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The Beginner's Guide To

Trend Analysis

THE BEGINNER'S GUIDE TO TREND ANALYSIS

Tips for determining the general market trend

by David John Hall

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A journey of a thousand miles begins with the first step.

Confucius

ABOUT THE AUTHOR



David John Hall is a self-professed trading addict.

If it's got anything at all to do with trading or the markets -- he's all over it.

For the past 6 years this has meant constant study of the stock markets indexes, trading, chart analysis, backtesting, system development and money management.

Frustrated with the high costs of subscription services and overly complicated black box trading systems that simply don't work, David set out to create RetailTrader.Net, an idea hub for small account retail traders of all experience levels.

The Beginner's Guide to Trend Analysis is part of an introductory series on trading and what it takes to understand price action and to profit in the market.

If you have any questions at all, feel free to email them to

<mailto:info@retailtrader.net>.

INTRODUCTION

Fellow Retail Traders -- what's up?! Today, I thought I'd put together a quick report to explain a little bit about how I view the market from a big picture standpoint and the types of things I look at to determine the trend of the overall market. As stocks move 4 to 1 in lockstep with the market it's important to know what direction we're moving in NOW and where we have come from in the recent past.

Also, with so many different ways to approach the markets available to you and so many unique styles of trading out there, I believe it's important to know just how any advisor or instructor approaches his or her trades before heeding their advice.

Because so much market activity is based in psychology, it's imperative that you find a style of trading that matches YOUR personality.

With that said, let's move onto the topic at hand: how I trade the market, and how someone could learn to trade like I do if they so desired.

NEWBIES WELCOME

For the better part of 3 years I have been working on the idea of simplifying the concept of trading for a newbie trader. I've been doing this by visiting forums, answering newbie questions and examining the questions that they ask. It's been pretty freaking awesome and I have learned a lot about my own style of trading, about trading concepts and about how different traders view the markets.

Picasso said that it took him a lifetime to paint with the simplicity and innocence of a 5 year old and I believe that traders are after the same thing -- striving to return to the simplicity of that first buy or sell decision.

HOW WE LEARN

In **Trading in the Zone** Mark Douglas states that, before we enter the trading arena, we have no pain at all associated with the act of buying and selling of stocks. We look at charts, see trends, observe that price can only move 1 of 3 ways and we think: **Hmmm, that's not so difficult.** Then we place that first trade and begin to understand the difficulties associated with it.

If our first trades are losers, we cram our brains with technical knowledge, convinced that "education" is the answer.

If our first trades are winners, we rapidly escalate our position size in direct relation to our ever increasing ego size until we blow up from over confidence.

At this point we will either wash out and never return to the market or we will join the traders whose first trades were losers, and we will try and get that "education" we feel will prevent future losing trades and the psychological pains associated with it.

That being said, is it possible to learn how to trade before actually trading? I'm not sure. It's my belief that many traders mistake "trading" and "analysis" for the same thing.

The act of looking at the market, marking indicator values, support/resistance levels etc. is not the same thing as placing and managing a trade.

THE DIFFERENCE BETWEEN WATCHING AND DOING

When I was a kid, I wanted to learn how to surf. I lived by the beach, saw people surfing every day, and knew I wanted to be a part of that lifestyle. What they were doing seemed simple enough. They hopped on their boards, paddled out, and caught waves.

So I saved up my allowance, bought a board and proceeded to flail around for the better part of two summers before I got it.

Sure, other surfers offered advice (or snickers). You're getting up too early, some said. You're getting up too late others said. Your board's too big, some said. Your board's too small, others said.

But no matter what I did I couldn't stand up. Until the day that I did. It wasn't a magical day. Or a different day. I was on the same board, doing the same things in the same way. But on this wave, it all clicked.

From there it took me another couple years to understand the nuances of surfing and to really excel, and after that I was out in overhead surf, catching tubes.

Now, was there something I could have been told during that period to help my learning curve? I doubt it. **The real secret came from perseverance, passion and experience.**

The same is true for the markets. You know where they are (all over the world). You know how to get to them (through your computer). You know how to hit the buy button, and you know how to hit the sell button. You should be aware of the different types of orders (market, limit, stop-loss) and what they mean.

Once you have that knowledge, you should start small. Don't paddle out on a double overhead day. Start on the small days. And take on more as you're comfortable.

Thinking back to surfing, I remember my first objective was just to stand up. After that I wanted to make it to the bottom of the wave. After that I wanted a good ride. Then I wanted to rip!

As a trader, I guess standing up would be that first profitable trade that just felt right. The bottom of that first wave might be a profitable week/month/year.

And ripping might be getting in and out of trades with ease, targeting and isolating potentially profitable trades and executing them as they come up.

TOP DOWN TRADING - WHAT IT MEANS

When it comes to our analysis we use a method called "Top-Down Trading". What this means is that we start our analysis at the Index level and move down to the individual stock level. To do this you have to be aware of 4 important steps:

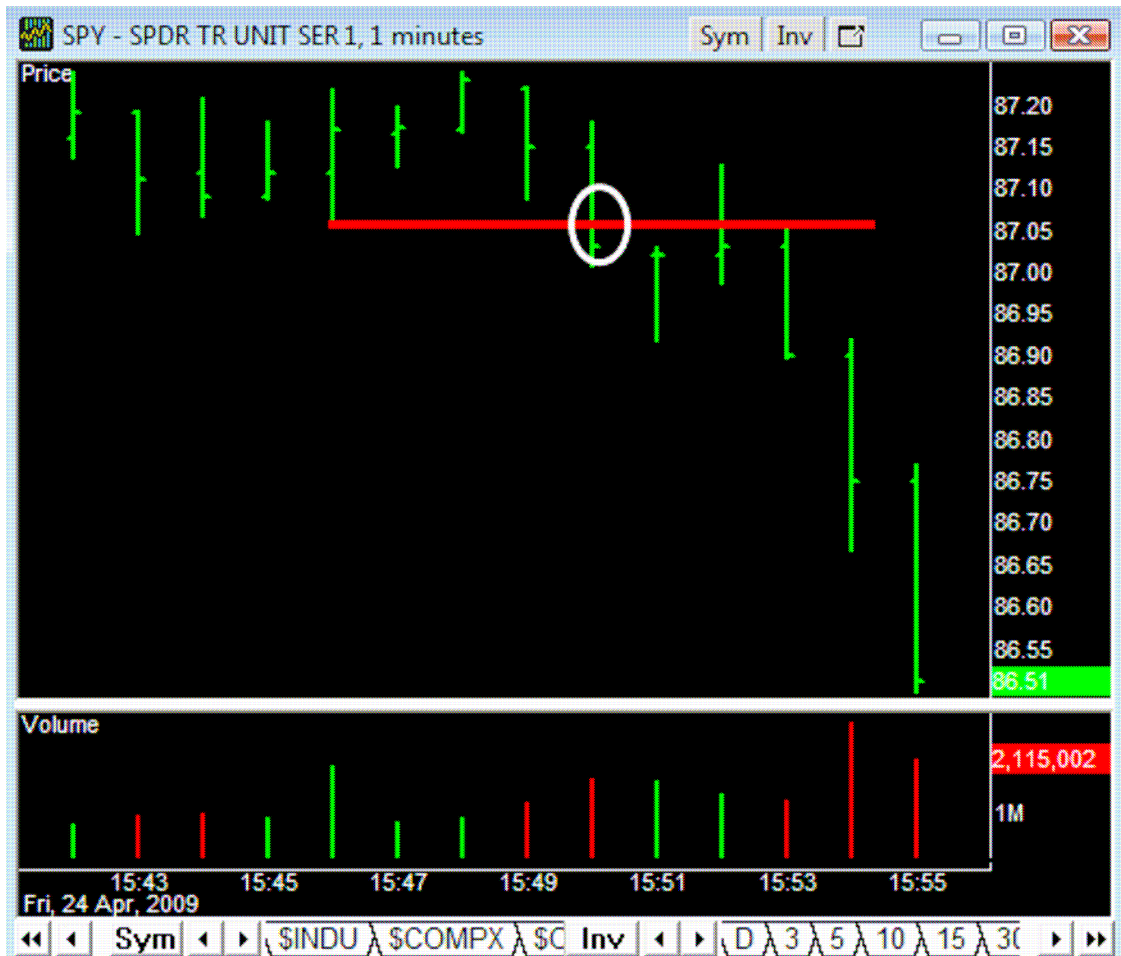
1. Market direction

Which way is the market going NOW -- on your time frame.

Obviously "now" doesn't mean right this second, it means what is the most recent trend of the market.

To highlight the difference, here are two charts. A one minute chart and a daily chart.

First, the one minute intraday chart:



This is what is called an intraday chart, meaning all of the price action takes place inside of a single day and the time frame is minutes to hours.

If you were taking trades based on information from this particular chart, your trades could be as short as 1 minute or as long 15 minutes and looking at what it is saying about price action "now" you would want to be "short" because the trend on your time frame would be down.

Now, take a look at this daily chart of the SPY which includes the price action highlighted in the one minute chart above:



Now, the trend is up. And as such I would want to be long. So there is step one. What is the market doing on your time frame -- going up (long) down (short) or sideways/who knows (cash)?

Why is it important that you trade in line with the general direction of the market? One word: **probabilities**. As an example, Here is a chart of the S&P 500 from 2007.



If you take a look at the chart of the S&P 500 from November of 2007 you'll see that over a span of three and a half months the S&P 500 experienced 2 nearly identical moves. One up and one down.

They're nearly the same distance and took nearly the same amount of time. Now, during the up move we had the following statistics from stocks composing the S&P 500.:

DURING UP MOVE (August 16, 2007 thru October 11, 2007)

Biggest Gain: 55.28%

Stocks that gained greater than 5%: 333 stocks

Stocks that gained greater than 0%: 421 stocks

Biggest Loss: -28.19%

DURING DOWN MOVE (October 12, 2007 thru November 26, 2007)

Biggest Gain: 34.37%

Stocks that gained greater than 5%: 44 stocks

Stocks that gained greater than 0%: 114 stocks

Biggest Loss: -63.79%

This is why its a great idea to focus your attention on the indexes and stay involved on the side of the trend only. Yes, there is money to be made trading the bounces along the way, but that's best left to the pros. As Retail Traders you stand a better shot at success if you can identify the trend and stay with it.

2. Which are the strongest/weakest sectors?

Money flows in and out of the market's favorite and least favorite sectors. In a weak market, weak sectors make excellent shorting opportunities, and in a strong market, leading sectors make excellent long opportunities.

You can get a quick glimpse of market sectors by checking out the candle glance sector charts at StockCharts.com. Here's the link:

<http://stockcharts.com/scripts/php/candleglance.php?XLF,XLK,XLI,XLB,XLE,XLP,XLV,XLU,XLY>

In strong markets, look for sectors making new highs. In weak sectors, look for markets making new lows. Or read our RetailTrader.Net Weekly Commentary for the sectors that we like.

3. Which stocks are the market leaders?

Once you have isolated the market direction, the strongest/weakest sectors, you will usually find the leaders in those same sectors. Not always -- but for now -- at this stage -- it's probably best for you to stay with sector correlation. Meaning, you will look for your long ideas in strong sectors and your short ideas in weak sectors.

4. Indicator Entry -- Chart Pattern

Once you have decided on market direction, isolated a sector, found a stock you will need an entry. THIS is where indicators play a part.

Unfortunately, this is where most newbie traders start! They think if they find the right indicator (or Holy Grail) they can trade any market at any time and get rich overnight. That's just not true.

The only time where indicators should be used (if at all) is for the market entry/exit. Then, as far as I am concerned, if you have the market direction right, you have the sector right and you have the stock right, ANY indicator will do.

I myself use mostly chart patterns. Two excellent books for this area of trading (entries/exits) are:

Technical Analysis Explained by Martin Pring or Technical Analysis of Stock Trends by Edward and McGee.

The latter was written in the 40's and as far as I am concerned hasn't been matched yet.

Here's a chart of the ETF I use to gauge the market's trend, the SPY.



Notice how the SPY was in an uptrend for at least 5 months here?
Now that's an awesome display and a great thing to be a part of.

The indicators are a 20 day moving average (white line) and a 50 day moving average (red line).

When the white is above the red like this I consider the market to be in an uptrend. And the way I trade that is to look for charts making bullish pattern set ups.

Here's a chart of Stamps.com (STMP) over the same period:



When you know the market is in an uptrend then you can take entries on individual stocks with more confidence because you know that the individual stocks follow the market at a rate of 4 to 1 and you know that your entry signals will be that much more successful.

Well, now you know how we trade the markets.

We use what is called a Top Down Trading Method which means we start with the index and work our way down.

To recap, here is this order in which we look at the market:

- 1. General Market Direction**
- 2. Sector strength/weakness**
- 3. Strong or weak stocks in leading or lagging sectors**
- 4. Entry based on indicator or pattern**

Good luck out there everyone.

And don't be discouraged if the learning curves take awhile. Some of the greatest traders of our time have blown up many accounts and taken YEARS to get this down.

The best thing you can do for yourself during this learning phase is to be patient, start small and give yourself lots of room for error.

Until next time....

David John Hall

CEO

Retailtrader.Net, LLC