

"Sharpening Your Trading Skills:" The Directional Movement Index

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A technical indicator I use to determine the strength of a market trend is the powerful Directional Movement Indicator (DMI), also called the Directional Movement System.

I'll explain the basics of the DMI to you first, and then, importantly, I want to share with you how I use the DMI, as well as other computer-generated signals such as the Relative Strength Index (RSI) and Slow Stochastics in my trading decisions.

The DMI is a trend-following system developed by Welles Wilder. The Average Directional Movement index, or ADX, is part of the DMI and determines the market trend. When used with the up and down Directional Indicator (DI) values--Plus DI and Minus DI--the Directional Movement Indicator is considered a trading system.

The rules for using the Directional Movement Indicator are: You establish a long position whenever the Plus DI crosses above the Minus DI. You reverse that position, liquidate the long position and establish a short position, when the Minus DI crosses above the Plus DI. There are some other rules to help prevent getting whipsawed by choppy markets, but I won't touch on them here.

For some traders, the most significant use of the ADX is the "turning-point" concept. First, the ADX must be above both DI lines. When the ADX turns lower, the market often reverses the current trend. The ADX serves as a warning for a market about to change direction. The main exception to this rule is a strong bull market during a blow-off stage. The ADX turns lower only to turn higher a few days later.

I use the DMI mainly to determine the strength of a market trend--either up or down. I look at the ADX line of the DMI. If the ADX line is trading above 30, then the market is in a strong trend. If the ADX line is below 30, it means the trend is not a strong one. Importantly, if the market is in a solid trend and scoring new highs (or lows), and the ADX line shows divergence and turns down, then that is one warning signal that the market trend is losing power and a market top or bottom may be close at hand. Even if the ADX line is well above the 30 level and starts to turn down at the same time the market is trading near new highs or lows, that is also a signal the trend is losing some power. However, as long as the ADX line is above 30, you should still consider a strong trend to be in effect.

As mentioned above, some traders use the DMI as a complete trading system. Also, some traders use the RSI or Slow Stochastics, or well other computer-generated technical indicators, for determining entry and exit points. I don't and here's why: I consider these computer-generated technical indicators to be secondary, yet still important, trading tools. I will use these "secondary tools" to help me confirm or reject ideas that are based on my "primary tools"--which are basic chart patterns, support and resistance levels and trendlines.

Linda Bradford Raschke is one of the best-known traders in the world. She, too, advocates the use of basic technical tools that have been around longer than computers. Renowned technical analyst John J. Murphy also says the best trading tools are the basic ones. In fact, I've been attending trading conferences for many years and the vast majority of traders speaking at the conferences consider these same basic charting techniques as their primary trading tools. You should, too.