TradeMentor

Chapter 1.4

Trends

TECHNICAL ANALYSIS: TRENDS, SUPPORT AND RESISTANCE

Charts, charts, charts. When most people think about trading Forex, they think about watching price movements flash by them on the charts and making money as they jump in and out of profitable trades. This is where traders show whether or not they have what it takes to be successful in Forex market.

Technical analysis, or chart reading, is the next natural step available after you have conducted your fundamental analysis. Fundamental analysis helps you determine whether you should trade a particular currency pair. Technical analysis helps you determine when you should buy or sell that currency pair.

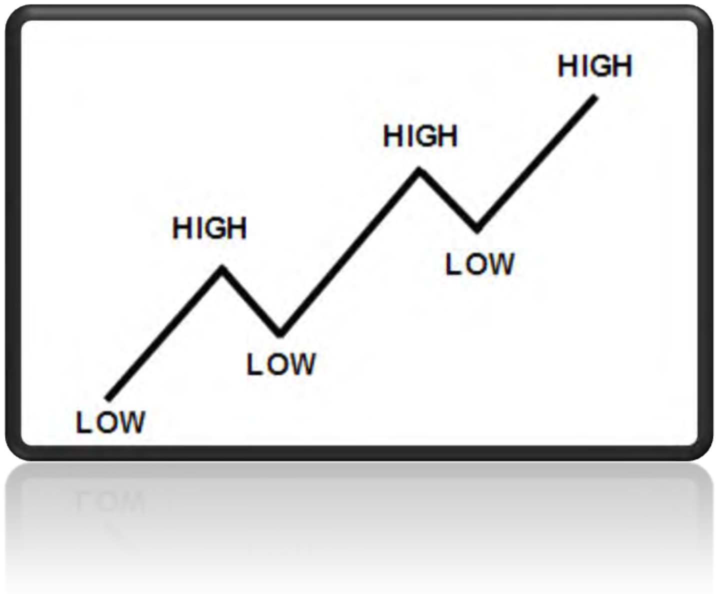
Many traders consider technical analysis to be somewhat of an art form that anyone can master with a little time and practice. To get started, you should focus on becoming comfortable with the following foundational concepts of technical analysis:

- Trends—Where prices may be going
- Support and Resistance - Where prices may stop and turn around

TRADING WITH THE TREND

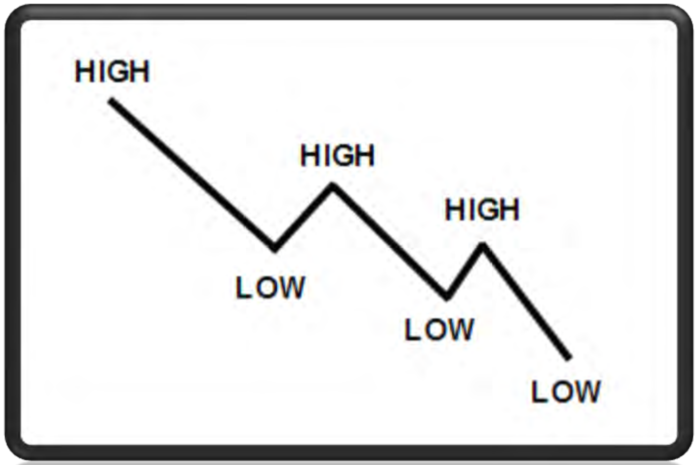
The key to making money in Forex is identifying trend and trading with it. Trends tell you where prices will most likely be going in the future. If the trend of a currency pair is pointing up, you need to buy the currency pair to make money. If the trend of a currency pair is pointing down, you need to sell the currency pair to make money. If the trend of a currency pair is pointing sideways, you either need to alternate between buying and selling or wait until the trend points up or down to make money. Whatever you do, never fight the trend. It will be an expensive battle if you do.

Trends do not move straight up or straight down. They usually move in one direction for a while and then retrace part of the previous movement before turning back around and continuing on the previous direction. Every time a currency pair turns around and begins moving in the opposite direction, it forms a new high or a new low. New highs form when a currency pair moves higher and then turns around and moves lower. New lows form when a currency pair moves lower and then turns around and moves higher. Identifying these highs and lows allows you to identify whether a currency pair is in an uptrend, a down trend or a sideways trend.

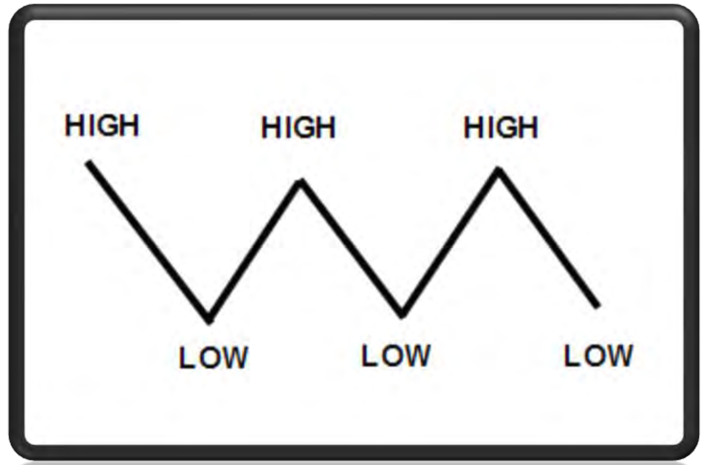


Up trends—currency pairs that are trending upward form a series of higher highs and higher lows.

Down trends—currency pairs that are trending downward form a series of lower highs and lower lows.



Sideways trends—currency pairs that are trending sideways form a series of highs that are at approximately the same price level and a series of lows that are at approximately the same price level.



Trends—whether they are up trends, down trends or sideways trends—can form over various time periods. Identifying the following trends over each time frame and being able to align them in your analysis is crucial to your success as a Forex investor:

-	Long-term trends
-	Intermediate trends
-	Short-term trends
-	Aligning trend time frames

Long-Term Trend

Fundamental factors are the major drivers of a currency pair's long-term trend. Now that you understand the impact interest rates have on an economy's currency, you are already one step ahead of the competition. You'll learn even more about the fundamental factors that drive long-term trends in later sections. For now, all you need to focus on is how to appropriately identify long-term trends.

Long-term trends, sometimes called major trends, are those trends that have dominated a currency pair for the longest period. Looking at this chart of the EUR/USD, you can see that the currency pair has been rising in an up trend from left to right—notice the series of higher highs and higher lows as time progressed.

Seeing this price action should give you a bias toward buying the EUR/USD. If the currency pair had been in a long-term downtrend, you would have a bias toward selling the EUR/USD.

Next, you need to look at the intermediate trend to see if it is trending in the same direction as the long-term trend.

Intermediate Trend

Intermediate trends, sometimes called minor trends, are more responsive than long-term trends because they cover a shorter period of time. These trends are also affected by fundamental factors. However, interest rates do not dominate intermediate trends like they do long-term trends. Other fundamental factors carry equal weight in their affect on intermediate trends. Looking at this chart of the EUR/USD, you can see that the currency pair was in a sideways intermediate trend during the highlighted time frame—notice the series of level highs and level lows as time progressed.

Notice that while the intermediate trend was moving sideways, the long-term trend was still moving upward. Trends tend to move in a stair-step fashion. Rarely do they move straight up or straight down.

Seeing this price action should confirm your bias toward buying the EUR/USD. However, it should also tell you that while your bias is bullish (you think the currency pair is going to move higher), you may want to wait to buy the currency pair until you see the intermediate trend move upward—in line with the long-term trend.

Next, you need to look at the short-term trend to see if it is trending in the same direction as the long-term trend and the intermediate trend.

Short-Term Trend

Short-term trends, sometimes called micro trends, are more responsive than both long-term trends and intermediate trends because they cover the shortest period of time. These trends are the most volatile trends and are predominantly affected by the news of the day. It is not uncommon to see these short-term trends change direction extremely rapidly. Looking at this chart of the EUR/USD, you can see that the currency pair was in a down-trending short-term trend during the highlighted time frame—notice the series of lower highs and lower lows as time progressed.

Notice that while the short-term trend was moving downward, the intermediate trend was still moving sideways and the long-term trend was still moving upward. It is possible to have each trend moving in a different direction, as you see here.

Seeing this price action should alert you that you may have to change your bias toward buying the EUR/USD in the future. However, since it is the only the short-term trend, you should not abandon your bullish convictions toward the EUR/USD just yet.

In this example, the long-term, intermediate and short-term trends for the EUR/USD are in conflict. You should not trade when the trends are in conflict. Instead, you should wait until you can align the trends from each time frame.

Aligning Trend Time Frames

Your most profitable trading opportunities will come when the long-term, intermediate and short-term trends all line up in the same direction. When the long-term, intermediate and short-term trends are all moving higher, it is an excellent time to buy the currency pair. When the long-term, intermediate and short-term trends are all moving lower, it is an excellent time to sell the currency pair.

You can see in the chart of the EUR/USD that the trend for each time frame has been moving higher for the past few months, and the EUR/USD has shot higher. Had you purchased this currency pair and held it through this most recent rally, you would have made a large profit.

Understanding trends is only half of the basic technical analysis picture. To complete the picture, you also have to understand the concepts of support and resistance.

Paying Attention to Support and Resistance

You will increase your trading profitability if you can accurately identify levels of support and resistance—areas where prices may stop and turn around in the future. Knowing where a currency pair may stop and turn around helps you enter and exit your trades at the most profitable times.

Support is a price level at which a currency pair tends to stop moving down and then turns around and starts moving back up.

Resistance is a price level at which a currency pair tends to stop moving up and then turns around and starts moving back down.

Support and resistance levels are not precise price points. Rather, they are general price ranges. For example, you are only going to frustrate yourself if you try to pinpoint a price level of 1.4225 on the EUR/USD as support. You will be much better off if you identify a price range of 1.4210 to 1.4240 or 1.4220 to 1.4230 as support. Give your support and resistance levels some room to be flexible.

You will find that support and resistance levels come in varying forms. To become a successful Forex investor, you will need to learn to recognize the following:

-	Horizontal support and resistance
-	Diagonal support and resistance

Horizontal Support and Resistance

Horizontal support and resistance levels are perhaps the easiest levels to identify. As you look at the charts of the currency pairs you are interested in trading, you will begin to notice that the currency pairs will often rise and fall to the same price levels before turning around and moving back in the opposite direction. These price levels are horizontal support and resistance levels.

Looking at the EUR/USD chart, for instance, you can see that certain price levels (indicated by bold red lines) acted as strong levels of support and resistance. During 2006, the EUR/USD bounced back and forth between a support level at about 1.2500 and a resistance level at about 1.2900.

Imagine you had bought the EUR/USD at 1.2500 as it was bouncing off of support and it was now approaching 1.2900. Knowing that this level has been a significant resistance level, you may consider exiting your EUR/USD trade so you can realize your profits before the currency pair turns around and begins moving lower.

Once you feel comfortable identifying horizontal levels of support and resistance, you can move on to diagonal levels of support and resistance.

Diagonal Support and Resistance

Diagonal support and resistance levels can be more difficult to identify when you are just getting started. However, diagonal support and resistance levels are usually the most important levels when you are analyzing a currency pair that is trending. Remember, you want to find trending currency pairs because it is much easier to make profitable trades when a currency pair is trending.

As you look at the charts of the currency pairs you are interested in trading, you will begin to notice that the currency pairs will often rise and fall in a stair-step pattern. These patterns form higher highs and higher lows or lower highs and lower lows. The lines that connect these highs and lows are your diagonal support and resistance levels.

Looking at the EUR/USD chart, for instance, you can see that the currency pair was creating a series of higher highs and higher lows through most of 2006 and 2007. If you connect all of the highs with a diagonal line and all of the lows with another diagonal line (indicated by bold red lines) you will be able to see the diagonal levels of support and resistance that are affecting the EUR/USD.

If you were watching the EUR/USD, you would wait until you saw the currency pair drop down to the uptrending support level before you bought it. Once you were in your trade, you could then watch for the EUR/USD to climb up to the uptrending resistance level before you exited the trade and took your profits.

The real trick to effectively investing using support and resistance levels is to combine both horizontal and diagonal levels in your analysis. Your currency charts have a wealth of information locked within them, and they are waiting for you to unlock that information with simple, but effective, technical analysis techniques.

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