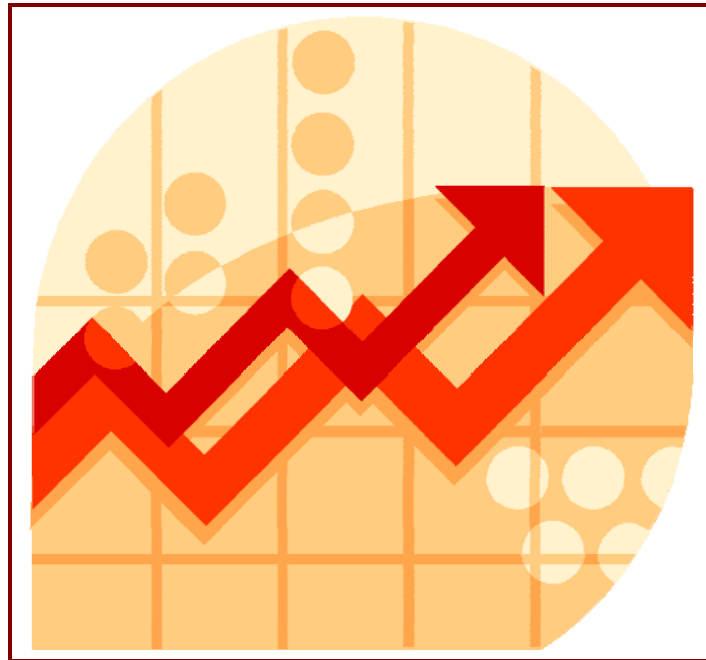


Tina Logan's



Change in Trend Direction

TINA LOGAN
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CHANGE IN TREND DIRECTION Table of Contents

TOPIC	PAGE #
INTRODUCTION TO TREND CHANGE	4-6
EARLY WARNINGS OF POTENTIAL TREND CHANGE	6-21
Climax Moves	7-9
Exhaustion Gap	7-8
Key Reversal	8-9
Divergence between Price and Indicator(s)	9-10
Reversal Chart Pattern	10-11
Slope of Trendline	11
Strong Ceilings and Floors – Main Time Frame	12
Strong Ceilings and Floors – Next Higher Time Frame	12-15
Overextended – Next Higher Time Frame	15-18
Divergence – Broad Market and New Highs-New Lows Index	18-19
Multiple Warnings	19-20
How to Respond to Warnings	21

CHANGE IN THE DIRECTION OF THE TREND

In my book *Getting Started in Candlestick Charting* (Wiley & Sons, 2008), there is a very important chapter on trend analysis (Chapter 7). That chapter serves as an introduction to this important area of technical analysis by providing instruction on trend direction and trend duration. This e-Book is a nice compliment to that chapter since it provides instruction on how to recognize when a trend may change direction.

Trends do not last forever. They eventually change direction, and when they do, it rarely happens in an abrupt manner with no warning. An exception for individual stocks is when news is released that has an impact significant enough to disrupt the trend. However, in many cases the news is an earnings announcement and traders have the opportunity to exit, or hedge their position, prior to such an announcement if their rules dictate (as mine do).

Indications that a trend may be weakening, or may run into trouble, are often apparent on a chart prior to a shift in direction. It is important for traders to learn to recognize warnings of a potential change in the trend so they can respond in an appropriate manner. A change in trend direction means that the prevailing trend will be disrupted by either a *correction* (or a trend reversal) or a shift to a period of sideways movement, referred to as *consolidation*.

Following are a few important reasons why traders should learn to recognize a potential change in the direction of an intermediate- or long-term trend:

- To protect open positions
- To initiate new positions
- To monitor the broad market averages and market sectors

Protect Open Positions

Traders who have open positions in the direction of the trend (e.g., a long position in an uptrend or a short position in a downtrend) can build up a lot of profits. They must be careful to avoid giving back a significant portion of those profits when the trend changes direction. Preservation of capital should be a trader's first priority. It's not what you earn that matters, it's what you keep!

Many financial advisors suggest that investors use a *buy-and-hold* approach. This calls for hanging on through the gyrations that occur in most trends because history has proven that the market will ultimately go higher. It is one thing to hold through minor interruptions of a trend; however, holding through a severe correction, or holding on to long positions through a bear market, can be destructive for investors.

When the technology bubble burst in early 2000, a devastating bear market followed and billions of dollars of wealth was lost. The technology-heavy Nasdaq Composite Index declined over 78% between March 2000 and September 2002. In order to recover a loss of that magnitude requires a gain of about 400 percent! Now, over five years later, the Nasdaq Composite is trading at around 2,500. That is nowhere near the high of over 5,100 set in March of 2000. Many investors held their once high-flying technology stocks all the way down, and many of those stocks have never recovered. This is a strong argument against the buy-and-hold method of investing.

I am a fan of trend-following strategies which strive to get aboard a trend as early as possible in its development and stay with that trend until it changes direction. However, I am not an advocate of buy-and-hold investing. I do not understand the reasoning behind acquiring gains and then watching much, or sometimes all, of those gains disappear and then waiting for the stock or market to come back. Some investors even watch their once profitable trades turn negative by following the buy-and-hold mantra.

By my definition, a trend-following strategy lets the profits run but employs a protective stop loss method in order to avoid giving back a substantial amount of the profits when the trend changes direction. It is great to ride the trend, but one should not ignore the need for prudent money management and risk management practices.

Initiate New Positions

One of the key skills traders should learn is to identify a trend as early as possible in its development in order to profit from it. Significant gains can be made during intermediate- and long-term trends. One way to benefit from a new trend is to determine that a prior trend may be ending. For example, after a decline, traders watch for signs that the decline is coming to an end so they can participate in a new uptrend.

It is not necessary to try to “nail the top” of an uptrend or “nail the bottom” of a downtrend. In fact, this is very difficult to do. It is more likely that you’ll be early or late when getting aboard or exiting a trend. Traders may choose to wait for sufficient evidence that the trend has turned (e.g., from a downtrend to an uptrend) before initiating a position. However, recognizing that a trend may be ending can allow them to get ready to participate if a new trend emerges.

Monitor the Broad Market

In addition to monitoring the trends of the individual stocks they trade, market participants should also stay on top of the trend of the major averages (the Dow Jones Industrial Average, the S&P 500 Index, and the Nasdaq Composite). The tone of the broad market can have a significant impact on individual stocks. When the broad market is in a strong uptrend (a bull market) most individual stocks will rise with it. And when the broad market is declining (a bear market) most individual stocks will decline with it.

The long-term direction of the broad market is a reflection of the health and growth rate of the U.S. economy. The charts of the major averages can act as leading indicators of the market fundamentals. After a bear market, when there are signs that the downtrend may be weakening, traders can stay on top of the action and watch for more signs that the bear market may be ending. They can prepare to initiate new positions when they recognize that a new uptrend may be emerging.

In addition, by monitoring sector and industry group charts, traders can determine when money is rotating from one group to another and invest their funds where the money is flowing.

This instruction details some early warnings that a trend may be weakening or in danger of changing direction. The discussion is in reference to a significant change in the trend direction (a correction or a prolonged period of sideways movement). In these cases, we're looking for a potential end of an intermediate- or long-term trend rather than the end of a short-term trend. This can be very beneficial for trend-following strategies. I consider monitoring of short-term trends to fall under the category of swing trading, which is another trading style that I employ regularly. For more information on swing trading or other trading-related topics, visit my website at www.tinalogan.com or e-mail me at tina@tinalogan.com.

EARLY WARNINGS OF POTENTIAL TREND CHANGE

If the market is trending up, traders with long positions try to avoid exiting the trend prematurely. And yet they don't want to get caught off guard when the uptrend changes direction. Traders looking to go short also watch for signs that an uptrend is weakening. Conversely, in a downtrend traders who are short try to avoid getting caught in a short covering rally, and traders looking to go long watch for signs that the downtrend is weakening and may soon change direction.

Getting aboard a new uptrend early in its development can be very advantageous. Therefore, in a declining market or stock, traders should watch closely for signs that the downtrend may be bottoming out in order to participate in as much of a new uptrend as possible, especially those traders and investors who either can't short or choose not to. They must make their profits during uptrends, whereas traders who trade both the long and short side can profit in bullish and bearish environments.

Traders can take a proactive stance and stay alert for early technical signs that a change in the direction of the trend may be coming. Table 1.1 lists several technical indications that an uptrend or downtrend may be weakening, or that there may be trouble ahead (e.g., resistance or support). One or more of these technical indications may occur *before* an intermediate- or long-term trend actually changes direction.

TABLE 1.1: EARLY WARNINGS OF POTENTIAL TREND CHANGE	
Uptrend	Downtrend
Bearish Climax Move	Bullish Climax Move
Bearish Divergence	Bullish Divergence
Bearish Reversal Chart Pattern	Bullish Reversal Chart Pattern
Slope of Rising Trendline	Slope of Declining Trendline
Strong Ceiling Above on Main Time Frame	Strong Floor Below on Main Time Frame
Strong Ceiling Above on Next Higher Time Frame	Strong Floor Below on Next Higher Time Frame
Overextended on Next Higher Time Frame	Overextended on Next Higher Time Frame
Bearish Divergence Between Broad Market and New Highs/New Lows Index	Bullish Divergence Between Broad Market and New Highs/New Lows Index

You may be wondering why candlestick reversal patterns are not listed in Table 1.1. Candlestick signals are typically only valid for a few days, whereas the events listed in Table 1.1 have stronger implications. In order to cause a significant disruption of a trend, usually there are signs other than a candlestick signal. However, the presence of a strong candlestick signal may add weight to many of these warnings. I recommend learning the candlestick reversal signals and I have written a book on the subject (*Getting Started in Candlestick Charting*, Wiley & Sons, 2008).

CLIMAX MOVE

After a long or strong rally, there are two types of climax moves to watch for:

- Potential Exhaustion Gap
- Key Reversal

A climax move that occurs at the end of an uptrend may also be referred to as a *blowoff top*. The initial move down from a climax top is often fast and sharp. Climax moves at the end of a downtrend may be referred to as *climax selling*. Climax moves are typically accompanied by very heavy volume, and they signal potential exhaustion by buyers (uptrend) or sellers (downtrend).

Exhaustion Gap

An exhaustion gap occurs when price is trending and leaps forward with a last gasp of buying pressure in an uptrend (Figure 1.1) or selling pressure in a downtrend (Figure 1.2) and leaves a void on the chart. That last push quickly fades and price reverses back into the gap and fills it. Volume is typically quite strong on these gaps.

Exhaustion gaps are usually filled fairly quickly. If the opening of an exhaustion gap in an uptrend does not provide support when tested, and price closes *below* it, that is a bearish sign. If the opening of an exhaustion gap in a downtrend does not provide resistance when tested, and price closes *above* it, it is a bullish sign.

A gap up in an up or down trend is only a potential exhaustion gap because, at the right edge of the chart, you won't know for sure yet if it will turn out to be an exhaustion gap or a continuation gap. However, when a gap forms at the end of a long trend, or after a swift move up or down within the trend, I err on the side of it being an exhaustion gap and take steps to protect my profits.



Figure 1.1 Upside Exhaustion Gap
Source: TeleChart 2007 ©



Figure 1.2 Downside Exhaustion Gap
Source: TeleChart 2007 ©

Key Reversal

A *negative (bearish) key reversal* occurs when price gaps up open to a new high in an overbought stock or market. Price reverses direction and closes near, or below, the prior bar's close accompanied by heavy volume. A negative key reversal formed on the daily chart of Endeavour Silver Corp. (EXK) on November 7, 2007 (Figure 1.3).

A *positive (bullish) key reversal* occurs when price gaps down open to a new low in an oversold stock or market. Price closes near, or above, the prior bar's close accompanied by heavy volume. A positive key reversal formed on the daily chart of Norfolk Southern Corp. (NSC) on January 22, 2008 (Figure 1.4).

The gap open should be a strong move in the direction of the trend. It is followed by an abrupt intraday reversal which will create a bar on the chart that skilled technicians will recognize as an obvious change in sentiment. The wider the key reversal bar's range and the heavier the volume, the more significant is the signal. In order to meet the criteria of a key reversal, price need not engulf the prior bar's range (from high to low). However, in some cases it will. Some key reversals will meet the criteria of either a counterattack line or an engulfing pattern (Japanese candlestick reversal patterns.)



Figure 1.3 Negative Key Reversal
Source: TeleChart 2007 ©



Figure 1.4 Positive Key Reversal
Source: TeleChart 2007 ©

On January 22, 2008, positive key reversals formed on several of the SPDR Select Sector exchange traded funds (ETFs). Since those ETFs are representative of the U.S. economy, that was a significant event.

DIVERGENCE

A *negative (bearish) divergence* occurs in an uptrend when the *peaks* in price continue rising while the *peaks* of one or more strong indicators begin to decline (Figure 1.5). A *positive (bullish) divergence* occurs in a downtrend when the *bottoms* in price continue falling while the *bottoms* of one or more strong indicators begin to rise (Figure 1.6).



Figure 1.5 Negative Divergence
Source: TeleChart 2007 ©

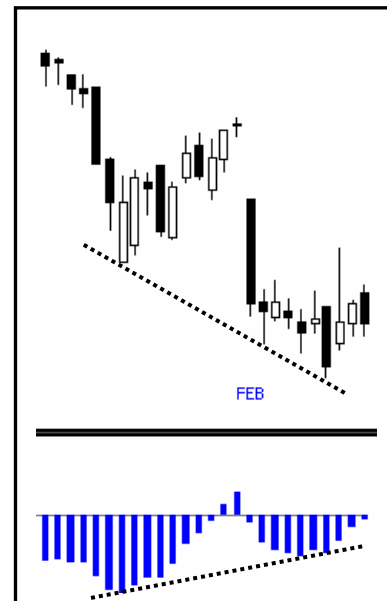


Figure 1.6 Positive Divergence
Source: TeleChart 2007 ©

A divergence warns that the trend may be losing momentum (weakening), even though the stock's price is still rising (uptrend) or falling (downtrend). A divergence can be a strong warning of a potential change in trend direction, especially if it is the first such divergence in some time and/or there are two or more non-related indicators divergent with price at the same time. For example, the Moving Average Convergence-Divergence (MACD) histogram (12-26-9 setting) and an oscillator, such as the Relative Strength Index (RSI) (14 period) are two indicators I use often for this purpose.

Note: In most cases, if more than one oscillator is divergent from price at the same time (e.g., RSI and Stochastics), it should be considered one signal, not multiple signals, because oscillators basically all measure momentum.

A divergence is a warning, not a guarantee. The divergence may get shrugged off as price continues to move in the direction of the trend. Even so, a divergence indicates a loss of, or lack of, momentum and should encourage traders to stay alert for additional warnings that the trend may be weakening.

REVERSAL CHART PATTERN

A long-term trend rarely reverses direction in an abrupt manner. An uptrend usually goes through a topping process before reversing, and a downtrend usually experiences a bottoming process. In an uptrend, when a stock or index stops making higher peaks and forms two or three nearly parallel peaks (double or triple top), it can be an indication that the trend may be about to reverse direction from up to down (refer to numbers 1 and 2 in Figure 1.7). In a downtrend, a stock or index may stop making lower bottoms and form two or three nearly parallel bottoms (double or triple bottom) indicating that the trend may reverse from down to up (refer to numbers 1 through 3 in Figure 1.8).

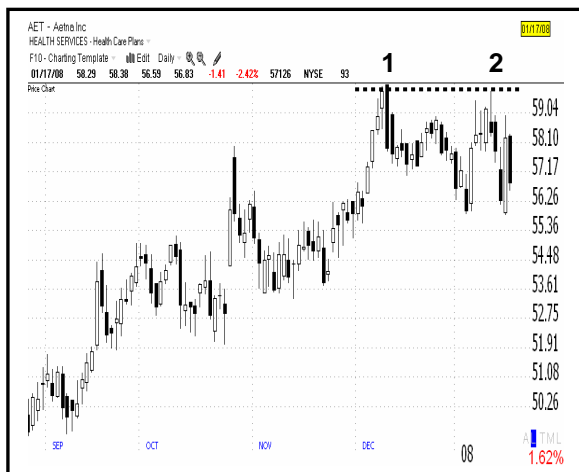


Figure 1.7 A potential bearish double top reversal pattern.

Source: TeleChart 2007 ®

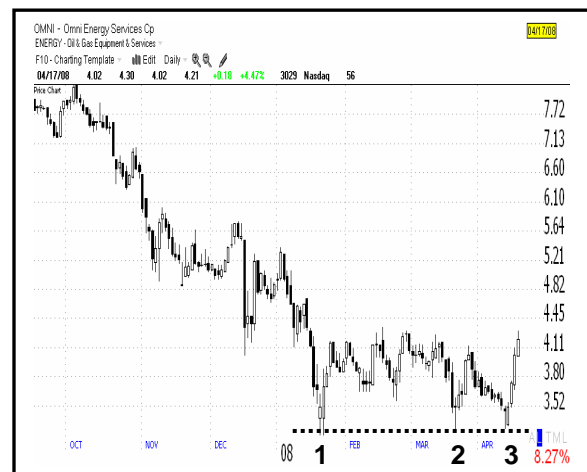


Figure 1.8 A potential bullish triple bottom reversal pattern.

Source: TeleChart 2007 ®

The presence of one of these reversal patterns should be seen as warning of a *potential* reversal. The patterns are not actually valid reversal signals until they are confirmed by a close below the lowest point between the peaks (topping pattern) or above the highest point between the bottoms (bottoming pattern). Just because a reversal pattern forms on the chart, it does not guarantee that a *trend reversal* will follow. Double and triple tops and bottoms, until they are confirmed, may just be periods of consolidation (e.g., a trading range or triangle). They may resolve with an upside breakout above the peaks (double or triple tops) or a breakdown below the bottoms (double or triple bottoms) resulting in a continuation of the trend.

TRENDLINE SLOPE

Trendlines are not static; they should be monitored regularly. As an uptrend evolves, there will be times when new price action forces you to adjust a trendline's angle, or to draw a new trendline. If you are forced to draw a new, steeper trendline because of an acceleration of the trend, be on the alert for a period of consolidation or a correction. Watch carefully for other signals that the trend may be weakening.

If the uptrend accelerates rapidly, the trendline angle will become much steeper (Figure 1.9). When that occurs, the trendline is likely to be broken soon because a steep ascent cannot be sustained for long. The uptrend may not reverse completely, but it is likely to at least retrace part of that steep ascent or move sideways to consolidate the gains. In a declining stock or market, the acceleration may occur to the downside (Figure 1.10). This may be an indication of capitulation. Capitulation is a phenomenon where investors "give up" and are willing to sell a declining stock at almost any price in order to exit their long positions. True capitulation will be accompanied by heavy volume and a sharp decline. Once the panic selling is over, the stock is vulnerable to a short covering rally.

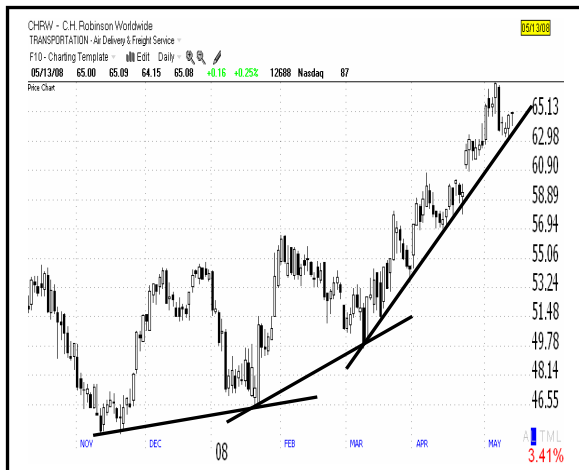


Figure 1.9 Change in slope: rising trendline.
Source: TeleChart 2007 ®



Figure 1.10 Change in slope: declining trendline.
Source: TeleChart 2007 ®

STRONG CEILING OR FLOOR – MAIN TIME FRAME

If an uptrending stock is approaching a strong ceiling, it is likely to find resistance at, or near, that point (refer to the dotted line in Figure 1.11). Eventually price may push through the resistance area. However, be aware that many experienced traders will use a strong ceiling as a target to exit all, or at least part, of their long positions. Their selling will often force price to retreat from the ceiling, at least temporarily.

In a downtrend, when price approaches a strong floor many traders with short positions will cover them, and traders looking to go long may initiate positions at the support area (refer to the dotted line in Figure 1.12).



Figure 1.11 Price advanced to a strong ceiling.
Source: TeleChart 2007 ®

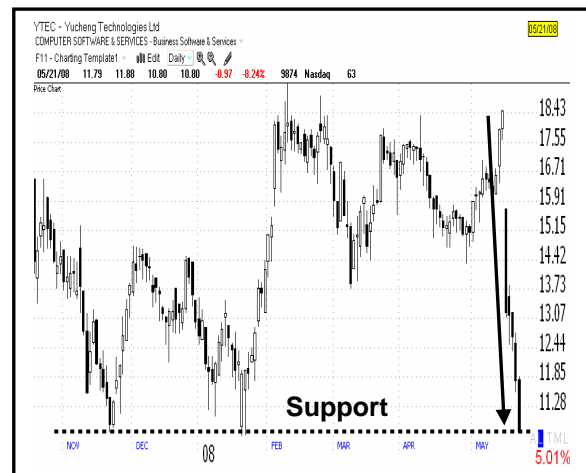


Figure 1.12 Price declined to a strong floor.
Source: TeleChart 2007 ®

STRONG CEILING OR FLOOR – NEXT HIGHER TIME FRAME

Keep an eye on the next higher time frame to the one you are trading on. For instance, if the daily chart is the main time frame, the weekly chart is the next higher time frame. Just because there is no strong ceiling or floor visible on the chart you are viewing (e.g., daily) does not mean that there is not one that can be seen on the next higher time frame (e.g., weekly). Experienced traders know to analyze more than one time frame. They will be aware of a past ceiling (resistance) or floor (support) on the weekly chart and may react when price approaches it again.

In Figure 1.13, a daily chart of Timken Co. (TKR) is shown on the left and a weekly chart on the right. The intermediate-term uptrend on the daily chart that began in mid-January 2008 has just come up against very strong resistance (dotted line) at a double top that formed on the weekly chart back in 2007. That resistance would not have been visible on the daily chart unless the price bars were tightly compressed so that a year or more of data appeared in the chart window.

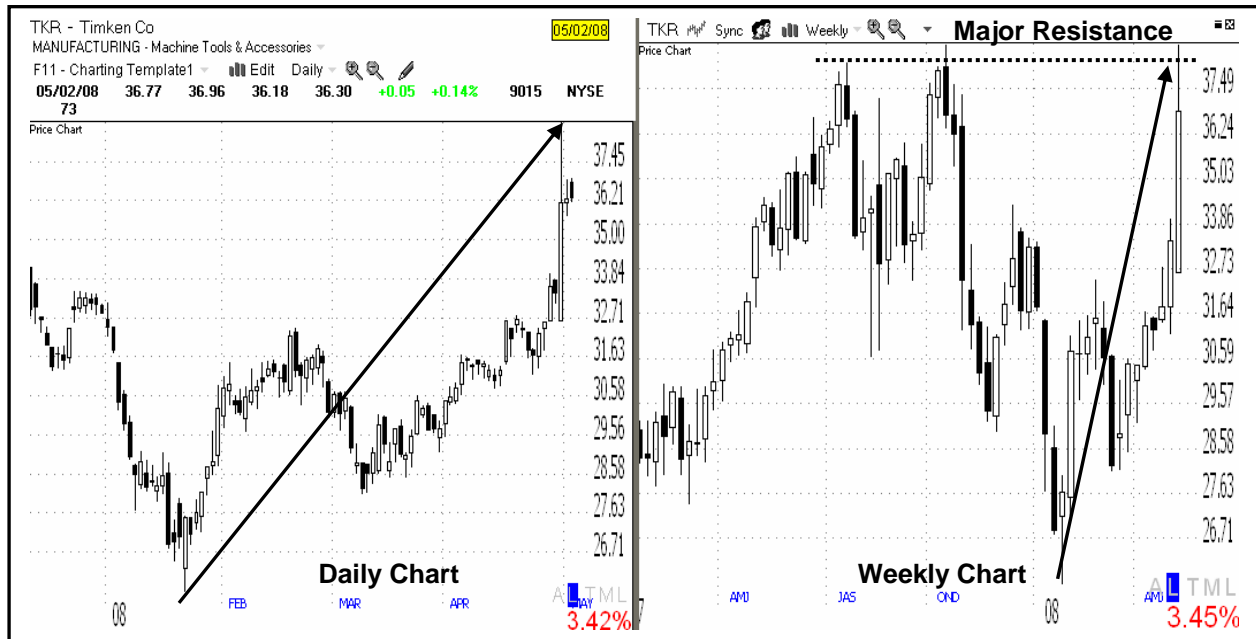


Figure 1.13 Price has reached a major ceiling on the weekly chart.

Source: TeleChart 2007 ®

Eventually a strong ceiling will be broken; however, since we can't know until after the fact when that will occur, when price approaches such a ceiling, some traders may elect to exit their long positions. Others may sell part of their position and hold some shares to see if the ceiling will be broken. Selling part of the position reduces exposure to a sharp downturn.

Figure 1.14 shows a daily chart of Valero Energy Corp. (VLO) on the left and the weekly chart on the right. Notice the very long lower shadow on the daily chart (a bullish hammer) on January 23, 2008. There is a reason for that long shadow. Many traders who had short positions observed the very strong floor on the weekly chart (dotted line) and covered their positions. In addition, many traders looking to go long were willing to initiate new positions at that floor. The buying pressure caused a strong intraday rally resulting in the long lower shadow.

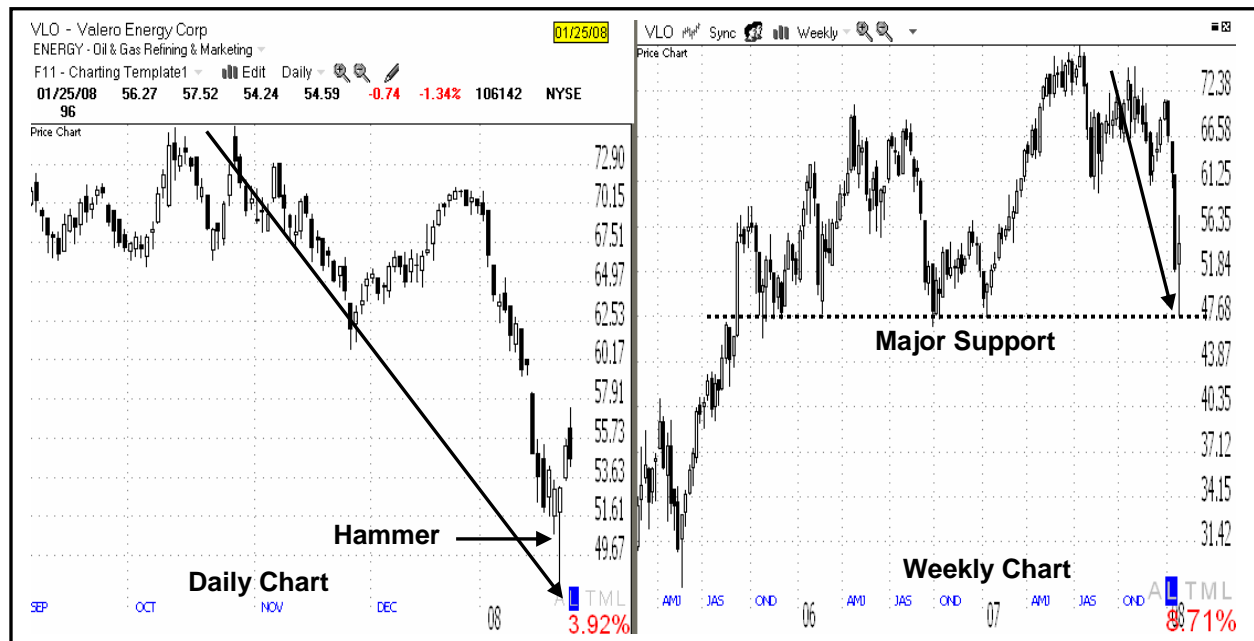


Figure 1.14 Price has declined to a major floor on the weekly chart.

Source: TeleChart 2007 ©

A strong floor will eventually be broken. This often occurs when the broad market declines causing most stocks to fall, or if money rotates out of a sector and traders start to take profits. News is also responsible for stocks breaking support (or resistance).

A ceiling (or floor) on the weekly chart may be the top (or bottom) of a trading range which is visible on that time frame. Figure 1.15 shows a daily chart of Seagate Tech (STX) on the left and the weekly chart on the right. The stock is in an intermediate-term downtrend on the daily chart and it may appear as if there is nothing to stop its fall. However, looking at the weekly chart, it is obvious that this stock has been trapped in a wide trading range for a couple of years and is testing the floor of the channel again.

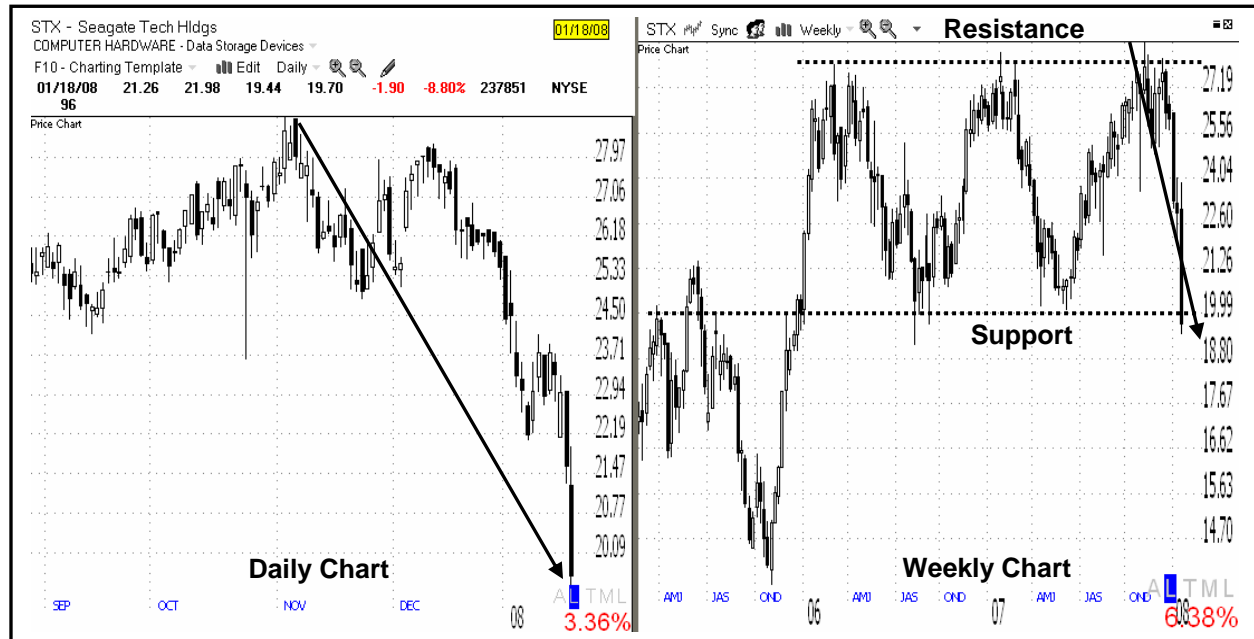


Figure 1.15 Price is trapped in a wide trading range on the weekly chart.

Source: TeleChart 2007 ©

Until the time when price is successful at breaking through a strong ceiling or floor, you cannot be certain on which attempt it will do so. Thus, when a stock is approaching strong resistance or support on the weekly chart, it should serve as warning to be alert for a change in the direction of the trend.

OVEREXTENDED – NEXT HIGHER TIME FRAME

Another sign to watch for on the next higher time frame is an overextended condition. Stocks generally only swing so far in one direction before they pause or pull back. The concept of price swings occurs on all time frames, including the weekly chart. Therefore, after a strong *swing* up of several bars on the weekly chart (which equates to a *trend* up on the daily chart), price gets overextended and is vulnerable to consolidation or a pullback. *Note:* There will always be exceptions where an overextended stock or market remains overextended for a prolonged period. However, that is more the exception than the rule. Profit-taking by active traders and investors usually causes price to consolidate or turn against the trend for a period of time rather than allowing it to continue to rise (uptrend) or fall (downtrend) unabated.

Figure 1.16 shows a daily chart of Bruker Corp. (BRKR) on the left and the weekly chart on the right. The 10-, 20- and 40-week simple moving averages (SMAs) are plotted on the weekly chart. Notice that over the past several months each time price lifted up away from the moving averages it was followed by a decline back toward the average (this is referred to as *reversion to the mean*). At the right edge of the weekly chart at the end of March 2008, price appears to be overextended once again. If price declines all the way back to the 40-week SMA, it will be the equivalent of a correction to the 200-day SMA on the daily chart (40 x 5 trading days in a week = 200).

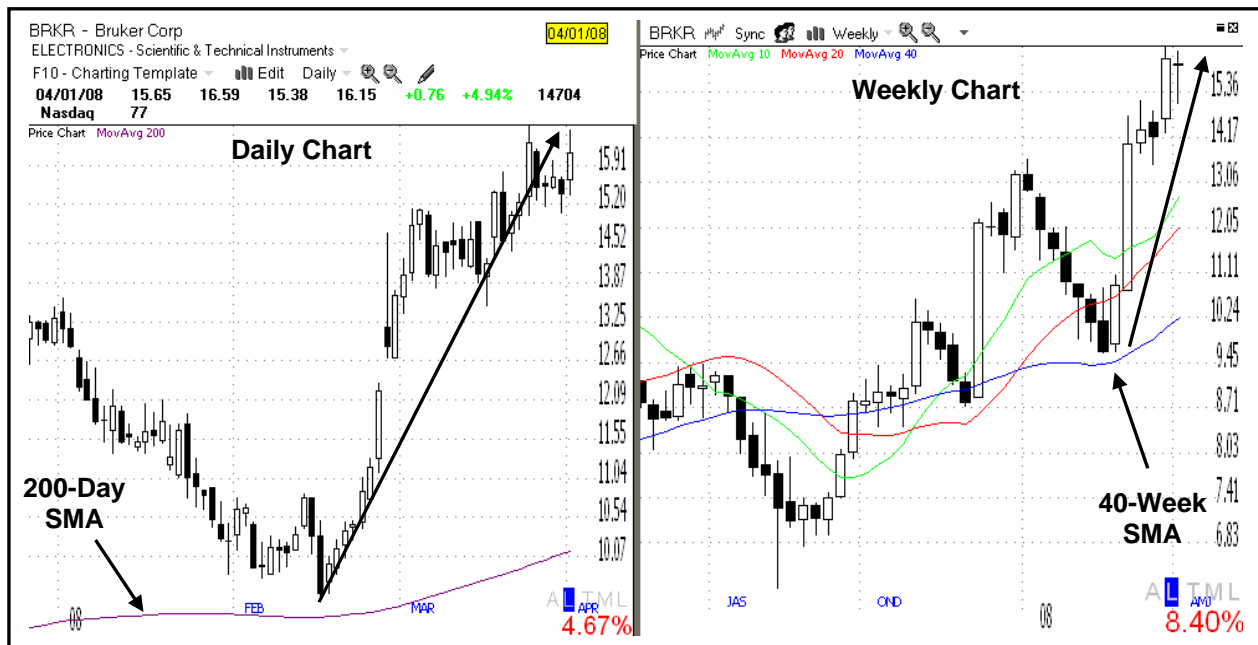


Figure 1.16 Price is overextended on the weekly chart.
Source: TeleChart 2007 ©

Traders can take a *proactive* stance and protect profits rather than watching much of them disappear during a retracement until the stop is finally hit (a *reactive* stance). To avoid holding positions into a correction, monitor the charts for conditions that merit taking at least partial profits, while also using a stop for protection.

Look at the weekly chart of BRKR several weeks later (Figure 1.17). Price pulled back again on the weekly chart, which wiped out almost the entire intermediate-term uptrend that occurred on the daily chart from mid-Feb. through end of March. The correction was almost 30% off the March-April highs.



Figure 1.17 Price pulled back on weekly chart.
Source: TeleChart 2007 ©

After a strong *swing* down on a weekly chart (which is a *trend* down on the daily chart), the stock becomes vulnerable to short-covering. Figure 1.18 shows the daily chart of Mobile Mini Inc. (MINI) on the left and the weekly chart on the right. After declining for a few weeks, price tends to gravitate back toward the 10- and 20-week SMAs. The 10-period SMA on the weekly chart is approximately equal to the 50-period SMA on the daily chart (10 x 5 trading days in a week = 50). Thus, when price pulls back up to near the 10-period SMA weekly, it is a *correction* of the downtrend up to the 50-day SMA on the daily chart. If a trader has a short position, a loose protective stop may hold up through such a correction, but a tight stop will inevitably be triggered.



Figure 1.18 Price is overextended on the weekly chart.

Source: TeleChart 2007 ©

Following are some reasons why it is important to watch for overextended conditions on the weekly chart:

- If price moves sideways on the weekly chart after a run up, that will equate to consolidation (a trading range) on the daily chart. The up and down swing motion that occurs when a stock is range-bound is more difficult to hold through than when price is trending. The protective stop may be hit as price consolidates.
- If price *pulls back* on the weekly chart, that decline will usually equate to a *correction* on the daily time frame. A protective sell stop may withstand a pullback on the daily time frame, but it will be hit during a deeper correction.

Summary: When price rises (uptrend) or declines (downtrend) far from the short-term moving averages on the weekly chart, start monitoring the long position (uptrend) or short position (downtrend) more closely on the daily chart to avoid getting whipsawed or caught in a sharp reversal.

DIVERGENCE BETWEEN BROAD MARKET AND NEW HIGHS / NEW LOWS

In addition to monitoring the trend on the individual stocks that you are trading, it is also important to stay in tune with the health of the broad market's trend. When the broad market is in a healthy uptrend, most stocks tend to rise with it. Conversely, if the trend of the broad market changes direction, many stocks will change direction with it, at least temporarily, regardless of their underlying fundamentals.

The daily chart in Figure 1.19 is the New York Stock Exchange Composite Index (NYSE). NYSE is a broad market index. It includes about 2,500 stocks, so it is a good one to use as a gauge for the U.S. market. The daily chart in Figure 1.20 is the NYSE New Highs-New Lows Index. You can view this chart free at www.stockcharts.com under the symbol: \$NYHL. This index shows the difference between the numbers of NYSE stocks making 52-week highs versus those making 52-week lows. The New Highs-New Lows Index falls under the category of *market indicators*. Market indicators are used to help determine the strength or weakness of the overall market.

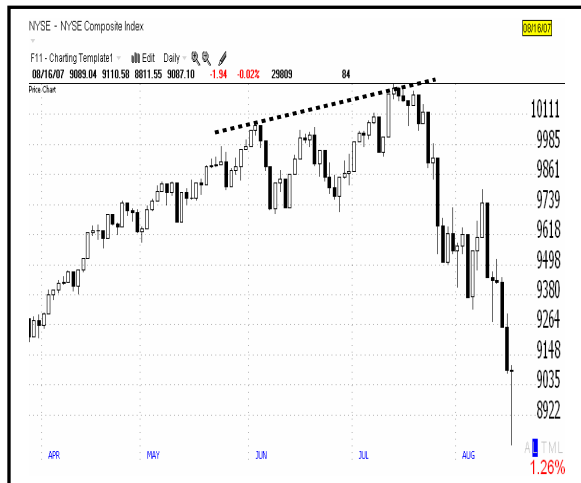


Figure 1.19 NYSE Composite Index
Source: TeleChart 2007 ©

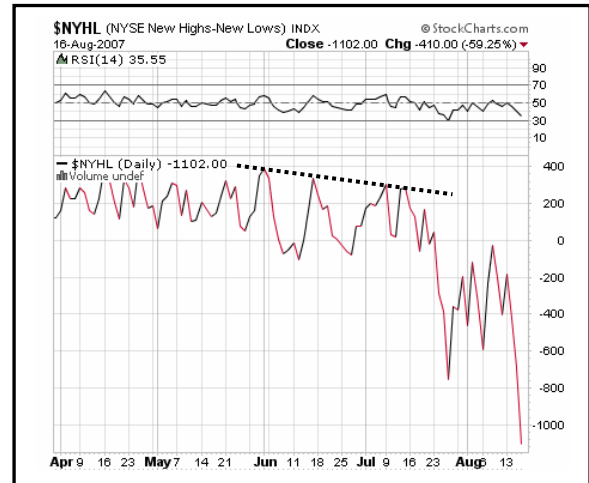


Figure 1.20 NYSE New Highs-New Lows Index
Source: StockCharts.com

During a bull market, the New Highs-New Lows Index should form rising peaks along with the NYSE Index. If this does not occur, there is a negative divergence. In a bear market, the bottoms should decline together or a positive divergence is in effect. A divergence does not guarantee that the broad market will change direction; however, it does send out a warning.

In July 2007, the New Highs-New Lows Index began forming declining peaks while the NYSE Index peaks were still rising. This created a negative divergence between the two indexes (refer to dotted lines on both charts in Figures 1.19 and 1.20). The broad market experienced a correction in August 2007 following the divergence.

MULTIPLE WARNINGS

Multiple technical warnings are stronger than single events. For instance, if the slope of a trendline accelerates *and* a divergence is present, the likelihood increases that the trend will change direction.



Figure 1.21 Multiple warnings of a potential change in trend direction.

Source: TeleChart 2007 ®

On the daily chart of Sina Corp. (SINA) in Figure 1.21, there are several reasons for concern that the intermediate-term uptrend may be in trouble. The following numbered items correspond to the numbers in the chart and indicator windows:

1. Negative Divergence - The most recent price peak is higher than the previous price peak; however, the current peak in the MACD indicator is lower than the prior MACD peak.
2. Trendline Slope – The uptrend has accelerated resulting in a steeper trendline. This angle will be more difficult to sustain for a long period of time.
3. Climax Move - Price gapped up on heavy volume leaving an exhaustion gap.

4. Resistance – Price tested, but did not close above, a prior ceiling. If the chart were compressed so that more data was shown, you'd see that this is a very prominent ceiling (the 2007 high).

Even with all these negatives, price may still move higher. However, I'd strongly suggest taking at least partial profits by selling part of a long position and taking a defensive stance on the remainder of the shares.

WARNINGS ARE NOT GUARANTEES

The technical events outlined in this section are early warnings. They are not guarantees that a change in the direction of a stock or market is imminent. Overextended conditions and warnings do not equal sell signals. They can get shrugged off as an uptrend continues higher, or as a downtrend continues lower. However, if a change in trend direction does follow one or more warnings, many complacent traders will be taken by surprise. Especially in the case of a broad market decline when many stocks will fall. Traders may look back later and recognize that there were warnings and say, "There were signs, why didn't I notice them!" For instance, prior to the Nasdaq crash in 2000, the new highs were being made by fewer and fewer stocks, which was a troubling early warning that the technology bubble was vulnerable to bursting.

It is always easier to see technical events with the benefit of hindsight, but we must trade from the right edge of the chart. Once you have developed a good base of technical knowledge and know what to look for, there is no reason you should miss major warning signs if you closely monitor the charts of your open positions, the broad market averages, and charts that represent the primary sectors of the economy.

ADD EARLY WARNINGS TO TRADING CHECKLIST

The early warnings discussed in this section may seem like a lot to look at and remember. There is a lot to be learned before becoming a successful trader. As your charting skills improve, monitoring charts will become second nature. In the meantime, I suggest developing some trading checklists to help condition charting and trade management skills. Create a checklist of the early warnings of potential trend change and post it near your trading desk for quick reference.

HOW TO RESPOND TO WARNINGS

The trend is your friend until it ends. If a warning appears indicating potential weakness during a trend, it may warrant one of the following actions:

- Close the position.
- Reduce exposure to a reversal by lightening up on the position (e.g., sell one-quarter, one-third or one-half of the shares).
- Tighten the protective stop.

If more than one warning occurs, it is an even more ominous sign. However, even multiple warnings do not necessarily warrant taking a position in the opposite direction. Make sure the criteria are met for a high-probability short position before simply exiting a long position and going short, or vice versa.

If you start to see warnings appear on index charts that represent the broad market, consider taking the following action for your positions:

- Decrease the typical position size to reduce exposure to a broad market reversal.
- Use little or no margin.
- Take some profits on upswings on long positions, or on downswings on short positions.
- Always maintain and closely monitor protective stops on every position. Disciplined traders may choose to use alerts rather than stop loss orders.

These steps will allow you to continue to benefit from the trend, but reduce your exposure in the event of a reversal. Even with stops on all positions, when a trend breaks, the initial move is often swift and sharp. Stops may suffer a good amount of slippage (sometimes severe slippage). So when you see warnings that the trend may be weakening, don't just leave it in the hands of your stops to get you out. Take a proactive stance and consider reducing exposure to that type of sharp selloff (long position) or rally (short position).

The above practices fall under a category called *risk management*. Unfortunately, many aspiring traders overlook prudent risk management which is why so many newcomers fail in this business. Managing risk is probably the most important element for long-term success.

CONCLUSION

I sincerely hope that you have found this instruction to be very helpful in developing your charting skills. Feedback from readers is valued and helps me to improve the products and services I offer. If you have any questions or comments regarding this lesson, please e-mail me directly at: tina@tinalogan.com. If you enjoyed this product, you won't want to miss out on the additional training that I offer. Visit the Training & Products page on my website at www.tinalogan.com for information about e-Books and mentoring services.

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