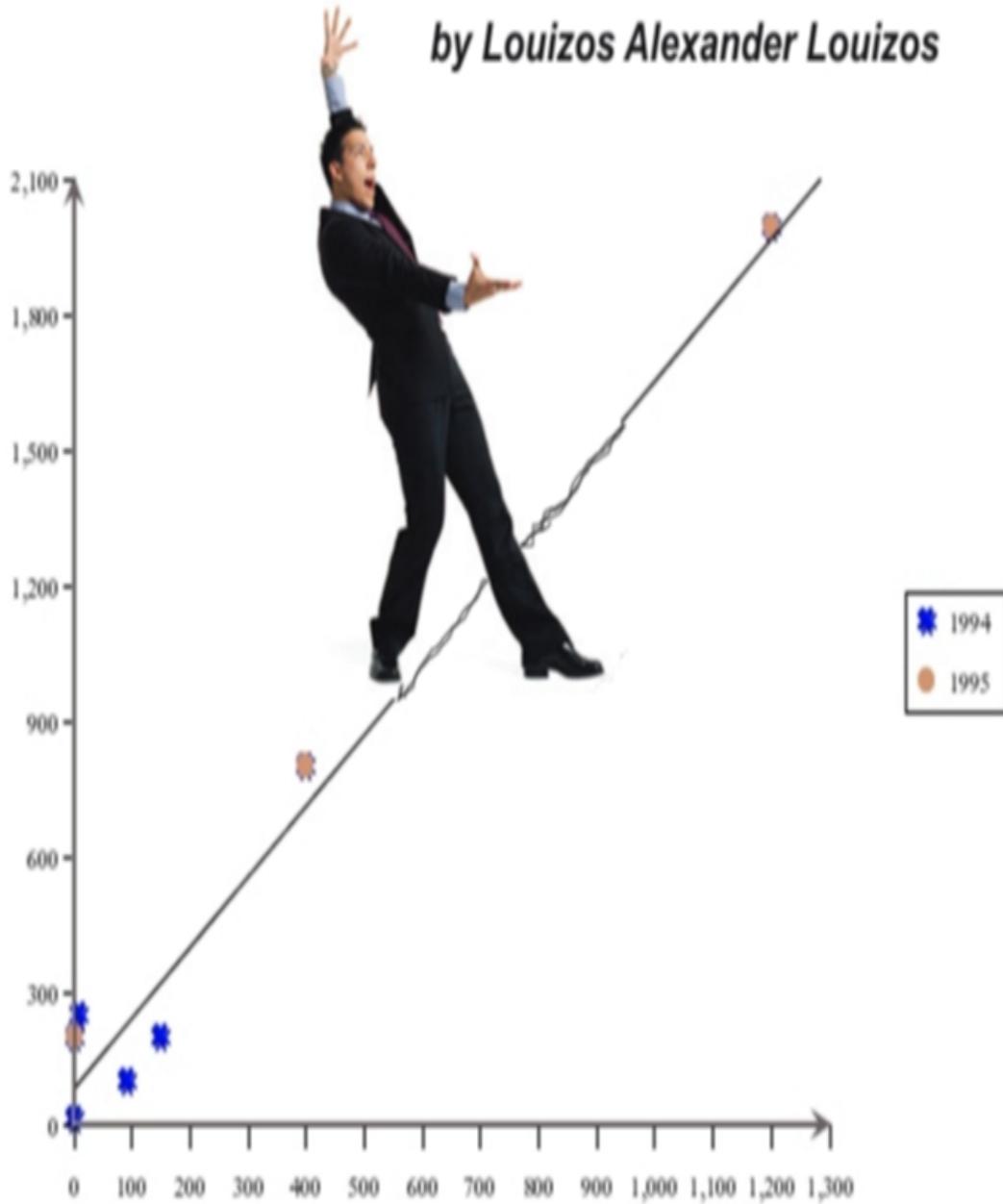


Trendline Analysis by Louizos Alexander Louizos, <http://www.easytradeforex.com>

Harness the Power of Trendline Analysis

by Louizos Alexander Louizos



TRENDLINE ANALYSIS

Great breakthroughs have surfaced with electronic trading and certain technical indicators are widely used. Nevertheless an affluent trader should be very skilled with trendline analysis in order to correctly predict Forex price movements. “Trend is my friend” is commonly said among traders. In this chapter you will learn how to correctly apply trendline analysis, one of the most important tools in your trading analysis.

Market moves following some patterns. Movement of the market is either up (upward market), down (downward market) or sideways (flat or non trending market). **Always avoid flat markets because market is fighting to make a decision and trading signals are cancelled because of the market sentiment.** Watch bellow a real market example of flat type of movements. **Remember: the longer the flat market the greater the outbreak will be because when market decides the next direction then a new trend evolves and many traders follow this trend.**

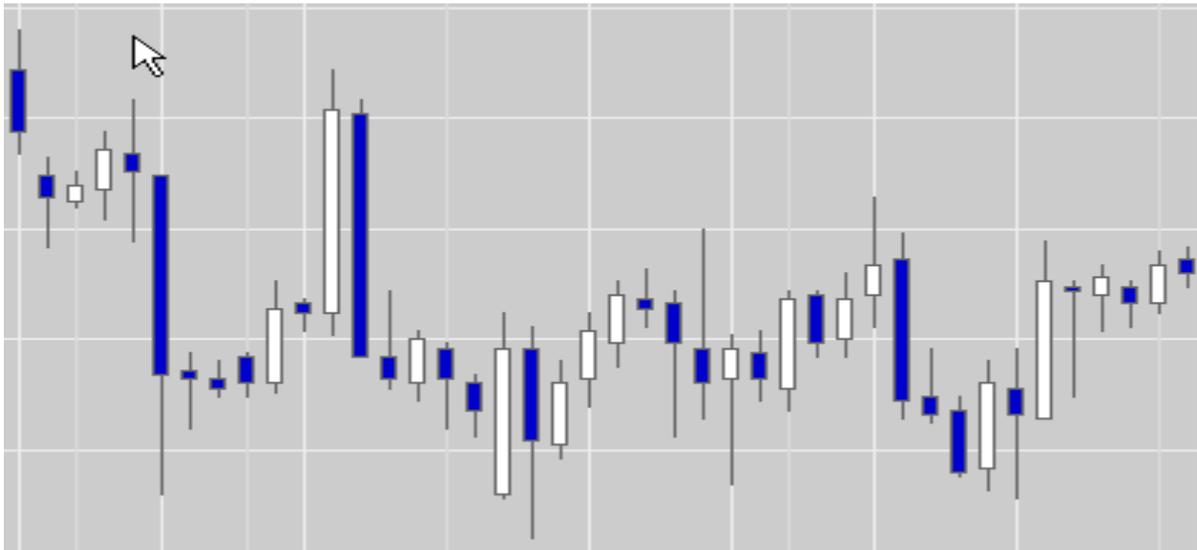


Figure 1. This figure shows a flat market



Figure 2 See what happened after the flat market finished. A strong uptrend evolved.

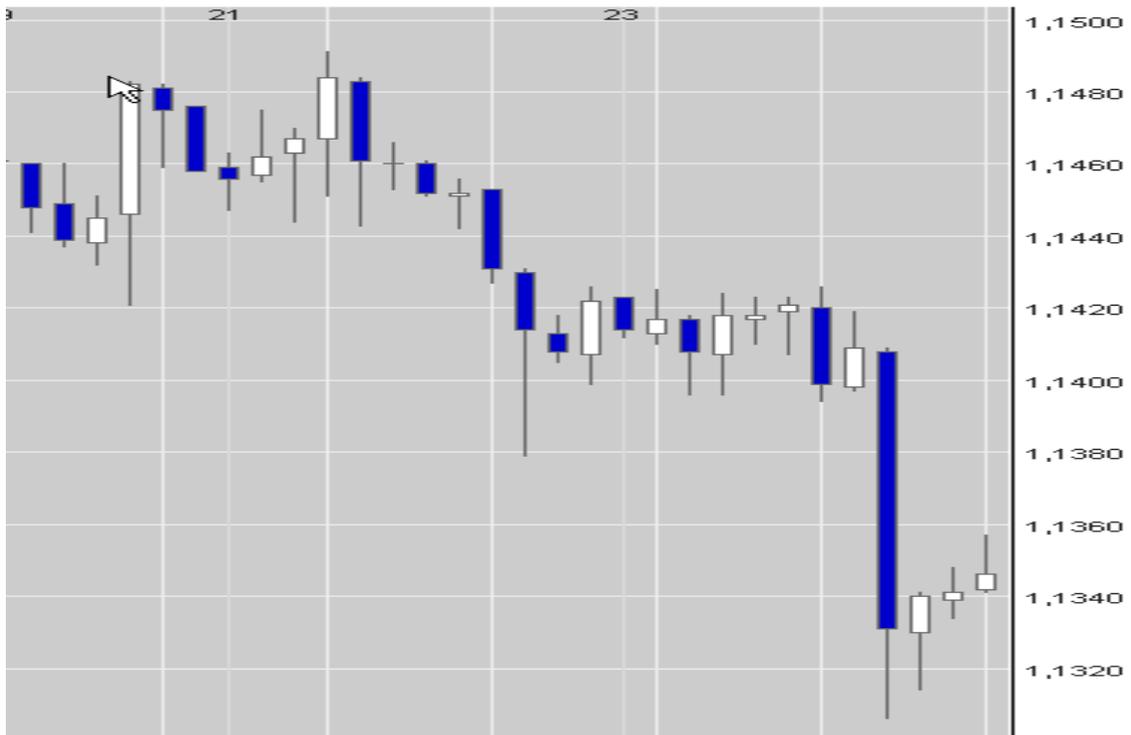


Figure 3 This figure displays a downtrend market environment

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Always remember: the longer the time period the most accurate your analysis will be. Always look the longer time charts and transfer your analysis to shorter time period. This last tip is something that is only referred in this book and can only be acquired through experience in trading. For example in a daily chart market may look flat and non decisive and in 1 hour chart you may recognize a trading signal. In this occasion you should be very skeptical. Or worst, daily charts shows downward trend and 1 hour chart shows a trading signal to get long. This way you may be caught up in the wrong direction. Continue reading to learn exactly how to avoid these traps.

SUPPORT AND RESISTANCE LEVELS

Market prices move in zig zag fashion. Peaks represent the price where more people sell than buy so market couldn't overcome this price. These prices are called resistance levels. The troughs on the other hand represent the price where buying pressure was higher than selling. These troughs are called support levels. **Connecting consecutive peaks a trader has a resistance line and connecting resistance levels a trader has support line.**

The first you have to learn is to draw support or resistance lines correctly and how to evaluate the significance of each line whether it is support or resistance.

When you realize that the market is upward trending you should draw a resistance line. To draw a resistance line pick up two peaks and draw the line connecting these peaks. See figure below. When a third contact point occurs then trendline is confirmed. Generally currency markets maintain its direction of trend.



Figure 4 A resistance line in an uptrend

Follow these rules to see whether your trendline is significant:

- 1) At least two peaks are connected. More connecting peaks confirm the trend line.
- 2) Most significant trend lines occur around the angle of 45 degrees. Trendline at sharper angles are indicating that trend is strong. Lower level trendlines indicate that trend is close to reversal.
- 3) Longer period trendlines should be given increased weight. Day charts trendlines are more significant than 1 hour charts.
- 4) Minor trendline penetrations (as long as 1%) should and may be disregarded. When connecting two peaks never mind about a peak penetrating a bit the trendline.
- 5) When you draw a trendline in candlestick or bar charts and connect two peaks or troughs and there is an intermediate shadow over the trendline this is not considered a break as long as the closing price is below the trendline See figure 2.13

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The same apply for connecting two troughs although the trendline is named support. Support lines are drawn in downtrend markets



Figure 5 Support line is drawn in a downtrend market

The most important thing about support and resistance lines is that when a confirmed support or resistance is broken then broken trend line is retested and support line becomes resistance and resistance becomes support. Notice below how the support line when broken became resistance.



Figure 6 A broken resistance line is broken then retested and became support

This way you already have the first prediction utility of market movement. Watch carefully market when it reaches significant support of resistance levels.

Test a lot with trend line support and resistance and channel designing (see below for channels). These are one of the most important tools you will ever use so it is very crucial to know how to use them correctly.

FOREX CHANNEL LINES

One of the most important elements of trendline resistance is channels.

Channels are two parallel lines that restrict price action. In order to draw a channel you should first draw a support or resistance line.

To draw a support or resistance line select an obvious trend and connect two hi or low points of price action. Then draw a parallel to the first line that restricts price movements. That is the channel line. **When price fails to reach support or resistance and is closer to channel line then we may see acceleration of the trend. When price fails to reach**

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channel line then the ongoing trend may be weakening. Channel breakout means that the prices retest the broken channel line. After successfully retesting of channel lines we have a price target at least equal to the channel width.

Channel lines act as resistance and support. When broken they are usually retested. This test gives us a trade entry point. If channel lines are at the same level as a Fibonacci retracement level then price reversal is imminent because Fibonacci resistance gives extra support to price action (you may take a look at our Fibonacci trading chapter in this book now). Look at the figure 2.14. It is an 11-17-2006 EUR/USD chart



Figure 7 Channel lines in an uptrend with Fibonacci levels

Look how the broken channel line is retested and then price action reverses. Watch the price target or the broken channel line equal to the width of the channel. Also notice how the channel line with added Fibonacci 50% support line restricted price action. This trade

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setup may be used as a trading system. Feel free to use it and see profits come. This setup is one of the favorites for professional fund managers.

TRENDLINE CHART FORMATIONS

There are chart formations indicating the reversal or continuation of a trend. These patterns occur in any time frame although the higher the time frame the more significant they are. We shall study at first trend reversal patterns. This means that when you recognize these patterns in a chart there is a high probability that the current trend will reverse.

HEAD AND SHOULDERS

Name of this formation is given after its shape. This formation looks like a head and shoulders. It consists of three consecutive rallies all based in the same support line named neckline. The two shoulders should be almost equal on height and head should be the highest. You may enter the market during retest of broken neckline. The most significant head and shoulders pattern is in weekly or monthly or daily charts. Head and shoulders on lower time frame are unreliable. Price target is the length between top of head and neckline.



Figure 8 A head and shoulders pattern in a daily chart.

In real market environment head and shoulders almost never appears as clean as the schematic. Trader must be careful not to misinterpret false head and a shoulder keeping in mind that neckline is seldom a perfect horizontal line although the significant point of the formation should be tangential to the neckline. The same applies to inverse head and shoulders



Figure 9 Inverse head and shoulder pattern.

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Look at the above market examples carefully. Then check the schematic below. Practice a lot. In order to recognize head and shoulders in market environment your eye should be flexible enough.



Figure 10. Schematics of head and shoulders pattern

DOUBLE TOP AND DOUBLE BOTTOM

This formation consists of two consecutive peaks or troughs of approximately the same height. The more equal the height the more significant the formation. Resistance line is formed connecting the two tops.



Figure 11 Schematics of double bottom and double top

Consider these in order to validate the formation:

- 1) The higher the time frame the more valid the formation

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- 2) Contact points should be tangential to the resistance line. In real market environment contact points cannot be perfectly tangential. Take this into account when deciding whether a formation is a valid double bottom or not.
- 3) You should only trade upon confirmed break and retest of resistance line. Breakout confirmation consists of a closing price outside the resistance line.
- 4) Target price is relevant to price and time symmetry and make take long to be fulfilled.



Figure 12 Double bottom in real market environment

TRIPLE TOP AND TRIPLE BOTTOM

The same apply to triple top and triple bottom formation. This formation is a hybrid of double top or bottom and head and shoulders.

TREND CONTINUATION PATTERNS

These patterns signal the continuation of the previous trend. Unlike trend reversal patterns they consist of short consolidation periods.

FLAG FORMATION

It looks like a flag. It consists of a steep upward or downward trend (flagpole) and a brief consolidation period which tends to be sloped in the opposite direction of the trend or it is simply flat. Consolidation is bordered by support and resistance lines which are parallel or mildly converging to each other. These lines give the flag. When price breaks out of consolidation price target is the length of the flagpole measured from the point of breakout. The higher the time period of flag formation the more valid the signal. Beware of false breakouts from the flag.



Figure 13 A bearish flag



Figure 14 Another bearish flag

PENNANT FORMATION

Pennants are the same as flags with the difference that support and resistance lines of consolidation period converge much more than flags.



Figure 22 A bearish pennant



Figure 15 A bullish pennant

TRIANGLE FORMATION

Triangles are pennants with no poles. There are four types of triangles:

- 1) *Symmetrical*: it consists of two symmetrically converging resistance and support lines with at least four significant points (eg. 2 on resistance and 2 on support). This pattern visualized the ambivalence of Forex market balance between supply and demand and breakout may occur on either side.
- 2) *Ascending triangle*: Flat resistance line and rising support line. The breakout should occur on the upside with price objective the width of the base of triangle measured above the breakout
- 3) *Descending triangle*: Flat support line descending resistance. Breakout should occur on the downside.
- 4) *Expanding triangle*. Support and resistance lines converging towards the beginning of the formation. Expanding triangles are rare in Forex Market.

In real market environment do not expect to find absolutely flat lines. Support and resistance lines should be designed according to hi/low of the prices. Take good care in designing these patterns.



Figure 16 A descending triangle

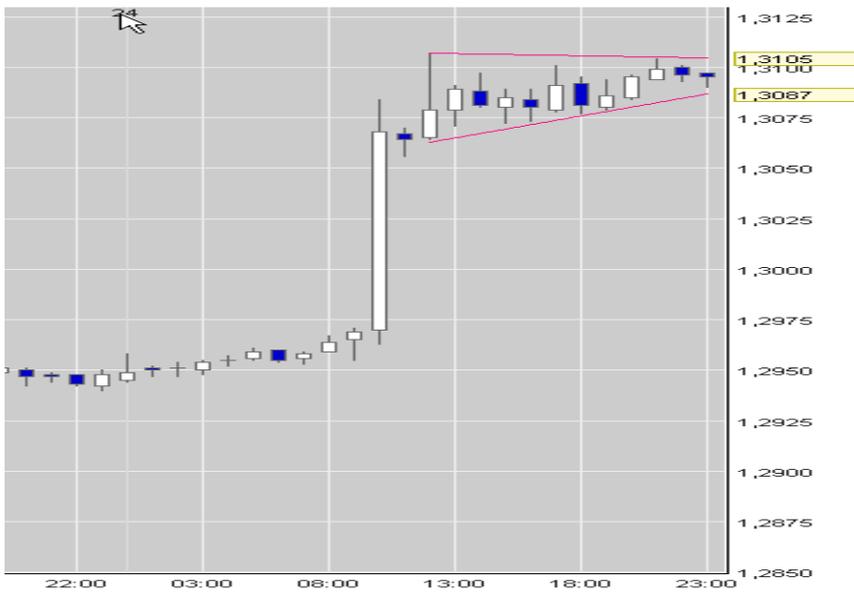


Figure 17 An ascending triangle

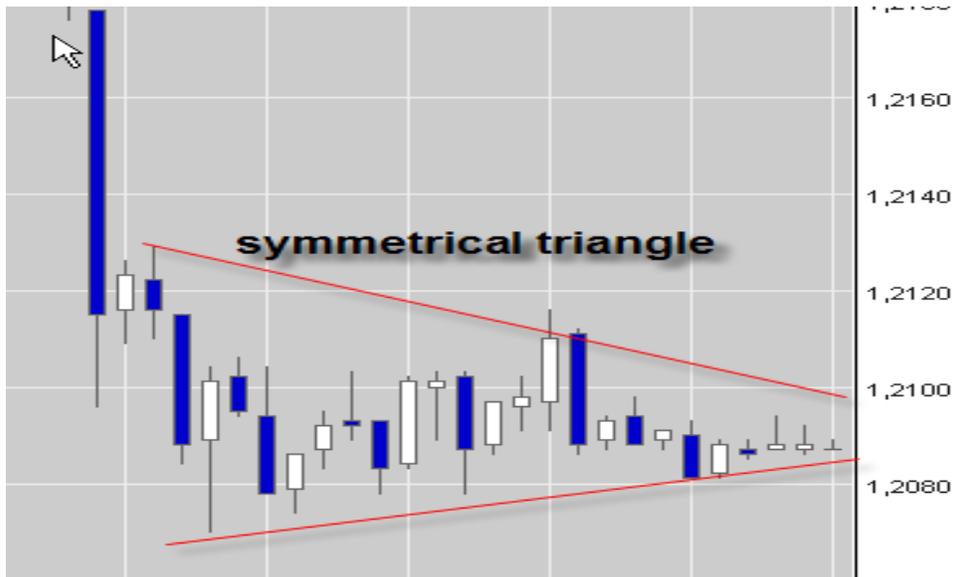


Figure 18 A symmetrical triangle

WEDGE FORMATIONS

It resembles the shape of triangles but it behaves like a pennant without a pole. It signals only continuation of the trend with no price objective. It is heavily sloped and breakout occurs to the opposite direction of the slope. There are two type of wedges: falling and rising.



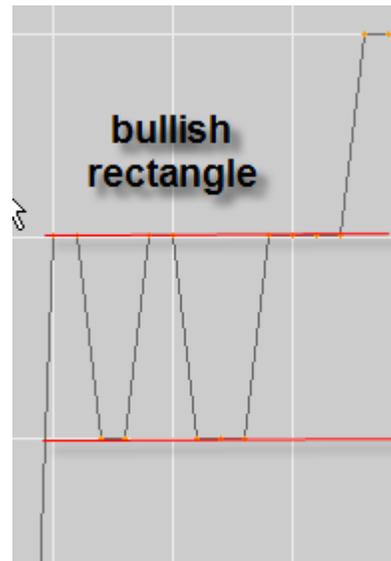
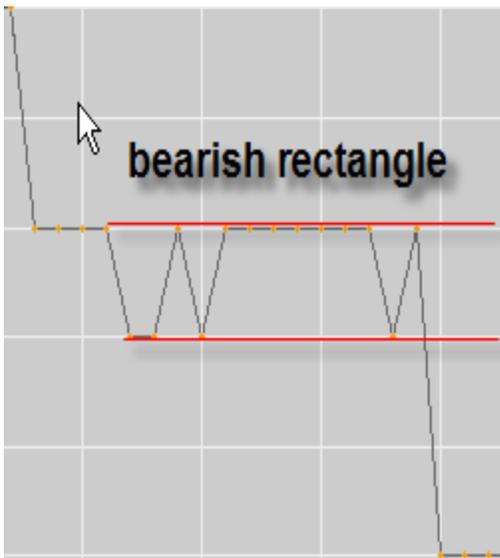
Figure 19 A falling wedge



Figure 20 A rising wedge

RECTANGLE FORMATION

This formation reflects a consolidation period. Breakouts may occur on either side and price objective is the height of the triangle.



ALWAYS REMEMBER

- 1) Always try to design these patterns in longer term time charts and on line charts. If you prefer to use candlesticks use the shadows as contact point for your resistance and support lines.
- 2) False breakouts are common so do not be trigger-happy with your trades until it becomes clearer. False breakouts tend to occur more often in the case of continuation patterns. Valid breakout on the other side shows the continuation pattern we thought we designed was a reversal pattern. Design your patterns carefully.

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Sincerely yours,
Louizos Alexander Louizos