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Figure 1 shows the chart of Jurong Technologies Industrial Corp Ltd (JurTech), which has depreciated by nearly 60 per cent in value. As the price of JurTech registered higher highs from
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May to September 2005, the MFI recorded a lower high reading. While uninformed investors were celebrating the new high, well informed investors became wary of the negative divergence happening on the weekly chart. No prize for guessing who will be able to better protect their investment. Following the divergence, Seagate made an acquisition of Maxtor that was JurTech’s major client at that time. As the market did not take the news too well, the uptrend reversed and the downtrend began.

In Figure 2, Ouhua’s price reached a new low in March. However, the MFI recorded a higher trough in March compared to late last year. This is known as a positive divergence. While many investors would like to identify the lowest low, not many succeeded. With the ability of identifying a positive divergence, this greatly increases one’s probability of catching a bottom.

As with the RSI, the MFI can be used to determine overbought or oversold condition. A stock is considered “overbought” if the MFI indicator reaches 80 and above, and a reading of 20 and below suggests a stock is “oversold”. However, when a stock is in a strong trend, it is less likely to have oversold reading. Similarly, it may stay overbought during a large part of the trend. Hence, during trending periods, it is important to identify the support or resistance level for the MFI.

As shown in Figure 3, the uptrend for CapitaLand that started in early August was well supported by the MFI. Every pull-back in price was supported by this MFI support. It must be observed that during this trend, the MFI did not record a single oversold reading. We know that in a healthy uptrend, price retracement is only good for the overall trend. Hence in trending period, whenever the price pulls back and the MFI reaches the support level, investors have a high probability entry signal.

“Volume combined with price action give us a good picture of whether money is flowing into or out of a stock.”

Figure 4 shows how the price movement of Seksun was resisted at the MFI resistance level. The first peak on the MFI chart occurred in January. Subsequent testing of this peak was unsuccessful with the price retracing soon afterwards. Hence, we would expect this MFI level to provide strong resistance in the future. Near those levels, the trader must be more careful in monitoring his or her holdings.

This article has highlighted how the MFI can be used to identify weaknesses in an uptrend or downtrend through divergences. With this knowledge, readers can better anticipate and act to protect their investments. The MFI can further be used to identify support and resistance levels where the stock price is expected to react, thus enabling investors to time their entries and exits with higher probability.