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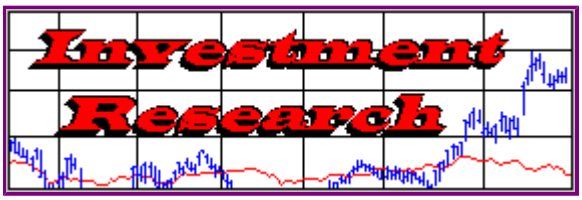


Introducing the MIDAS Method of Technical Analysis (16)
by Paul Levine

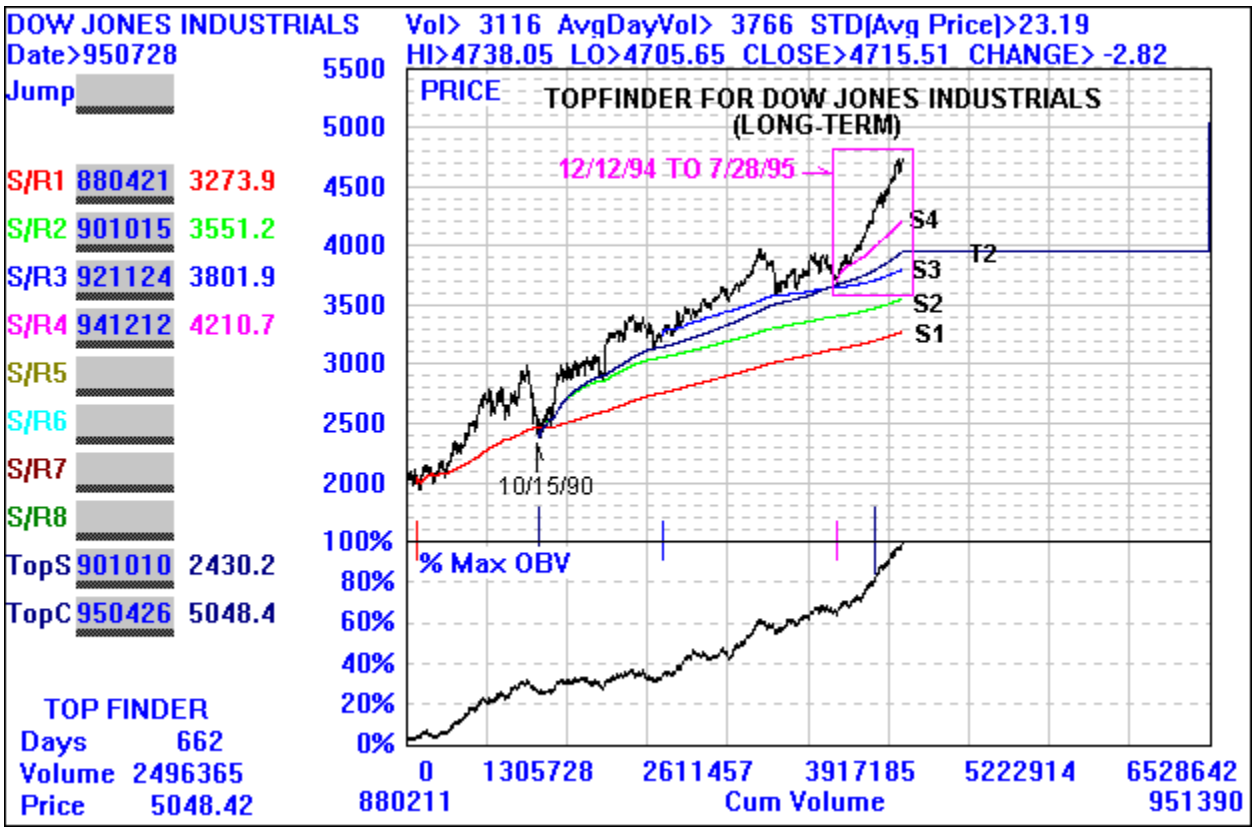
This is the sixteenth article in a series. Click here to go to the first, second, third, fourth, fifth, sixth, seventh, eighth, ninth, tenth, eleventh, twelfth, thirteenth, fourteenth, or fifteenth article.

We have thus far applied the MIDAS method of technical analysis to individual stocks, although we speculated at the outset that its applicability extended to markets in general. To the extent that all markets are driven by the same basic psychological factors, this is perhaps not too unreasonable an idea. In the few remaining articles of this series, we will therefore look at some new types of market data from the MIDAS perspective. We begin here with stock market indices.

Market indices are simply the weighted averages of the prices in a subset of the universe of stocks. The "Dow" (Dow Jones Industrial Average) uses thirty high capitalization companies at the core of the American economy. The S&P-500 is based on a broad cross section of medium to high capitalization companies spanning the whole range of economic activities. The NASDAQ Composite Index has as its focus newer and more dynamically changing enterprises. Each index thus represents a different facet of the economy, or - more properly - the consensus view or paradigm of the near to intermediate term (6 months to a year) prospects thereof.

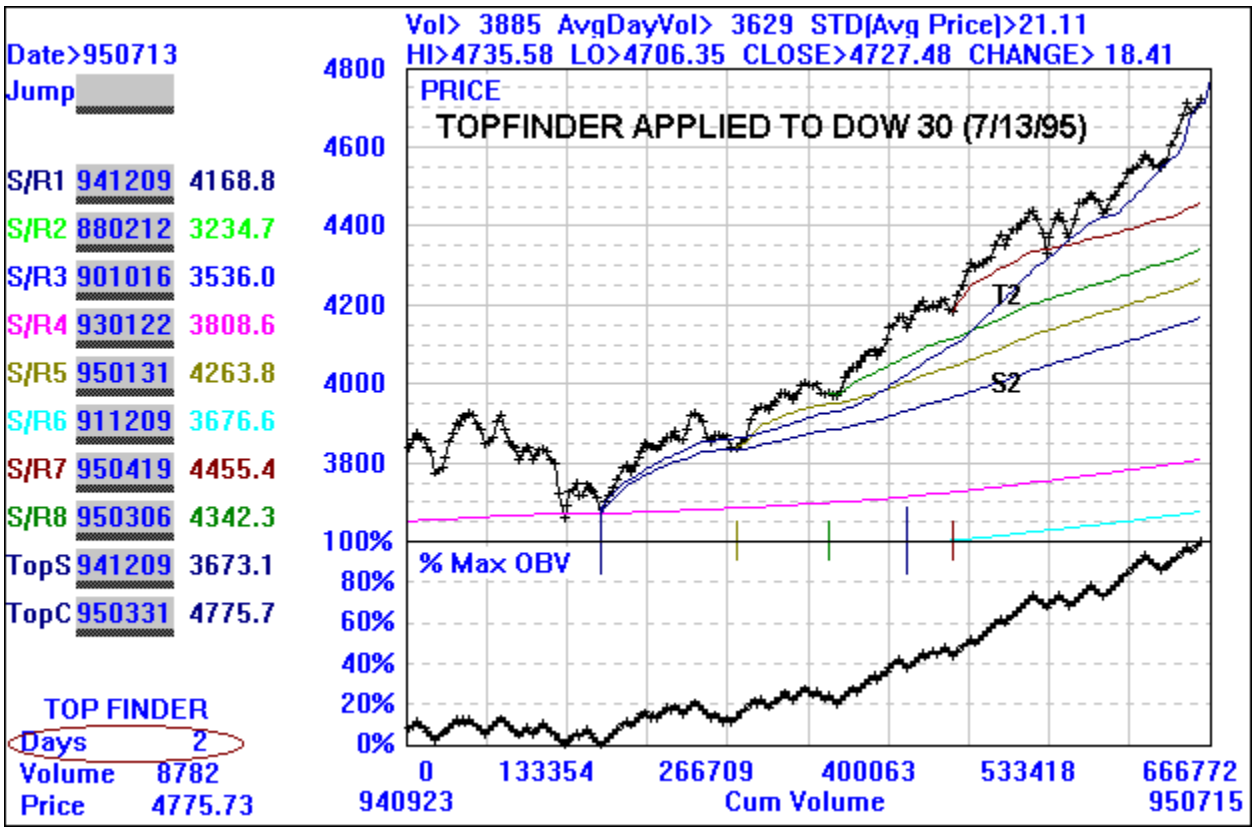
Recalling our earlier analogy (cork floating on the ocean) that individual stocks are strongly coupled to the market "tides", then one would expect that the zig zags in market indices should parallel those seen in individual issues. In filtering out the individual idiosyncrasies of single stocks or stock groups, the indices preserve the most basic aspects of the herd psychology, or as it's more delicately phrased, the "mood of the market". Since MIDAS tries to quantify this psychology, there is hope that it will have some applicability.

Without further preamble, then, in the first figure we apply the full MIDAS armamentarium to the Dow from 1988 to the present. (We shall henceforth display only charts generated by the WINMIDAS software, since - captioning aside - the entire chart can be produced from scratch in well under five minutes!) If we restrict attention to the seven year period prior to December 1994, it is seen the Dow was reasonably well characterized by a three-tier hierarchy of MIDAS support levels, with a pullback to S3 in mid December 1994.

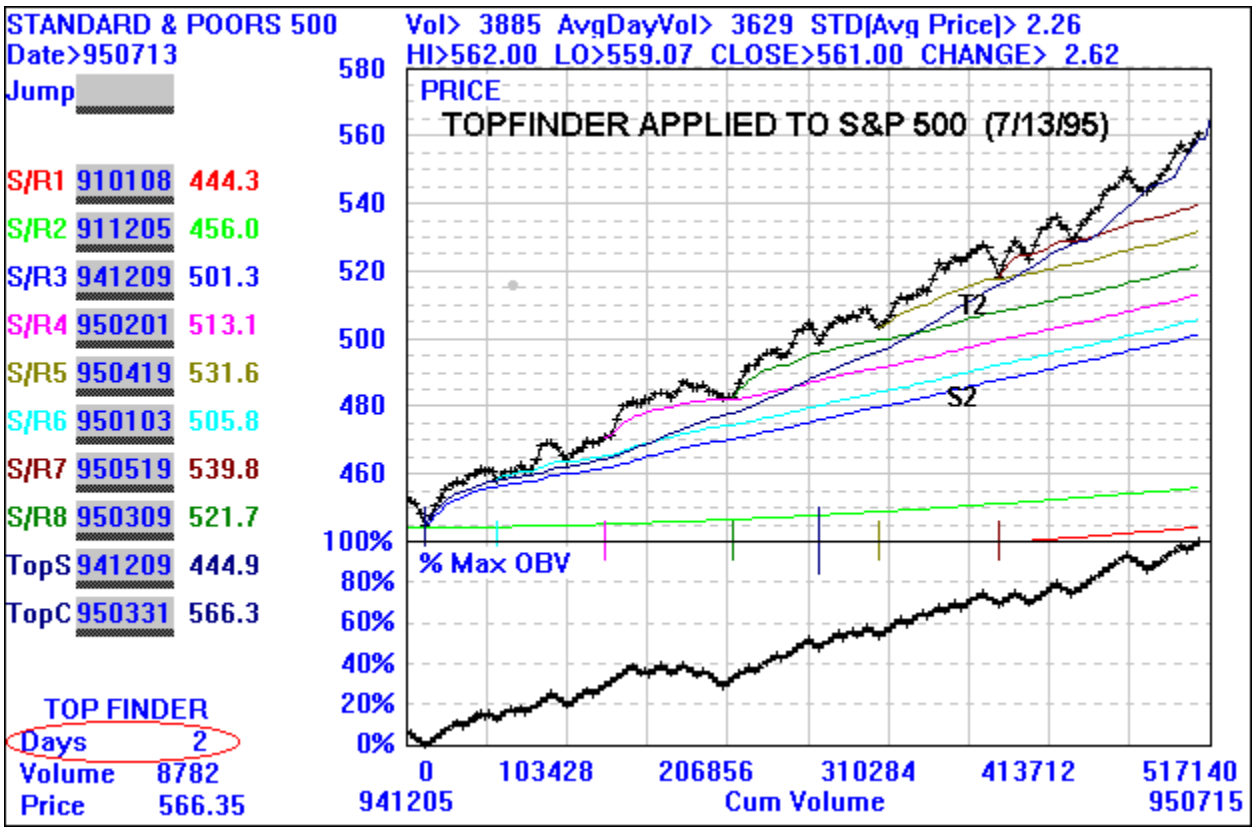


Furthermore, a TOPFINDER (T2) launched on 10/15/90 did a good job of accommodating the three main trend reversal points in that time period. The fact that this TOPFINDER has about 662 trading days (about 2 1/2 calendar years) of "fuel" left leads one to be generally sanguine about the long term trend of the market and - by implication - of the economy over this future span of time.

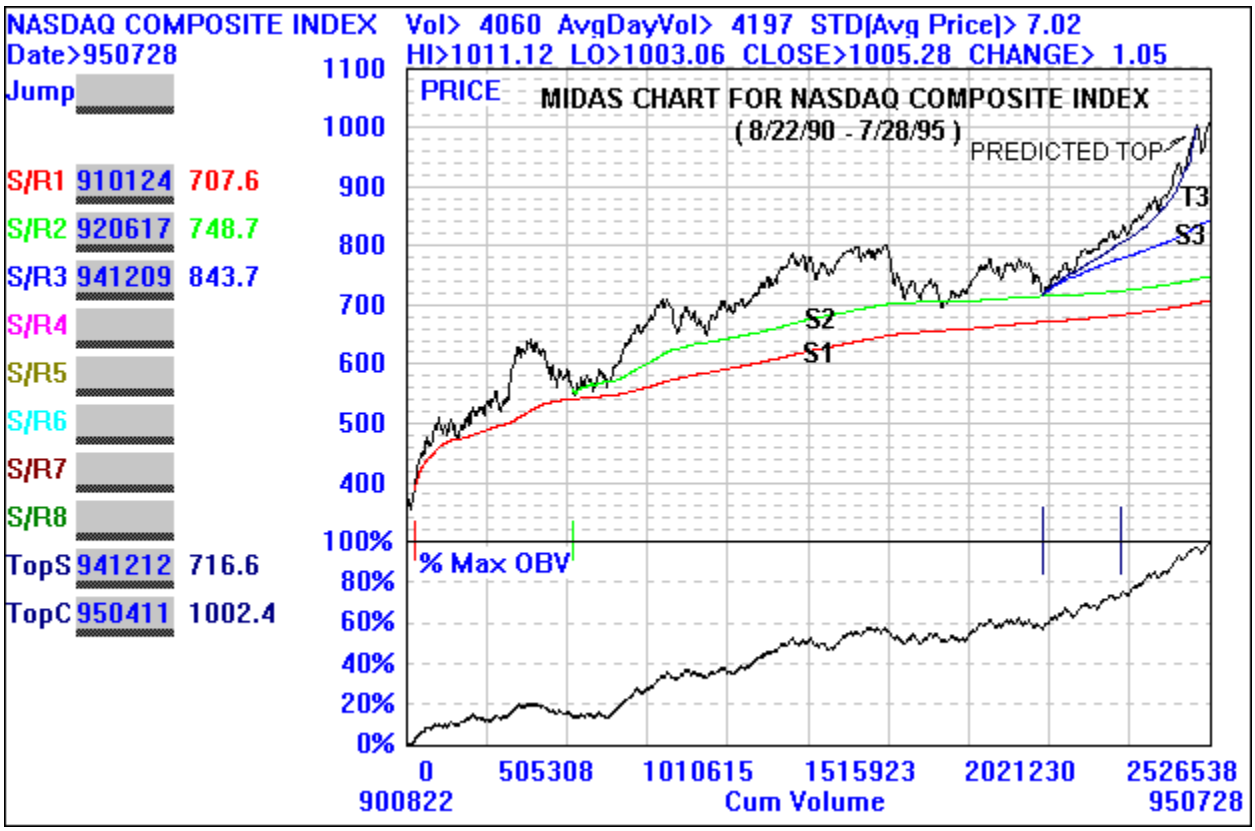
Since December of 1994, the market has taken off on an uncharacteristically monotonic rise which has every technician asking "where will it end?". Accordingly, in the second chart we apply TOPFINDER to this rise in the Dow. (To appropriately dovetail with the first chart, the labels here should read S4 and T4). The chart was generated on 7/13/95 and at that time we circled ("ellipsed" would be more appropriate) the fact that TOPFINDER gave the market only two more trading days until a predicted top of 4775 on July 17th.



Ominously, when a corresponding MIDAS chart for the S&P 500 was generated at the same time (see the third figure), TOPFINDER predicted a top in this index as well two days hence. As we shall see presently, ditto for the NASDAQ. So we have the quite remarkable circumstance that the same algorithm applied to three distinctly different market indices was predicting a top at the same time! (It must be freely admitted, however, that prior to July 13th the ambiguities inherent in fitting a two-parameter curve to rapidly rising price data did lead to premature expectations of the top; however by July 13th a sufficient number of zig zags were in hand to define the TOPFINDER fairly unambiguously).



So what happened? On July 17th the Dow reached an intraday high of about 4770, and then proceeded to sell off sharply in the next two days reaching an intraday low of about 4530 on Wednesday the 19th. 240 Dow points top to bottom in two days! A triumph for TOPFINDER? Maybe, maybe not. For as seen in the fourth figure which is a MIDAS chart for the NASDAQ Composite Index, generated after the close on July 28th, the sharp drop subsequently reversed itself and we are now back to where we were on July 17th (in fact slightly higher).



The ultimate verdict on TOPFINDER's utility in timing the market is therefore still with the jury. If the market henceforth extends its gains over a time span of more than a few weeks (which we could view as a reasonable margin of error in top prediction) then the only conclusion that can be reached is that TOPFINDER by itself (i.e. without the use of supplementary indicators) is not a reliable timing tool for market indices. My suspicion is, however, that TOPFINDER does have some truth in it. Perhaps it catches the top of the left shoulder in a head and shoulders top, or the first top in a double or triple top formation. Or maybe in this case at least MIDAS has come up with "fool's gold"! Time will tell.

TOPFINDER aside, the MIDAS S/R hierarchy does in fact appear to be useful in characterizing trend reversal points in market indices, as was seen in the first figure. At the very least, it provides downside targets (i.e. expected points of at least temporary support) in any selloff which might materialize. If the market should appear to be bouncing from such a theoretically predicted level one would take such a bounce seriously. Thus MIDAS can be viewed as an otherwise unavailable filter for deciding whether a given bounce is tradable or of the "dead cat" variety.

In the next article we will look at commodities and foreign markets.

Return to Investment Research

Paul Levine first became interested in technical analysis when he was a "runner" on Wall Street as a high school student. After graduating from MIT and gaining a PhD in theoretical physics from CalTech, he took a fresh look at the problem some thirty years ago and stumbled upon what has now evolved into the Midas method. Following retirement as Chief Scientist and a co-founder of Megatek Corporation in 1981, he developed further elaborations of the method and is now in his fourth year as a professional trader. He can be reached via e-mail at WinMidas website**">winmidas@winmidas.com or visit the WinMidas website**.

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