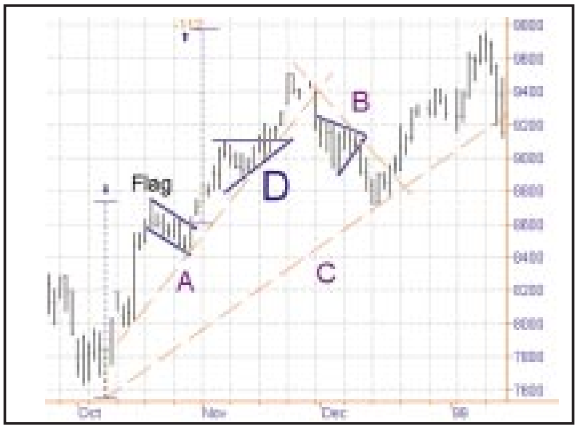
Signal

TRADER'S GUIDE TO TECHNICAL INDICATORS

Keeping the trend going

(This is the second in a series of articles on basic technical analysis.)



As a market moves up or down, it frequently leaves tracks on price charts that develop into recognizable formations providing some degree of predictability.

For the technical analyst, the good news is that most charts offer a number of such patterns to analyze, whether it is a one-minute, daily or monthly chart; the bad news is that what you see may not be what other traders see and markets are notorious for not always "behaving" like a pattern suggests. So, while chart patterns can give you some good clues, don't try to read too much into them.

As the first article in this series emphasized, the first step in technical analysis is discovering the basic trend of the market. The next thing you'll want to know is will the trend continue or will it reverse and, having made that determination, how far is the ensuing move likely to go.

As a market extends an existing trend, it sometimes appears to pause for a while to wonder if it's doing the right thing. On a bar chart, this pause may last for only a few price bars or for a number of bars, and the congestion or consolidation area that develops may form a pattern that traders describe as a "flag," a "pennant" or one of several types of triangles. Where they occur in a trend is important.

The flag formation is a favorite of trend-followers, who like to wait for a pullback in a major trend before taking a position in the direction of the main trend. In this formation, prices typically run up or down sharply, forming the "flagpole," then move against the main trend for a few bars – preferably, not more than 10 bars or so. The market often breaks out of this short-term countertrend in the direction of the main trend, and traders place their orders just above this breakout point to capture the trend move. The March Dow Jones chart that was used to illustrate trends in the previous article shows one example of a flag just above point A.

An additional feature of the flag formation is that some analysts use it to measure how far a trend might go. On the March Dow Jones chart, the length of the "flagpole" (dotted line) is roughly 1,150 points from the October low to the point where the flag begins. When you add 1,150 to the point where the market breaks out above the flag formation at about 8,600, you get a target of 9,750. The Dow didn't get that high before it turned down in November. But did the move in January fulfill the flag's "promise"? That's the kind of debate chart analysts have.

Triangles and pennants are consolidation areas that move into an apex on diminishing volume because traders are waiting to establish a position until they see a breakout. Then, on a breakout, volume increases as traders follow the market and establish their positions.

"Ascending triangles" have a relatively flat top and a succession of higher lows. Note that on the March Dow Jones chart, the formation at D might also be classified as another flag. But the market struggles to get above the high where the flag begins before it finally breaks out to the upside. Ascending triangles are among the most reliable formations as the series of higher lows suggests underlying strength that is pushing upward just waiting to break above the surface. Some analysts also add the width of the triangle at its beginning to the breakout point to measure a possible target.

A "symmetrical triangle" such as the one that occurs during the downtrend at B is sort of a battleground from which the market can emerge in either direction. A succession of lower highs and higher lows comes together on lighter volume in a series of narrower range bars toward an apex. The market inevitably breaks out with a wide-range day on heavier volume in one direction or the other. In this case, the breakout is a continuation of the short-term downtrend. When you add the width at the beginning of the triangle (about 350 points) to the breakout point, the downside target is reached almost exactly as projected.

Next month: Reversal formations