

How To Draw and Use Trendlines

1. The Basics: “How a Kid with a Ruler Can Make a Million”

When I began my career as an analyst, I was lucky enough to spend some time with a few old pros. I will always remember one in particular, who told me that a kid with a ruler could make a million dollars in the markets. He was talking about trendlines. And I was sold.

I spent nearly three years drawing trendlines and all sorts of geometric shapes on price charts. And you know, that grizzled old trader was only half right. Trendlines are one of the simplest and most dynamic tools an analyst can employ... but I have yet to make my million dollars, so he was either wrong or at least premature on that point.

Despite being extremely useful, trendlines are often overlooked. I guess it's just human nature to discard the simple in favor of the complicated. (Heaven knows, if we don't understand it, it must work, right?)

In Figure 7-1, I have drawn a trendline using two lows that occurred in early August and September 2003. As you can see, each time prices approached this line, they reversed course and advanced. Sometimes, Soybeans only fell to near this line before turning up. And other times, prices broke through momentarily

before resuming the larger uptrend. But what still amazes me is that two seemingly insignificant lows last year pointed out the direction of Soybeans – and identified several potential buying opportunities – for the next six months!

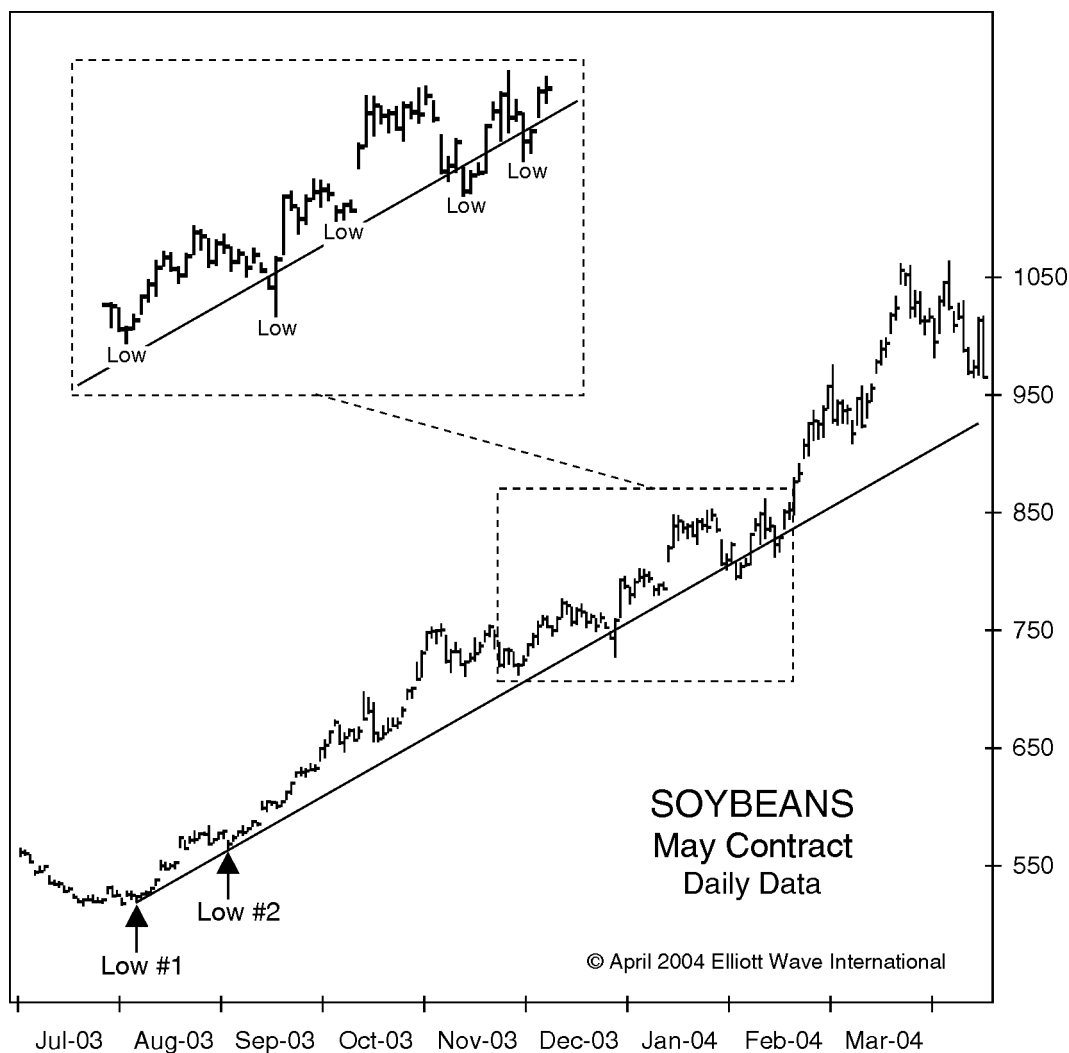


Figure 7-1

Primary Angle

Besides simply connecting highs and lows, you can draw trendlines in many other ways that are just as exciting and informative. Figure 7-2 shows a technique I call Primary Angle. Notice the upward trendline drawn in Sugar in late 1999 (A1). Now look at the trendline up from the 2002 low (A2). See anything interesting? These two trendlines are parallel! The slope of the late 1999 rally is the same for the 2002 advance. In fact, the range of the weekly high for the 2002 advance encompasses this line. The same is true for the two downward sloping trendlines drawn off the 2000 and 2003 highs (B1 & B2); the angle of the decline is the same.

Another way to use Primary Angle besides identifying possible trend changes is clear in Figure 7-3. The trendline up from the March low is a parallel of the late February advance. As you can see, prices were falling off of this trendline by the March high. I interpret this move as weak price action with waning momentum. And resulting price action supports this conclusion. In Figure 7-4, notice how prices are to the right of the downward trendline from the March high. Again, this selloff lacks the intensity of its predecessor. You can see in Figure 7-5 why this makes sense from an Elliott perspective. The wave pattern from the late February 35.05 peak is an expanded flat correction (3-3-5). Wave (a) bottomed at 31.75 (basis May), and wave (b) topped at 35.18 [after making a moderate new high beyond the extreme of wave (a)]. Wave (c) of 9 is under way, targeting Fibonacci support at 30.44-29.63. It's not surprising to see prices behave like this near the end of a wave pattern.

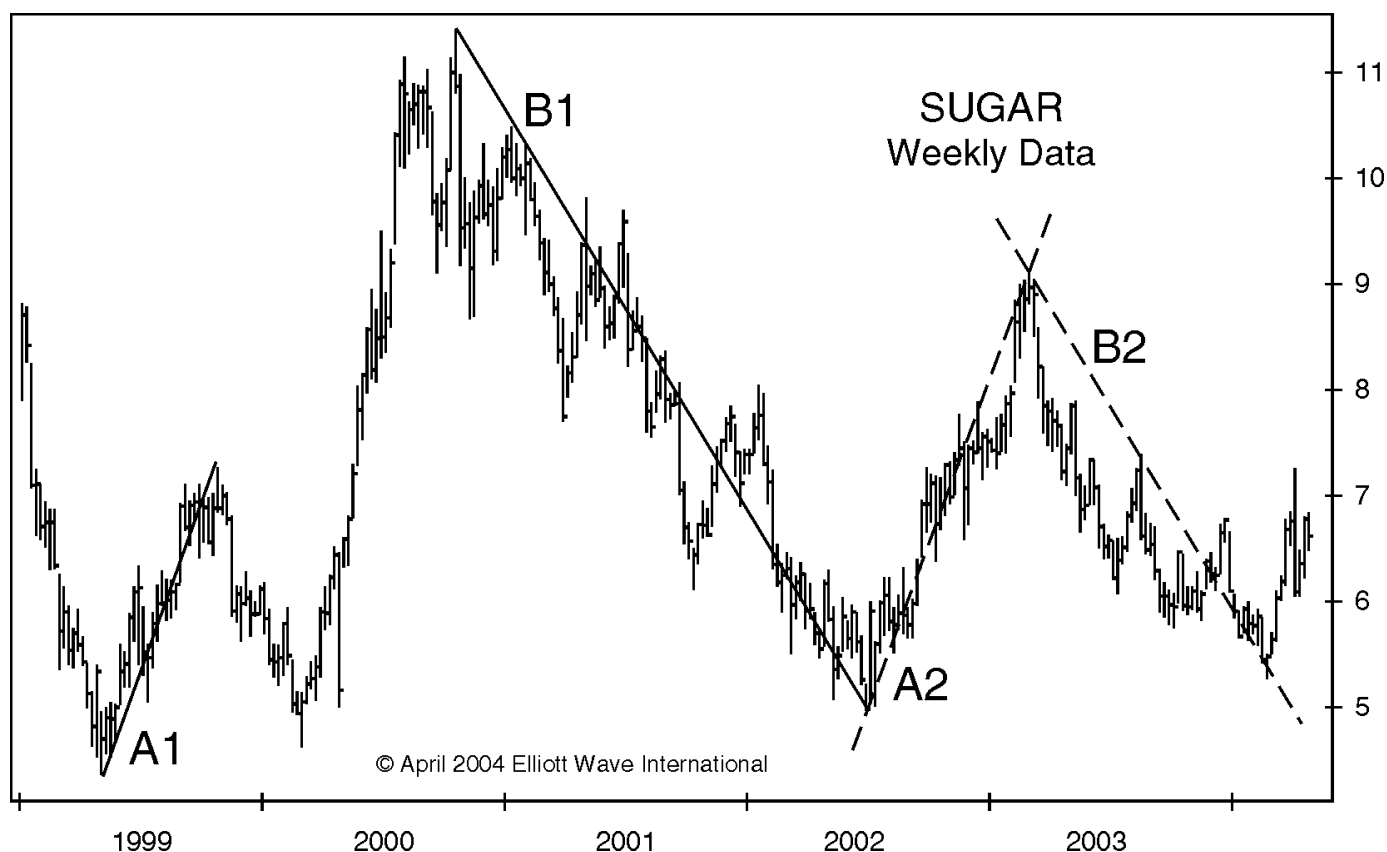


Figure 7-2

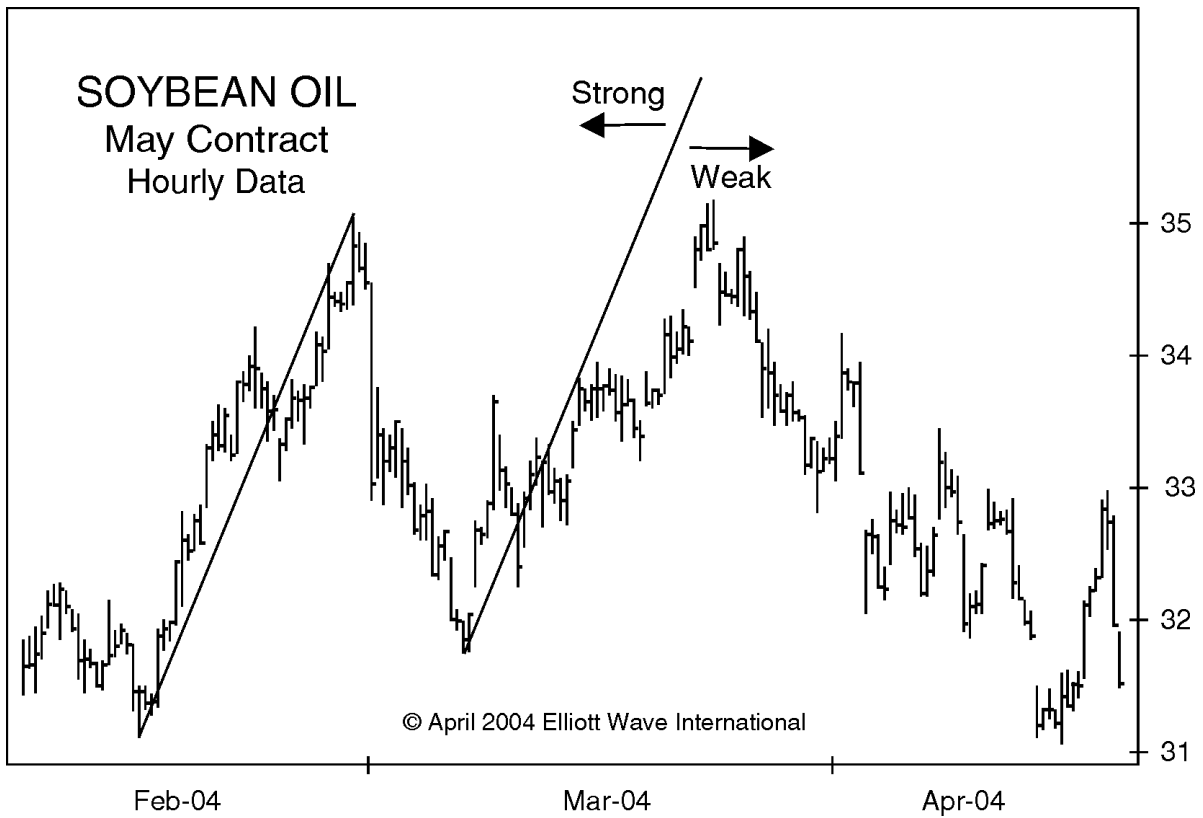


Figure 7-3

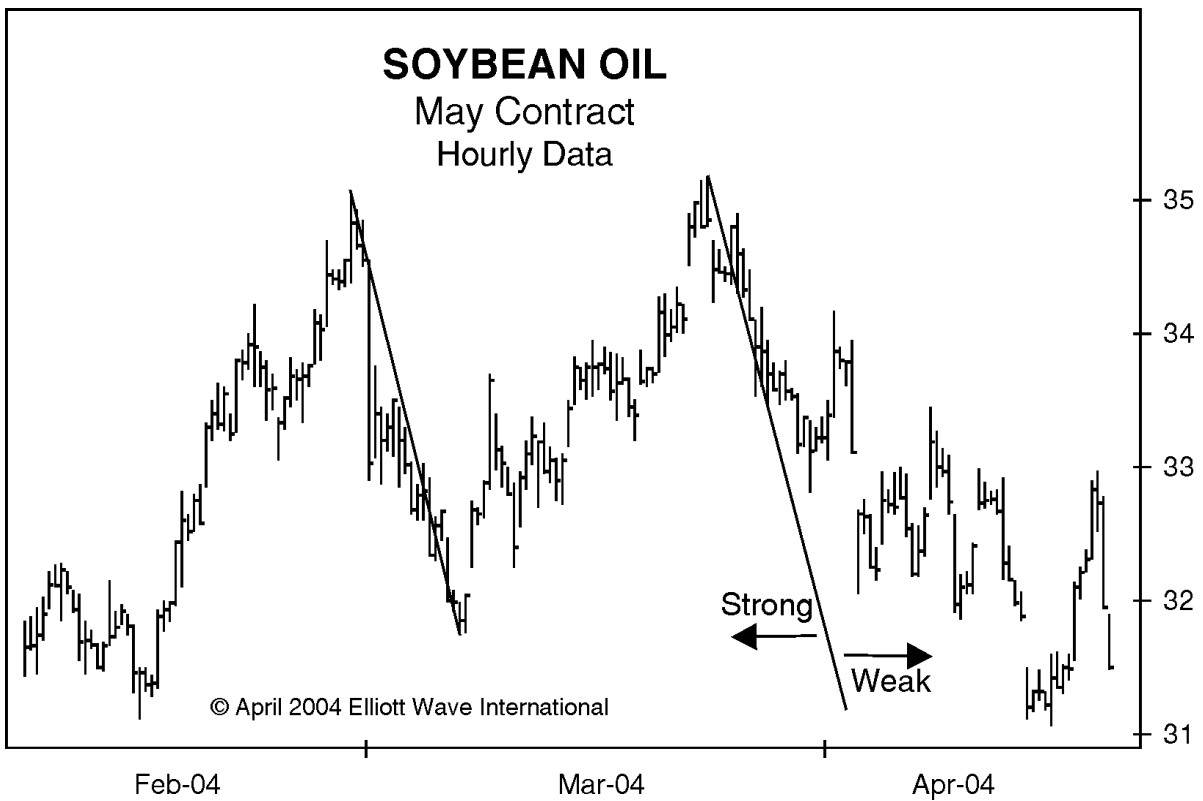


Figure 7-4

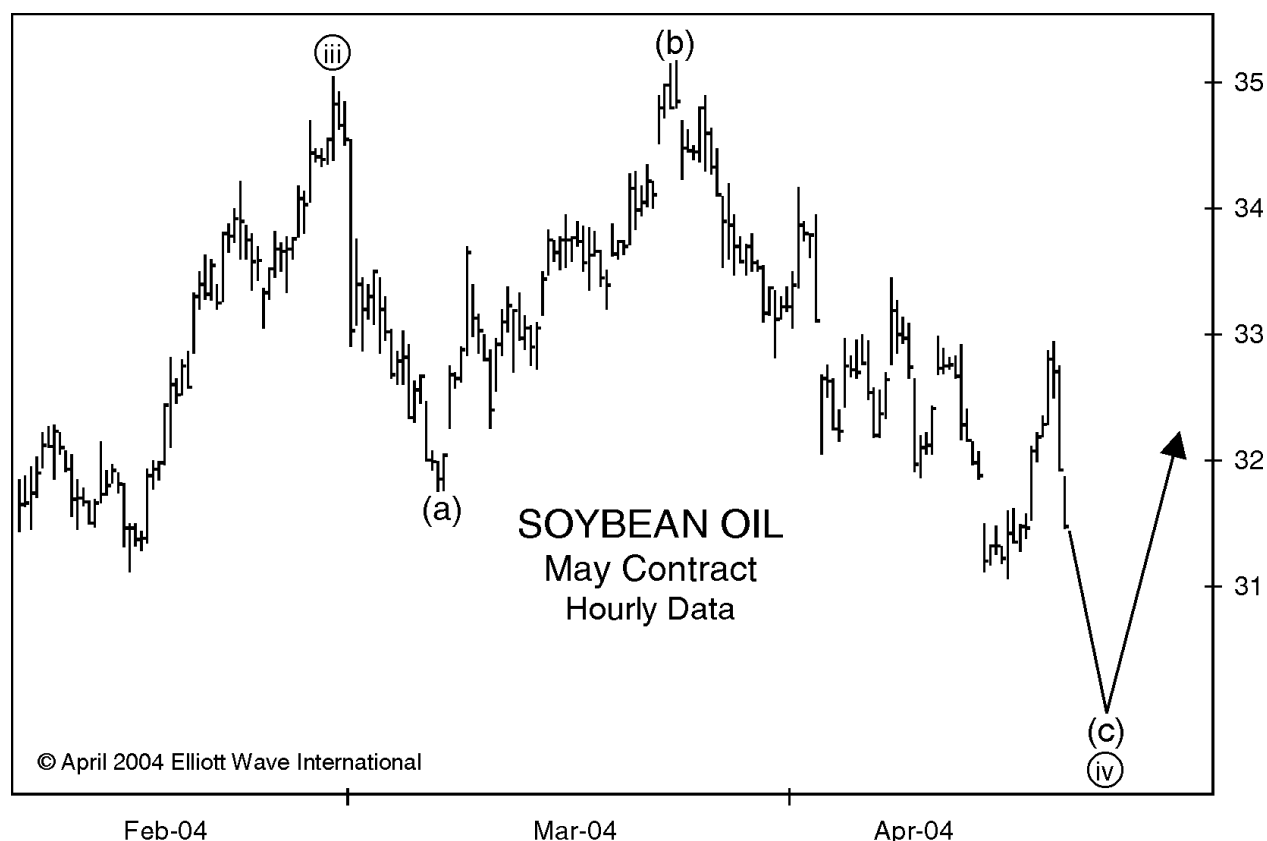


Figure 7-5

Triple Fan

Figure 7-6 displays another trendline technique called the “Triple Fan.” I picked this up from a wonderful book called *Timing the Market* by Curtis Arnold. I am surprised at how often this tool ushers in significant moves. Down from the September 2003 high in Coffee, three downward sloping trendlines are drawn against peaks 1, 2 and 3; this is your fan. A break of the third trendline often signals a significant move or change in trend, which it did in this case. In December 2003, Coffee gapped above this line and tried to test the top of it before rallying to 80.60.

A similar example is illustrated in Figure 7-7, June Live Cattle. Beginning with a significant extreme, three downward sloping trendlines are drawn across the tops of three following peaks. Clearly, these lines provided important support during the mad cow incident in December 2003 and the late selloff in March.

In short, even the most basic trendlines are a great analytical tool. They work on any time frame and any market. You can draw them vertically (for timing purposes), horizontally (for marking support and resistance) and diagonally (to identify possible turning points).

Note: A special thanks goes out to that old pro who emphasized the basics and told me about the kid with the ruler, Pete Desario.

[April 2004]

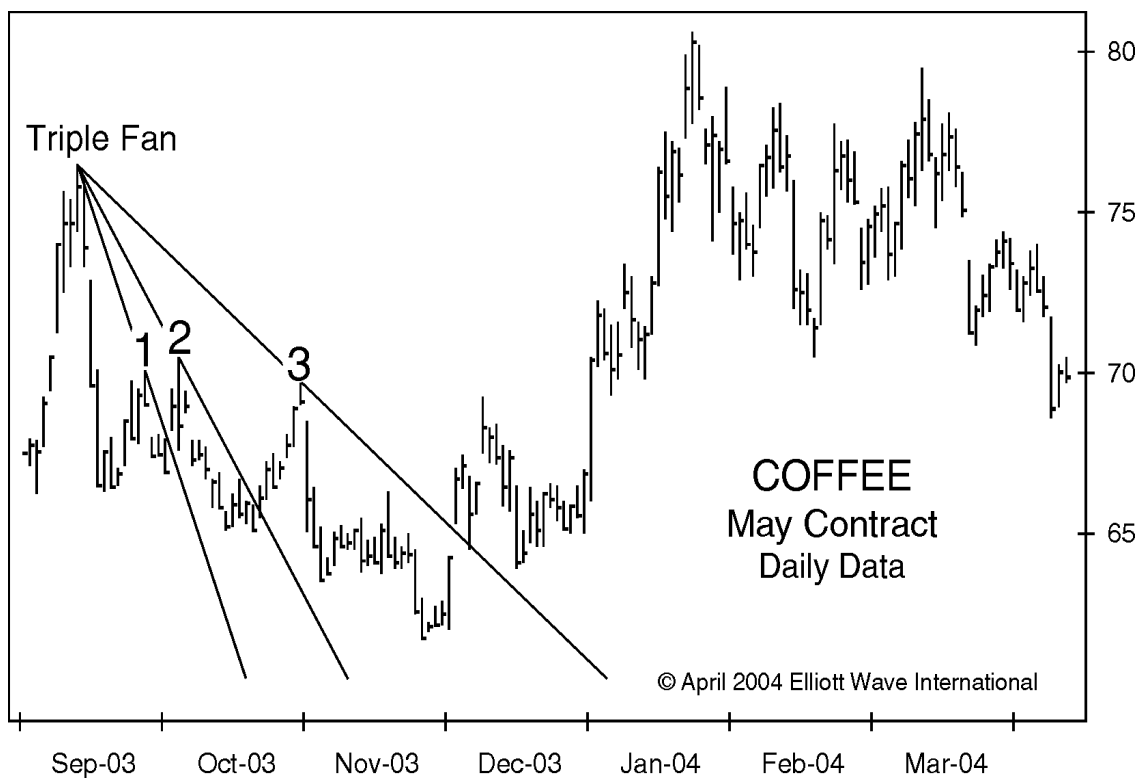


Figure 7-6

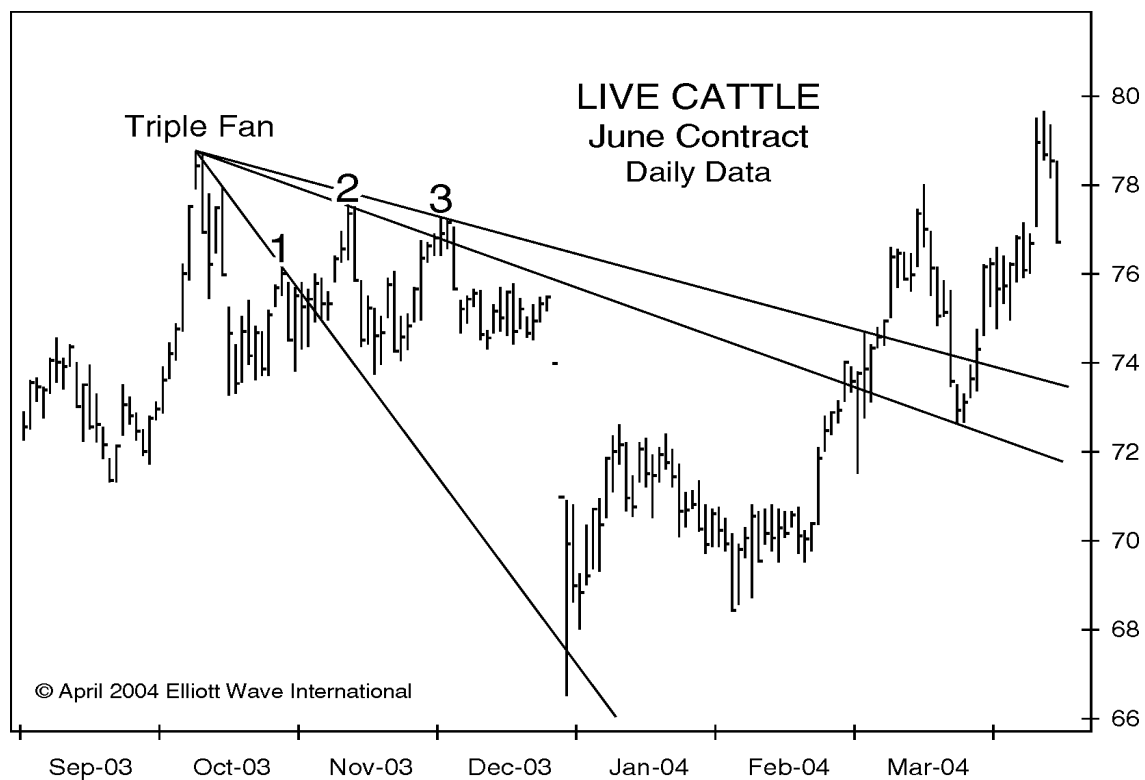


Figure 7-7

2. How To Use R.N. Elliott's Channeling Technique

Now let's take the subject one step further and discuss R.N. Elliott's Channeling Technique. Elliott saw that parallel lines often mark the upper and lower limits of impulse waves, specifically waves four and five. In other words, prices trend within a channel. And it's a good thing they do, because it gives us yet another reliable method for identifying support and resistance. What's more, a channel's "life-span" – how long price action keeps within its boundaries – speaks directly to how big or small a move to expect once prices have broken the channel and a reversal is at hand.

So here's how you draw them.

First, when you need to identify support for wave four, draw a line connecting the ends of waves one and three (see Figure 7-8). Then, draw a parallel line that touches the extreme of wave two. These two lines outline your channel, and the lower line shows you the likeliest support for wave four.

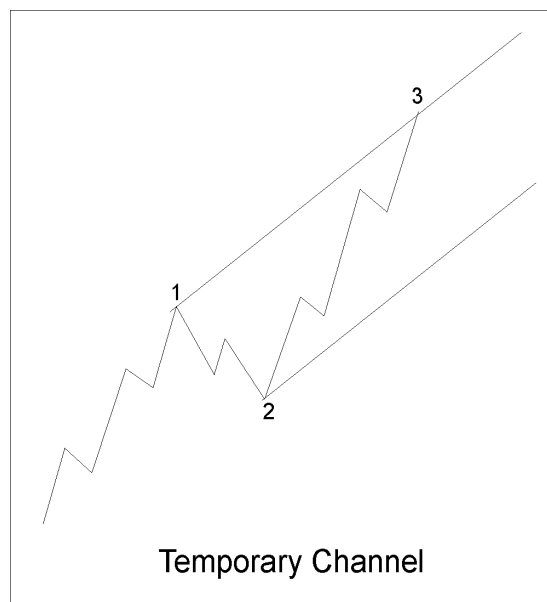


Figure 7-8

A trick I have picked up over the years is to double the channel (see Figure 7-9). To do this, place a third parallel line beneath your lower line, at the point where all three lines have equal space between them. The channel width is now double that of the Elliott channel. When your original channel doesn't hold, and evidence continues to argue for a fourth wave, this lower line will provide support.



Figure 7-9

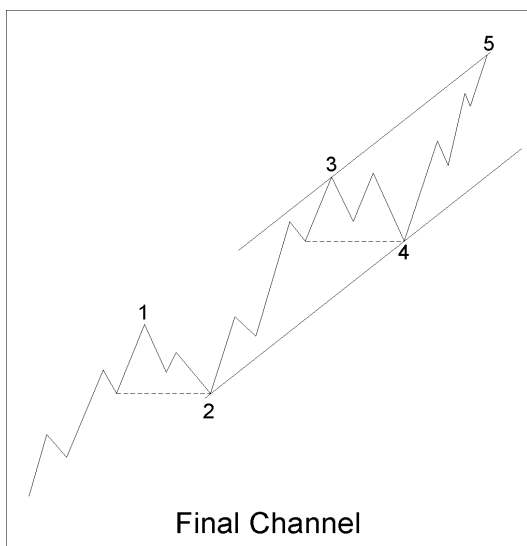


Figure 7-10

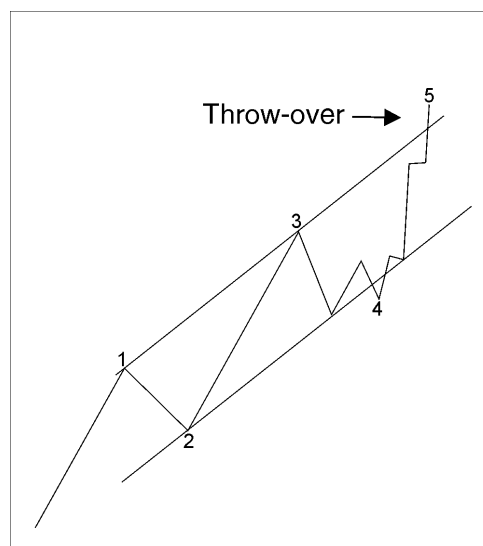


Figure 7-11

The next channel we'll draw serves to identify a likely target for wave five. Your first line connects the ends of waves two and four. Draw a parallel line at the extreme of wave three (see Figure 7-10). The upper boundary of this channel identifies fifth-wave resistance. If you're contending with a third wave that is parabolic, then use the extreme of wave one. (Parabolic is simply a term used to describe price action that travels far in a short period of time.)

Fifth waves are tricky, and sometimes prices will exceed this upper boundary line (called a throw-over — see Figure 7-11) or undershoot it. R.N. Elliott noted this possibility and discovered a significant clue that helps determine when a throw-over will or will not occur: Volume. When volume is heavy as prices approach the upper boundary line of the channel, chances are high that a throw-over will occur (see Figure 7-12). When volume is light, wave five will either meet the upper boundary line or fall short. I've got another hint of my own that may help: when volume is light, the center of the Elliott channel will act as resistance (see Figure 7-13).

[May 2004]

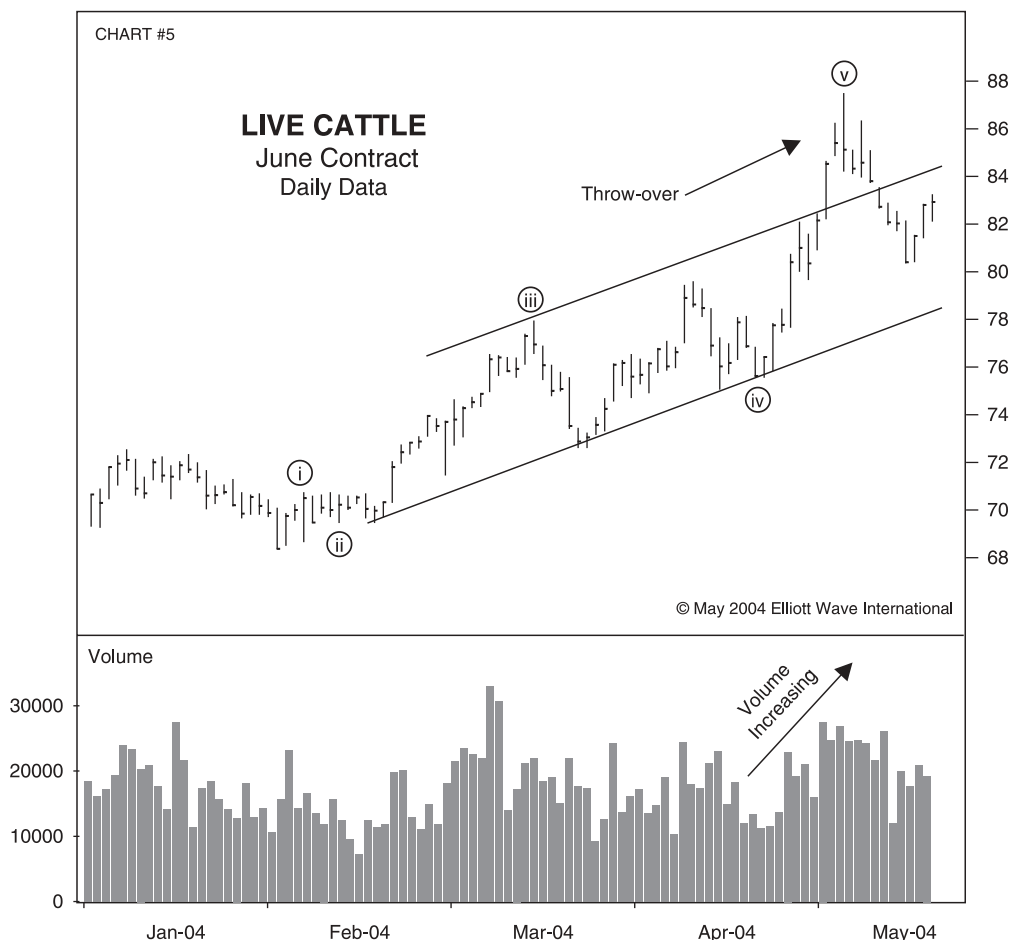


Figure 7-12

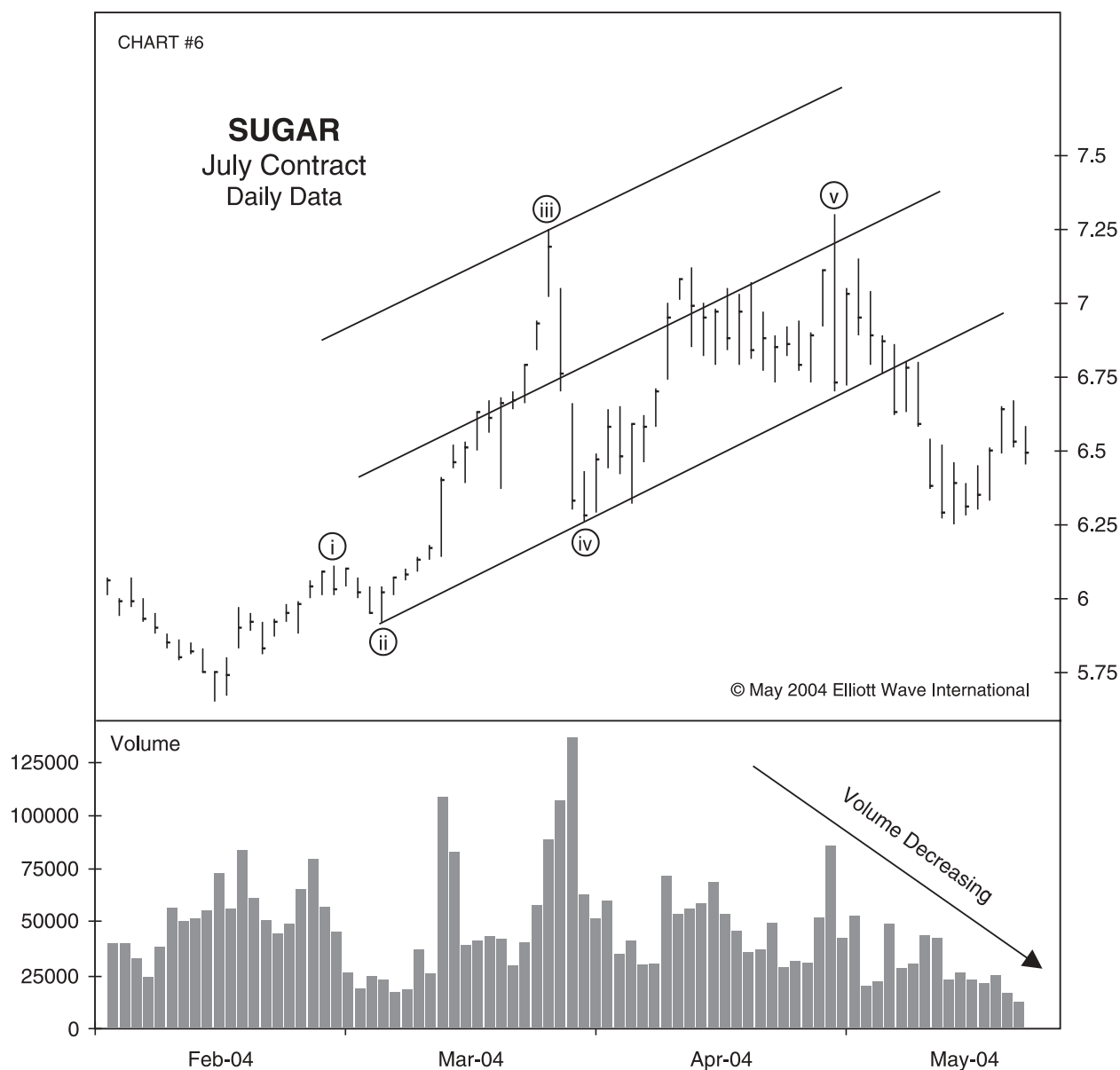


Figure 7-13

3. How To Use Jeffrey Kennedy's Channeling Technique

We've now dealt with trendlines and Elliott's channeling technique. Before I move on to a different topic, I'd like to share my own channeling technique.

All too often, Elliotticians balance a bullish wave count with a bearish alternate. It's frustrating to find out that what you thought was wave C was actually wave three. So when does a C wave become a third wave? Or how do you know if the wave 4 you're counting goes with wave 2, and not a smaller or larger degree wave two? I spent years trying to design a tool or technique that would confirm wave patterns and answer these questions. Here's what I came up with.

My theory is simple: Five waves break down into three channels, and three waves need only one. The price movement in and out of these channels confirms each Elliott wave.

Base Channel

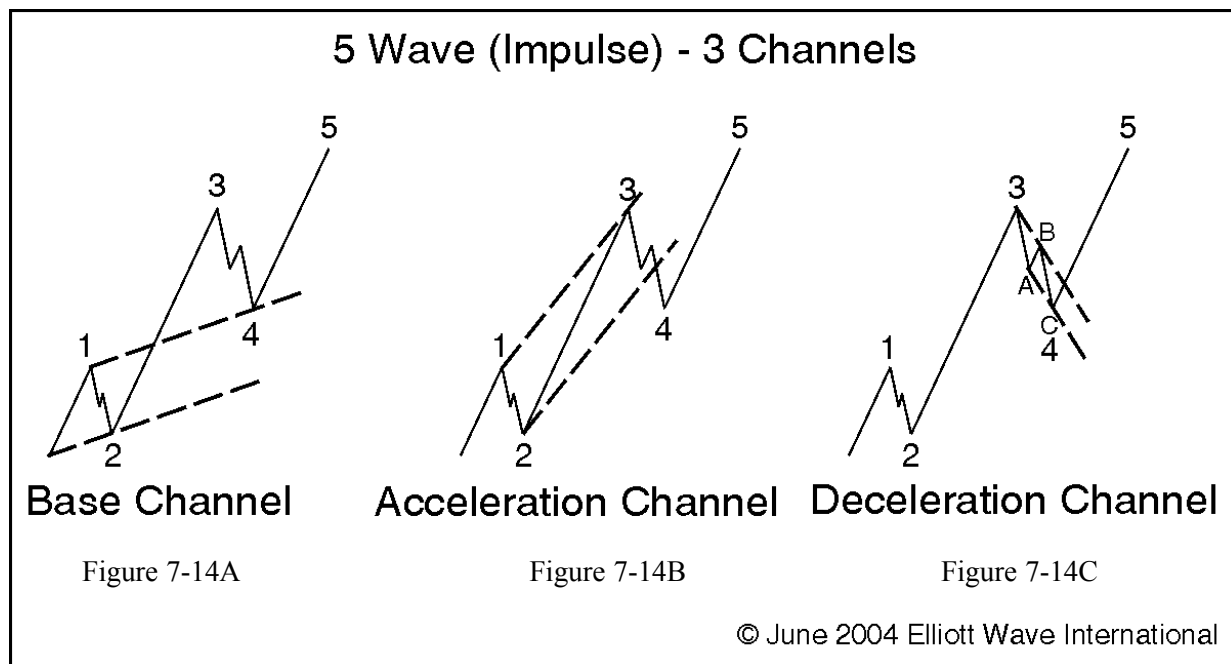
Figure 7-14 shows three separate five-wave patterns with three different channels drawn: the base channel, the acceleration channel and the deceleration channel.

The base channel contains the origin of wave one, the end of wave two and the extreme of wave one (Figure 7-14A). Of the three channels, the base channel is most important, because it defines the trend. As long as prices stay within the base channel, we can safely consider the price action corrective. Over the years, I've discovered that most corrective wave patterns stay within one price channel (Figure 7-15). Only after prices have moved through the upper or lower boundary lines of this channel is an impulsive wave count suitable, which brings us to the acceleration channel.

Acceleration Channel

The acceleration channel encompasses wave three. Use the extreme of wave one, the most recent high and the bottom of wave two to draw this channel (Figure 7-14B). As wave three develops, you'll need to redraw the acceleration channel to accommodate new highs.

Once prices break through the lower boundary line of the acceleration channel, we have confirmation that wave three is over and that wave four is unfolding. I have noticed that wave four will often end near the upper boundary line of the base channel or moderately within the parallel lines. If prices break through the lower boundary line of the base channel decisively, it means the trend is down, and you need to draw new channels.



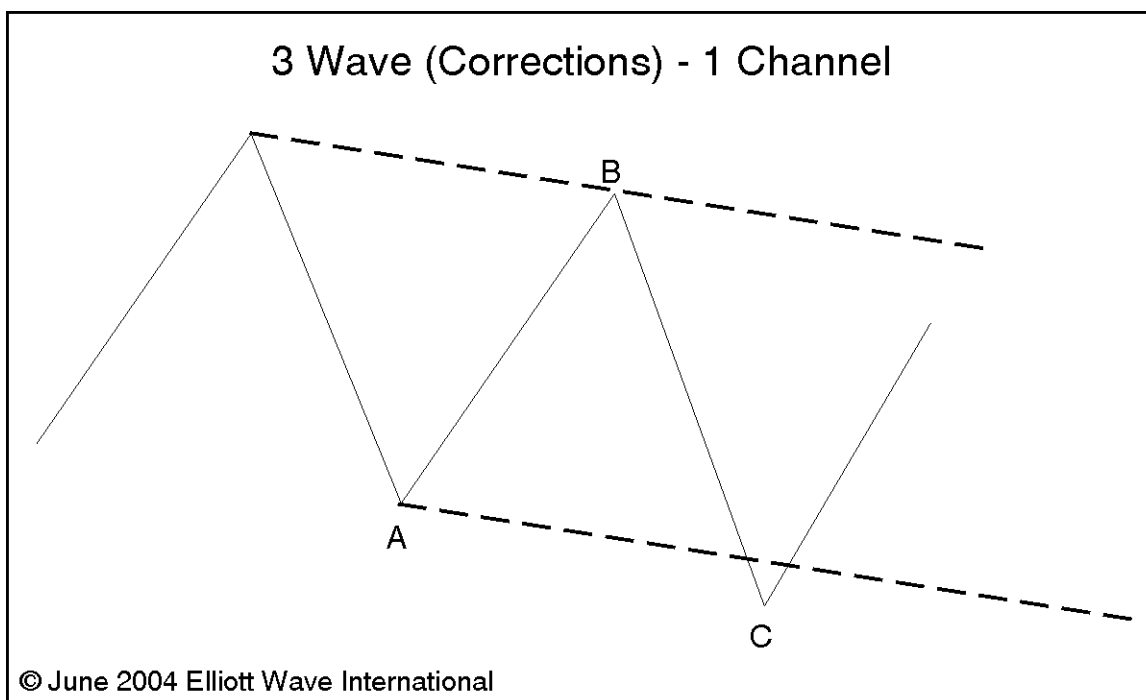


Figure 7-15

Deceleration Channel

The deceleration channel contains wave four (Figure 7-14C). To draw the deceleration channel, simply connect the extremes of wave three and wave B with a trend line. Take a parallel of this line, and place it on the extreme of wave A. As I mentioned before, price action that stays within one price channel is often corrective. When prices break through the upper boundary line of this channel, you can expect a fifth-wave rally next.

In a nutshell, prices need to break out of the base channel to confirm the trend. Movement out of the acceleration channel confirms that wave four is in force, and penetration of the deceleration channel lines signals that wave five is under way. Now for some real examples:

In Figure 7-16, you can see that most of the January selloff in Coffee was within one channel. Since price action within one channel is typically corrective, I still considered the larger trend up. This approach was helpful in alerting me to a possible one-two, one-two setup in Coffee.

In May 2004, I cited many reasons for a further rally in December Corn. In Figures 7-17, 7-18 and 7-19 you can see the underlying progression of the base, acceleration and deceleration channels and how they supported the wave count.

In August Lean Hogs (Figure 7-20), you'll notice how prices broke the base channel momentarily in wave (c) of 4. Normally, this would be troubling, because the base channel defines the trend. But Figure 7-22 shows that prices were still within the deceleration channel, which implied the move was still countertrend. A combined break of the base and deceleration channels would have signaled a trend change. And, finally, Figure 7-23 illustrates how the Elliott wave channeling technique identifies fifth-wave objectives.

As an analyst and trader, I am slow to adopt anything new, yet quick to get rid of anything that doesn't work consistently. I developed this channeling technique in the mid-1990s and still use it today. No, it doesn't always work, but I believe it offers great value in the proper labeling and identification of Elliott waves.

[June 2004]

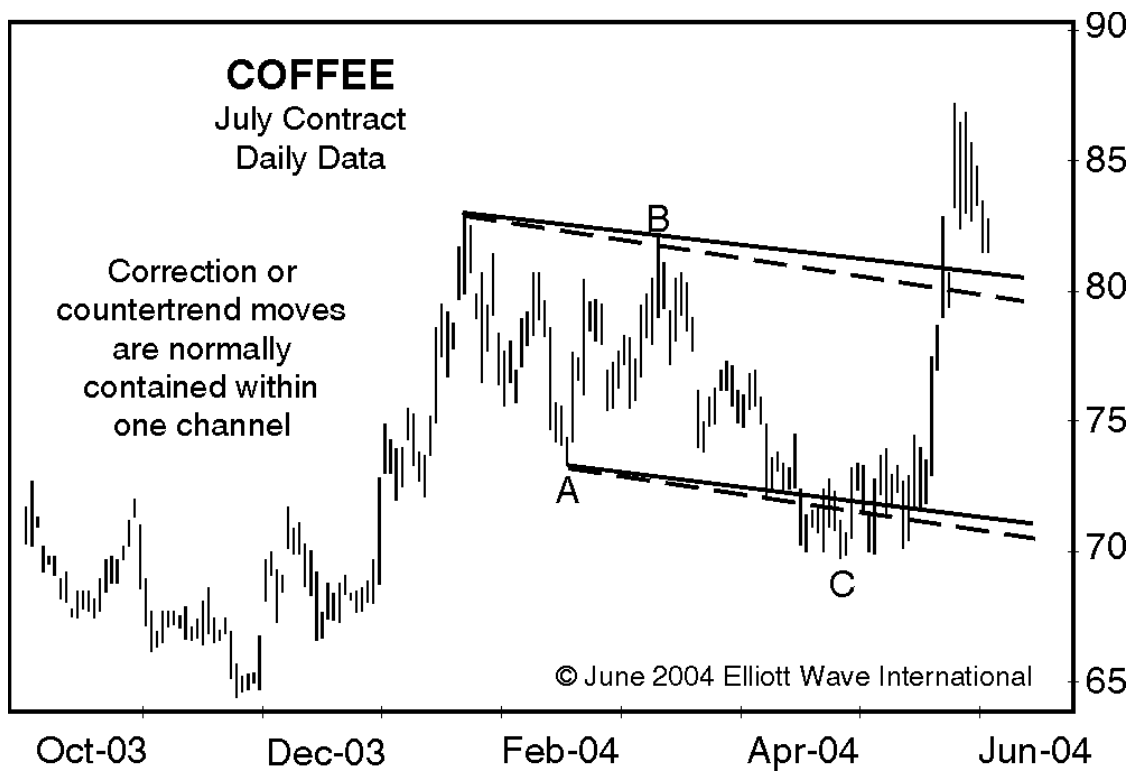


Figure 7-16

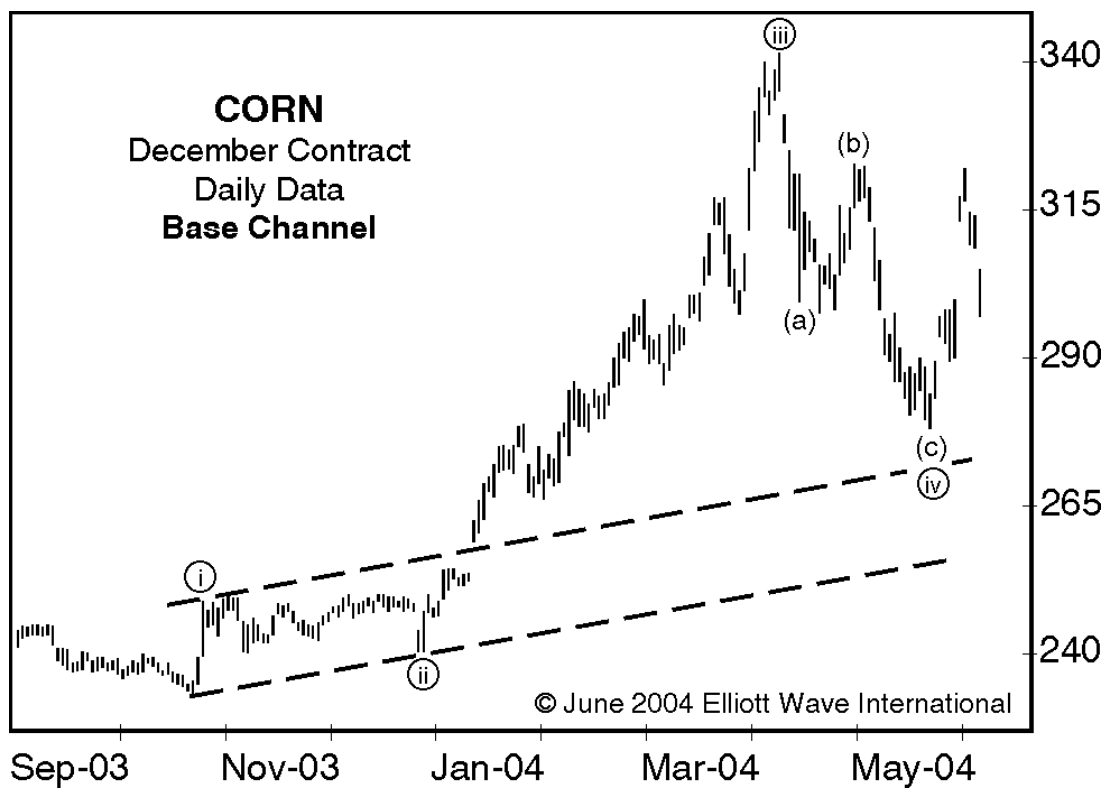


Figure 7-17

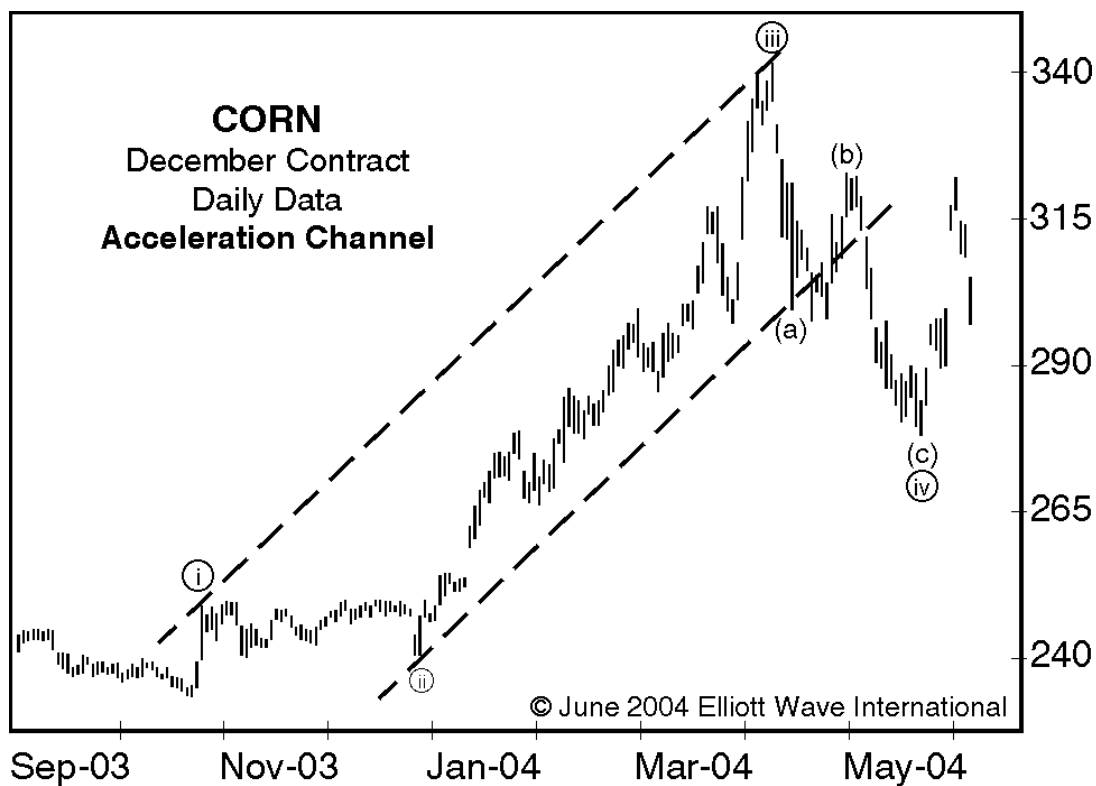


Figure 7-18

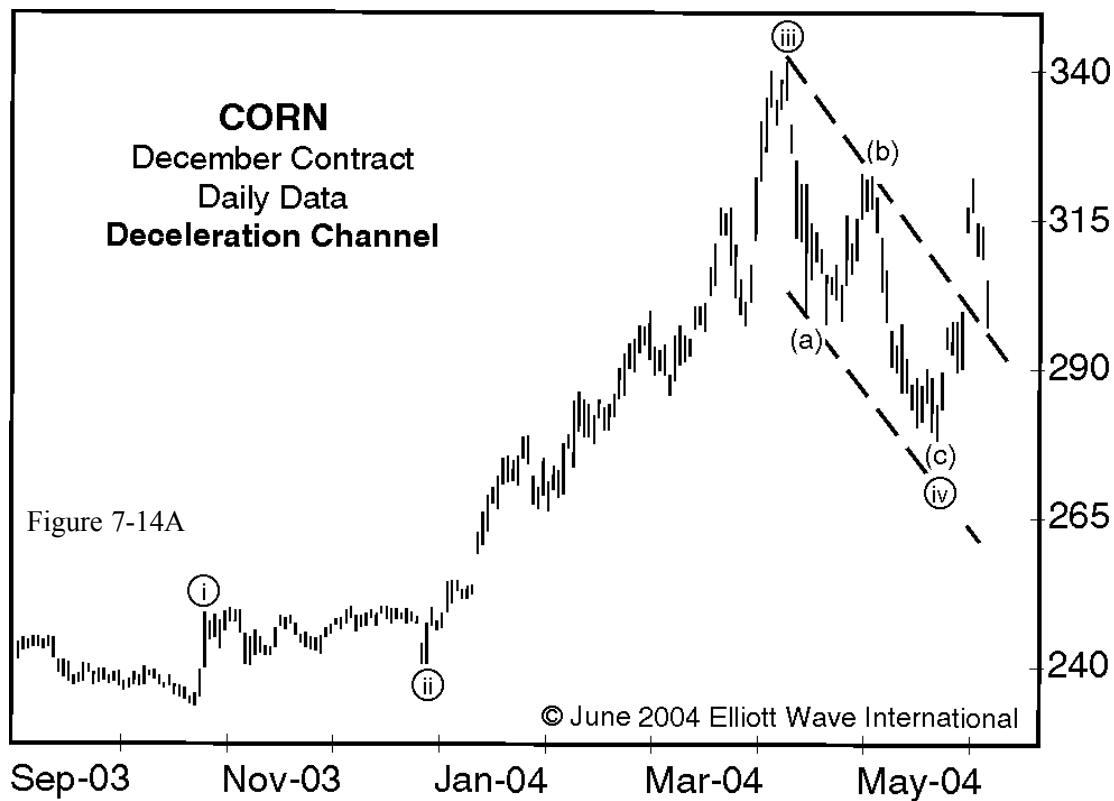


Figure 7-19



Figure 7-20

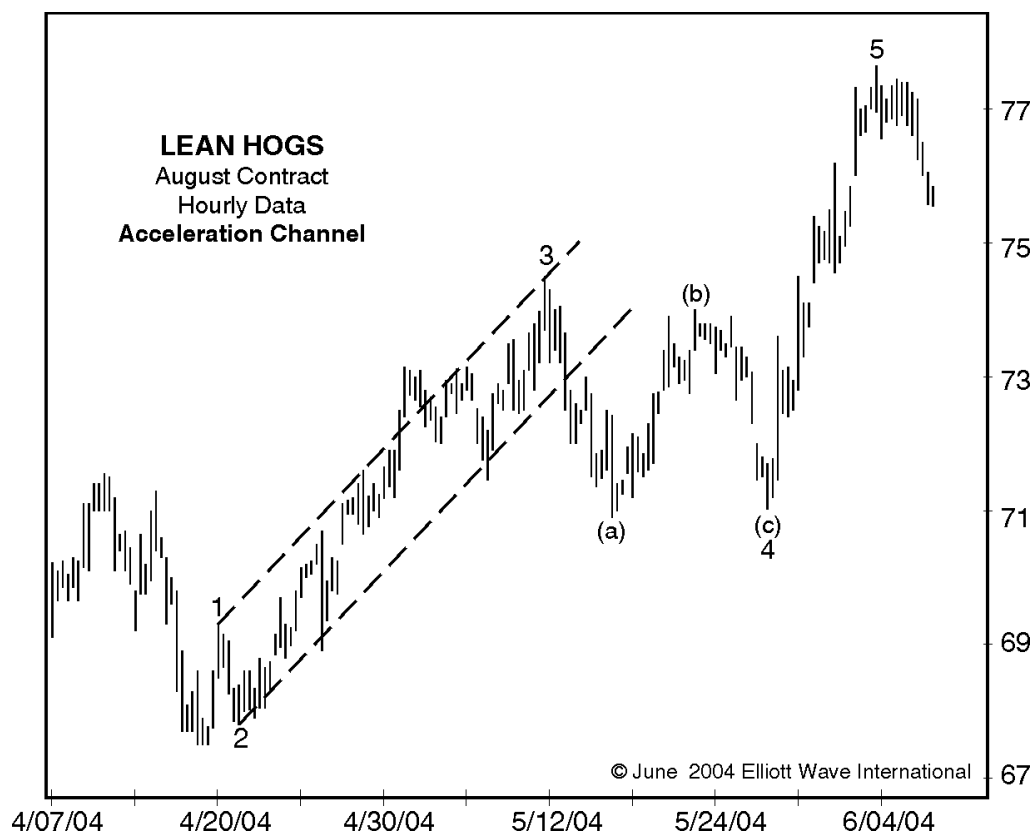


Figure 7-21

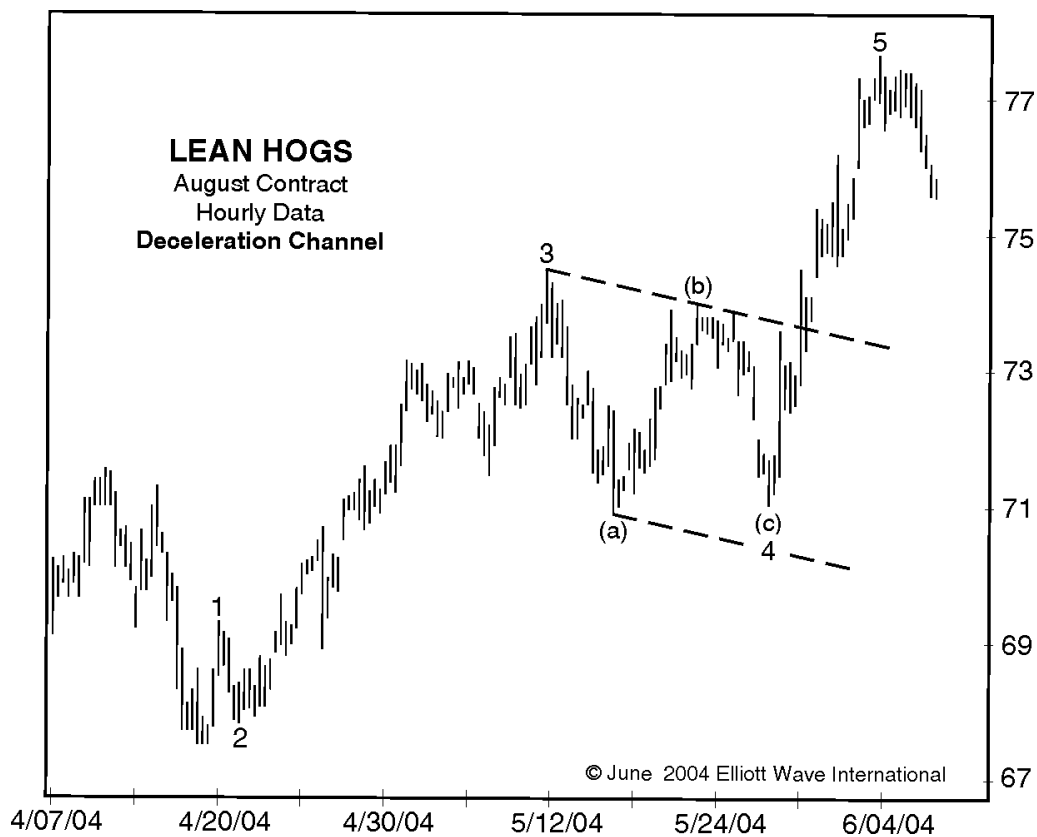


Figure 7-22



Figure 7-23

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Four years in the making, Trader's Classroom Collection Volumes 1 & 2 feature 128 pages and 23 chapters from one of the most experienced Elliott wave teachers; Jeffrey Kennedy. Each chapter gives you valuable tips and techniques to help you identify turns and trends in the markets.