How To Correctly Identify The Trend (part 2 of a series)

In last week's article I discussed the way I determine the trend prior to entering trades in the FX market. While the article was rudimentary in terms of its approach, it drove the point home. Naturally, the drawback to that one dimensional approach is that it only dealt with determining the trend on one time frame. While this style/approach may suit some traders, I find it more efficient to look at multiple time frames as a way to potentially increase the odds of success on a trade.

This week, I will build upon the concepts from last week and begin to demonstrate how looking at one or two additional time frames can be a useful process.

First, let's review what was discussed last week. What is the trend on the chart of EUR/USD below?

There are actually two correct answers, 1. Sideways or 2. Down

Prices are below a slightly downward sloping moving average. This is not a chart that demonstrates an up-trend. However, what is your answer if at the same time you were looking at the 240-min chart of EUR/USD versus the 60-min chart noted above?

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Here, there is only one answer; the trend is ‘Up’.

So, when you combine the analysis of both charts you sort of have a dilemma. If you are looking to execute the trade off the 60-min chart, it makes it tough to go short (despite 60-min trend being down) when the next higher time frame is indicating that you are going against the overall trend. Conversely if you are looking to execute off the 240-min chart, the 60-min chart is less relevant and you would look to isolate high probability long entries. ***Higher time frames should always take precedent.***

This is the part of trading where it can become more ‘art’ than ‘science’ and hence highlights the serious limitations of a purely mechanical approach. As we get further into this series of lessons, it will become even clearer how subjective the distinctions can become.

Let’s look at another example. In this case we are presented with three time frames for analysis. While the 240-min and daily charts are in a clear downtrend, the 60-min chart is likely to limit downside moves due to its current technical condition.


(EURJPY A0-FX - Forex Cross Rate,60) Dynamic,0:00-0:00
145.50
145.00
144.50
143.942
143.50
143.00
Sideways to up
141.951
141.50
Copyright © 2004 eSignal.
Stochastic(15(3),3)
83.03
OBV
Stochastic(15(3),3)
Stochastic(20(2),2)
RSI(5,C)
04/19
04/20
04/21
04/23
04/24
04/25 12:00
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(EURJPY A0-FX - Forex Cross Rate,240) Dynamic,0:00-0:00
145.50
145.00
144.50
144.00
143.406
143.00
142.00
141.50
Trend is down, but a counter-
trend bounce is under way
Copyright © 2004 eSignal.
Stochastic(15(3),3)
16.16
OBV
Stochastic(15(3),3)
Stochastic(20(2),2)
RSI(5,C)
04/02
04/09
04/16
04/23
04/27 08:00
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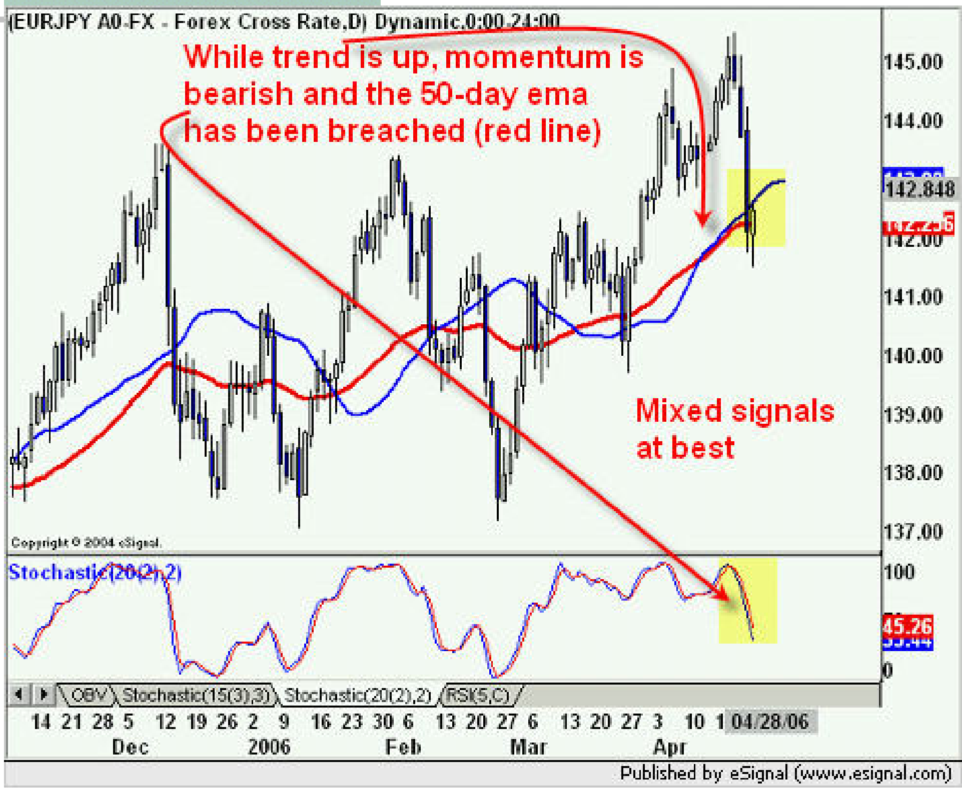

What is the answer then? Wait for more information.

For those that are familiar with my work, you know that I am always of the mindset that sitting on your hands can be the most effective trade. Is there a way for a trader to make money on EUR/JPY to the long side? Absolutely, but the probabilities of this trade playing out are reduced because of the higher time frames.

While I understand that this week's lesson may have been a bit confusing and left you with no clear answers, (it's OK, it is a tough concept to grasp when you continue to add new variables) in the lessons that follow, there will be new studies added that will begin to offer you an ideal and relatively simple way to identify the trades that have the higher probability of playing out. While trend identification is key, it is only one piece of the puzzle.

As always, feel free to send me your comments and questions.

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