Following the flow of money

By Ng Ee Hwa

What a bull-run! The Straits Times Index (STI), together with the rest of the global indices, is scaling new highs after the February scare caused by the 10 per cent drop in the Shanghai bourse. During that period, most of the markets worldwide saw massive selling and this led to panic among investors and traders. Those who held on to their shares emerge as victors amidst a market rebound to greater heights.

However, was it blind faith or powerful "hoping" skill that made them winners? Market exuberance is notoriously known to puncture any bull-run in spectacular fashion. We are already in the fourth year of the bull market, which started in mid-2003. Along the way, we come across warnings on market exuberance and how the bull-run would end soon. Though the market's resilience has caught many bear advocates by surprise, the truth is, no bull-run will last forever. Rather than play the guessing game or argue with other opinionated investors, we must formulate and follow our own strategy to protect our investments. Knowing a simple indicator like Money Flow Index (MFI) can help us formulate such a strategy.

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The MFI is a momentum indicator that is similar to Relative Strength Index (RSI) in terms of interpretation and calculation. The only difference is that the MFI is volume weighted and hence, is a good measure of the strength of money flowing in and out of a stock. The RSI only takes the price action into calculation and missed out a crucial component of technical analysis - volume. Volume combined with price action give us a good picture of whether money is flowing into or out of a stock. We do not want to be in the dark if money is flowing out of a stock that we own. The MFI compares "positive money flow" to "negative money flow" to create an indicator that can be compared to price in order to identify the strength or weakness of a trend. It is measured on a scale of zero to 100 and is often calculated using a 14-day period.

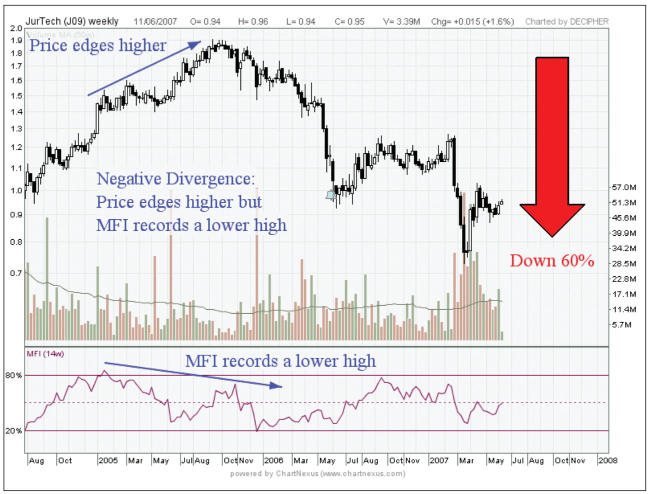

Figure 1: Negative divergence between price and MFI

The MFI can be interpreted much like the RSI in that it can signal divergences and overbought/oversold conditions.

DIVERGENCES

Positive and negative divergences between a stock and the MFI often indicate the imminent reversal of a trend. If the stock price is rising, but there is more volume associated with daily price

Figure 2: Positive divergence between price and MFI

drops than with price increases, this suggests a weak uptrend that threatens to reverse as money flowing out of the stock is "stronger" than money flowing into it.

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

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.

Figure 3: MFI support

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.

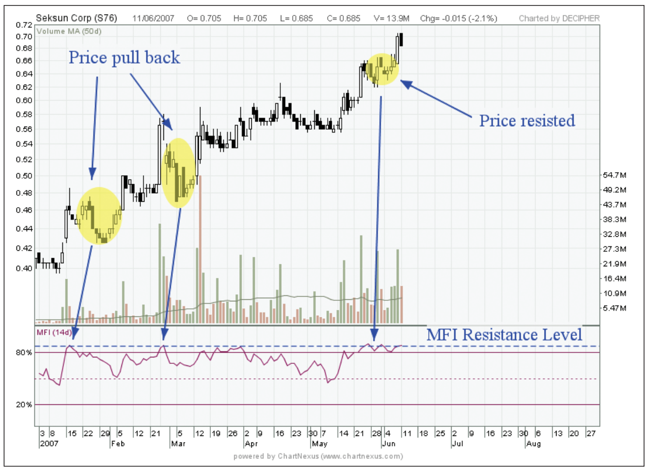

Figure 4: MFI resistance

OVERBOUGHT/OVERSOLD

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.

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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. **SI**

Ee Hwa is a private trader and market strategist for ChartNexus. His unassuming and generous sharing of his insight into Singapore's stock market using layman terms makes learning technical analysis fun and easily understandable. He is the chief trainer for ChartNexus.