Know Them, Profit From Them

Make The Trend Your Friend In Forex

So you didn't see that last headline-grabbing market move coming? Here are some techniques you can use to make sure you'll be prepared next time.

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Of the many market sayings that traders throw around, none may be more overused and less understood than the adage "The trend is your friend." All too often, the phrase is used after a trader has taken a countertrend position and subsequently been stopped out at a loss. At this point, remorse sets in, and most traders kick themselves not only for having lost on a countertrend trade but also for not having caught the latest move in the trend itself.

To avoid this all-too-common scenario, let us suggest using several technical tools to identify whether a trend is in place, and then additional indicators to help maximize trading profits. Having a strategy in place to identify trends is essential to successful trading in any market, but especially so in the case of the foreign exchange (forex) markets. Currencies have a greater tendency to move in trends due to the longer-term macroeconomic elements that drive exchange rates, such as interest rate cycles or global trade imbalances. Currencies are also predisposed to short-term, intraday trends due to international capital flows reacting to day-to-day economic and political news.

IDENTIFYING THE TREND

In its most basic sense, a *trend* is simply a prolonged market movement in one general direction, either up or down. From a trader's perspective, though, that simple definition is so broad as to be almost meaningless. For our purposes, a trend should be defined as a predictable price response at levels of support/resistance that change over time. For example, in an uptrend the defining feature is that prices rebound when they near support levels, ultimately establishing new highs. In a downtrend, the opposite is true: Price increases will reverse as they near resistance levels, and new lows will be reached. Trendline analysis should establish support and resistance levels.

Trendline analysis is often underestimated because it is perceived as overly subjective and retrospective in nature. While there's some truth in those criticisms, they overlook the reality that trendlines

FIGURE 1: JUMP IN AND HANG ON FOR THE RIDE. If you are an aggressive trader and entered a long position at point A, and only exited your position at point C, you would be pleased with the results. This can be achieved with just a few simple indicators.

help focus attention on the underlying price pattern, filtering out the noise of the market. For this reason, trendline analysis should be the first step in determining the existence of a trend. If trendline analysis does not reveal a discernible trend, there probably isn't one.

Trendline analysis is best employed starting with longer time frames (daily or weekly charts), and then carrying them forward into shorter time frames (hourly or four-hourly) to identify shorter-term levels of support and resistance. This approach has the advantage of highlighting the most significant levels of support/resistance first and less important levels next. This helps reduce the chances of following a short-term trendline break while a major long-term level is lurking nearby.

Another technical tool that can be used to verify the existence of a trend is the directional movement index (DMI), which was developed by J. Welles Wilder. Using the DMI removes the guesswork involved with spotting trends, and can also provide confirmation of trends identified by trendline analysis. The DMI system is composed of the ADX (average directional movement index) and DI+ and DI- lines. The ADX is used to determine whether a market is trending (regardless if it's up or down), with a reading over 25 indicating a trend and a reading below 20 indicating no trend. The ADX is also a measure of the strength of a trend: the higher the ADX, the stronger the trend. Using the ADX, traders can determine whether there is a trend, and thus whether to use a trend-following system.

As its name would suggest, the DMI system is best employed using both components. The DI+ and DI- lines are used as trade entry signals. A buy signal is generated when the DI+ line crosses up through the DI- line; a sell signal is generated when the DI- line crosses up through the DI+ line. Wilder suggests using the "extreme point rule" to govern the DI+/DI- crossover signal. The rule states that when the DI+/- lines cross, traders should note the extreme point for that period in the direction of the crossover (the high if DI+ crosses up over DI-; the low if DI- crosses up over DI+). Only if that extreme point is breached in the subsequent period is a trade signal confirmed.

The ADX can then be used as an early indicator of the end/pause in a trend. When the ADX begins to move lower from its highest level, the trend is either pausing or ending. This signals it is time to exit the current position and wait for a fresh signal from the DI+/DI- crossover.

Let's look at a recent long-term trend (Figure 1) and put trendline analysis together with the DMI system. An aggressive

An approach utilizing trendline analysis, the DMI, and the parabolic indicator should help traders.

FIGURE 2: ADD A COUPLE OF MORE INDICATORS. Here, the parabolic indicator was used. The exit signal was given one day after the ADX gave its exit signal.

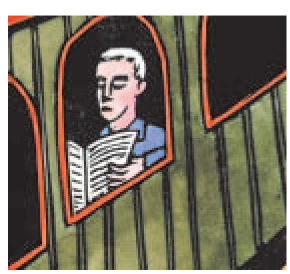
trader might initiate a long position as the daily resistance line is breached on November 12, 2003 (point A). A trader looking for confirmation might wait a day, until the DI+ crosses up through the DI- line (November 13). A conservative trader might wait for confirmation of the DI+/- crossover by waiting for the extreme point (high) to be exceeded in line with Wilder's extreme point rule. This confirmation is given the following day (November 14).

As the market begins to move higher, the support trendline drawn off the lows is tested but holds, underscoring the validity of the nascent trend. Although the market has moved higher in line with the DI+/DI- crossover and trendline support, the ADX is still below 25 until December 2, 2003 (point B), when a trend is finally confirmed. At this point, a trader should recognize that the market is trending and trend-following systems can be employed.

This introduces additional tools that can be used to maximize profit within a trending market. We have already suggested using the ADX as an early indicator of the end of a trend. Note that from point B, when it first registers above 25 to indicate a trending market, the ADX continues to make new highs until January 14, 2004 (point C), when it closes lower. This signals a likely end to the uptrend; it's time to exit the long position.

A second tool used to identify an exit point and possibly the end of a trend is the parabolic indicator†. The parabolic indicator follows the price action but accelerates its own rate of increase over time and in response to the trend. The result is that the parabolic is continually closing in on the price, and only a steadily accelerating price rise (the essence of a trend) will prevent it from falling below the parabolic, signaling an end to the trend. Figure 2 shows the parabolic indicator overlaid on the previous chart. Note that the parabolic gives an exit signal (point D) the day after the ADX experienced its first lower close.

The basic trendlines that are drawn could also have signaled the end to the uptrend. Note that the price accelerates above the upper channel line in the final extension of the uptrend, tests back to the break, and then goes on to make new highs. The subsequent price decline back below the upper channel line would then signal the end of the upmove. In addition, another support line similar to the parabolic could also be drawn, and its breach would have been the earliest signal of the end of the upmove.



WHAT ABOUT SHORT-TERM TRADING?

The same tools can be used for short-term decision-making, even in markets that are trading sideways, or so-called trendless markets. While the market may not be trending in a long-term sense, there are multiple smaller, short-term movements taking place that can be exploited. (One caveat must be noted, though: Traders must be aware of what

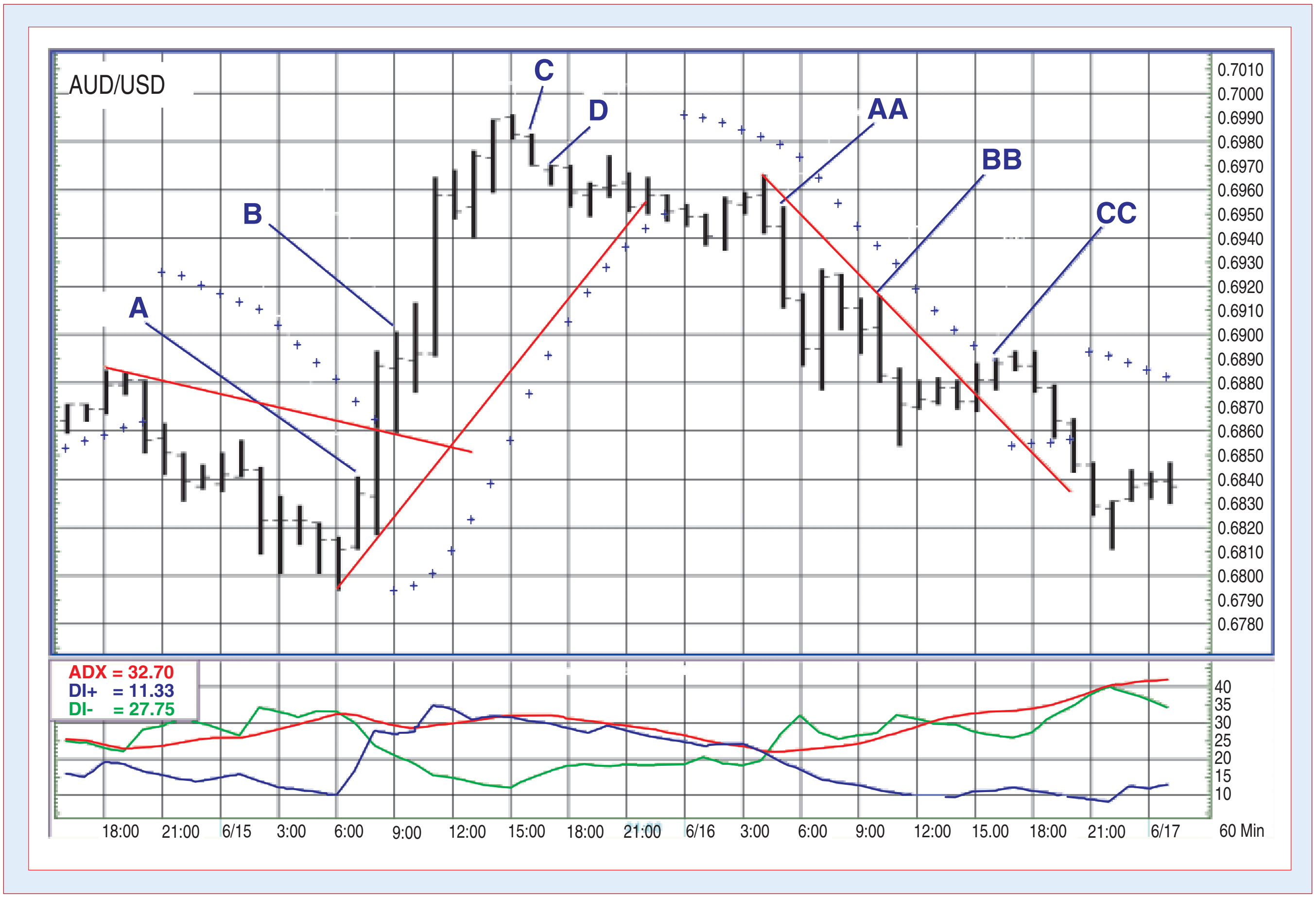


FIGURE 3: INTRADAY BASIS. On this hourly chart of the Australian dollar, the first entry signal was at point A. You could have held on until point D, where you should have sold your position. The next entry signal was at point AA (short) with a signal for covering that short position at point CC.

is happening in the bigger picture. If shorter-term ADX readings indicate a trending market, traders must be circumspect in initiating trades that are counter to the larger, daily trend.)

Let's look at a short-term scenario using an hourly chart of the Australian dollar (Figure 3). The first hint of a potential trading opportunity is the quick convergence of the DI+/DI- lines in the hour marked by point A. This is caused by the sharp bounce in price during that hour. The next hourly bar breaks through and closes above trendline resistance, precipitating DI+ crossing up through DI-.

Following Wilder's extreme point rule, we wait for the previous high to be surpassed, which happens in the next hour at point B. At this point, several signals indicate a long position: the break of trendline resistance, crossover of DI+/DI-, the extreme point rule satisfied, break of parabolic. As the market moves higher, the ADX begins to rise as well, peaking at point C and declining at point D, giving us our signal to exit the long position. Basic trendline and parabolic supports are then broken several hours later, setting the stage for the next potential move.

The next signal is given at point AA as the DI- crosses up through the DI+, generating a sell signal. This coincides with the price falling below recent hourly lows. The ADX begins to move up, indicating the possibility of a trend forming, and eventually rises over 25 at point BB. This indicates that a trend is in place and that the parabolic should be followed. Trendline and parabolic resistance are then breached and the ADX stalls at point CC, indicating an early but profitable exit from the trade.

THE TREND IS YOUR FRIEND

Profiting from market trends is the essence of making the trend your friend. The first step to profiting from both short- and long-term trends is to understand and identify them. The next step is employing a disciplined trading strategy that is specific to trends. A conscientious approach utilizing trendline analysis, the DMI system, and the parabolic indicator should help traders make more friends of market trends.

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SUGGESTED READING

Wilder, J. Welles [1978]. *New Concepts In Technical Trading Systems,* Trend Research.
‡GAIN Capital

†See Traders' Glossary for definition
‡See Editorial Resource Index

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