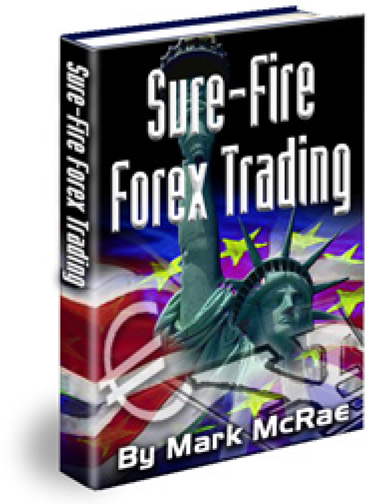


This Lesson Is Provided By

www.surefire-forex-trading.com

Using The CCI Indicator With The Candlestick "Reversal Bar" Pattern

In this lesson I will show you how to combine the characteristics of the CCI indicator along with the Reversal Bar candlestick to form a little trading method. I will be using the reversal bar and not the Key Day Reversal Bar (there is a difference).

First let us look at the basics of these two indicators to help us understand why we should combine them.

CCI

The Commodity Channel Index developed by Donald Lambert is designed to identify cyclical turns in price. It is a momentum indicator, which measures the position of price in relation to its moving average. This signals when the market is overbought/oversold or when a trend is weakening.

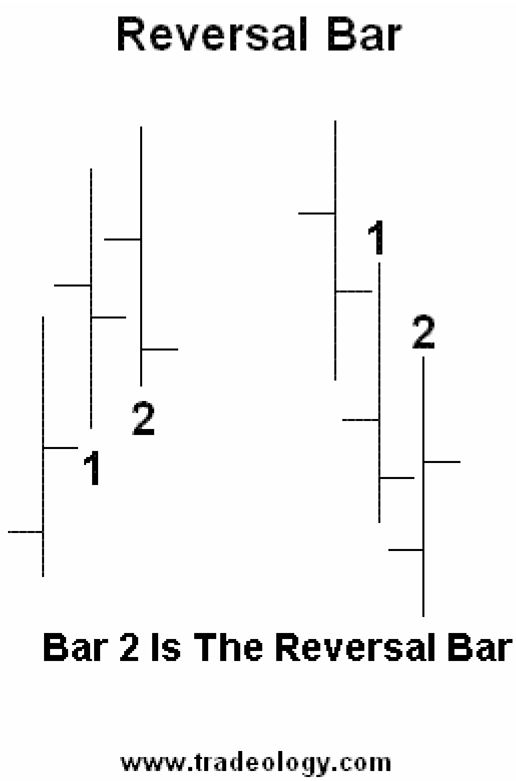
It is represented by a single line, which oscillates between fixed ranges of +200 to -200. In its basic form it can be used in 2 ways –

1. As an overbought/oversold indicator. When the CCI moves above +100, it indicates a strong uptrend and the +200 value would determine the overbought area. Price would be expected to turn down from around the +200 range and a sell order could be placed once it crosses the +100 level down.
2. To determine divergences from the price trend.

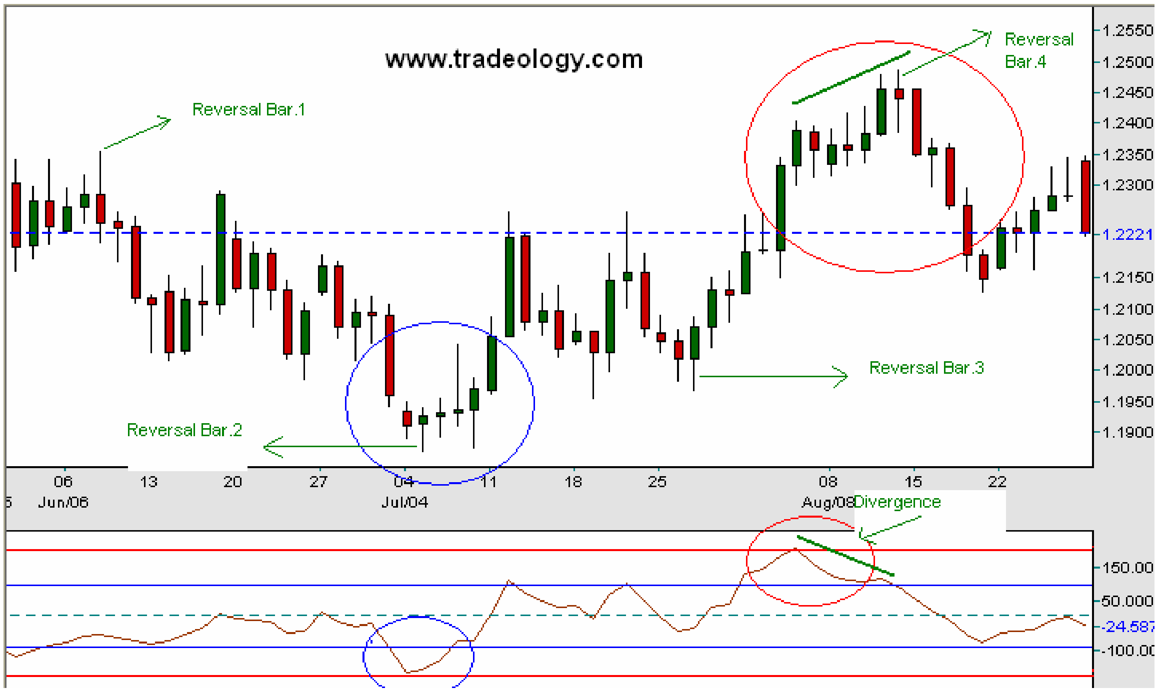
Reversal Bars
These are single candlestick patterns, which are very effective. In the example below I have used a daily chart but these parameters could apply to any time frame.

For an Up Reversal Bar (reverse the rules for a down Reversal Bar) -

- **<u>Reversal Bars work best in a developed trend</u> –** If a trend has been going for some time, then it is reasonable to wonder when it is going to end. The reversal bar can help. If a trend has previously been down, then the reversal bar (bar #2) should make a lower low.
- **<u>Close should be greater than the previous close:</u>** Not only should the price reverse back up, but it should do so convincingly.
- **<u>Close should be greater than the open:</u>** At the end of the day there is more interest in buying the market than selling it.



Ideally one should place a buy order above the high of the Reversal Bar and the stop below the low of the bar (for an up reversal bar). This would help take care of volatile spikes occurring in the next few bars.



I have marked the outside -200/+200 range in red lines, and the mid -100/+100 range in blue lines.

If you look at the example chart above and try to interpret the CCI without taking into account the Reversal bars, which are marked, then we have 2 situations where we have the CCI indicating the change of trend. The potential change in trend is indicated by the fact that the CCI has reached -200 or + 200 and is either overbought or oversold.

The first blue circle shows an oversold situation, where the CCI has turned up from the -200 level. This is an indication to go long and I would wait for the CCI to cross the -100 level before entering a trade.

The second red circle shows an overbought situation along with divergence, which is a strong signal to go short. Similarly, one would wait for the CCI to cross the +100 level down, before taking a short position.

The problem is that the CCI indicator is not strong enough as a stand alone method but when you also use reversal bars as a confirmation, it can be very accurate.

There are 4 Reversal Bars marked on the chart, as these bars satisfy all the 3 conditions mentioned above to qualify as Reversal Bars. All 4 of the reversal bars resulted in a profit but the Reversal bars 2 and 4 occur around the time the CCI was overbought/oversold, which gives the trade an additional confirmation.

Having two factors confirm the signal, shift the odds more heavily in our favor. I would disregard the signals from the Reversal bars 1 and 3, since the CCI does not confirm the signal. It would mean a missed trade but at that time I would not risk my capital on something I was not confident about.

This additional confirmation becomes useful if you are trading on a smaller time frame such as the 4 hour or even the 1hour chart where an occurrence of a reversal bar would not necessarily be an indication of a price shift.

In cases where a reversal bar might be a beginning of a retracement, rather than a change in trend the CCI can be a very good filter. With retracements the CCI generally doesn't reach oversold/overbought areas and would warn us that the reversal bar does not mean a change in trend.

Remember, all these lessons are meant to give you ideas that you can change, improve, test and mold to your own trading style.

Good Trading

Mark McRae