The Close is the Key

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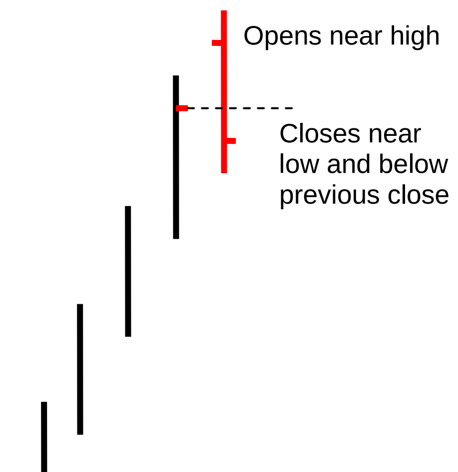
There are two very closely related reversal signals that traders should be able to recognise and adjust their tactics when they see them. One is quite subtle and is not recognised by many market observers. The other is a very dramatic event in terms of what traders may have experienced psychologically during the day. While they will feel that something important has happened, they may not recognise it as a very important reversal pattern.

Closing Price Reversal

The closing price reversal occurs reasonably frequently. The first requirement is that the price is trending up. An uptrend is a series of price bars that have higher highs and higher lows, relative to the bars that preceded them. This may not be a perfect series. There may be some non-trending bars in the series. There may even be a bar or two that reverse the trend temporarily. However, the general direction of the bars will have been to make upward progress over time.

When a regular trend unfolds in this way, with the price rising on most days compared to the previous day, traders will be fairly pleased with themselves and quite relaxed. In the best trends, the closing price will be higher each day, sometimes by a lot and sometimes by only a cent or two. However, it will be higher.

Then, one day there will be a price bar which closes lower than the previous day. Since this happens reasonably often, many traders are likely to notice that the closing price was lower, but see it only as a minor and hopefully temporary interruption to the trend. However, it may be more important than they think. Most of the time it will only signal a pause in the trend, which may be quite short. On the other hand, it could be a more protracted pause. Even more importantly, it could be a warning that the trend may swing from up to down. This may be a minor trend change, or it could be something bigger.



Closing Price Reversal

Some traders even talk themselves out of worrying about this reversal signal. They do not recognise it, but know something is not right. They examine the chart and see that the last bar has a higher high and a higher low than the one before it. They console themselves that the trend is still intact. They are right. The trend has not changed. But the lower closing price is the indicator of the closing price reversal and if they can recognise it, they will become better traders.

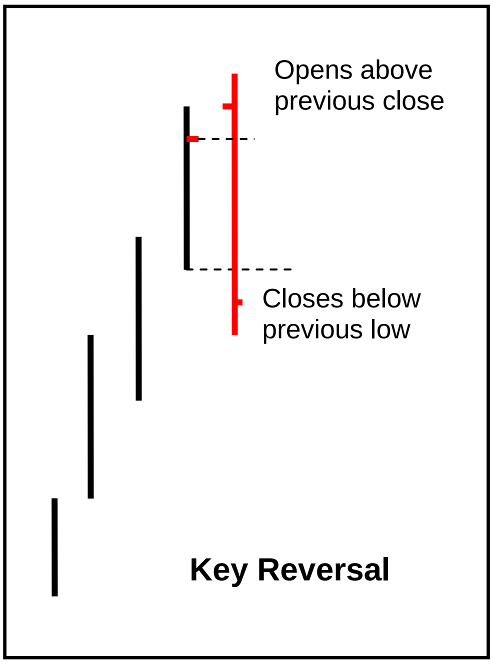
The diagram labelled *Closing Price Reversal* shows the necessary elements of the pattern, which are:

- There is an uptrend.
- There is another uptrending bar – it has a higher high and a higher low than the previous bar
- Its opening price is near the high of the day
- Its closing price is near the low of the day
- The closing price is lower than the closing price for the previous bar

Recognising the closing price reversal is only the first step. The important step is to decide what to do about it. All trends pause from time to time, so it would be premature to sell out in a hurry. However, it would be prudent to guard against the other possibility, which is that the trend could change from up to down. It may therefore be prudent to tighten up the level at which traders would sell to protect their profits. For a very short-term trader, this might mean moving a stop-loss level up to just below the low of the closing price reversal bar.

Key Reversal

The other reversal signal has many similarities to the closing price reversal. It has some important differences that make it a far more potent signal psychologically. Chartists have termed it a ***key reversal***, because it can be a very significant signal. It is often, but not always, found at important turning points in uptrends. So it behoves traders to be able to recognise it and know what to do when they see it.

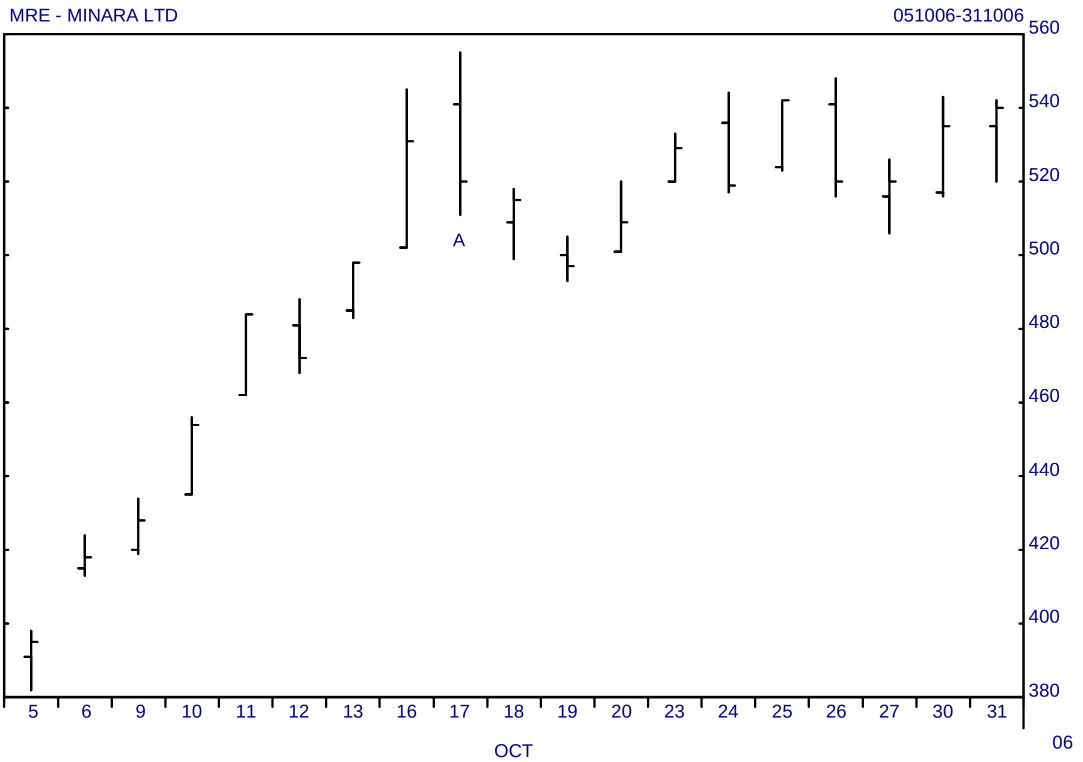


As with the closing price reversal, there will be an ongoing uptrend leading into it. The new day will open higher than it closed the night before. Traders will feel quite secure at this and when the price then moves even higher. Soon, the price starts to slip back. As the day goes on it falls further and further. This is very tough on the psychology of traders. Falling prices discomfort them, even though they know all markets fluctuate within the uptrend. As the price falls further, traders start to panic and sell, so that the price falls even further. When it falls below the low of the previous day and trading closes down there, every trader who bought on the previous day and most who bought today will be suffering losses on paper. Some will have seen their unrealised profits washed away completely.

The diagram labelled *Key Reversal* shows the necessary elements of the pattern, which are:

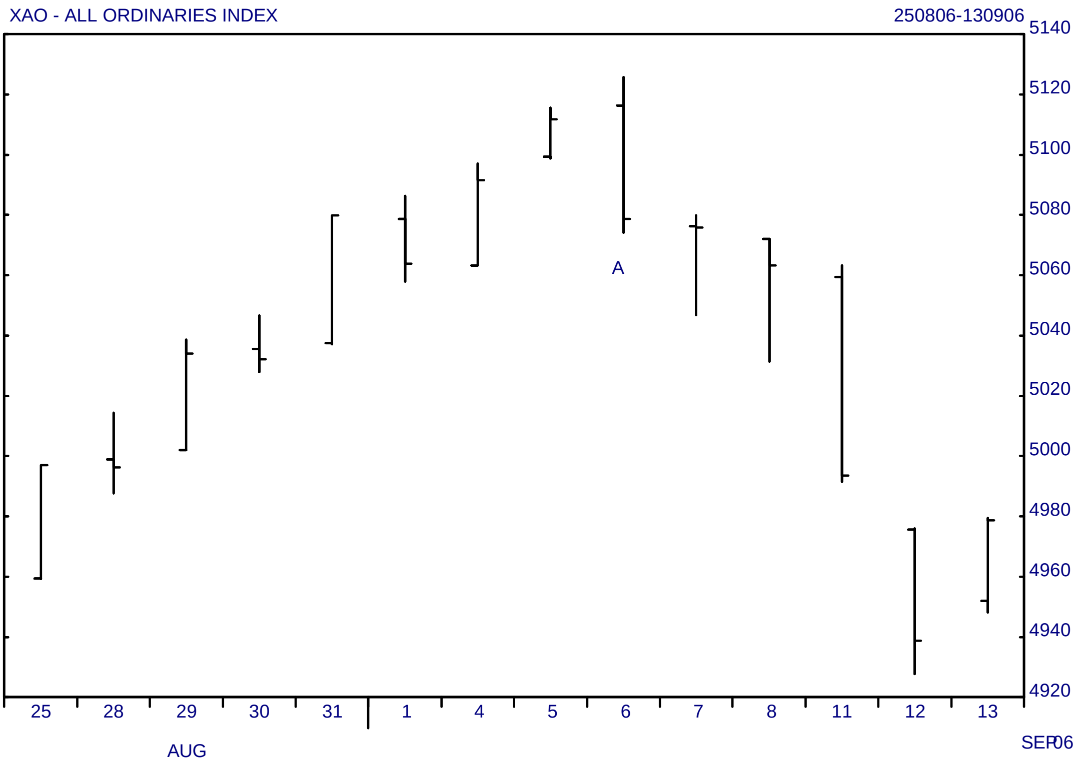
- There is an uptrend.
- The opening price of the next bar is higher that the closing price on the previous bar
- The price moves higher after the opening
- The price falls lower than the low price of the previous bar
- The closing price is lower than the low of the previous bar

Like the Closing price reversal, recognising the key reversal is the important first step. It is also useful to realise that key reversals are more likely to lead to a change in the direction of the trend, than other reversal signals, at least in the immediate future. Key reversals are also not unknown at important peaks in bull markets. It is therefore even more important for traders to bring the levels at which they will sell to protect their profits up to quite close to the low of the key reversal bar.



Minara (MRE) Daily Bar Chart

A good example of the closing price reversal occurred on the daily bar chart of Minara. The chart begins with a strong and consistent uptrend from 5 October 2006. On 17 October (the bar marked A), Minara opened above the previous closing price. After going a little higher, it fell well back into the range of 16 October and closed lower than it had the previous day. If traders had moved their level at which to sell to protect profits up to just below the low of the closing price reversal bar, they would have sold on 18 October. This would have kept them out of an essentially sideways pattern for ten days.



All Ordinaries Index Daily Bar Chart

Reversal signals also occur on index charts. On 25 August 2006, a very strong uptrend began on the daily bar chart of the All Ordinaries index. On 6 September (marked A), the market opened higher than it closed the day before and kept rising. Then it began to fall. It closed a long way below the previous low. This was a dramatic key reversal. Smart traders would have recognised the danger and moved up the levels at which they would sell to protect their profits, getting out of any holding quite quickly, if it fell next morning. This would have avoided the very sharp four-day fall that wiped out all the gains from 25 August.

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