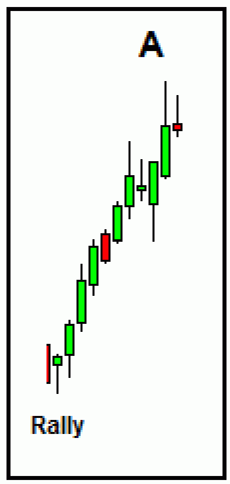
RALLY AND TREND BEHAVIOUR

By Daryl Guppy

Are markets showing a rally or a new uptrend? It's a question we have been asked several times in recent weeks. Rally, extended rally, parabolic trend or long term trend? The difference between these trend behaviors is very important because they determine the trading and investment strategy we can use.

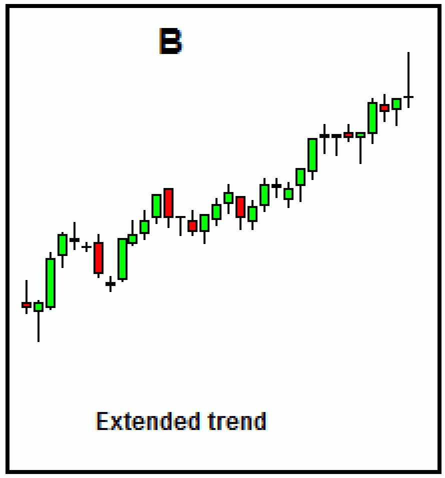
Very briefly a trend has multipole major retreat and rebound points. A rally has a collection of individual highs without retreat and rebound behavior.

We start with a rally. The key distinguishing feature of a rally is the way price continues to move upwards without any significant retreat. The slope of the price rise is steep, shown in chart example A. This type of rise is unsustainable so traders use a tight stop loss to protect profit in the trade. A rally will have an inevitable collapse. Most times a rally continues for a short time – perhaps 10 to 15 trading days.



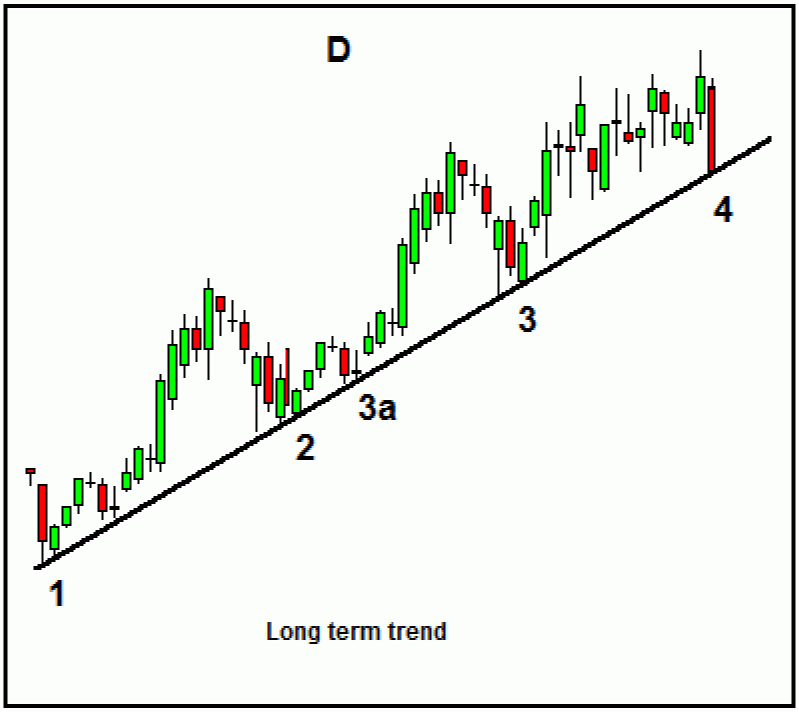
An extended rally is less steep and looks like a new sustained uptrend. An extended rally may include some days where there is a strong price retreat, but then this is quickly followed by another up day. This is shown in chart example B. The small price retreat also show this trend is not sustainable so traders are also ready to exit the trade when the protect profit stop is hit.

The problem is that many investors see the extended rally and they think it is a new sustainable uptrend. They do not sell when the price dips and they can get caught in a major trend reversal.



The parabolic trend is a special type of rally. This trend is created when the rally accelerates and moves up very quickly. The trend is best described with a curved trend line. This is shown in chart example C. The curved line is a quadrant of an ellipse, but it has a unique feature. The right end of the curve eventually becomes vertical. This gives an exact date when the parabolic trend will end. The trend may end sooner, but it is unlikely to continue beyond the absolute ending date. This trend may last several weeks, and occasionally for several months.

The parabolic trend has another characteristic. Parabolic trends usually collapse very quickly and often have a 50% or more retracement. Traders use very tight protect profit stops to manage these parabolic trend trades. Also they do not enter the trade again until there is proof that the trend collapse has ended.



A long term trend is created by a series of rallies, retreats and rebounds. This is shown in chart example D. The retreat and rebound point, or valleys, create the key anchor points for the long term uptrend line. Two anchor points are needed to plot the position of the long term trend line. Three anchor points confirm the position of the trend line. Note that point 3a is not an anchor point. It is a development of the major retreat and rebound behavior at point 3. This is a reliable method for defining the trend. Investors can buy with confidence when the price hits the trend line because there is a high probability the price will rebound. If the price does not rebound and falls below the trend line then this is a signal that the long term uptrend has ended.

An uptrend is drawn when each new high is higher than the previous high. The line is drawn touching the LOWS of these bars. Why the lows? Because a close below the lows indicates the bears have beaten the bulls. A downtrend is drawn when each new low is lower than the previous low. The line is drawn touching the HIGHS of these bars. Why the highs? Because a close above the highs indicate the bulls have beaten the bears. The more times the trendline is touched, but not broken, by price movements, the more significant, or accurate, the line is. Trendlines can be short term - a few days- medium term - a few weeks or months- and long term, a few months, or even years.