



Indicators Part 4

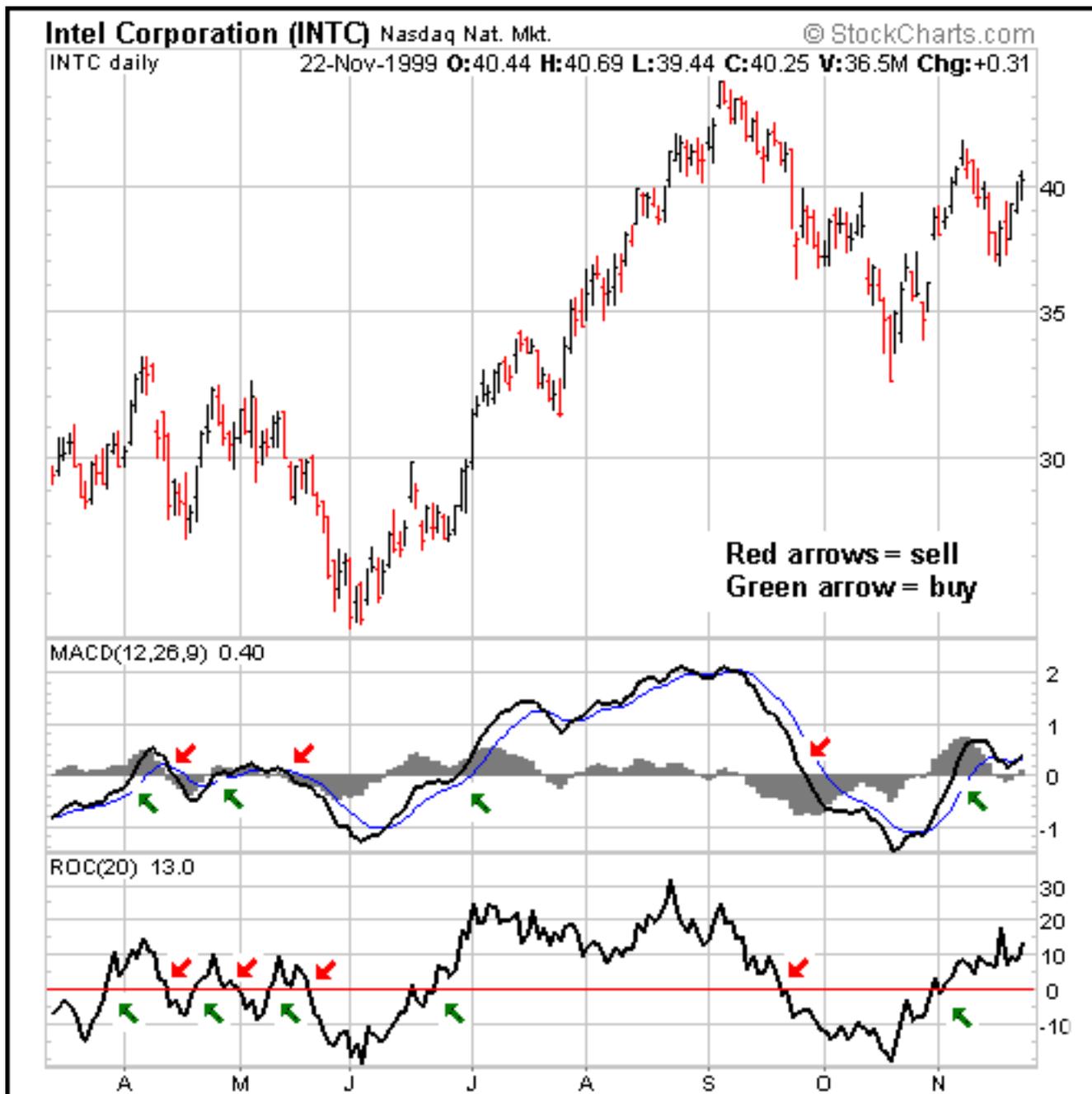
Centerline Crossovers

As the name implies, centerline crossover signals apply mainly to centered oscillators that fluctuate above and below a centerline. Traders have been also known to use centerline crosses with RSI in order to validate a divergence or signal generated from an overbought or oversold reading. However, most banded oscillators, such as RSI and Stochastics, rely on divergences and overbought/oversold levels to generate signals. The middle ground is a bit of a no man's land for banded oscillators and is probably best left to other tools. For our purposes, the analysis of centerline crossovers will focus on centered oscillators such as [Chaikin Money Flow](#), [MACD](#) and Rate-of-Change (ROC).

A centerline crossover is sometimes interpreted as a [buy](#) or [sell](#) signal. A buy signal would be generated with a cross above the centerline and a sell signal with a cross below the centerline. For MACD or ROC, a cross above or below zero would act as a signal.

Movements above or below the centerline indicate that momentum has changed from either positive to negative or negative to positive. When a centered momentum oscillator advances above its centerline, momentum turns positive and could be considered bullish. When a centered momentum oscillator declines below its centerline, momentum turns negative and could be considered bearish.

Intel



On this Intel chart with MACD and ROC, there have been a number of signals generated from the centerline crossover. There were a couple of excellent signals, but there were also plenty of false signals and whipsaws. This highlights some of the challenges associated with trading oscillator signals. Also, it stresses the importance of combining various signals in order to create more robust buy and sell signals. Some traders also criticize centerline crossover signals as being too late and missing too much of the move.

A centerline crossover can also act as a confirmation signal to validate a previous signal or reinforce the current trend. If there were a positive divergence and bullish moving average crossover, then a subsequent advance above the centerline would confirm the previous buy signal. Failure of the oscillator to move above the centerline could be seen as a non-confirmation and act as an alert that something was amiss.

Intel



On the Intel chart with MACD, the centerline crossover acts as the third in a series of bullish signals. Even after the third signal, Intel still has plenty of upside left.

1. There was the higher low forming that signaled a potential positive divergence.
2. There was the bullish moving average crossover to confirm the positive divergence.
3. And finally, there was the bullish centerline crossover.

Some traders would worry about missing too much of the move by waiting for the third and final confirmation. However, this can be a more reliable signal and help to avoid whipsaws and false signals. It is true that waiting for the third signal will reduce profits, but it can also help reduce risk.

IBM



Chaikin Money Flow is an example of a centered oscillator that places importance on crosses above and below the centerline. Divergences, overbought levels and oversold levels are all secondary to the absolute level of the indicator. The direction of the oscillator's movement is important, but needs to be placed in the context of the absolute level. The longer the oscillator is above zero, the more evidence of accumulation. The longer the oscillator is below zero, the more evidence of distribution. Hence, Chaikin Money Flow is considered to be bullish when the oscillator is trading above zero and bearish when trading below zero.

On the IBM chart, Chaikin Money Flow began to turn down in July. At this time, the stock was declining with the market and the decline in the oscillator was normal. However, in the second half of August, concerns began to grow when the oscillator failed to continue up with the stock and fell below zero. As the stock advanced further, Chaikin Money Flow continued to deteriorate. This served as a signal that something was amiss.

Oscillator Signals - Conclusions

Banded oscillators are best used to identify overbought and oversold conditions. However, overbought is not meant to act a sell signal and oversold is not meant to act as a buy signal. Overbought and oversold situations serve as an alert that conditions are reaching extreme levels and close attention should be paid

to the price action and other indicators.

To improve the robustness of oscillator signals, traders can look for multiple signals. The criteria for a buy or sell signal could depend on three separate yet confirming signals. A buy signal might be generated with an oversold reading, positive divergence and bullish moving average crossover. Conversely, a sell signal might be generated from a negative divergence, bearish moving average crossover and bearish centerline crossover.

Traditional chart pattern analysis can also be applied to oscillators. This is a bit trickier, but can help to identify the strength behind an oscillator's move. Looking for higher highs or lower lows can help confirm previous analysis. A trendline breakout can signal that a change in the direction of the momentum is imminent.

It is dangerous to trade an oscillator signal against the major trend of the market. In bull moves, it is best to look for buying opportunities through oversold signals, positive divergences, bullish moving average crossovers and bullish centerline crossovers. In bear moves, it is best to look for selling opportunities through overbought signals, negative divergences, bearish moving average crossovers and bearish centerline crossovers.

And finally, oscillators are most effective when used in conjunction with pattern analysis, support/resistance identification, trend identification and other technical analysis tools. By being aware of the broader picture, oscillator signals can be put into context. It is important to identify the current trend or even to ascertain if the security is trending at all. Oscillator readings and signals can have different meaning in differing circumstances. By using other analysis techniques in conjunction with oscillator reading, the chances of success can be greatly enhanced.

Written by Arthur Hill

[Part 1](#) | [Part 2](#) | [Part 3](#) | [Part 4](#)

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