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Tips for Traders | 3/16/2009 11:28:00 AM

How to Read the Signs of Change—Trend Change, That is...

I have been trading for many years. I traded successfully through the Arab oil embargo, the Hunt Brothers silver debacle, the tough economic times during the Jimmy Carter years, and the inflation and high interest rates that plagued Ronald Reagan's early Presidency. I've seen periods where trending markets were the norm, and periods where range trading dominated most markets. I am lucky to have seen and traded during so many different types of markets because I have no short or long bias in my trading and I trend trade as well as I trade ranges. Where does this flexibility in style come from?

George Santayana, a US philosopher and poet, wrote: "Those who cannot remember the past are condemned to repeat it." This is true in all facets of life, and trading is no exception. I use "chart replay" after trading hours to study the markets on a regular basis. After exceptional trending moves in the markets, I spend countless hours studying my hand-drawn charts, analyzing what happened, why it happened, how it unfolded, and what clues were there for me to recognize a potential set up before the large trending move unfolded. Trading is hard work and it takes countless hours of studying and practicing if you want to be a successful trader. Many people tell you there are "easy methods" and "simple indicators" that can make you a successful trader. The truth is simple: Hard work, studying, and preparation can help you become a successful trader. There are no short cuts, there are no magic indicators. There is no "Holy Grail" of trading. There is only hard work, studying, and good trading habits.

We have seen some momentous moves in the past year. In fact, most of you have never seen market moves as dramatic as we have seen in many markets in the past year. There are many analysts and commentators in the media telling you all that these moves are over and a return to "normal" markets are at hand. In my experience, when the markets are in their large trending mode, they tend to stay in that mode for years, not months. I will be surprised if we have seen the end of extreme volatility and large moves.

What can you do to prepare yourself to successfully trade in the current environment? George Santayana said it all: Study the past for clues about how you can trade successfully if this volatility and trendiness continues. Let me go through a handful of the large moves we experienced in the past year and point out the signs I saw on my hand-drawn charts, and maybe that will give you some insight into what I look for when trading in these types of markets. As you study each chart, look for the signs that a trend has begun, a sign that the trend is continuing, and a sign that a change in behavior has begun. The signs are all there for you in the charts as price unfolds, but you have to work hard to attune your eyes to see them and recognize them for what they are.

Let's start with soybeans:

The grain markets have been in an up-trending market for a handful of years. Prior to 2007, it was rare to see CBOT soybean futures above $7.50 a bushel. The natural trading range was $4.25 a bushel to $7.25 a bushel. For many years, the bulk of trading took place within this range, and successful traders would use those value areas as part of their entry and exit strategies. But in 2002, several changes occurred in the grain markets. First, people began thinking about Ethanol and biodiesel fuels. Second, the expansion of the Chinese economy accelerated and the Chinese government became an aggressive buyer of grains to meet the demand of their newly emerging middle class.

Even though soybean prices occasionally traded above the $7.50 a bushel area prior to 2007 (see the brief run up to $10 a bushel in early 2004 on the chart), these higher prices were rare and never lasted long. In fact, every time a rally over $7 a bushel was underway in the beans, futures traders could be heard chanting "Beans in the teens!" at the Chicago Board of Trade. But when the underlying fundamentals changed in late 2006, grains began a multi-year run higher that took soybean prices above $15.00 a bushel in mid-2008!

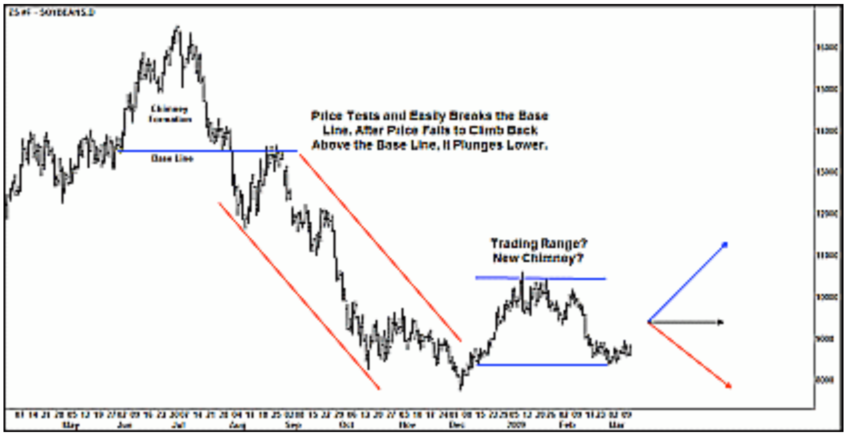
What were the signs that a significant rally was coming in the soybean futures? Soybean prices had a nice rally between 2002 and 2004 and briefly broke above $10 a bushel. The selloff in soybean prices formed a base just above the area that had acted as resistance, at $7.50 a bushel. Once the base line was broken, a deeper selloff occurred and prices consolidated in their normal trading range (roughly $4.50 a bushel to $7.50 a bushel through the end of 2006). This long consolidation allowed price to restore its energy, and when the fundamentals shifted to support higher grain prices across the board in early 2007, soybean futures exploded higher. The key to recognizing that the new uptrend was underway was noticing that price had broken back above the $7.50 base line. If you look at the chart one more time, you'll see that prices were range bound when they were below $7.50 a bushel and they were trending strongly once they broke above this key base line.

Here's a quick tool to help measure the potential of these geometric explosive moves. Take the low of the prior trading range, marked A, and measure how far price traveled to the high of the first leg of the rally, marked B. If you take the distance price travelled in the first leg higher, multiply it by 1.618, and add the results to the low made at the beginning of the second rally higher, marked C, you'll have a very accurate target for a geometric rally. In this case, it predicted soybean futures would top out at $16.00 a bushel, within 50 cents of the actual high.

Will you ever see a move this far, this fast in the soybeans again? If you trade long enough, you'll begin to see that all things repeat. And of course, those who learn from history will also profit from it! Let's see what happened to soybean futures after they made a high over $16 a bushel in late 2008.

Continuing our discussion of spotting trend change, let's see what happened to soybean futures after they made a high over $16 a bushel in late 2008…

Once soybean prices topped out, they formed another chimney formation. When the base of the chimney, at $13.50 a bushel, failed to hold, soybean prices headed lower. They rallied once and tested the base line, but when they were unable to break back above it, they began a near-vertical fall that ended under $8 a bushel! The key to the change in behavior here was the break below the $13.50 base line and the failed test of that same baseline. Once it was clear prices were not going back above $13.50, the selloff was on.



Soybean prices are now in an interesting formation. Price is congesting between $8 and $11 a bushel in a chimney-like formation. Should the base line of the chimney successfully keep soybean prices above $8 a bushel, expect beans to eventually begin a long summer rally. However, should prices successfully break below the base line price of $8 a bushel, the long run down from nearly $17 a bushel is not yet over and bean prices could be in for a deeper selloff this summer.

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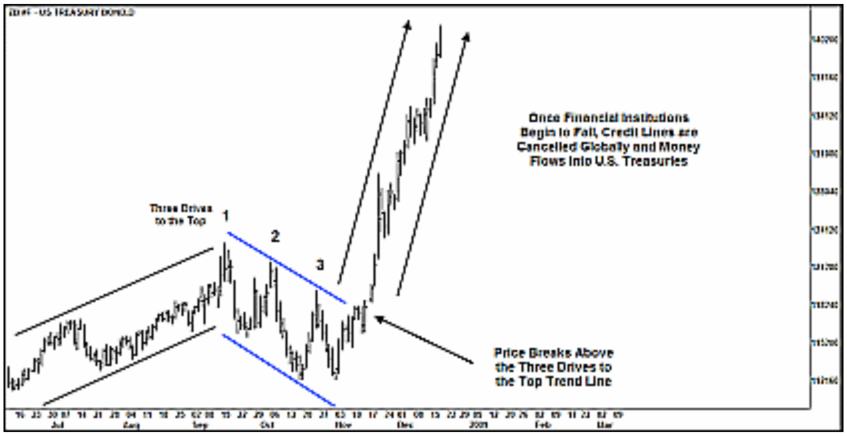
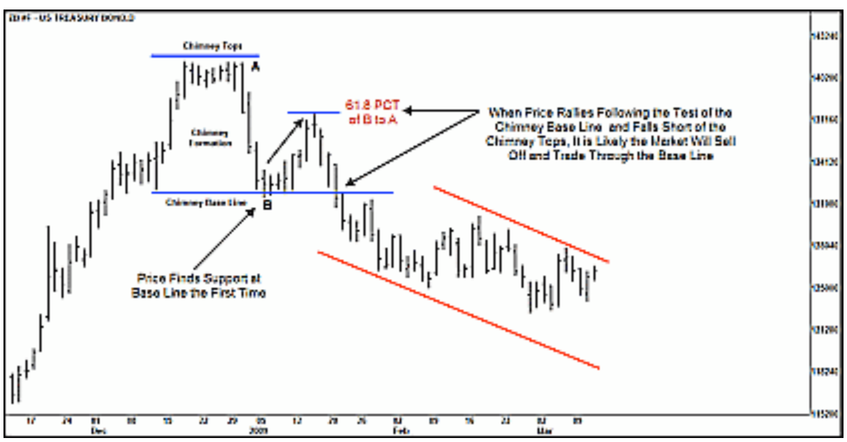
Treasury bond futures on the CBOT had a nice summer rally in 2008, moving from 112 to 122 from July to mid-September. Bonds then sold off in an orderly fashion, leaving three lower highs, a classic formation known as “Three Drives to the Top,” before bottoming out in late-October at the 112 area. A series of collapses of US financial institutions in November caused most banks to cancel all outstanding credit lines, and the ensuing liquidity crisis caused a rush into US Treasury bond futures. Once the trend line drawn above the down-sloping highs of the “Three Drives to the Top” formation gave way to the up side, the flight to quality rally took bond futures as high as 140 by early-December 2008!



Again, there was a change in behavior for you to see—if you were looking for it. When prices broke above the trend line drawn above the three lower drives to the top, the fierce rally began.

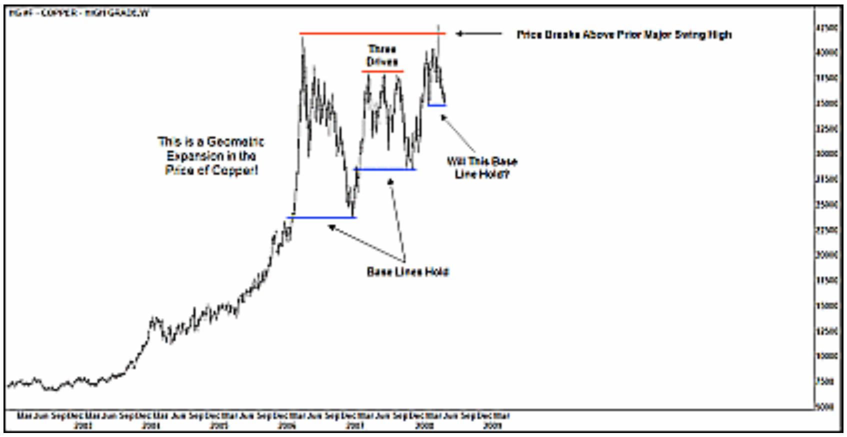
Let's see how US 30-year Treasury bond futures are doing in 2009:



Once bond prices topped out above 140 in December, they eventually sold off and formed a base line at roughly 131. You can see that this base line held for some time, but as the current President began announcing his fiscal packages, bond prices broke below the base line and have been trading lower in an orderly fashion ever since. Once again, a base line break signaled a clear change in behavior. It's easy to spot and very reliable, once you begin to recognize it.

There are no clear clues regarding the future price of bond futures. As long as prices stay below the 131 price that forms the base line, bond prices will remain under pressure. Although the media constantly bombards us with stories about the Treasury adding massive amounts of cash to the US banking system, the charts show that none of that cash is finding its way to the public—at least not yet!

Now let's look at copper prices. At one point in 2008, copper was trading so high that organized crime in major US cities were cruising through expensive neighborhoods and stripping large houses of their copper gutters and downspouts!



In many ways, we take copper for granted in the United States. But in countries like China and India, there is so much infrastructure building going on that uses basic industrial metals that the demand is hard to comprehend. These countries just plain need these materials, and in many cases, these countries are price insensitive. In the case of copper, the demand increased dramatically in 2004. There is a small chimney formation that I purposely didn't mark on this chart. See if you can find it and identify its base line. If you can see it, you'll find that the base line was tested, it held, and then prices quickly climbed above the top of the chimney tops. And with it, the geometric expansion of the price of copper was underway!

Once copper prices got above $400, old copper began to be magically “found” and sold to recyclers at an increasing rate. Melting down old copper is very economical, so it is a very lucrative business, especially when copper is nearly three times its prior historic highs.
You can see the first sharp selloff, and note that it left a perfect chimney and base line. The base line held, and price then rallied and consolidated between $275 and $375. The base line of this consolidation held, and after it was tested a second time, the price of copper began a new leg higher, this time making a new high for the move.

The last formation on this chart is a perfect chimney formation with a clean base line. The fate of copper in the second half of 2008 and into 2009 depended on the base line. If it were to hold, copper prices would trade higher. If it failed to hold, copper prices would trade lower to test one or both of the prior base lines.

Now, we will analyze what happened to copper in late 2008 and 2009.

Let's see what happened to copper in late 2008 and early 2009.

The base line support you see at the beginning of the chart below is the bottom of the chimney formation from the prior chart—I've just zoomed in so you can see it better. Look carefully! Price tried to break below this base line several times, and this base line proved to be stubborn support. But price finally did break below this base line at $350. Price climbed back to test it once, but was unable to break and hold back above it. Once it was clear the base line was going to act as resistance instead of support, a near vertical selloff in the price of copper began.

The change in behavior was simple to recognize. It didn't take computer generated lagging indicators, nor did it take expensive proprietary “trend detecting” methods. Once you learn to read market structure and begin looking for changes in behavior, price will begin talking to you.

Copper bottomed out in late 2008 at about $125, which is where the entire ride higher started in 2004. It is now making a gentle series of higher highs and higher lows. Have we seen a change of behavior? I think it's too early to decide whether this current rally is a countertrend rally (a pullback in an overall major down trend) or if it is a clear change in trend and a new uptrend has begun. Time will tell—and if we watch the charts, price will give us a clear signal!

We’ll now look at the commodity that had everyone's attention for the past few years: Crude oil.

Let's face it: When oil headed higher from $75 a barrel, it was an easily identifiable trend. Price easily broke every swing it left, and every swing low it left behind as support held, all the way from $75 a barrel up to nearly $150 a barrel! Breakout traders were rewarded every time they bought a new high for the move, and traders who were more comfortable simply buying pullbacks in a simple trend channel got the same satisfaction. The ride in crude was a one-way ride from $75 a barrel to nearly double that at $148 a barrel.

Was there an early sign from price? Once again, a simple base line that acted as support when a potential selloff began was the key. When the base line successfully stopped the fall in the price of crude oil, prices turned back higher and never looked back. You can see the same type of base line support was tested and held at $95 a barrel, and once again, when it held, the trend higher accelerated.

The signs are usually there for all of us to see. If we look at the charts with an open mind and a clear head and know the signs from studying past price history, these signs are there for us to take advantage of.

Next, we’ll analyze what the markets had in mind for crude oil in the second half of 2008 and early 2009.

Let's see what the markets had in mind for crude oil in the second half of 2008 and early 2009.

Crude oil prices sold off hard from their $148 highs. At first, the selloff came in a series of cascades lower, but in September 2008, price broke below a base line at $110 barrel and left a lower base line at $90 a barrel. Simply put, these two base lines held the future of the price of crude oil. If crude prices broke and held above the base line at $110 a barrel, a new uptrend would be underway, but if prices broke and held below the base line at $90 a barrel, a sharper selloff would commence. The decision that price had to make was marked by these two base lines and the outcome would turn out to be the major change in behavior in this market.

Looking at this chart, you can see that the downside selloff was as severe as the rally higher was sharp. On the way down, every swing low left by price was easily broken, and all the swing highs held as resistance while price remained in a strong downtrend. The price of crude oil fell in a near vertical fashion from $110 a barrel to $35 a barrel.

Crude oil prices are now trading in a consolidation pattern. After such a strong vertical move, price is restoring its energy while trading in this range between $35 a barrel and $50 a barrel. I note with interest that crude oil has had a number of higher weekly closes, but this is not a change of behavior. There simply isn't a clear sign yet that oil is going to break out of this range to the upside or downside. Price will tell us when it has begun its move by showing us a change in behavior.

Let's now analyze US dollar performance in recent years and see what the future may hold for the dollar.

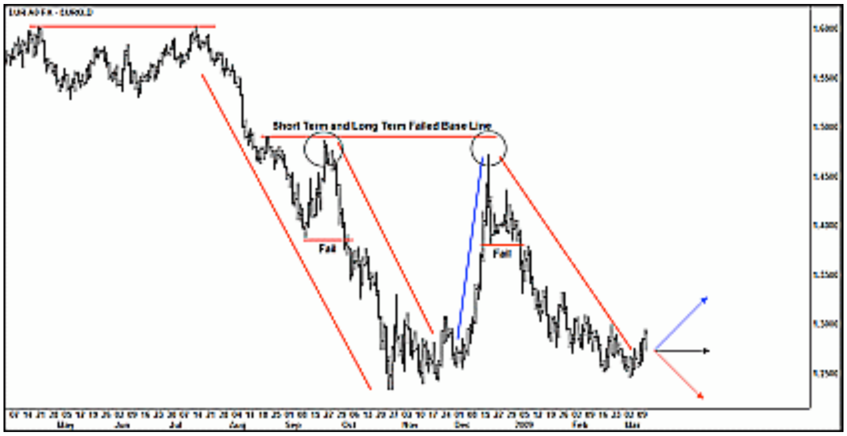
This is a weekly chart of the CME euro FX contract, which is the euro FX paired with the US dollar. Looking at the left portion of the chart, there are a series of drives to the top, all lower. I purposely did not draw in the down-sloping trend line above these drives to the top—I left that exercise for you! Once price broke above the down-sloping trend line marking the three drives to the top, the euro FX began a very strong rally against the US dollar, moving from 95 cents to over $1.35 before a base line of support finally broke. A selloff began that ended just below the $1.20 area, and then the euro began to climb again. Much like we saw with crude oil, all styles of buyers for the euro FX were rewarded, and the trend was relentless, topping out at nearly 1.60 dollars per euro FX.

I marked in the overhead base line resistance at the multiple tops. Can you see the base line support I purposely did not draw in below the same formation? Once again, price has shown us the two “lines in the sand,” and all we need do is wait for price to show us a change in behavior. One of these lines will not hold, and when we see which is broken, we'll know where the next major move is headed.

Let's see how the US dollar is doing so far in 2009 and try to determine where it will go next.

Let's see how the US dollar is doing so far in 2009 and try to determine where it will go next—again, by looking at the euro.

You can see that the lower base line did not hold (Again, I left it for you to draw in). Once price penetrated this base line just above $1.50¸ the selloff commenced. There was a brief pause at the $1.40 level and a pullback that tested a short-term base line. When that short-term base line successfully acted as resistance, price turned lower again, and this minor base line became the major “line of action.” Price fell sharply, penetrating 1.25 dollars per euro FX, and then rallied to nearly test this major line of action before turning back down hard. There was a smaller base line test on the way down, but it failed to act as support, and the euro fell back to the $1.25 level.



There have now been a series of higher closes in the euro FX against the US dollar. Have we seen a change in direction? My heart tells me the dollar will suffer in the long term because of our current fiscal policies, but the chart in front of me shows no clear sign of a change in behavior. Remember this: We can “want” the market to do something, but the market is always right! Until the market shows me a change in behavior, my hopes and wishes are just that—hopes and wishes. I am a trader, so I trade what I see, not what I want or wish to happen. The market will tell me when a change in behavior has occurred. I just need to be looking at the charts with an open mind and a clear head.

I wish you all good trading! Stay safe and close to those you love in these difficult times.

Best,

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