TRADING the LINE

5 Ways You Can Use Trendlines to Improve Your Trading Decisions

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Trading the Line — 5 Ways You Can Use Trendlines to Improve Your Trading Decisions

By Jeffrey Kennedy, Elliott Wave International

Chapter 1 - Defining Trendlines
Find out what a trendline is and what it represents.

Chapter 2 - Drawing Trendlines
Learn how trendlines identify resistance and support. Also, find out how to draw trendlines and spot trendline breaks.

About the Author



Jeffrey Kennedy is the Chief Commodity Analyst at Elliott Wave International (EWI). With more than 15 years of experience as a technical analyst, Jeffrey writes and edits *Futures Junctures*, EWI's premier commodity forecasting package that includes *Daily Futures Junctures*, *The Weekly Wrap-Up* and *Monthly Futures Junctures*. EWI has published four volumes of his *Trader's Classroom Collection*, and numerous on-line webinars and eBooks, which present Jeffrey's trading insights, market analysis and advice on how to apply the Wave Principle in real time. Besides analyzing markets, he is a popular speaker at international technical analysis conferences and teaches seminars for EWI on how to spot trading opportunities using the Wave Principle and other technical indicators.

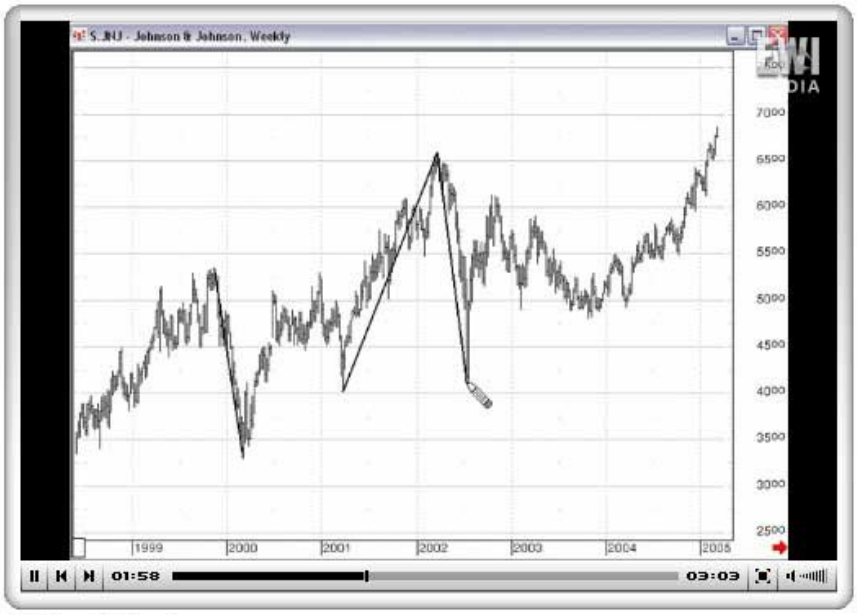
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Chapter 1

Defining Trendlines

Before I define a trendline, we need to identify what a *line* is. A line simply connects two points, a first point and a second point. Within the scope of technical analysis, these points are typically price highs or price lows. The significance of the trendline is directionally proportional to the importance of point one and point two. Keep that in mind when drawing trendlines.

Figure 1-1



A trendline represents the psychology of the market, specifically, the psychology between the bulls and the bears. If the trendline slopes upward, the bulls are in control. If the trendline slopes downward, the bears are in control. Moreover, the actual angle or slope of a trendline can determine whether or not the market is extremely optimistic, as it was in the upwards sloping line in Figure 1-1 or extremely pessimistic, as it was in the downwards sloping line in the same figure.

Now we're on to the fun part – drawing trendlines. You can do this several different ways. You can draw them horizontally, which identifies resistance and support. Or, you can draw them vertically, which identifies moments in time. You primarily apply vertical trendlines if you're doing a cycle analysis.

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Figure 1-2



You can also map trendlines at an angle, like you see in Figure 1-2, which identifies price *and* time. There's really not a wrong way to draw a trendline, which is why trendlines are a simple, crucial tool.

Chapter 1 Key Points

- A trendline represents bull market versus bear market psychology.
- Trendlines exhibit how optimistic or pessimistic the markets can be.
- Horizontal trendlines identify resistance and support. Vertical trendlines identify moments in time. Diagonal trendlines identify both price and time.

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Chapter 2

Drawing Trendlines

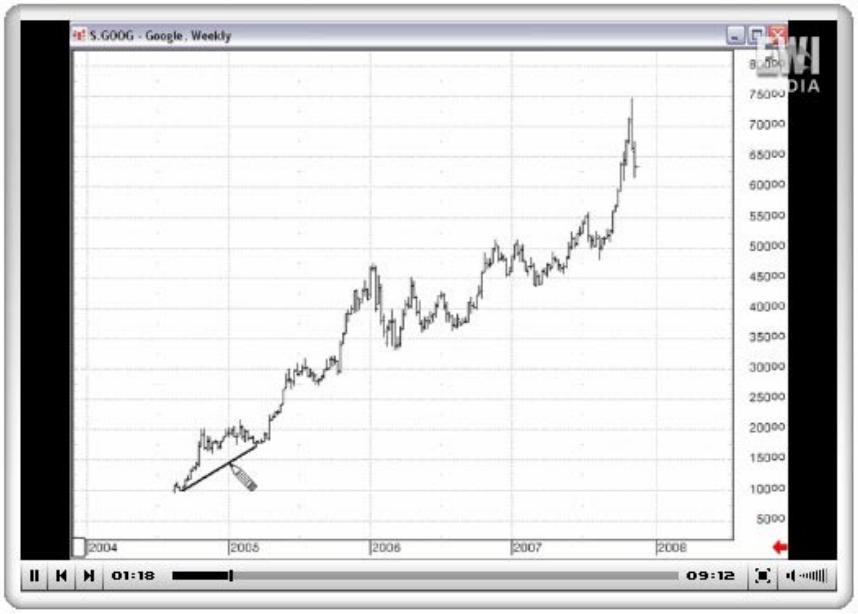
Figure 2-1

In this section, I'll show you how I draw trendlines. I'll start with the most common, simple way to draw them. Just connect two extremes, two highs in this instance, to identify resistance, as seen in the line in Figure 2-1.



Figure 2-2

Another way to draw them is connecting lows, to identify potential support. For this example, refer to Figure 2-2, which shows a price chart of Google. If you connect the lows in this chart, you might be surprised what develops when that trendline is extended.



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Figure 2-3



In Figure 2-3, that one little trendline between the lows in 2004 and the lows in 2005 consistently provided support for a number of retracements, or counter trend movements, within the advance in Google since then.

When you're drawing trendlines from low to low, you can do something else with them that I find pretty interesting. Oftentimes, I like to identify the low extremes within a move and then take a parallel. In the example shown in Figure 2-3, look at the trendline from the lows within the advance in Google, take a parallel of that line off the extreme – the highest we've seen – and you can see the most recent peak in Google, the upper line, provided resistance. It was just a simple trendline drawn on the lows and extended upward in a parallel line off the intervening extreme.

Figure 2-4



Next, in Figure 2-4, look where the upper boundary line provided resistance of the trendline. Notice there is another use for it. The midpoint of the trendline provides resistance in four different areas, which is why I include the center point or the midline when I draw parallel trendlines or price channels.

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Figure 2-5
The price chart shown in Figure 2-5 is of coffee, and again, I've already drawn a trendline on it. I connected the two extremes, points labeled 1 and 2, which provided support for points labeled 3 and 4.



Figure 2-6
Let's look at another example in Figure 2-6, a cotton weekly chart, to exemplify how useful trendlines can be. I've connected the lows, points 1 and 2, and taken a parallel off the extremes of the price move at point 3. This shows how a simple trendline identifies resistance in cotton. This is why you should draw trendlines – because one drawn some months ago, some days ago, some weeks ago, even some years ago can still be applicable today. This one little trendline in the previous figure, drawn from one low to another low, was effective on more than one occasion.



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Figure 2-7
Notice the resistance it provided in Figure 2-7.



Figure 2-8
Trendlines are probably the most basic analytical tool you can apply, whether it's a stock, currency or commodity; yet, they're extremely effective. More often than not, two parallel lines contain counter trend or corrective price action. Usually, it provides support, and you see prices either reverse near the lower boundary line or the center line. As you can see in Figure 2-8, the lower boundary line provided solid support for a subsequent move up in prices.



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Figure 2-9
Now, here's a neat little trick. In Figure 2-9, we use trendlines a different way. By connecting the two lows, we distinguish the breakout point. Later, it provides support when prices revisit the same line (circled).



Figure 2-10
Or, we can connect the highs and take it from an intervening low, as seen in this soybean weekly chart. The reversal that occurred in price at the lower boundary line is circled.



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Figure 2-11

Most of the lines that I've drawn thus far have been from high to highs, taking parallels off intervening lows, or they've been from low to low, taking parallels off intervening highs. That's not the only way to draw trendlines. Case in point – look at Figure 2-11. We connected the two lows, and it provided support in Google for the subsequent events shown. However, there was another way to identify support in this stock without drawing the traditional low-to-low trendline.



Figure 2-12

You could have drawn the trendline by connecting the highs and then taking the parallel off the intervening low, as shown in Figure 2-12. The circled area shows support.



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Techniques for Drawing Trendlines

Figure 2-13
I've explained how to draw trendlines from extremes – from high to high and low to low. In Figure 2-13, I drew two trendlines from significant highs to a significant lows. Upon first glance, the initial trendline does not provide the analyst or trader with much information. However, if you draw a trendline from a significant high to a low, or vice versa, and take a parallel of that trendline to the most extreme point within the move, you might discover if the trend will break or continue.



Figure 2-14
For example, I've drawn a trendline from a significant low to a significant high in Figure 2-14. I then take a parallel of that line off the lowest move within the price sequence. That trendline identifies the end of one trend and the beginning of a new one. As soon as prices began closing below the trendline, the previous move was done.



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Figure 2-15
Figure 2-15, a weekly bond chart, shows another example. Draw a trendline from the high to the low, take a parallel of that line and move it over to the most extreme move within the decline. Penetration of this line signals the completion of this decline



Figure 2-16
Look at Figure 2-16, which is the same weekly bond chart as before. Draw a trendline from the low to the high, take a parallel of that line, move it over to the right, to the most extreme portion of that move. You now know what prices must do to signal the onset of a new trend.



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Defining Trendline Breaks

Figure 2-17
In Figure 2-17, a much shorter-term timeframe is illustrated in a 60-minute price chart of the E-Mini Dow. Draw a line from the low to the high then take a parallel to the most extreme portion of the move. When prices begin breaking below this line, the previous move is done.

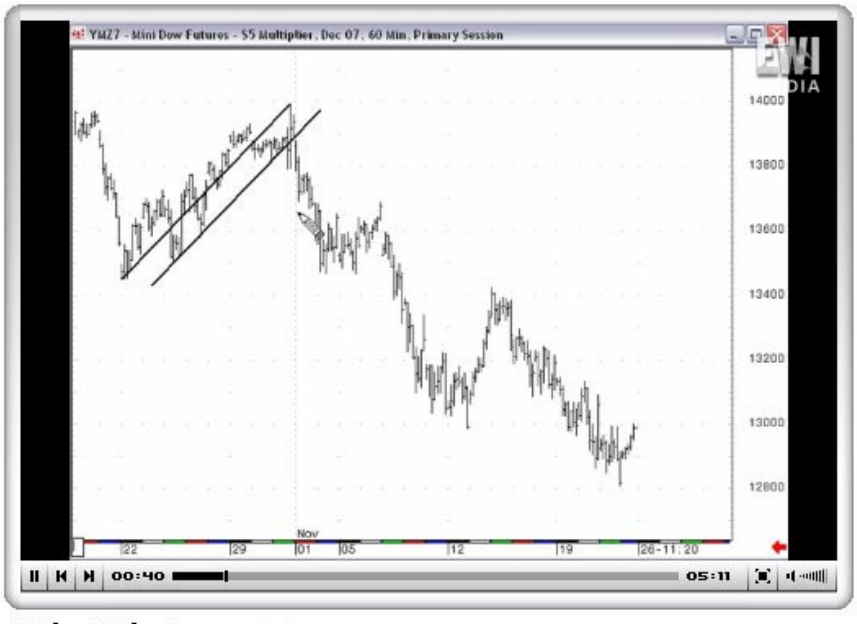
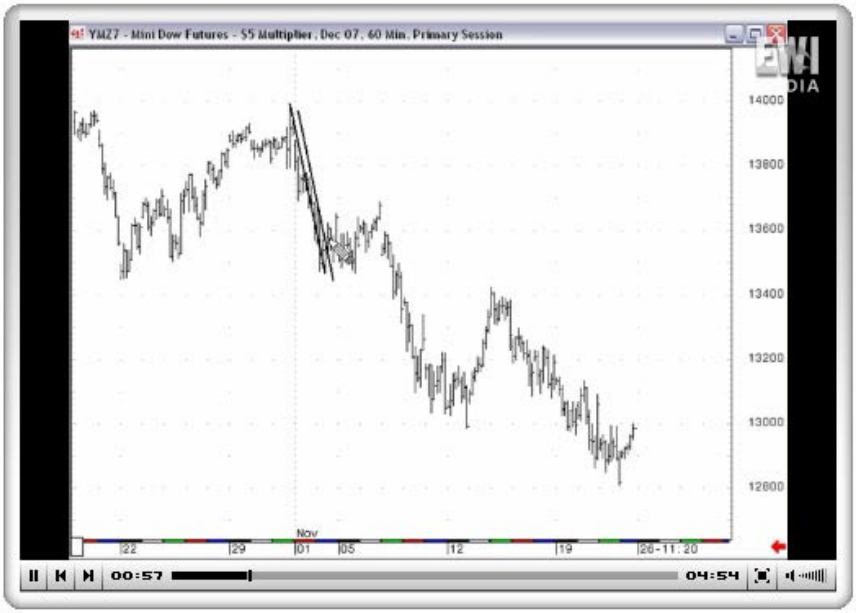


Figure 2-18
You can utilize this approach with much sharper moves as well, such as the decline in Figure 2-18. When prices begin moving above it or closing above it, then that's a good indication the previous move is done.



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Figure 2-19

Question: When is a trendline break a trendline break? Some people think closes above or below trendlines indicate a trendline break. I prefer to see price action begin moving above or below a trendline on a high or low basis. For example, in Figure 2-19, we see some closing price action below the lower trendline which I don't really constitute as a legitimate break of the trendline. Not until the high of the bar is below the trendline (where the pencil is pointing), is there an actual break of the previous trendline.

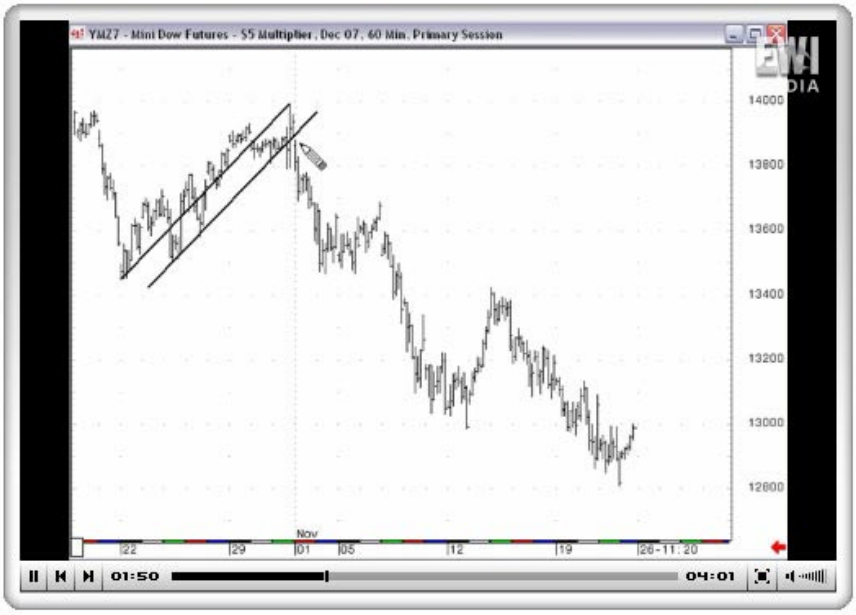


Figure 2-20

Let me readdress the question to make my point clear. What constitutes a legitimate trendline break? Well, in this instance, in Figure 2-20, I'm not looking for closing price action below the trendline, but rather the high of the price bar forming below the trendline. In this instance, we did close below the trendline (marked with the short line and pencil). However, two or three price bars later, the high of the bar is actually below the trendline.



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Figure 2-21
Let's go back to a previous example. When the high of the price bar is below the trendline, it signals a sell off to the downside.



Figure 2-22
The lows of these price bars in Figure 2-22 were above the secondary trendline and that confirmed the previous move was done.



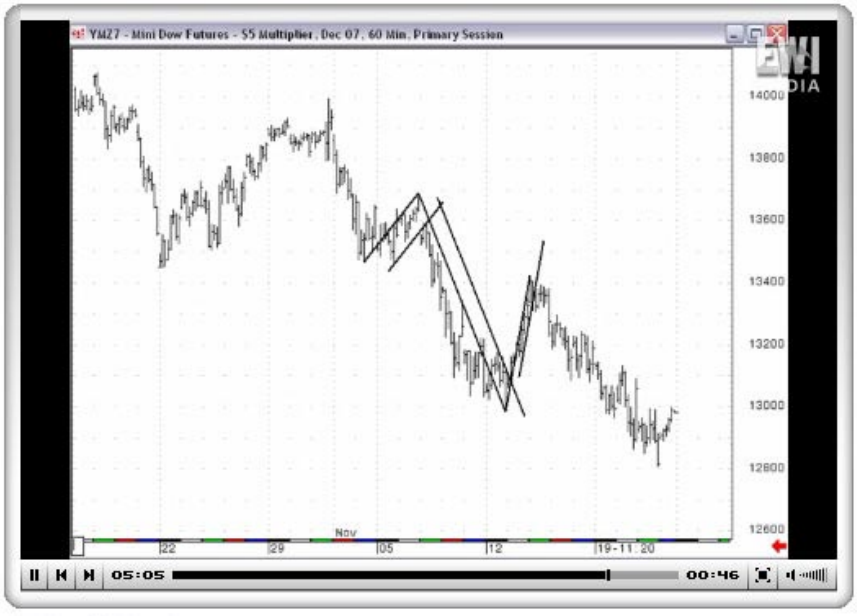
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Figure 2-23
In the subsequent advance in Figure 2-23, when the highs of each price bar begin forming below the trendline, the previous price move ends, and a new price move begins.



Figure 2-24
As you can see in Figure 2-24, the low of the price bar was above the secondary trendline, indicating an advance. The low of the price bars are above the secondary trendline, arguing that this a legitimate trendline break, so prices should move up for a while.

So, while you can draw trendlines from different extremes, you can also take parallels of those lines, creating price channels. You can garner a lot of information from the simple approach I've outlined here.



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