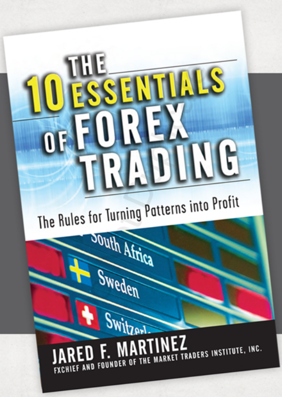
THE FOREX LIFE LINE

HOW SIMPLE TREND LINES CAN BE ALL YOU NEED TO EFFECTIVELY TRADE THE FOREX MARKET



CHAPTER 6 OF
THE 10 ESSENTIALS OF
FOREX TRADING

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CHAPTER 6

TRENDS AND TRENDLINES

A TREND IS YOUR FRIEND

For some traders, learning to trade on the Forex is like learning how to build a car from scratch, without an instruction manual. Many of you have acquired quality parts, such as breaks, wheels, motors, seats, and steering wheels, yet as you attempt to put them together, you are not coming close to building that perfect little car you envisioned.

To become a successful trader, you need the right parts, with the right manual, to put all the parts together and have your car work properly. After all, a part such as a $2.00 gasket can bring your car to a screeching halt. Just look at what happened to the space shuttle *Challenger*.

I will never forget the day it happened. At the time, I owned a business that took photographs for NASA of all the work being done on the space shuttle at the Kennedy Space Center. We took pictures of all the different phases, from construction, to liftoff, to landing, and then had a company in Japan print laser photographs of the images for resale to the public. There were just as many employees who worked on the shuttle seeking these quality laser photoprints as there were tourists around the world wanting them. In fact, importing and exporting them is what introduced me to the exchange difference in currencies, which is how I became familiar with currency trading.

By 1986, laser photoprints had caught on and our company was offered licensee rights for many national parks around the United States, as well as for tourist parks such as Disney, SeaWorld, and Universal Studios.

Through our importing, we exchanged hundreds of thousands of U.S. dollars once or twice a week for Japanese yen. At the time, I really knew very little about currency trading, but I did recognize the constant fluctuation of the currencies as I was exchanging them. I wasn't trading the yen against the U.S. dollar to make money, but I saw that prices fluctuated up and down. So I watched the price movement to make sure I got the best deal at the time of the exchange; meaning, I was always waiting for the best time to make an exchange, enabling me to get as many yen as possible for my U.S. dollars.

In the late 1980s, I almost went bankrupt—not from mismanagement of my company, as the company was growing by leaps and bounds, but from the yen strengthening from 280 yen against the U.S. dollar to 150 yen to the U.S. dollar in less than 90 days. My cost of production doubled over a period of 90 days as the Japanese yen kept numerically falling and falling. The yen was increasing in value against the U.S. dollar as it dropped in price until it stabilized around 140 to 150 yen to the dollar. That is why products made from Japanese firms such as Sony and Sanyo doubled in price back in the late 1980s. That shift in economy opened the doors of opportunity for many U.S. manufacturers to now compete with the Japanese. It also forced the Japanese to start manufacturing their products here in the United States.

It is amazing how one person's loss becomes another person's windfall. I was going bankrupt, losing millions of dollars, while successful currency traders were making millions by shorting the market.

Had I taken the time to educate myself about currency trading and trends back then, using a simple piece of trading software like what we use at MTI, I could have been making $130,000 to $1,300,000 from a relatively small investment in the currency market, instead of losing millions as the U.S. and Japanese economies shifted.

I was unable to find a chart of the yen falling 13,000 pips back in the 1980s, however, I did find an example of a yen chart falling 3,100 pips in three months, between August 1998 and October 1998.

Looking at the chart of Figure 6-1, trading 10 lots or shorting the market with 10 lots by investing $10,000, brought a return to the trader of $300,000 in three months. Can you see how the inner trend line crossed over from the north to the south of the outer trend line, signaling a sell position for a long-term trader?

FIGURE 6-1 USD/JPY (Daily Chart)

TRADING A TREND UNTIL IT BENDS

Currency trading is very different than trading stocks. Companies can file bankruptcy, like Enron, or go completely out of business, taking their share value down to zero. On the other hand, with currency trading, there is no threat of a country going bankrupt. The country is not going to go bankrupt and turn the currency worthless. What *can* happen is that severe economic changes take place between countries, creating dramatic changes in the currency value of one country versus another. When that happens, it can create an incredible financial return for savvy, educated currency traders.

Study the four charts of Figure 6-2. In Figure 6-2A, the euro trended down 1,300 pips in four months, creating a $13,000 return trading one lot, or investing $1,000. How would you like to learn how to make this type of passive income trading long-term positions in currencies? A $10,000 investment would have brought a return of $130,000.

In Figure 6-2B, the Swiss franc (CHF) trended up 1,400 pips in four months, creating approximately a $13,000 return trading one lot, or investing

FIGURE 6-2 Identifying Trend Direction on Different Currency Pairs

(A)

(B)

FIGURE 6-2 ***Continued***

(C)

GBP/USD (Daily Chart)

(D)

USD/CAD (Daily Chart)

$1,000. The reason is that the CHF does not pay $10 per pip—it has a fluctuating pip value.

In Figure 6-2C, the British pound (GBP) trended down 1,600 pips in four months, creating approximately a $16,000 return trading one lot, or investing $1,000.

In Figure 6-2D, the Canadian dollar (CAD) traded against the U.S. dollar (USD) and trended down 2,400 pips in seven months, creating a return of approximately $19,000 if you were trading one lot, or investing $1,000. The CAD also has a fluctuating pip value.

Trends appear across all time frames. They appear on monthly, weekly, and daily charts for long-term trading; they appear from eight-hour charts down to one-hour charts for day trading; and even on one-hour down to three- to five-minute charts for scalping.

Learning how to spot a trend that can last several hours for scalping, several days for day trading, and several months for long-term trading can create an enormous financial return for the skilled and educated trader.

The Forex trades 24 hours a day, and any time during those 24 hours you can turn on your computer and sit down to trade. The most important first step of success in trading currencies is determining market direction. The fact is if you want to make money currency trading, you will have to take a bullish or bearish position. One or the other—never both! You cannot make money taking a bullish *and* bearish position at the same time; you would be in a net zero position, making and losing the same amount of money with every pip movement.

People trade according to their personalities. Aggressive people love to scalp, while passive people prefer long-term trading. Figuring out your trading style is very important before you trade. However, whether you are a passive trader or an aggressive trader, you need to be able to determine market direction before you trade. You need to learn how to find the current trend before you enter the market, because you need to trade in the direction of the trend at all times. Do not fight the trend. Fighting a trend is like trying to swim upstream through violent forceful rapids. It doesn't work. Traders can make many mistakes. The biggest mistake is trading in the wrong direction!

One of the best ways to determine market direction is to have a piece of trading software, such as MTI 4.0, with an automated trend indicator that keeps up with the trend direction on any time frames (see Figure 6-3). As the market moves, the trend lines move with it. You can see how the market is constantly bouncing off the inner trend line. For example, on April 12, 2005, if the uptrend is going to stay in place when the inner trend line is broken, the market moves to the outer trend line and that is where the next

FIGURE 6-3   USD/CHF (Daily Chart)

bounce will take place. It is when the outer trend line is broken that the majority of the time the market incurs a major reversal, as you see taking place around August 1, 2005, in Figure 6-3.

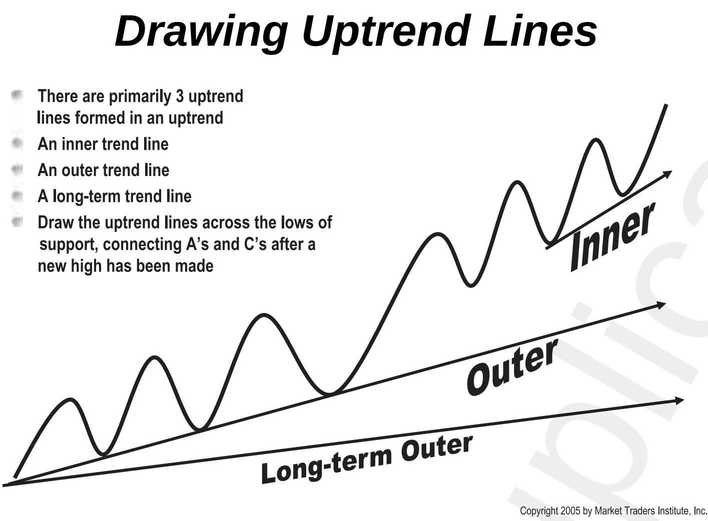
If you are an active trader and you use trading software that does not have a moving trend line indicator, you will need to learn the skill of drawing correct trend lines—with correct being the operative word. An incorrectly drawn trend line can mean the difference between making and losing money on a trade. Drawing trend lines is a skill that can be taught, but I think it is always best to have an automated trend line indicated on your software to keep up constantly with the trends you want to monitor.

In this chapter, we focus on finding, drawing, and monitoring three trend lines:

1. An inner trend line
2. An outer trend line
3. A long-term trend line

These Three trend lines form on all time frames and in both uptrends and downtrends (see Figure 6-4).

FIGURE 6-4



As the market moves, it will only move in one of three directions: up, down, or sideways. When it moves in any direction, it waves. Those waves become the emotional enemy of most traders. For some traders, it can take years to trust those waves and ride them to their end target.

SPOTTING AN UPTREND

If the market is going to move up, or trend up, on any time frame, it will wave up, creating higher highs, then wave back down, creating higher lows. I have never seen it go directly to the moon like an Apollo rocket. If it were to go to the moon, it would wave as it went, creating higher highs and higher lows. At some point, the trend will end, but until it ends, most successful traders try to take advantage of the move and take the ride up until it bends or ends. Believe it or not, most traders make all their money in trends and lose it all again in consolidation.

As the market trends in any direction, it moves at different speeds, just like a car. Most trends travel at a 45-degree angle as they move, akin to a car driving at normal speed. The trend line that is used for that 45-degree movement is called the outer trend. When a trend moves at a slower pace, a long-term trend line is created. Every now and then, the trend gets on a freeway at highway speed, ascending at a greater angle than 45-degrees, creating what is called an aggressive trend, or the inner trend line. Up and down inner trends, outer trends, and long-term trends all develop at the same time on all time frames (see Figure 6-5).

DRAWING UPTREND LINES

In drawing any uptrend line, you will draw a straight line, connecting all your visible levels of support without penetrating the bodies or wicks of the candles (see Figure 6-6). I have found that drawing the uptrend lines across the wick lows is more accurate than drawing them across the lows of the candle bodies and allows the trader to project the exact place of the future bounce (see Figure 6-6).

There is something magical that takes place when the market hits a trend line. Most traders call it a phenomenon. You will appreciate this phenomenon when it is explained in Chapter 8.

The market is like a large, never-ending river filled with violent rapids as well as slow-moving, calm waters. The market goes where it wants, when it wants, and yet it is governed by a set of natural laws, just like a river

FIGURE 6-5 EUR/USD (Various Time Frames)

FIGURE 6-6 EUR/USD (One-Hour Chart)

is governed by gravity and obstacles in its path. As the market moves in a direction, it has a tendency to retrace back to a trend line as if it were being directed by gravity and obstacles. If any current trend is going to stay in place, once it retraces back to a trend line, the market will bounce in the direction of its previous trend, and the trend line will act as the obstacle that will change the direction of the current movement. In other words, correctly drawn trend lines can project future levels of potential support in an uptrend and future levels of resistance in a downtrend.

FINDING AND DRAWING INNER, OUTER, AND LONG-TERM UPTREND LINES

You find and draw inner uptrend lines by finding the last two levels of support and drawing the line from left to right. You find and draw the outer uptrend line by starting at the far left of the chart and moving to the right, connecting the majority of your lower levels of support with a straight line. In other words, you start at the left of the chart and find your lowest wick low. From there you draw a straight line at about a 45-degree angle up, finding the next or higher level of support. You then connect the two wick lows, or levels of support, with the uptrend line, without penetrating any candles on the chart. As long as the chart is making higher highs and higher lows, you stay below the lows of support (see Figure 6-7).

Find and draw the long-term trend line by either compressing the chart or going to a larger time frame, connecting your levels of support starting from the far left of the chart moving forward. Because inner and outer trend lines form on all time frames, you need to look at a daily chart, where if you happen to see an inner and an outer uptrend line, the inner uptrend line will represent the most recent up movement for that time frame. The outer uptrend line represents the up movement over the past couple of months. If you look at an hourly chart, the inner uptrend line represents the up price movement over the past few hours, whereas the outer uptrend line represents the up price movement over the past couple of days. It is always best to compress your charts in the time period you are looking at to find any additional outer trend lines, or the long-term trend line.

FIGURE 6-7 EUR/USD (Four-Hour Chart)

Successful traders constantly monitor all uptrend lines on all time frames. Why? The movement on smaller time frames will always respond to the trend lines on larger time frames. This means that if the market is retracing back down toward an uptrend line on a daily chart, that retracement on the daily chart may be a 200-pip retracement and will form a downtrend on a 60-minute chart. If you only look at the 60-minute chart to do your analysis, you will be in a strong downtrend and your bias will be bearish. You will probably enter the market bearish. However, the way Murphy's law works, you will be entering at the end of that 60-minute trend, because as soon as the market from the daily chart hits its up trend line, the 60-minute chart will reverse and begin to rally, and you will be sitting there scratching your head, losing money and wondering what happened.

Once again, the inner, outer, and long-term uptrend lines can be found on any chart and on any time frame. Outer trend lines represent the overall movement on the chart for that time frame, and the inner trend line represents the most recent movement for the time frame. As long as the market is above the outer uptrend line, there is an 80 percent chance the market will continue bullish. You must remember, uptrend lines act as future levels of support. They are like a floor, and when the market hits them, they usually bounce back up. If the inner trend line is broken, the market usually moves to the outer trend line and will bounce back up from there. If the market breaks the outer trend line, the market will predominately move to the long-term trend line and bounce back up from there. If the long-term trend line is broken, as a rule there will be a major reversal (see Figure 6-8).

INCORRECT WAYS OF DRAWING UPTREND LINES

Correctly drawing trend lines will be critical to your success and will help to prevent you from losing money.

On one of my many trips to South Africa, I flew down to Cape Town to meet with a gentleman named Joubert who owned a trading company that was struggling. All their traders were losing way more money than they were making.

As I walked around the room for the first time, looking at their trading screens, I saw screen after screen with nothing but incorrectly drawn trend lines. I said to myself "no wonder they are all losing money!"

As I continued to walk around the room, looking at their screens, I noticed different trading systems and I wondered what other things they were doing wrong that they thought they were doing right. I was still

FIGURE 6-8 EUR/USD (Daily Chart)

standing there when, all of a sudden, one trader yelled out: "Swiss is getting ready to hit an uptrend line, get ready to trade it!" I walked over and looked at his screen only to quickly see, like all the others, he had incorrectly drawn his uptrend line.

I said, "Short the Swiss." Surprised and shocked, everyone in the room looked at me as if I were crazy.

He said, "Swiss is hitting an uptrend line, why would you even think of shorting it? Swiss is still in an uptrend and getting ready to hit a level of support."

I calmly replied, "The uptrend is dead on the Swiss, it is not hitting an uptrend line, it has already broken the inner and outer uptrend lines and is now moving to the long-term uptrend line, which is about 150 pips away. I would go short on the Swiss."

He asked, "What is an inner, outer, and long-term trend line?"

I replied, "That is why I am here."

He said, "Well, I'm going long."

I looked at everyone and said, "I guess this will be a moment of truth then." Then I looked at the traders and said, "From the screens I can see you are all drawing trend lines incorrectly. But if you believe in your uptrend line, then trade it and go long and I will understand." Then I said, "Anyone wanting to make money on Swiss, go short for the next 125 to 150 pips, then reverse your position and go long for another major move up."

As I walked into Joubert's office I held my breath, hoping that the market would continue to fall as I had predicted, knowing full well that the market does what it wants to do. Fortunately, Swiss fell exactly 150 pips to the long-term uptrend line and bounced back up like a basketball.

Trend lines need to be drawn correctly in order to make money trading. Learning the simple skill of correctly drawing trend lines can help you learn where to get in and can help you learn how to preserve your equity by getting out when it begins to turn. The following charts show the wrong ways to draw uptrend lines. In Figure 6-9, you cannot draw your uptrend lines through the candles of support—they must be at the bottom wicks of support.

FIGURE 6-9 EUR/USD (Daily Chart)

In Figure 6-10, the dotted line was at one point the correct uptrend line, but the market broke the uptrend line and retraced, continuing in an uptrend. As long as the market is making higher highs and higher lows, you cannot draw the line through the candles—you must draw the uptrend line across the lows of support.

In Figure 6-11, the uptrend is over and has been broken. The market is reversing and is currently trending down creating lower lows and lower highs. In this case, with the market creating lower lows and lower highs, you need to draw the uptrend line across the lows of support, until the market quits making higher highs and higher lows. The moment the market stops making higher highs and higher lows and starts making lower lows and lower highs, that is the moment the market is reversing.

Figure 6-12 shows that your trend lines must always be straight; they cannot be crooked. Only automated trend lines from your computer can wave or be crooked.

FIGURE 6-10 EUR/USD (One-Hour Chart)

FIGURE 6-11 EUR/USD (15-Minute Chart)

FIGURE 6-12 EUR/USD (One-Hour Chart)

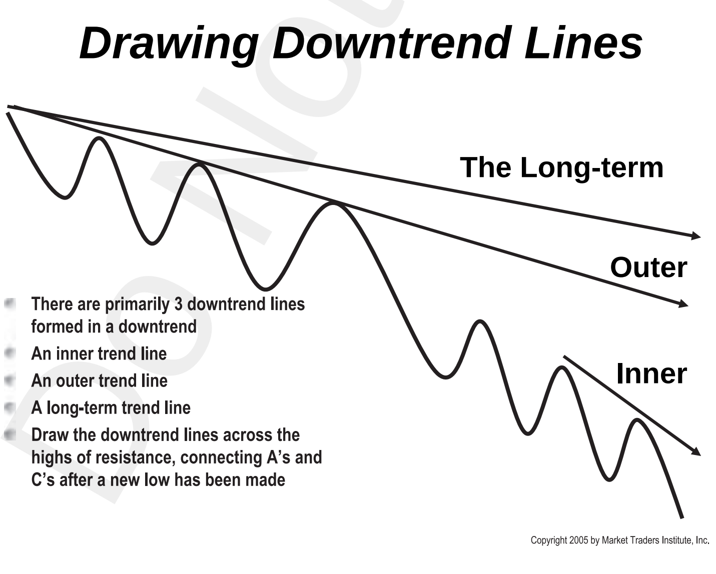
FINDING AND DRAWING DOWNTREND LINES

One of the neatest things about learning to trade in this market is that in a downtrend, the market reacts the same way as an uptrend, but in the opposite direction. That means all the rules are the same, but in the opposite direction. Instead of the market making higher highs and higher lows as it trends up, it makes lower lows and lower highs as it trends down. Instead of the market bouncing up off an uptrend line, which is a future level of support, the market bounces down on a downtrend line, creating a level of resistance. Downtrend lines act as ceilings for the market and are future projected levels of resistance.

Once again, the best way to determine market direction is to start drawing trend lines. If the candles are above the uptrend line, the market is probably going to continue up. If the candles are below the downtrend line, the market is probably going to continue to trend down. Drawing downtrend lines is a skill that just about anyone can learn.

At the risk of repeating myself, the rules for drawing downtrend lines are exactly the same as drawing in an uptrend, but in the opposite direction. It is like turning everything upside down. Instead of drawing the lines across the lows of support we will draw the lines across the highs of resistance (see Figure 6-13).

FIGURE 6-13



FINDING AND DRAWING INNER, OUTER, AND LONG-TERM DOWNTREND LINES

You find and draw the inner downtrend line by finding the last two levels of resistance and drawing the line from left to right. You find and draw the outer downtrend line by starting at the far left of the chart and moving to the right, connecting the majority of your higher levels of resistance using a straight line. In other words, you start at the left of the chart and find the highest wick high and, from there, you draw a straight line at about a 45-degree angle down, finding the next or lower level of resistance. You then connect the two wick highs or levels of resistance with the downtrend line, without penetrating any candles on the chart, following the lower lows and lower highs. As long as the chart is making lower lows and lower highs, you will stay above the highs of resistance (see Figure 6-14).

Now find and draw the long-term downtrend line by either compressing the chart or going to a larger time frame, connecting the levels of resistance starting at the far left of the chart moving downward. Because inner and outer

FIGURE 6-14 EUR/USD (One-Hour Chart)

trend lines form on all time frames, if you look at a daily chart and happen to see an inner and an outer downtrend line, the inner downtrend line will represent the most recent down movement for that time frame, or the movement over the past few days. The outer downtrend line will represent the down movement over the past couple of months. If you are looking at an hourly chart, the inner downtrend line will represent the down price movement over the past few hours, and the outer downtrend line may represent the down price movement over the past couple of days. It is always best to compress your charts in the time period you are looking at to find any additional outer downtrend lines or any long-term uptrend or downtrend lines.

Successful traders are constantly aware and monitor all trend lines on all time frames because the movement on smaller time frames will always respond to the trend lines on larger time frames. For example, if the market is retracing back up toward a downtrend line on a daily chart, that retracement on the daily chart may be a 200-pip move up. A 200-pip retracement from a daily chart will be an uptrend on a 60-minute chart. If you only look at the 60-minute chart to do your analysis, you will be in a strong uptrend and your bias will be bullish. You will probably enter the market bullish, however, the way Murphy's law works, you will be entering at the end of that 60-minute trend, because as soon as the market from the daily chart hits its trend line, the 60-minute chart will reverse and begin to dip, and you will lose money.

Just like uptrend lines, the inner, outer, and long-term downtrend lines can be found on any chart and on any time frame (see Figure 6-15).

Outer downtrend lines represent the overall movement on the chart for that time frame, and the inner trend line represents the most recent movement on that time frame. As long as the market is below the outer downtrend line, there is an 80 percent chance the market will continue bearish. Downtrend lines act as ceilings and future levels of resistance. If the inner downtrend line is broken, the market usually moves to the outer downtrend line and will bounce back down from there. If the market breaks the outer downtrend line, the market will generally move to the long-term downtrend line and bounce back down from there. If the long-term trend line is broken, as a rule there will be a major reversal (see Figure 6-16).

INCORRECT WAYS OF DRAWING DOWNTREND LINES

The same rules apply to drawing incorrect downtrend lines as they do to drawing incorrect uptrend lines, but in the opposite direction. Traders need

FIGURE 6-15 USD/CHF (Various Time Frames)

FIGURE 6-16 GBP/USD (One-Hour Chart)

to learn how to draw downtrend lines correctly in order to help them project the next bounce down. When you draw downtrend lines, you cannot draw your lines through the candles of resistance—they must be at the tops of the wicks of resistance.

As long as the market is making lower lows and lower highs, you cannot draw the line through the candles—you must attach the downtrend line across the highs of resistance.

The downtrend is over when the market stops making lower lows and lower highs and begins making higher highs and higher lows. When that happens, an inner, outer, or long-term downtrend line has been broken. As a rule, the market will begin to reverse in the opposite direction.

TRENDS INSIDE OF TRENDS

As the market moves, it can create trends inside of trends (see Figure 6-17). In this chart, you see the market aggressively trending up on the north

FIGURE 6-17 EUR/USD (Daily Chart)

side of the outer uptrend line, then breaking the inner uptrend line and reversing. After it reverses, it trends back down, forming the inner downtrend line until it hits the outer uptrend line, where it bounces and begins to trend back up forming an inner uptrend line again.

TRADING CHANNELS

As a trend moves, it likes to move inside a trading channel. A trading channel is described as the market moving at an up or down angle inside two trend lines that create somewhat of a channel. The trend lines of the trading channels act as both resistance and support. If any are moving up—or a downtrend breaks a trend line and it stays in place—the trading channel will usually shift. In Figure 6-18, you see how a trading channel has shifted and how the centre uptrend line at one time was support for the market and with the shifting of the trading channel, now became resistance for the market in the new trading channel.

FIGURE 6-18 EUR/USD (Daily Chart)

THE VALUE OF TREND LINES

Using trend lines as part of your trading system, and in conjunction with other indicators, increases your chances of success. Why? Because of convergence, where there are several things taking place at a single price point, having several indicators could confirm and support trading decisions.

CONCLUSION

Uptrend and downtrend lines not only indicate market direction but also act as levels of support and resistance. In a downtrend, trend lines are future locations where the market may bounce back down. In an uptrend, trend lines are future locations where the market may bounce back up. Either way, they are just another little piece of the puzzle that increases the probability of a continued move. The key is to always look for that convergence, along with a trend line bounce in the direction of a trend.

The following are always great tools to use when determining when to enter this market:

1. Trading software that can help determine trend direction with use of buy and sell signals
2. Bullish and bearish candlestick formations
3. Finding levels of support and resistance
4. The knowledge that past resistance many times becomes future support, and vice versa
5. The knowledge that trend lines act as floors of support and ceilings of resistance in the market and become visible locations for the next bounce in the direction of the trend

The more information you can gather as to why the market should bounce in a certain direction at a certain price point, the higher the probability for success. You now have five great trading tools to add to your tool kit, with more to come in future chapters. Regardless of how great a trade may look, it will always come down to trading within the equity management rules, which you will be learning about in Chapter 12. Even if you found a convergence with 15 reasons why the market should bounce in your direction, if the trade does not meet the equity management requirements, you need to have the discipline to pass on the trade. Trading will always be about risk versus your reward, just like life is.

Thank You!

Thank you for taking a look inside Jared Martinez's book, *The 10 Essentials of Forex Trading*. There is way more information and tips regarding the Forex market in his full book. Find out more information about it, or find out how to order at these sites:

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