

Unveiling the Power of Undercutting 20EMA & 50EMA

In the dynamic world of swing trading, where every decision can make or break a trade, understanding key technical indicators is crucial. Of all the indicators, moving averages are the most popular and versatile indicators that are applied to various markets and timeframes.

Among moving averages, the **20 Day Exponential Moving Average (20EMA)** and **50 Day Exponential Moving Average (50EMA)** hold immense significance. In this blog, we'll delve into the importance of undercutting the 20EMA and 50EMA and what traders should look for when incorporating them into their swing trading arsenal.



The 20-day moving average

The 20EMA is a short-term moving average that gives more weight to recent prices, making it a sensitive indicator to short-term market movements. It is a relatively simple indicator to use, making it a good choice for both beginner and experienced traders. Pullback and momentum traders often use 20EMA to identify the current market momentum and potential entry & exit points.

The 50-day moving average

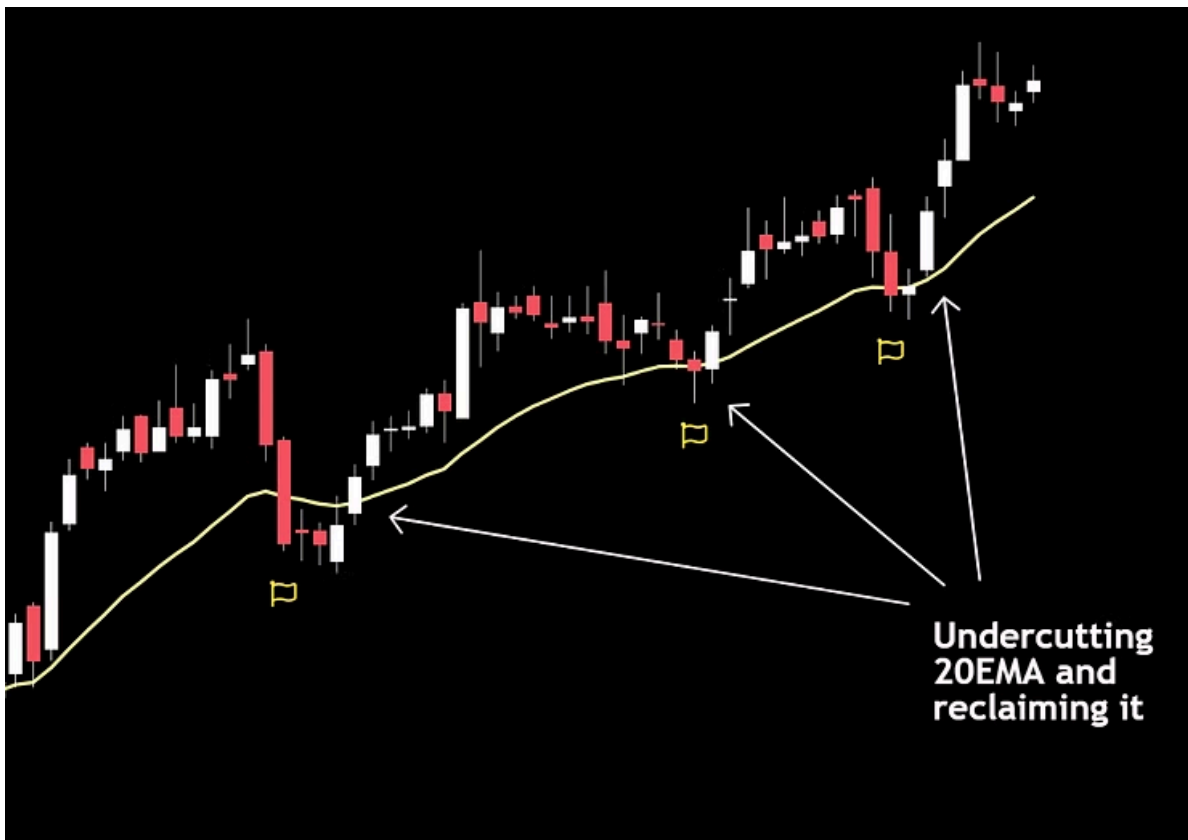
The **50-day moving average** is a **medium-term moving average** that provides a balance between responsiveness and reliability. It is widely followed by traders and investors to gauge the overall trend of an asset. Compared to shorter-term moving averages, such as the 20-day moving average, the 50-day moving average is less sensitive to short-term price fluctuations.

Renowned traders like **Mark Minervini** and **William O'Neil** have incorporated the 50-day moving average into their trading methodologies. Minervini emphasizes buying stocks that are in sync with the market and have a strong price structure, including the 50-day moving average. Similarly, O'Neil, famous for the CANSLIM approach, relies on this moving average as a key factor in identifying leading growth stocks during uptrends.

Importance of Undercutting

Undercutting the 20EMA or 50EMA occurs when the price of an asset briefly falls below the 20-day or 50-day moving average before rebounding. A brief dip below the 20EMA or 50EMA followed by a swift rebound can suggest strong buying pressure, supporting a potential uptrend continuation.

In the figure below, the flags marked in yellow are the days when the stock breaks down 20EMA and closes below it. However, in the next few days, the stock immediately goes back above 20EMA and reclaims it. This action is known as undercutting of 20EMA.





Using Undercutting of 20EMA and 50EMA as a trading strategies

Swing traders can use the undercutting of the 20EMA to identify short-term reversals within an existing trend. When the price dips below the 20EMA and quickly bounces back, it may signal an opportunity for a swing trade in the direction of the rebound. Positional traders can use the undercutting of the 20EMA as well as 50EMA as an opportunity to add to their existing positions or entering a previously missed breakout.

Key Consideration while using this Trading Strategy

It is important to combine this trading strategy with an awareness of the broader market context. The strategy works better when overall trend is up, while one must have cautious approach in a choppy or sideways market.

In a downtrend, using an undercut strategy may lead to false signals, as brief bounces above the 20EMA or 50EMA are common in downtrends without signaling a substantial reversal. Thus, relying on this strategy in a downtrend increases the risk of false positive signals, resulting in potential losses for traders.

Identifying Undercut setups with Pro-Setups

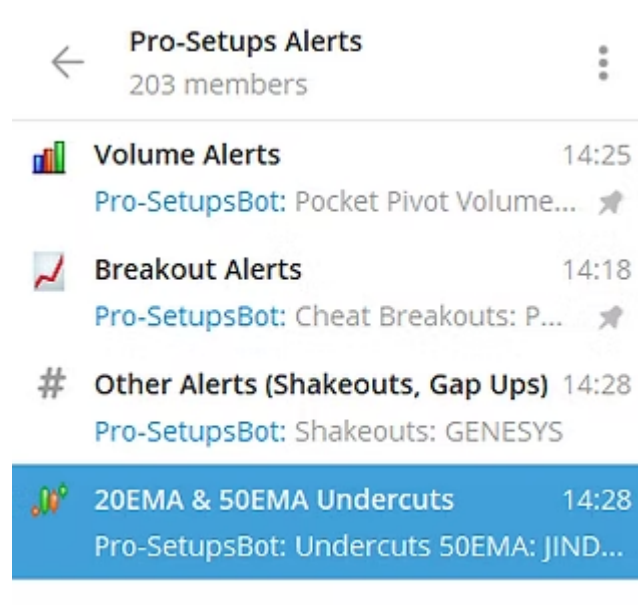
Since the 20EMA and 50EMA undercuts work better in an Uptrend, we have defined certain rules for identifying them:

- Stock must be in an Uptrend (must be a green trend on daily timeframe).
- Its 50EMA must be rising.
- Stock should have been trailing above 20EMA for some days prior to its breakdown.

In Pro-Setups Dashboard, we have a **dedicated filters for identifying 20EMA and 50EMA undercut setups**.

The screenshot shows the Pro-Setups Dashboard with the 'MOVING AVERAGE FILTERS' tab selected. It displays four sliders for 'AWAY FROM' percentages: 10EMA (-28 to 19), 20EMA (-47 to 32), 50EMA (-62 to 45), and 200EMA (-72 to 107). A red box highlights the 'UNDERCUTS' dropdown menu, which is currently set to 'Undercuts' and has checkboxes for '20EMA Undercuts' and '50EMA Undercuts'.

In our Pro-Setups Alerts group on Telegram, we also have **real-time alerts** for getting stocks that undercut their 20EMA or 50EMA.



Cautions and Considerations

- **False Signals:** Not every breakdown and rebound signals a continuation. False breakouts can occur, so confirmation is crucial. In fact, the percentage of false signals can be quite high.
- **Market Context:** Consider broader market conditions and sector trends. A breakdown within a general market downturn might not lead to a continuation.
- **Volume Confirmation:** Pay close attention to trading volume during the undercut. A surge in volume accompanying the price drop and subsequent rebound adds weight to the signal, indicating active participation from market players.
- **Risk Management:** Always prioritize risk management. Use stop-loss orders to protect capital in case the rebound fails and the trend reverses. Since there can be plenty of false signals, tight stop loss will be the key to successful trading using this strategy.

Some examples

Let's look at **some examples where undercutting of 20EMA happened**, and which would have come in our scanner too.

In each of these charts:

- We have two trend bars at the top - the upper one being weekly timeframe trend and lower one being daily timeframe trend.
- The orange line is 20EMA.
- Second line is 50EMA, which is marked green when it is rising and red when declining.
- The black flag is the breakdown of 20EMA, and red arrows are the days when stock rebounds and undercuts 20EMA.

- Charts are marked with necessary annotations for the explanation.
- It is assumed that these setups were considered for swing trading only. A setup is considered passed if it gives even a short upswing, and failed if it could not manage to hold on to 20EMA after the undercut.

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You must have noticed that while there were successful rebounds, in many cases the rebounds failed as well.

In conclusion, while the 20EMA or 50EMA undercut strategies are effective in specific market conditions, it's crucial to recognize their limitations, especially when a stock is in a downtrend. A balanced perspective involves considering a range of other factors, including other technical analysis, higher highs & higher lows, momentum indicators and, importantly, fundamental analysis.

In the end, trading is fundamentally a probability game and success in it is not about eliminating risks but managing them wisely, using a diverse set of tools, and recognizing that no single strategy guarantees success in every market condition.

If you have any comments, suggestions, or feedback, please feel free to share. I can be reached at puneet@pro-setups.com. Happy Trading!