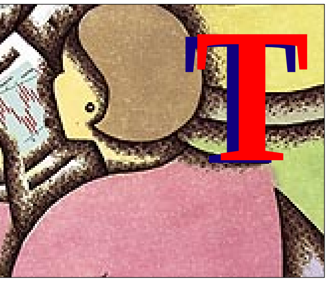
Triangles And Trends

Building positions is an essential exploitation of a successful trade, and triangle formations can be key to doing so.



The classic technical trader relies upon various chart formations for determining market tops, bottoms, and consolidations. Although the triangle chart formation can be a trend reversal or a consolidation, I want to show you how to use it as a continuation pattern, how to identify it as it develops, and how to trade it.

What *are* triangles? They are simply sideways trading action, with the widest part of the correction occurring earliest in the development of the pattern. As the market marks time, the trading range narrows, forming the shape of a triangle.

Why do triangles occur? According to the classic tome *Profits In The Stock Market*, by H.M. Gartley:

> The most logical explanation appears that the period of formation of the triangle reflects an uncertain state of mind and a re-appraisal of the situation. During this time, all buyers and sellers are gradually influenced, by economic and statistical factors, to withdraw from the market. As a result, fluctuations narrow down and volume of trading diminishes until a new impetus affects the market. Prices often move out of this state of equilibrium as a result of news which is interpreted as important marketwise.

Triangles are easy to see in hindsight, but with a little quantification, I can define a technique to spot a triangle as it first develops. That way, you'll have the chance to trade the triangle as it's developing.

by Thom Hartle

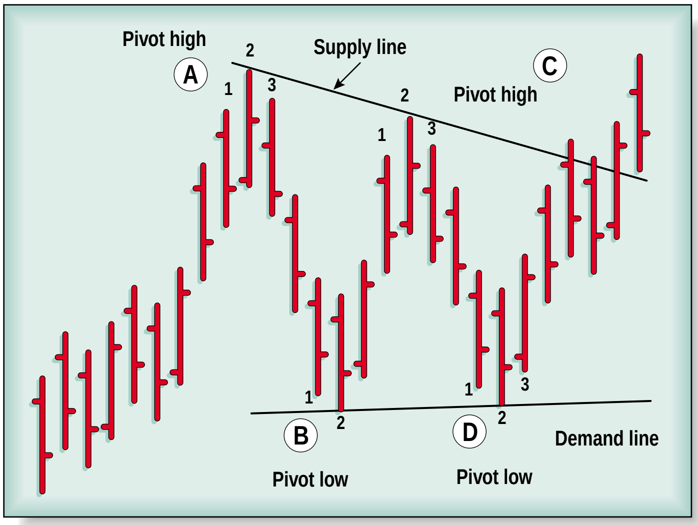


FIGURE 1: TRIANGLE. To draw a triangle, you need a supply line and a demand line. Use isolated highs and lows to determine the support and resistance points.

To outline a triangle, there are two trendlines to draw. The upper trendline, which is referred to the *supply line*, represents resistance. The supply line represents a lack of conviction by the buyers to commit more funds to the market, and because of that, there is enough profit-taking and short-selling to turn prices back down.

The lower trendline is the *demand line* and represents support. Here, the buyers come back out in force and turn prices up again. The key to drawing the correct trendlines is the use of a three-bar pattern referred to as *isolated highs and lows*. (See sidebar, "Isolated highs and lows.") These patterns are simply attempts by the market to move in one direction; the second bar's high is the highest point for the isolated high, and the second bar's low is the lowest point for the isolated low.

So when a market is in an uptrend, the first isolated high (Figure 1, point A) warns us that the upward trend may be stalling. That's just a warning. The first isolated high marks a momentary peak, and a countertrend move may follow. If the pullback occurs, I look for an isolated low (point B) to form during the decline. This isolated low will mark the completion of the first leg of the triangle. Here, the selling has waned enough that both new buyers and short-covering will push the market back up. After that, the market will advance again, but that won't take out the first isolated high. At that point, a second isolated high, lower than the first, unfolds; the supply line can then be drawn. This supply line can either be horizontal or declining.

A triangle is not formed until the next isolated low, the fourth point, has formed. (The next decline should not pass below the first isolated low.) Once this isolated low occurs, I can draw my demand line. The demand line can be horizontal or rising. To be a proper triangle, the two lines must converge when extended.

As a rule of thumb, measure from the first isolated high to the right where the demand and supply lines converge, and often the market will emerge from the triangle approximately two-thirds of the way to where the lines converge. So once I have drawn in the supply and demand lines, I wait for the market to penetrate either the supply or demand line.

Naturally, I would have an advantage if I had any idea which line would give way. Since I'm looking for continuation patterns, one solution would be to look for the leaders in a bull market. Once I find them, I can anticipate whether the supply line will give way and the price of the stock enter into a new uptrend.

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Taking action

The first step to determining the current market leaders is to narrow the universe of possible candidates. There are many ways to locate strong stocks. One technique is to review *Investor's Business Daily* and take a look at the holdings of the top-performing mutual funds. In doing so, you will find the companies that have been propelling the mutual funds to the top of the performance lists. Most of those companies will have high rankings based on IBD's scale for earnings per share growth and relative strength. These mutual funds have committed resources to pick strong stocks, so this list of holdings is a good place to start.

Once I have a list of candidates, I narrow it further by using a multiple time frame technical analysis approach. The foundation of this technique is to analyze two different time frames, such as weekly and daily charts. You can use any method of your choice to determine the trend of a higher time frame, and then trade based on signals in concert with both trends.

For example, if you are trading daily bars, look to the weekly