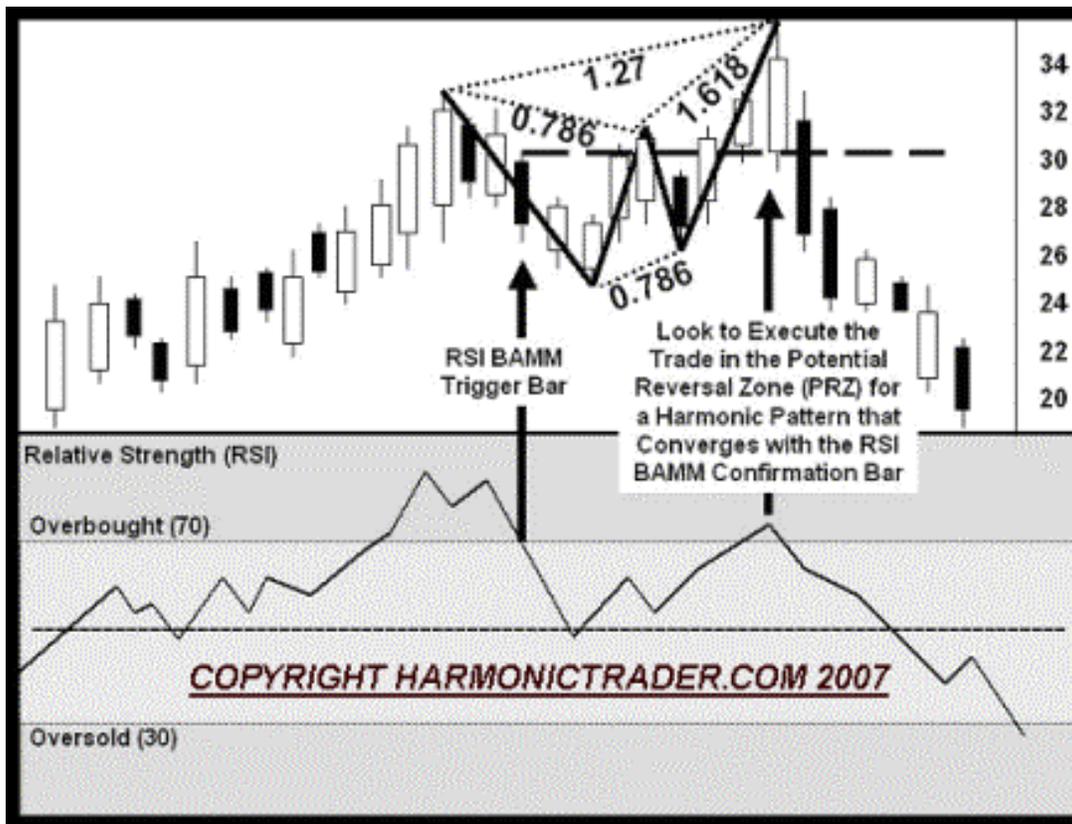
Extreme RSI BAMB Trigger Bar Signals a 1.618 Extension



Similar to the 1.13 RSI BAMB extension, the 1.618 limit is defined by the position of the Trigger Bar. In this case, a Trigger Bar that is the extreme prior high will result in a corresponding pattern that utilizes a 1.618 projection. Within the Harmonic Trading arsenal of patterns, this will usually manifest Crab or Deep Crab patterns.

Pattern Completion in RSI BAMB Area

Sometimes the RSI BAMB extensions (1.13/1.618) create a zone, where a pattern like a Bearish Butterfly completes – typically at the 1.27 XA projection – in the middle of the range. Although this may create some confusion, it is important to remember that the pattern completion point represents the most critical price level in this area.



This underscores the importance of the Potential Reversal Zone (PRZ) within the RSI BAMB limits (1.13-1.618) as the most critical price area for the ultimate execution of the trade.

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