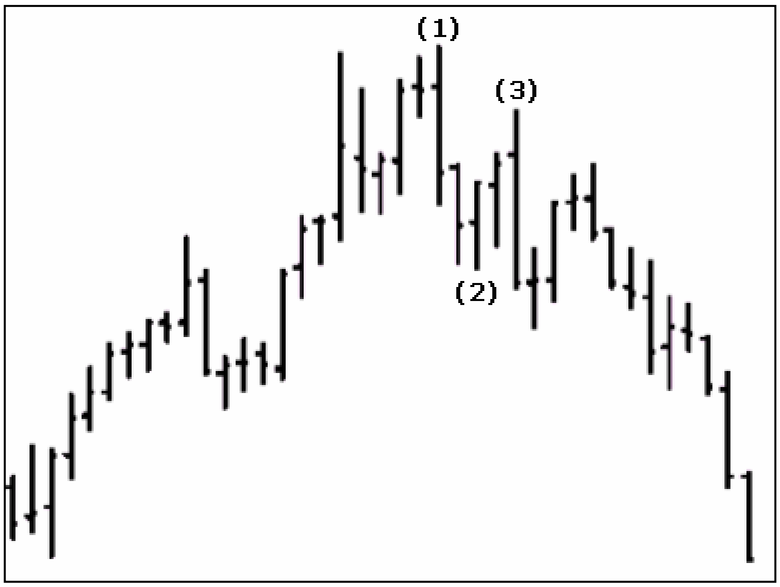
Trading Stochastic Crossovers with 1-2-3 Top Formations

By Joe Ross

1-2-3 TOPS

We begin this article by defining a 1-2-3 top.



A 1-2-3 top is formed at the end of an uptrend. Typically, prices will make a final high (1), correct downward to point (2), where a move begins leading to point (3). At that time, what appears to be a resumption of the former trend [the move from (2) to (3)], fails to continue, and prices move down towards (2).

SEARCHING FOR AN ENTRY TO GO SHORT

1-2-3 tops give us a chart formation from which we can determine where prices might have reversed trend. In order to gain an early short entry at the higher price levels, we filter the 1-2-3 top formation with simple Stochastics. The combination of the formation and the indicator help us to properly time the entry to sell short.

Being able to enter a winning trade in a timely manner is basic to success, and affords the opportunity of gaining a free trade. Getting a free trade is important. My method of trading involves covering costs and taking a profit as quickly as possible. That way, the rest of the trade is free.

Getting a free trade goes hand in hand with getting paid to trade, which should be a fundamental objective of every trader. As a speculator, you are undertaking risk. Therefore, you must make every attempt to be paid for the risk that you take. Timely entry enhances that attempt.

When trading 1-2-3 top formations, we want to get in ahead of the actual breakout of those price levels that are deemed to be important when a trend has finished moving in one direction, and begins to move in the opposite direction. If the breakout is true, the result will be significant profits. If the breakout is false, we will have at least covered our costs and taken some profit for our effort.

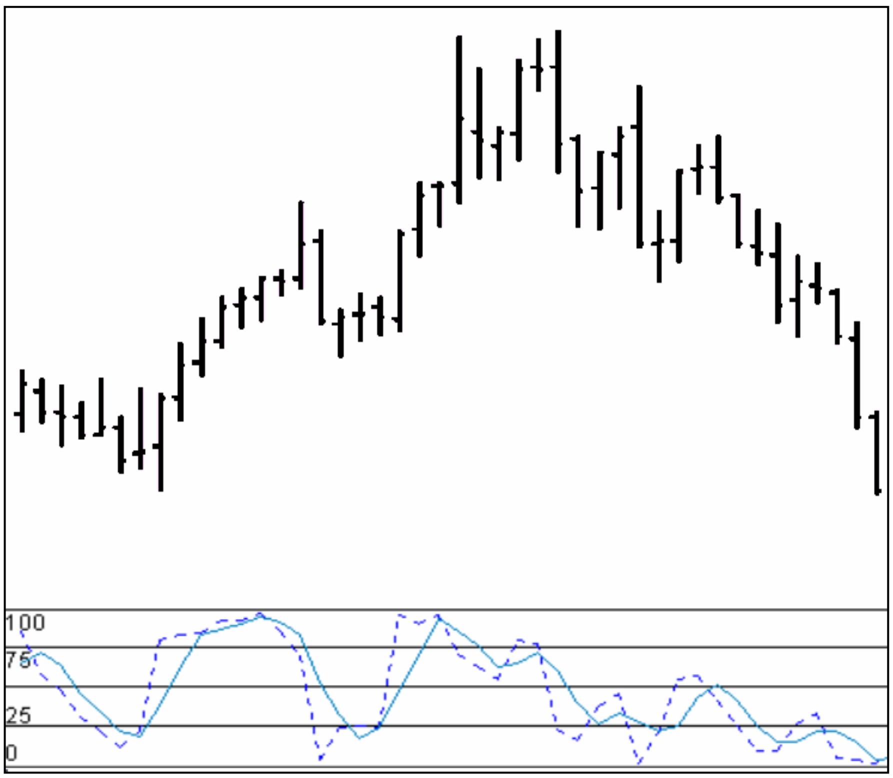
When prices begin to move counter-trend to the direction they were previously moving, it is imperative for us to know that this is happening. More than that, we want to know before other traders know it is happening. To accomplish this, we use a filter for the 1-2-3 top.

What are the important price levels at the time a new trend begins, and how can we spot them? The 1-2-3 top gives us the answer. As you will soon see, the (2) point is very important.

It is essential to be sure that prices have actually begun trending in the opposite direction before attempting a trade in that direction. To do that, we must use some sort of filter. To use a filter, we need to be sure we understand what that filter is, and how to properly use it.

FILTERING THE ENTRY WITH A SHORT-TERM STOCHASTIC SETTING

The filter we are going to use has come to be called "Stochastics," even though there is nothing stochastic about it. Stochastics is available on virtually all trading software. For the program we are using to present this, we set the parameters at 5,1,3. This may differ from a program you might use which may set them at 5,3,1.



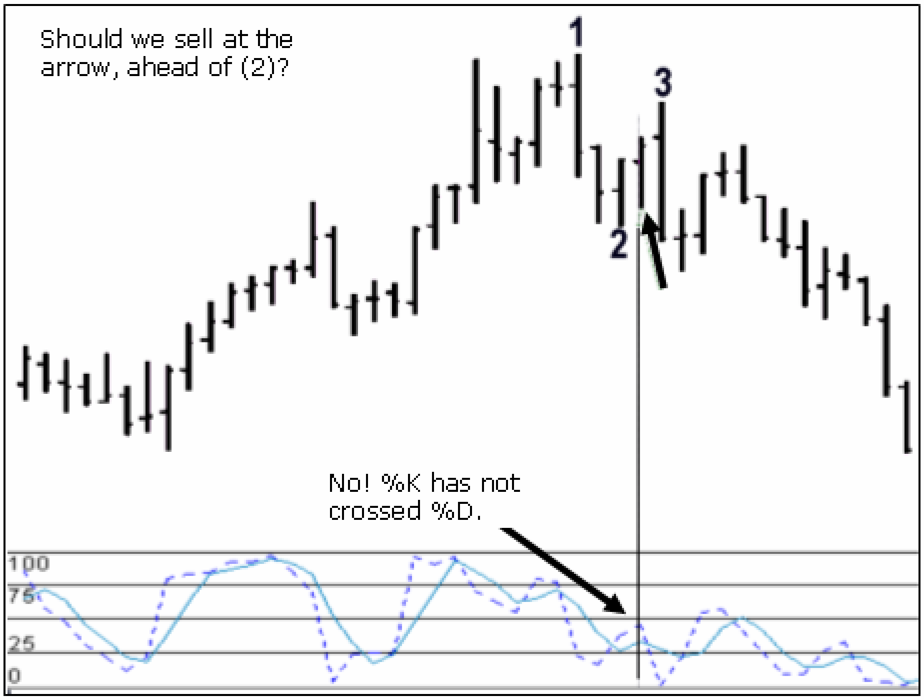
The setting of '5' is the number of bars (daily, in this case) we are using for the calculation. The number '1' is the setting for %K, and the number '3' is the setting we are using for %D. %K represents the moving average of the stochastic values, and is the dashed line on the next chart. %D is a '3' bar moving average of the '1 bar' moving average, the solid line.

Be aware that these settings make for an extremely sensitive study. However, if we are going to use an indicator here, we want it to be very responsive to the price movements. There are two valid signals available when working with the Study and 1-2-3 tops.

1. Buy and sell signals are based entirely on a crossing of the "D" plot by the "K" plot.

2. Divergence indicates that a violation of (2) should not be taken, because the trend may not be ready to end. Now let's put that into practice.

Question: Should we sell short ahead of a violation of (2)? The answer is seen on the next chart.



How about on this next chart, should we sell at the arrow ahead of a violation of (2)?

Again, the answer is no. Why? Because %K has not crossed %D

Let's ask one more time. Is it time to sell short at 1 tick below the bar being pointed to by the arrow.

This time the answer is yes! %K has crossed %D.

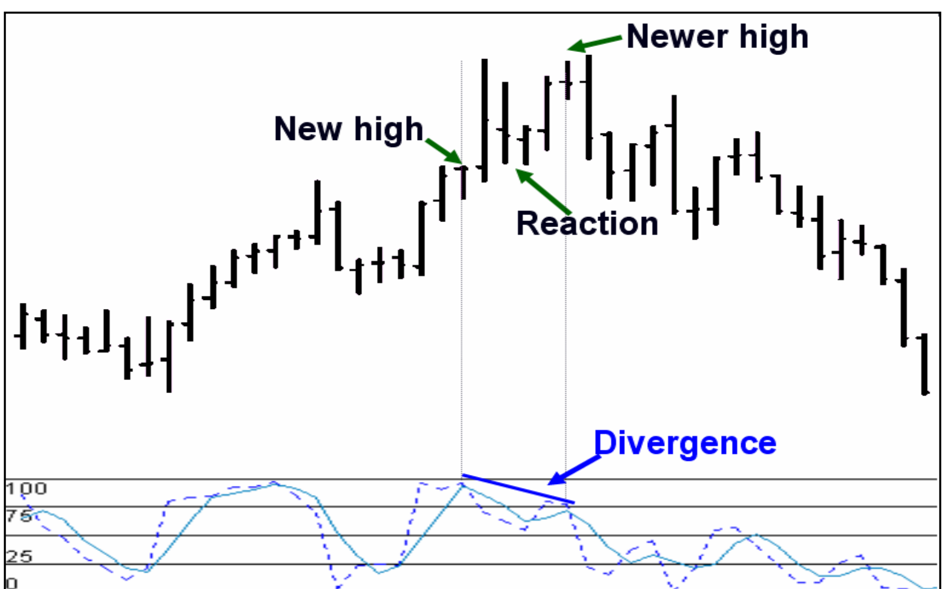
Why did we use Stochastics as the filter? Because the method is based upon an observation: As price increases, daily closes tend to accumulate closer to the highs of the daily range. The opposite is also true: As price decreases, daily closes tend to accumulate closer to the lows of the daily range. This observation is derived from intraday monitoring of closes, but works in any time frame.

What is happening here is when prices have made a new high, then react, and subsequently move to a higher high, while corresponding peaks of "D" make a high and then a lower high, *a bearish divergence has taken place*. This affords us a warning that the ascending trend may be almost over. Let's see how that happened on the chart we've been viewing.

Our use of Stochastics as a filter for the (2) point is quite apart from the way most people try to use this study. Most users of Stochastics try to find "overbought" and "oversold" situations by viewing Stochastics relative to a fixed scale that attempts to measure momentum but, as you can see, we don't care where Stochastics are relative to a scale. We simply want to know where %K and %D are relative to one another.

Now, how do we manage this trade?

MANAGING THE TRADE AFTER ENTRY



We begin with the concept of using sets of three. Three one lots, three five lots, three two lots, all according to what you can afford with your margin account. If you can't trade three one lots, then trade two one lots. Anything less than that means you are severely undercapitalized and have virtually no management capability whatsoever.

With sufficient capital to manage the trades, you cash one contract as soon as you can cover costs and extract a profit. The profit does not have to be large, but the amount is strictly up to you. We cannot possibly know how much profit will be satisfactory to you. Certainly we would not expect to take as much profit from a grain trade as from a stock index trade at this point.

Once you have covered costs and taken some profit, the next step is to move forward any protective stops for the remaining two-thirds of your position. Once again, we cannot tell you where to move your stop. No one can, and if someone tries, we suggest you run as fast as you can away from that person. Only you can know where those stops should be. They should be placed within your comfort zone.

Whether you move both protective stops to the same price level or separate them is entirely up to you. Believe us when we say that no one can tell you where to place your stops. It will pay to experiment with how many contracts to use for profit taking at each point in the trade. For instance, with a ten lot you may find that it pays to liquidate contracts in this way: 6, 3, 1, allowing the last contract to trail as far as it will go. It is much easier to reach your first objective for a trade than it is to reach the last.

I know! You want to know where to place the protective stop. I can't tell you that because it is different for every individual. You could have placed your initial protective stop loss one tick above the entry bar, and, in fact, on this particular trade that is exactly what I did. When I filter my trades with Stochastics in the manner in which I showed, I feel pretty safe in placing my initial stop in that manner.

By doing that, I am allowing the market to dictate to me where the stop should go. However, placing a stop there might be uncomfortable, in which case I either use a smaller stop, or stand aside because the stop is simply greater than my comfort level will allow.

Joe Ross, trader, author, trading educator has been a trader for over 4 decades.
He is one of the most eclectic traders in the business. His trading experience includes position trading of shares, and futures. He day trades stock indices, currencies, and forex. He trades futures spreads and options on futures, and has written books about it all - 12 to be exact. Joe is the discoverer of The Law of Charts™, and is famous for the Ross hook™ and the Traders Trick Entry™.

He still trades regularly. His company, Trading Educators, Inc., is dedicated to teaching people not only how to trade, but how to make money trading.
You can learn more at

http://www.tradingeducators.com/