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Trends: "You've Gotta Know When to Hold 'em"

The Trend is Your Friend

We refer you our guiding principle, that of Forrest Gump. The main idea is to trade trending markets and avoid choppy ones. In an uptrend, buy every dip. In a downtrend, sell every rally. At the end of the trend, when it bends, you will be wrong once. After that, stand aside to see if a consolidation develops. Every method or indicator we employ must serve a purpose within the guiding principle and every effort must be directed to detecting emerging trends and entering in the direction of the trend. We listen only to the market.

What Does a Trend Look Like?

The simplest way to visualize a trend is to draw them using Vic Sperandeo's definition. We refer you to "How Do I Draw a Trendline?" for additional information. In this section we will be using the same chart to illustrate our concepts so that they may be compared easily.

The Ruler Method

The first method used to visualize trends is to use a ruler and draw some lines.

The Moving Average

The second method is to use a moving average. A moving average is a rolling average of some number of prior prices, plotted on the chart. Three types are often used: simple, weighted and exponential. Each has it's own merits. Many technical traders attempt to use moving averages or a combination of them to produce trading signals. Moving averages are excellent trend-following indicators but perform poorly in choppy markets. In general, if the price is above the moving average, the trend is up. If the price is below the moving average, the trend is down.

Average Directional Index (ADX)

To further refine our trend detection and measurement system, we employ the ADX. ADX was invented by J. Welles Wilder in the 1970s and was documented in his book, New Concepts in Technical Trading Systems.

Charles LeBeau and David W. Lucas, in their book Technical Traders Guide to Computer Analysis of the Futures Market provide an excellent analysis of the application of ADX.

"The function of the ADX is to measure the strength of the trend, not the direction of the trend. You must use an additional indicator [i.e. your eyeballs]...for market direction...Some technicians attribute a great deal of importance to the level of the ADX as an indication of trend strength and they would argue that a reading of 28 indicates a stronger trend than a reading of 20. We've found that the direction of the ADX is much more significant that its absolute value...A rising ADX indicates that a strong trend is underway and suggests that trend following trading strategies

are in order. A falling ADX indicates a trendless market where countertrend strategies should be used instead of trend following methods [we just stand aside]."

In the chart above, ADX rose during the initial downtrend from 1365 to 1335 on June 22. It dropped during the consolidation between 1335 and 1350 on June 23 and then rose again as the downtrend continued on June 24 and peaked at 55 when the market touched 1320. We have observed that ADX values in the 50-60 area have often marked buying or selling climaxes in the S&P.

The Dunnigan Method

In addition to connecting a series of higher lows to form an uptrend line, or connecting a series of lower highs to form a downtrend line, we can get microscopic and look at individual bars in relation to their immediate neighbors. In his book, New Blueprints for Gains in Stocks and Grains & One-Way Formula for Trading in Stocks and Commodities, William Dunnigan outlined the Thrust Method of stock trading, which we shall not delve into here. However, we have taken his ideas and modified them for our own trading since his "bar count" takes our guiding principle of trading with the trend down to the smallest detail. His observations are also consistent with the principles of Japanese Candlestick theory. In his day, Dunnigan and his fellow traders only had access to bar charts, which they drew by hand from information culled from newspapers, so it is indeed interesting for him to have arrived at many of the same conclusions that the Japanese did hundreds of years before.

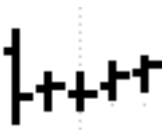
The Dunnigan Bar Count

Three "**up**" bars from the first bar, the reference bar. "Up" means higher high and higher low compared to the bar before.

Four "**down**" bars from the first bar, the reference bar. "Down" means lower low and lower high compared to the bar before.

The bar on the right-hand side is an "**inside**" bar, with its entire trading range inside that of the bar on the left.

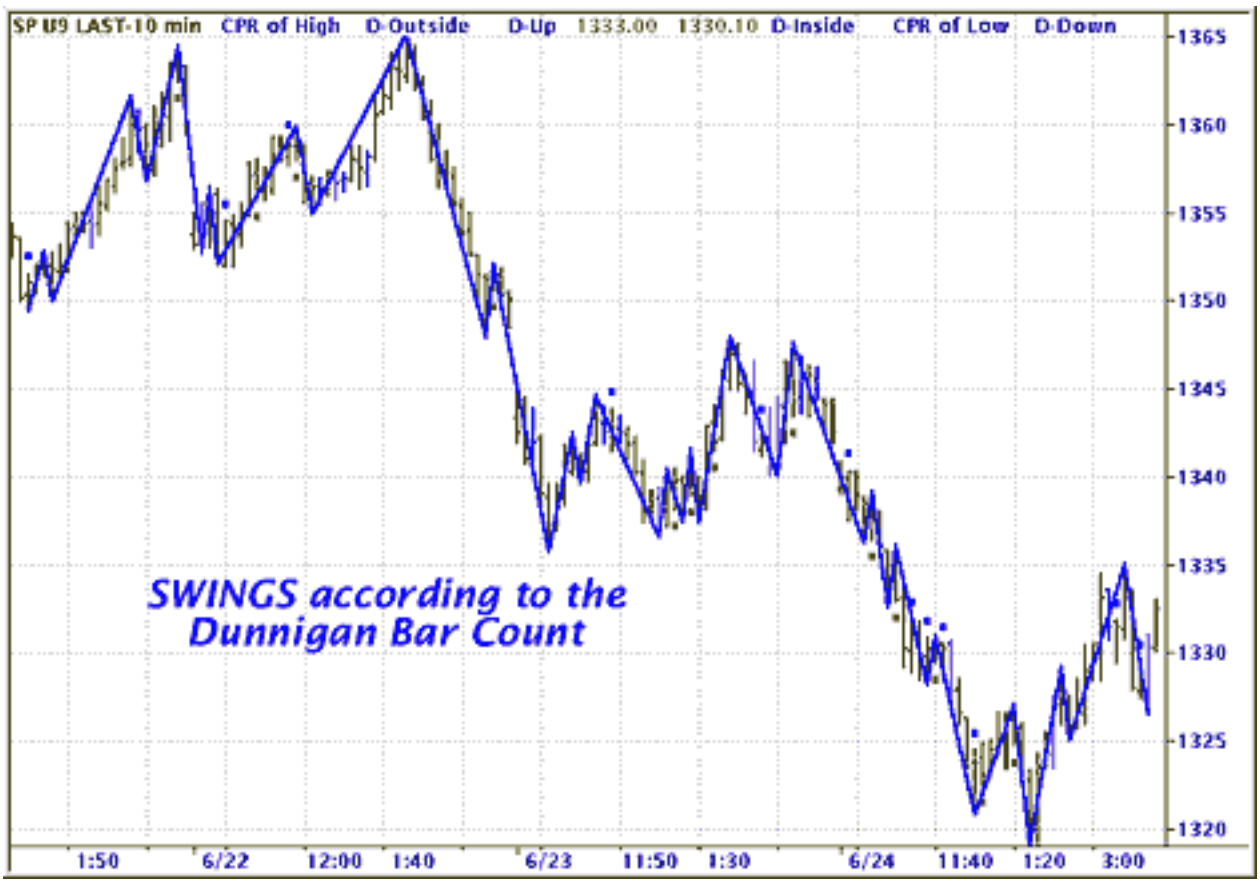
The bar on the right-hand side is an "**outside**" bar, with its entire trading range outside that of the bar on the left.



An "**inside range**", a series of four bars that all traded within the range of the bar on the left-hand side.

The second and the fourth bars are "**narrow range**" up bars, when compared to the bars to their left.

While it takes some time to train the eye to count bars the Dunnigan style, it is well worth it. You will note during periods of strong up or downtrends, there is rarely more than one bar that goes against the trend and this is useful for entry and exit points, which we shall elaborate on later.



Using Dunnigan's count, we can connect the bars using his rules and come up with the following chart. Note how precise trend definition can be on the microscopic scale.