ADX Directional Movement Index

DMI indicates when a trend is present and the overall strength of a market.

Here we focus on directional movement, or DMI from J. Welles Wilder. It was Welles Wilder that developed the Relative Strength Index – RSI, a very popular everyday trading indicator.

Welles Wilder clearly understood and stated that his trading systems only work well when an issue is trending, and he estimated that stocks will trend only about 30% of the time, leaving his systems on the sidelines 70% of the time

When the ADX line begins to drop below the 40 level on the scale of 0 – 100, it is time think about selling your position if you are long as this is a clear signal of the trend breaking down. Then as the downtrend comes to an end, the ADX line rising above the 20 levels is an indication that an uptrend is now in the early stages of development.

According to Wilder the DMI should be used with the ADX as a filter.

- A **rising ADX** line means the market is trending and a better candidate for a trend-following system.
- A **falling ADX** line indicates a non-trending market.
- Some traders also look for an ADX greater than 20 or 25 to confirm that the market is trending. When the ADX line starts to **drop** from above the 40 level, that is an early sign that the trend is weakening. A **rise** back above 20 is often a sign of the start of a new trend.

Signals

Generally speaking, the two main buy and sell signals generated by DMI are as follows:

- A **buy** signal is given when +DI crosses above the -DI line.
- A **sell** signal is given when +DI crosses below the -DI line.

However, some refinements are suggested by experienced traders:

- The crossing of DI lines only provides an early warning signal; other criteria must be fulfilled for the actual signal.
- The ADX should be between the upper DI line and the lower one.
- An ADX below 25 is a strong warning to avoid trading.

Wilder himself developed a refinement to take care of whipsawing (when the DI lines cross back and forth over a short period, providing unreliable signals). He called it his Extreme Point Rule.

The **Extreme Point Rule** is derived by noting the high or low point on the day when the +DI and the -DI cross one another. +DI determines the high or low point (if +DI is ***above*** -DI the Extreme Point is the high of the day, if +DI is ***below*** -DI, the Extreme Point is the low for the day).

The extreme point is then used for the actual buy or sell signal. For example, if the price once again rises above the Extreme Point price level you have a buy signal. If the price fails to rise above the extreme point, you should continue to stand aside. The converse holds true for sell signals.