

TRADER'S GUIDE TO TECHNICAL INDICATORS

The trend is your friend

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



Technical analysis can become a sophisticated art, but even a casual glance at a price chart can provide you with one of the simplest, yet most important, pieces of information you need to know as a trader:

- (1) The market is going up.
- (2) The market is going down.
- (3) I don't know which way the market is going.

Traders can make money in any of these market conditions, but one of the most common trading axioms is, "Trade with the trend." Whether price direction is uncertain enough to put a market in the "I don't know" category or is providing a clear picture of a trend, your first step in forming a trading strategy is to determine where the market appears to be headed.

You can determine the direction and strength of a trend in various ways, but the basic tool of the technical analyst is the trendline, a straight line that connects key spikes of a price move. An uptrend is defined simply as a succession of higher lows and higher highs. A trendline connecting a series of higher lows shows the magnitude of the uptrend and serves as "support" for future price moves. A downtrend is simply a succession of lower highs and lower lows. A trendline connecting a series of lower highs indicates the degree of the downtrend and serves as "resistance" for future price moves.

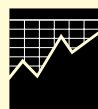
Trends tend to persist and the more points of contact of price lows or highs to the trendline, the more valid the trendline is. On the chart of March Dow Jones futures, the erratic action in September did not provide the chartist many clues. But as the market moved up, prices tended to hug the steep trendline A in November. When that trendline became difficult to maintain, a small downtrend developed for about a month (B). As prices started to move back up in mid-December, a new, shallower trendline (C) could be drawn.

Some analysts prefer to use closes for their trendline points, ignoring extreme highs or lows that may occur at price peaks or dips. Whatever you use, a trendline that is about 45 degrees is the most reliable. If it is steeper than that, the market usually cannot maintain that kind of momentum for long; if it is much shallower than that, the market may not have sufficient strength for a profitable trend-following move.

A trendline is like defining a borderline for making buy or sell decisions. In the ebb and flow of trading, some traders are positioning for the long haul, some for the short term; some are motivated by mounting losses and maybe even margin calls, some are adding to or taking profits. In the midst of all these transactions and opinions about the market, the trend or lack of one reflects the psychological summary of what people expect.

The visual presentation of this mass psychology shows up in various patterns and formations on a price chart. Some suggest a trend will continue, others indicate a market is reversing – or, at least, moving out of the previous trend into a more uncertain "I don't know" period. Seeing these patterns is a subjective art that we'll begin to take up next month.

Next month: Continuation formations



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