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Rainbow Convergence: Some Charting Magic

eResearch Corporation is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan looks at moving average convergences and what happens to stock prices when they occur.

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Bob Weir, CFA
Contributing Analyst

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February 7, 2019

The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

Rainbow Convergence: Some Charting Magic

One of the chart features that I discuss quite often in my *Daily Edition* is what we call a "rainbow convergence". It is named for the point on the chart where all of the pretty moving average type lines come together. Some of those indicators may be new to some readers, so you can get a quick tutorial on what they mean at this article.

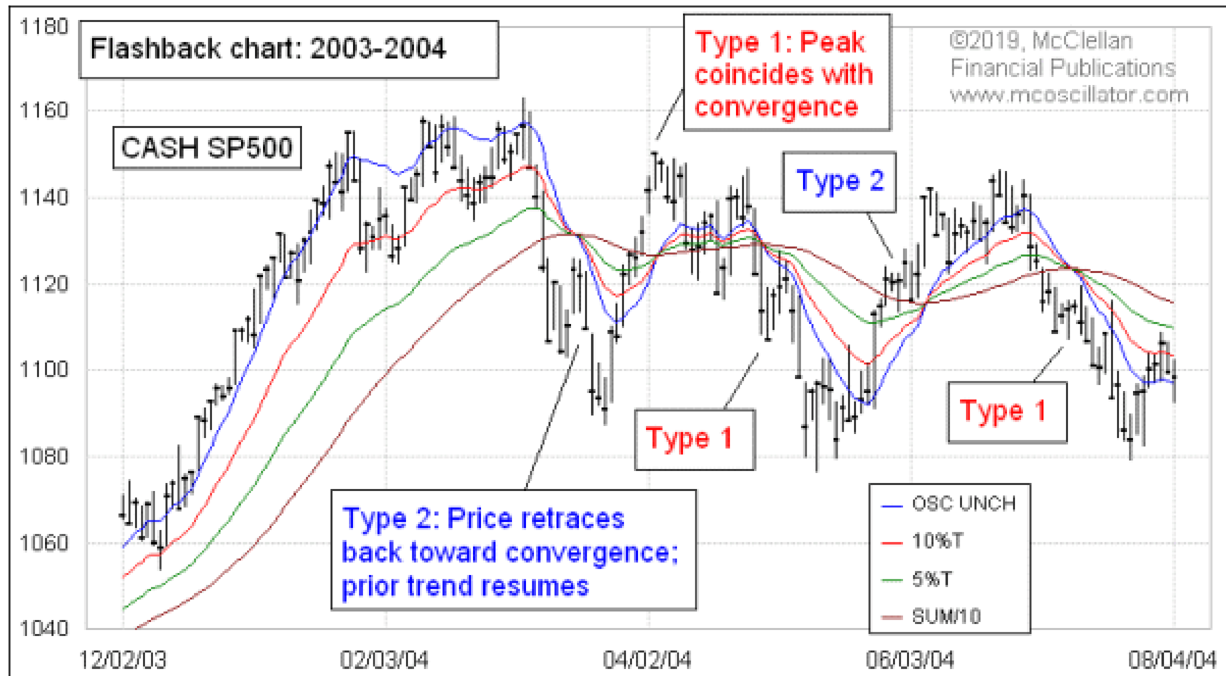
A rainbow convergence can be important to watch because the way that prices behave as it is happening gives us information about what lies ahead. There are two types of price behavior at the moment of a convergence, each with a different meaning.

Type 1 involves prices making an accelerated move which brings about the convergence. A great example is shown in this week's chart. When that happens, the moment of the convergence tends to mark an end to that short-term move, and the entry into a pause. The mission of the pause is to test the blue Price Oscillator Unchanged line, and the outcome of that test governs whether the pause is just a rest break or, instead, is an outright reversal. In the case of that October 2018 rainbow convergence, prices retraced back to the blue Price Oscillator Unchanged line, but not through it, and the down-move resumed.

Type 2 happens when prices retrace back toward the price-time point of an impending rainbow convergence, but not through it, and the implication is that the trend which preceded the retracement should resume itself. This week's chart also shows an example of that phenomenon, and sure enough the uptrend which preceded the retracement back toward the convergence was resumed after that retracement.

These two in the top chart are not the only instances of this phenomenon happening.

Here is a chart of these indicators from 2003-04 which does a good job of illustrating that this is a durable phenomenon.



Interpreting an impending rainbow convergence is a little bit harder to do in real time. One has to watch what prices are doing as the moment of the convergence approaches. And it is always possible that a potential Type 2 retracement might actually keep going and cross through all of these lines, thereby negating the meaning of a retracement back toward the convergence. One has to watch out for that.

You can watch this phenomenon yourself, and you don't need all four of these lines on the chart. The middle two are sufficient, and they are easily calculated in any charting platform. They are the 10% Trend and 5% Trend of closing prices. Some people would call those a 19-day Exponential Moving Average (EMA) and a 39-day EMA, but we prefer the originalist terminology for them coined by Pete Haurlan in the 1960s, when he introduced the use of EMAs for tracking stock prices. When those two EMAs cross, all of these lines cross, so for the purposes of tracking this phenomenon, they are sufficient.

<continued>

It is worth noting that this phenomenon is not exclusive to just these two EMAs. Here is the DJIA from 2007-12 with its 50-day Simple Moving Average (SMA) and its 200-day SMA:

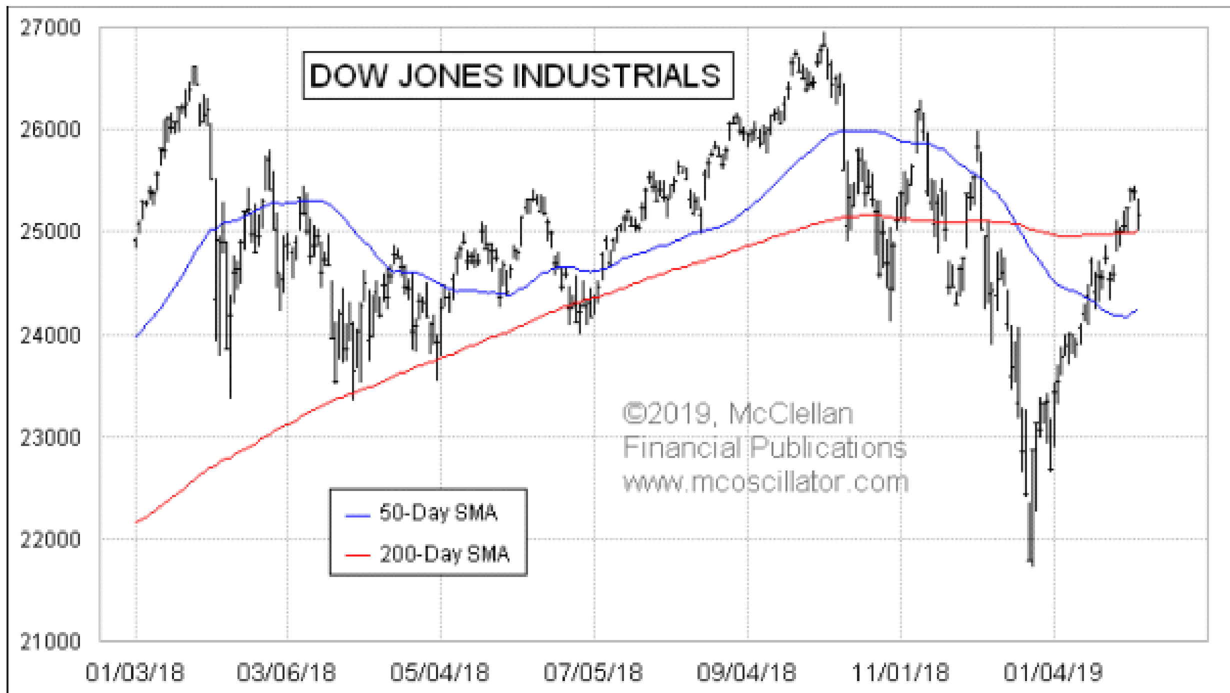
I picked that period as an example because it has a nice collection of both types of convergences. When the 50-day and 200-day SMAs cross, some analysts call that a "Golden Cross" or a "Death Cross", depending on if the 50 is going up or down through the 200. I have noted before that the Death Cross does not always live up to its hype as a bearish indication, and this point about the behavior at the time of the convergence helps us to understand why.

The same principle works for these two MAs. The behavior of prices at the time of the convergence tells us about what lies ahead. So a move that gets exhausted just as the lines are coming together is likely all done at that point. But a retracement back to the crossing point says that the preceding move should resume itself.

I have not tested all possible combinations of moving average speeds to see if it works everywhere; you are welcome to do such testing if you wish.

This principle of how to interpret a "Death Cross" did come up recently. The two MAs for the DJIA crossed on December 19, 2018, just 3 trading days ahead of the December 24 bottom. The big accelerated move which brought about the crossing ended at almost the exact moment of the convergence of those two SMAs.

See the chart on the next page.



So the key takeaway of this is that the meaning of two moving averages crossing is not always the same. It depends on what prices are doing at the moment of that crossing, and that is important to remember for anyone seeking to make such interpretations.

Tom McClellan, Editor,

The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* is provided on the following page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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