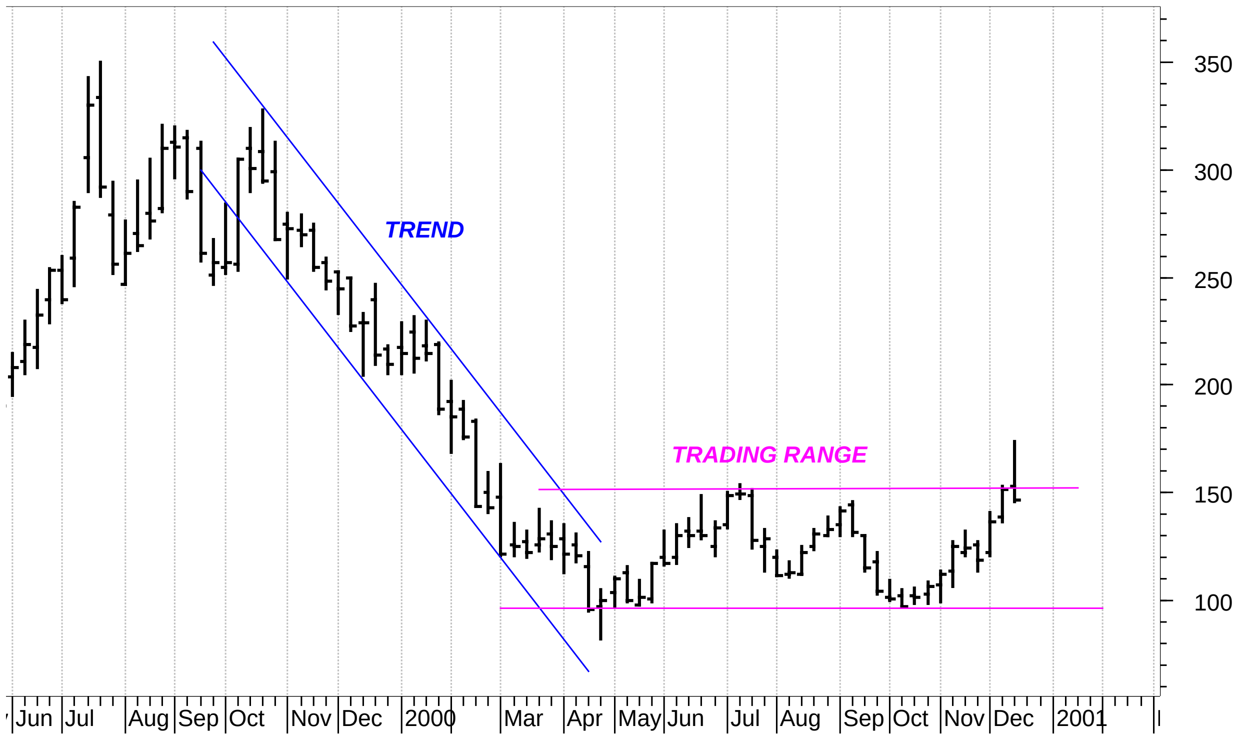
The Trend is your Friend

TRADERS' BIGGEST PROBLEM

Trading is likely the most exciting way to make a living and/or accumulate a fortune. You are your own boss and your own worst enemy. You alone must deal with the frustration of your own choices. If you lose, there is no one else to blame. You made the losing decision, even if that decision was to let someone else make your decision or to follow someone else's approach. On the other hand, if you win, don't have to say "Thank you" to anyone. You are not obliged to anyone but yourself. There is no politics nor anyone to whom you must cater. You are truly "sliding down the razor blade of life."

But here is the problem. Most of the time, the market goes nowhere. Only 25 to 40 percent of the time does the market trend, during the remaining 60 to 75 percent of the time the market goes nowhere. Most professional traders make nearly all of their profits in a trending market. Here is our problem: we don't want to spend out time entering and exiting a market that is going nowhere. If the market is going nowhere, then the opportunity is NO-WHERE. We want to change that to opportunity is NOW-HERE.

This chart shows that BHEL has been in a trading range since March, 2000.



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TREND AND TRADING RANGE

Traders try to profit from changes in prices: Buy low and sell high or sell short high and cover low. Even a quick look at a chart reveals that markets spend most of their time in trading ranges. They spend less time in trends.

A trend exits when prices keep rising or falling over time. In an **uptrend**, each rally reaches a higher high than the preceding rally and each decline stops at a higher level than the preceding decline. In a **downtrend** each decline falls to a lower low than the preceding decline and each rally stops at a lower level than the preceding decline and each rally stops at a lower level than the preceding rally. In **trading range** most rallies stop at about the same high and declines peter out at about the low.

A trader needs to identify trends and trading ranges. It is easier to trade during trends than in trading ranges.

PSYCHOLOGY OF TRENDS AND TRADING RANGE

An uptrend emerges when bulls are stronger than bears and their buying forces prices up. If bears manage to push prices down, bulls return in force, break the decline, and force prices to a new high. Downtrends occur when bears are stronger and their selling pushes markets down. When a flurry of buying lifts prices, bears sell short into that rally, stop it, and send prices to new lows.

When bulls or bears are equally strong or weak, prices stay in a trading range. When bulls manage to push prices up, bears sell short into that rally and prices fall. Bargain hunters step in and break the decline, bears cover shorts, their buying fuels a minor rally, and the cycle repeats.

Prices in trading ranges go nowhere, just as crowds spend most of their time in aimless mulling. Markets spend most of their time in trading ranges than trends because aimlessness is more common among people than purposeful action. When a crowd becomes agitated or excited, it surges and creates a trend.

THE HARD RIGHT EDGE

Identifying trends and trading ranges is one of the hardest tasks in technical analysis. It is easy to find them in the middle of the chart, but the closer you get to the right edge, the harder it gets.

Trends and trading ranges clearly stand out on old charts. Experts show those charts on seminars and make it seem easy to catch trends. Trouble is your broker does not allow you to trade in the middle of the chart. He says you must make your trading decisions at the hard right edge of the chart!

The past is fixed and easy to analyze. The future is fluid and uncertain. By the time you identify a trend, a good chunk of it is already gone. Nobody rings a bell when a trend dissolves into a trading range. By the time you recognize the change, you will lose some money trying to trade as if the market was still trending.

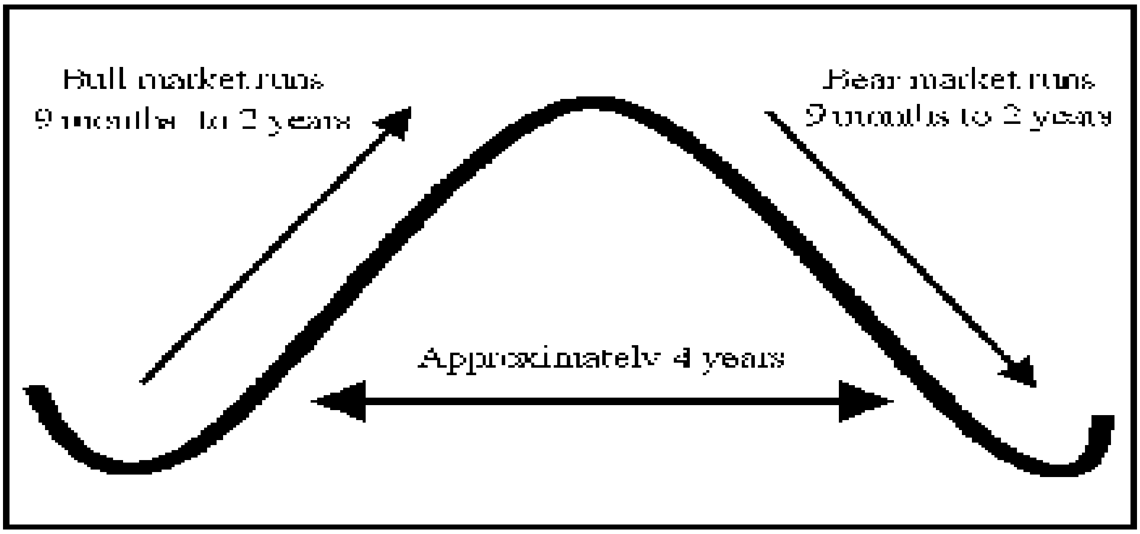
Most people cannot accept uncertainty. They have a strong emotional need to be right. They hang on to losing positions, waiting for the market to turn and make them whole. Trying to be right in the market is very expensive. Professional traders get out of losing trades fast. When the market deviates from your analysis, you have to cut losses without fuss or emotions.

THREE IMPORTANT TRENDS

You may be asking yourself the question, "What is a trend and how long does it last?" There are countless numbers of trends, but before the advent of intraday charts, there were three generally accepted durations: primary, intermediate and short-term.

The **main,** or **primary trend**, is often referred to as a bull or bear market. Bulls go up and bears go down. They typically last about nine months to two years with bear market troughs separated by just under four years. These trends revolve around the business cycle and tend to repeat whether the weak phase of the cycle is an actual recession, or if there is no recession and just slow growth.

Primary Trend



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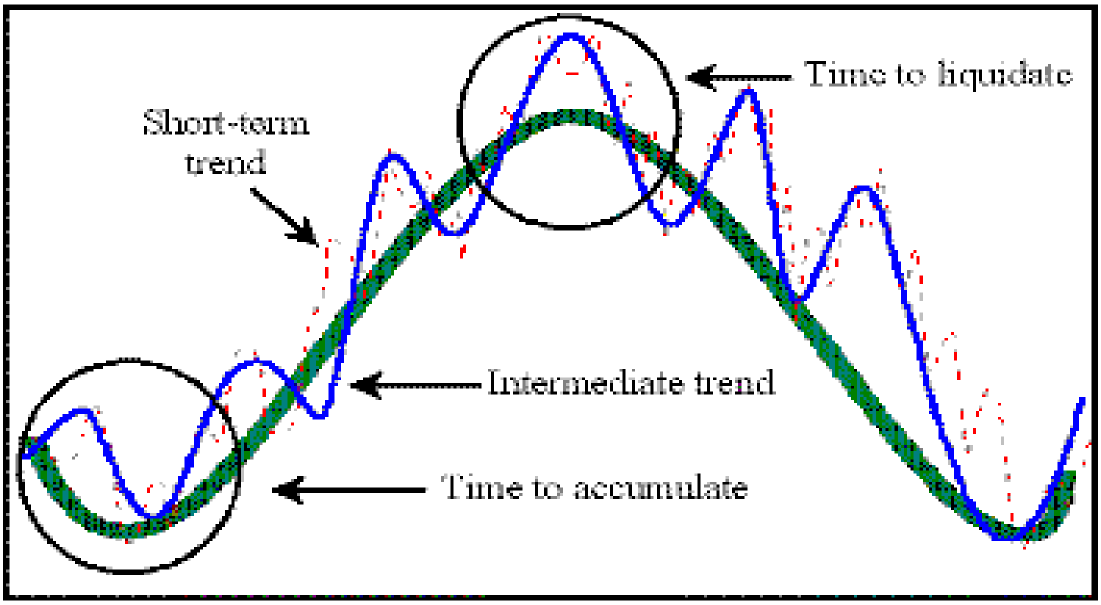
Primary trends are not straight-line affairs, but are a series of rallies and reactions. These series of rallies and reactions are known as **intermediate trends**. They can vary in length from as little as six weeks to as much as nine months, or the length of a very short primary trend. Intermediate trends typically develop as a result of changing perceptions concerning economic, financial, or political events. It is important to have some understanding of the direction of the main or primary trend because rallies in bull markets are strong and reactions are weak. On the other hand, reactions in bear markets are strong and rallies are short, sharp, and generally, unpredictable. If you have a fix on the underlying primary trend, you will be better prepared for the nature of the intermediate rallies and the reactions that will unfold. In turn, intermediate trends can be broken down into **short-term trends**, which last from as little as two weeks to as much as five or six weeks. They are shown in the figure below by the dashed lines.

Market Cycle Model



Since all three trends discussed are shown in the above figure, there are a couple of points worth making. First, as an investor, it is best to accumulate when the primary trend is in the early stages of reversing from down to up, and liquidate when the trend is reversing from up to down. Second, as traders, we are better off if we position ourselves with the long side in a bull market since that is when short-term uptrends tend to have the greatest magnitude. By the same token, it does not usually pay to short in a bull market because declines can be quite brief and reversals to the upside unexpectedly sharp. If you are going to make a mistake, it is more likely to come from a counter-cyclical trade.

If you're an intraday trader, you may think all of this does not apply to you, but really, it does. It is important to remember that even on intraday charts, the predominant trend determines the magnitude and duration of the shorter moves. You may not feel a three-hour rally is closely related to a two-year primary bull market move, but it is just as related as a five or six-day trend.

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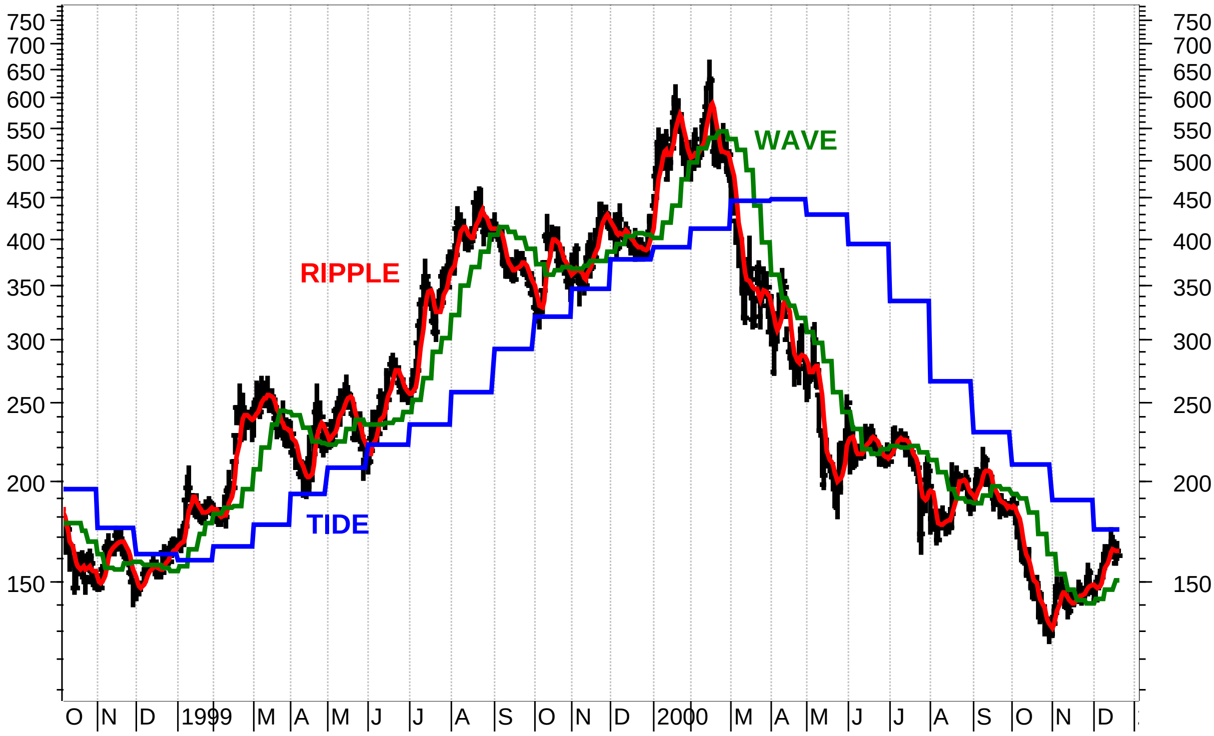
Charles Dow, the author of the venerable Dow theory, stated at the turn of the century that the stock market had three trends. The long term trend lasted several years, the intermediate trend lasted several months and anything shorter than that was a minor trend. Robert Rhea, the great market technician of the 1930s, compared the three market trends to a tide, a wave and a ripple. He believed that traders should trade in the direction of the market tide and take advantage of the waves and the ripples to time your entry and exit.



A two year daily chart of Mahindra & Mahindra showing the three trends in a bull and bear market.

CONFLICTING TIMEFRAMES

Most traders ignore the fact that markets usually are both in a trend and in a trading range at the same time! They pick one time frame such as daily or hourly and look for trades on the daily charts. With their attention fixed on daily or hourly charts, trends from other time frames, such as weekly or 10 minute trend keep sneaking up on them and wrecking havoc with their plans.

Markets exist in several time frames simultaneously. They exist on a 10 minute chart, an hourly chart, a daily chart, a weekly chart, and any other chart. Traders often feel confused when they look at charts in different time frames and they see the markets going in several directions at once. The market may look for a buy on a daily chart and a sell on the weekly chart, and vice versa. The signals in different time frames of the same market often contradict one another. Which of them will you follow? Most traders pick one time frame and close their eyes to others – until a sudden move outside of "their" time frame hits them.

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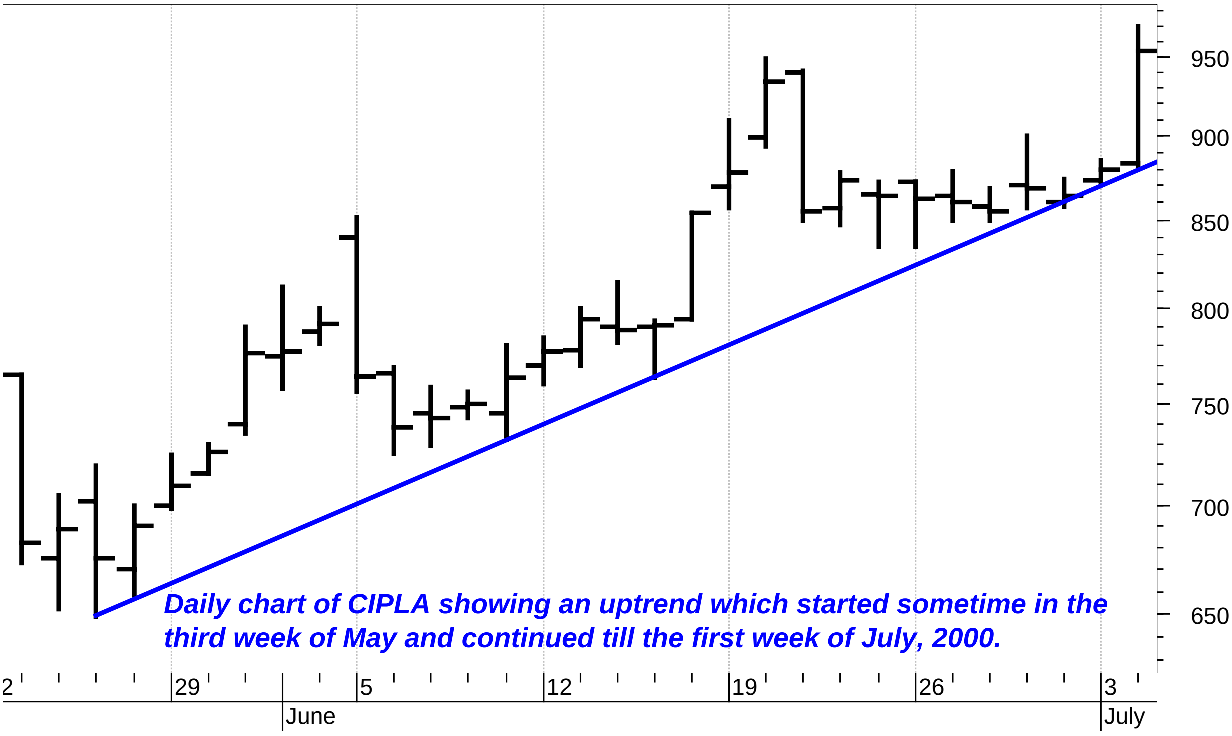

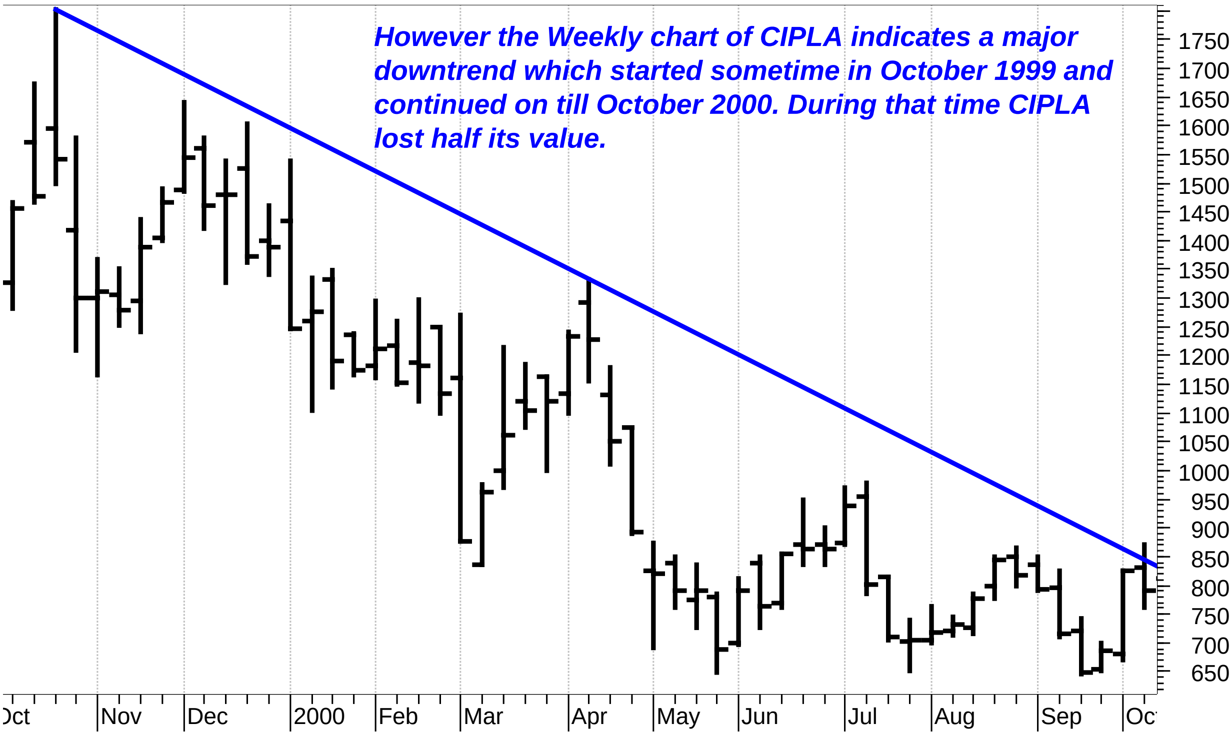

A FACTOR OF FIVE

When you are in doubt of a trend, step back and examine the charts in a timeframe that is larger than the one you are trying to trade. A factor of 5 links all timeframes. If you start with the weekly charts and proceed to the dailies, you will notice that there are five trading days to a week. As your timeframe narrows, you will look at hourly charts – and there are approximately 5 to 6 trading hours to a trading day. Intra day traders can proceed even further and look at 10 minute charts, followed by 2 minute charts. All are related by a factor of five. The proper way to analyze any market is to analyze it in at least two time frames. If you analyze daily charts, you must first examine the weekly charts and so on. This search for greater perspective is one of the key principles of the Trades Edge Stock Trading System.

METHOD AND TECHNIQUES

There is no single magic method to identifying trends and trading ranges. There are several methods and it pays to combine them. When they confirm one another, their message is reinforced. When they contradict one another, it is better to pass up the trade.

1. Analyze the pattern of highs and lows. When rallies keep reaching higher levels and declines keep stopping at higher levels they identify an uptrend. The pattern of lower lows and lower highs identifies a downtrend, and the pattern of irregular highs and lows points to a trading range.

2. Draw an uptrendline connecting significant recent lows and a downtrendline connecting significant recent highs. The slope of the latest trendline identifies the current trend A significant high or low on a daily chart is the highest high or lowest low for at least a week. As you study charts, you become better at identifying those points. Technical analysis is partly a science and partly an art.

3. The direction of a slope of a moving average identifies the trend. If a moving average has not reached a new high or low in a month, then the market is in a trading range.

4. Several market indicators, such as MACD and the Directional system help identify trends. The Directional system is especially good at catching early stages of new trends.

CONCLUSION

Markets change, new opportunities emerge, and old ones melt away. Good traders are successful but humble people – they always learn. The primary purpose of the market is to find immediately the exact price where there is an equal disagreement on value and an agreement on price. Speculators get paid for buying what nobody wants when nobody wants it and selling what everybody wants when everybody wants it. Remember there is no such thing as a bad trader. There is only a well trained or badly trained trader.