Trading the Line

How to Use Trendlines to Spot Reversals and Ride Trends

eBook

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Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends

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Introduction

My name is Jeffrey Kennedy, and I'm the editor of *Future Junctures*. In *Trading the Line*, I will explain several important aspects of trendlines, including how to define them and utilize them to identify trade setups.

Specifically, in this eBook, I will cover the following topics: the definition of a trendline; what a trendline represents; types of trendlines; techniques for drawing trendlines; trendline trade setups; the Wave Principle and trendlines; and the Kennedy channeling technique.

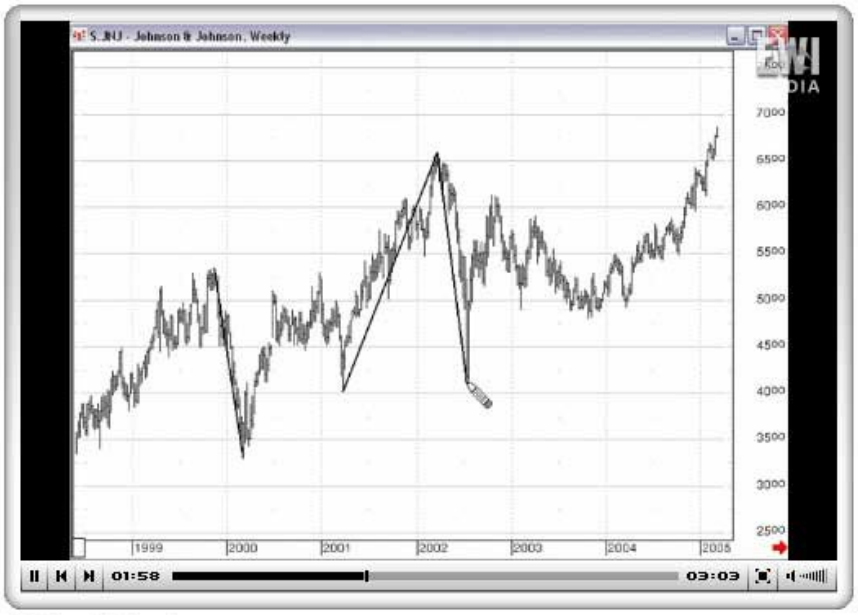
Editor's note: This webinar was originally presented live in January of 2008.

Chapter 1

Defining Trendlines

Before I define a trendline, we need to identify what a *line* is. A line simply connects two points, a first point and a second point. Within the scope of technical analysis, these points are typically price highs or price lows. The significance of the trendline is directionally proportional to the importance of point one and point two. Keep that in mind when drawing trendlines.

Figure 1-1



A trendline represents the psychology of the market, specifically, the psychology between the bulls and the bears. If the trendline slopes upward, the bulls are in control. If the trendline slopes downward, the bears are in control. Moreover, the actual angle or slope of a trendline can determine whether or not the market is extremely optimistic, as it was in the upwards sloping line in Figure 1-1 or extremely pessimistic, as it was in the downwards sloping line in the same figure.

Now we're on to the fun part – drawing trendlines. You can do this several different ways. You can draw them horizontally, which identifies resistance and support. Or, you can draw them vertically, which identifies moments in time. You primarily apply vertical trendlines if you're doing a cycle analysis.

Figure 1-2

You can also map trendlines at an angle, like you see in Figure 1-2, which identifies price *and* time. There's really not a wrong way to draw a trendline, which is why trendlines are a simple, crucial tool.

Chapter 1 Key Points

- A trendline represents bull market versus bear market psychology.
- Trendlines exhibit how optimistic or pessimistic the markets can be.
- Horizontal trendlines identify resistance and support. Vertical trendlines identify moments in time. Diagonal trendlines identify both price and time.

Chapter 2

Drawing Trendlines

Figure 2-1

In this section, I'll show you how I draw trendlines. I'll start with the most common, simple way to draw them. Just connect two extremes, two highs in this instance, to identify resistance, as seen in the line in Figure 2-1.

Figure 2-2

Another way to draw them is connecting lows, to identify potential support. For this example, refer to Figure 2-2, which shows a price chart of Google. If you connect the lows in this chart, you might be surprised what develops when that trendline is extended.

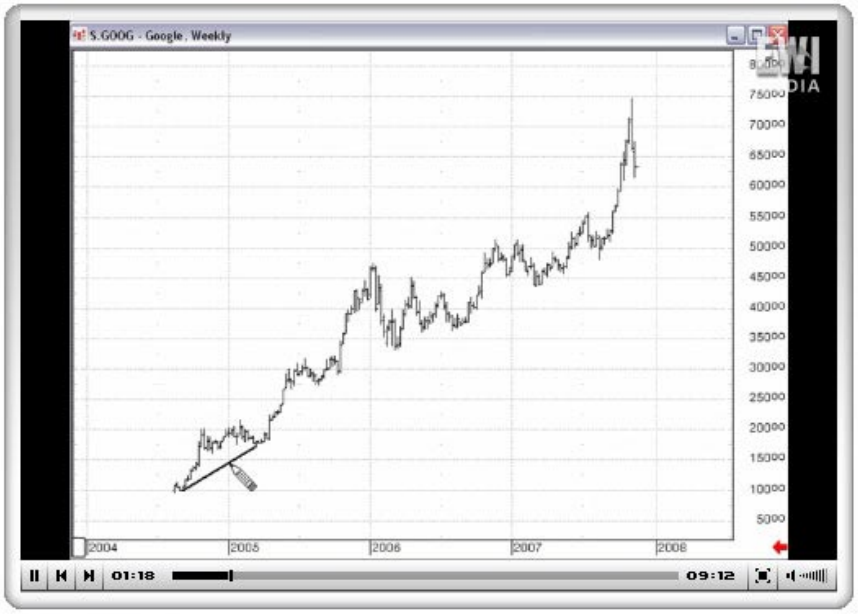


Figure 2-3

In Figure 2-3, that one little trendline between the lows in 2004 and the lows in 2005 consistently provided support for a number of retracements, or counter trend movements, within the advance in Google since then.

When you're drawing trendlines from low to low, you can do something else with them that I find pretty interesting. Oftentimes, I like to identify the low extremes within a move and then take a parallel. In the example shown in Figure 2-3, look at the trendline from the lows within the advance in Google, take a parallel of that line off the extreme – the highest we've seen – and you can see the most recent peak in Google, the upper line, provided resistance. It was just a simple trendline drawn on the lows and extended upward in a parallel line off the intervening extreme.

Figure 2-4

Next, in Figure 2-4, look where the upper boundary line provided resistance of the trendline. Notice there is another use for it. The midpoint of the trendline provides resistance in four different areas, which is why I include the center point or the midline when I draw parallel trendlines or price channels.

Figure 2-5
The price chart shown in Figure 2-5 is of coffee, and again, I've already drawn a trendline on it. I connected the two extremes, points labeled 1 and 2, which provided support for points labeled 3 and 4.

Figure 2-6
Let's look at another example in Figure 2-6, a cotton weekly chart, to exemplify how useful trendlines can be. I've connected the lows, points 1 and 2, and taken a parallel off the extremes of the price move at point 3. This shows how a simple trendline identifies resistance in cotton. This is why you should draw trendlines – because one drawn some months ago, some days ago, some weeks ago, even some years ago can still be applicable today. This one little trendline in the previous figure, drawn from one low to another low, was effective on more than one occasion.

Figure 2-7
Notice the resistance it provided in Figure 2-7.

Note: For an additional example, see Slide 32 of Jeffrey Kennedy's online trading course *Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends*.

Figure 2-8
Trendlines are probably the most basic analytical tool you can apply, whether it's a stock, currency or commodity; yet, they're extremely effective. More often than not, two parallel lines contain counter trend or corrective price action. Usually, it provides support, and you see prices either reverse near the lower boundary line or the center line. As you can see in Figure 2-8, the lower boundary line provided solid support for a subsequent move up in prices.

Figure 2-9
Now, here's a neat little trick. In Figure 2-9, we use trendlines a different way. By connecting the two lows, we distinguish the breakout point. Later, it provides support when prices revisit the same line (circled).

Figure 2-10
Or, we can connect the highs and take it from an intervening low, as seen in this soybean weekly chart. The reversal that occurred in price at the lower boundary line is circled.

Figure 2-11

Most of the lines that I've drawn thus far have been from high to highs, taking parallels off intervening lows, or they've been from low to low, taking parallels off intervening highs. That's not the only way to draw trendlines. Case in point – look at Figure 2-11. We connected the two lows, and it provided support in Google for the subsequent events shown. However, there was another way to identify support in this stock without drawing the traditional low-to-low trendline.

Figure 2-12

You could have drawn the trendline by connecting the highs and then taking the parallel off the intervening low, as shown in Figure 2-12. The circled area shows support.

Techniques for Drawing Trendlines

Figure 2-13
I've explained how to draw trendlines from extremes – from high to high and low to low. In Figure 2-13, I drew two trendlines from significant highs to a significant lows. Upon first glance, the initial trendline does not provide the analyst or trader with much information. However, if you draw a trendline from a significant high to a low, or vice versa, and take a parallel of that trendline to the most extreme point within the move, you might discover if the trend will break or continue.

Figure 2-14
For example, I've drawn a trendline from a significant low to a significant high in Figure 2-14. I then take a parallel of that line off the lowest move within the price sequence. That trendline identifies the end of one trend and the beginning of a new one. As soon as prices began closing below the trendline, the previous move was done.

Figure 2-15
Figure 2-15, a weekly bond chart, shows another example. Draw a trendline from the high to the low, take a parallel of that line and move it over to the most extreme move within the decline. Penetration of this line signals the completion of this decline

Figure 2-16
Look at Figure 2-16, which is the same weekly bond chart as before. Draw a trendline from the low to the high, take a parallel of that line, move it over to the right, to the most extreme portion of that move. You now know what prices must do to signal the onset of a new trend.

Note: For an additional example, see Slide 54 of Jeffrey Kennedy's online trading course *Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends.*

Defining Trendline Breaks

Figure 2-17
In Figure 2-17, a much shorter-term timeframe is illustrated in a 60-minute price chart of the E-Mini Dow. Draw a line from the low to the high then take a parallel to the most extreme portion of the move. When prices begin breaking below this line, the previous move is done.

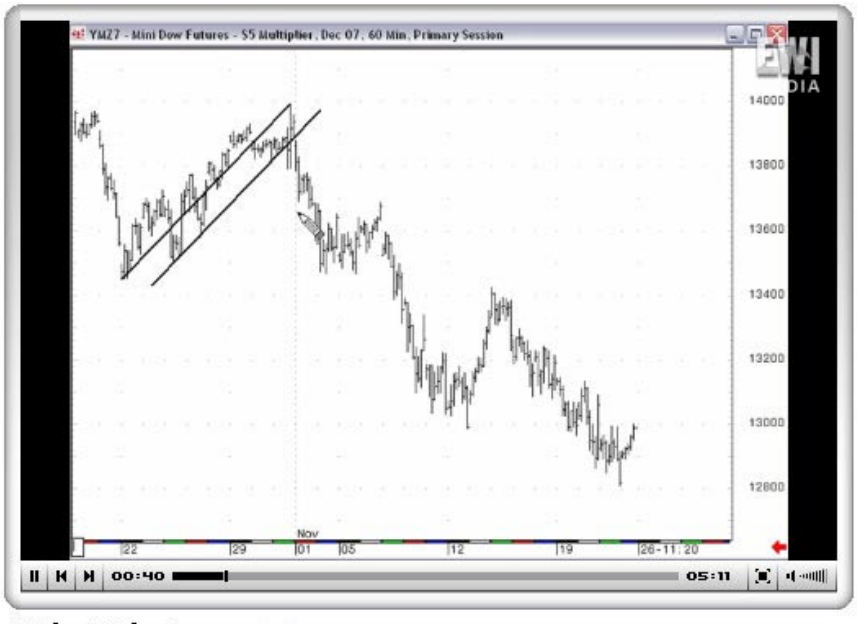


Figure 2-18
You can utilize this approach with much sharper moves as well, such as the decline in Figure 2-18. When prices begin moving above it or closing above it, then that's a good indication the previous move is done.

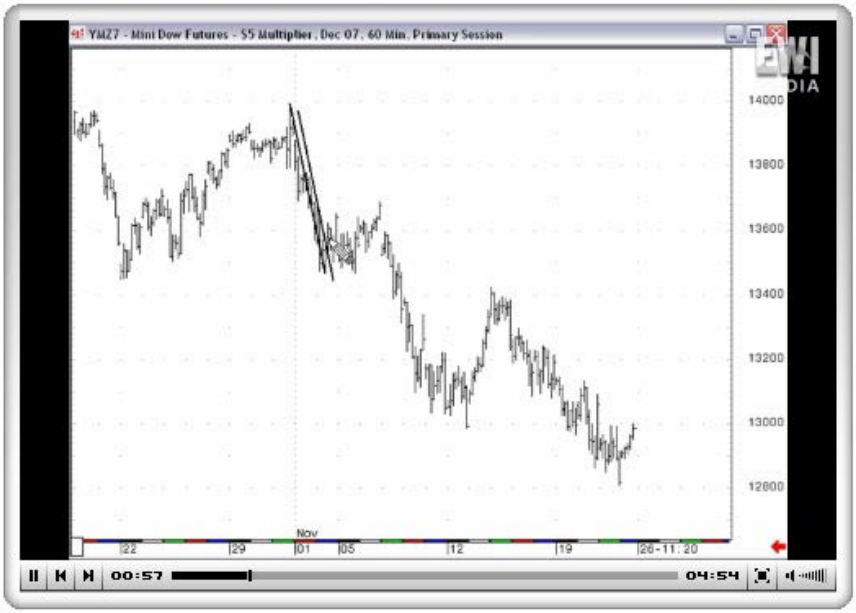


Figure 2-19

Question: When is a trendline break a trendline break? Some people think closes above or below trendlines indicate a trendline break. I prefer to see price action begin moving above or below a trendline on a high or low basis. For example, in Figure 2-19, we see some closing price action below the lower trendline which I don't really constitute as a legitimate break of the trendline. Not until the high of the bar is below the trendline (where the pencil is pointing), is there an actual break of the previous trendline.

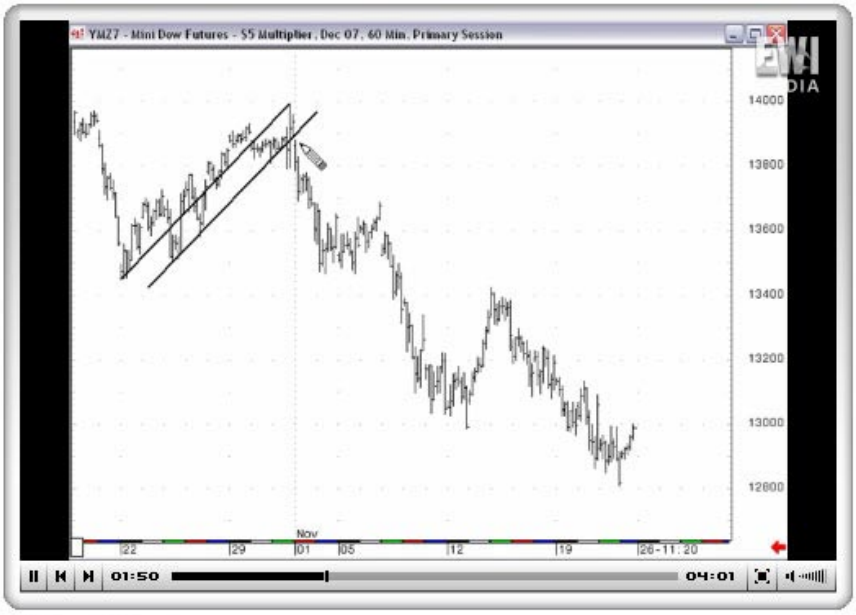


Figure 2-20

Let me readdress the question to make my point clear. What constitutes a legitimate trendline break? Well, in this instance, in Figure 2-20, I'm not looking for closing price action below the trendline, but rather the high of the price bar forming below the trendline. In this instance, we did close below the trendline (marked with the short line and pencil). However, two or three price bars later, the high of the bar is actually below the trendline.

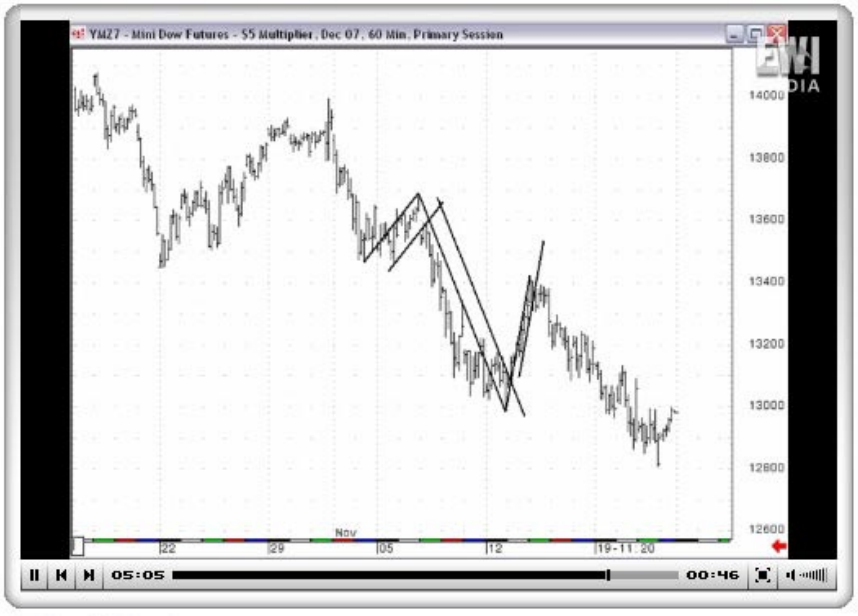
Figure 2-21
Let's go back to a previous example. When the high of the price bar is below the trendline, it signals a sell off to the downside.

Figure 2-22
The lows of these price bars in Figure 2-22 were above the secondary trendline and that confirmed the previous move was done.

Figure 2-23
In the subsequent advance in Figure 2-23, when the highs of each price bar begin forming below the trendline, the previous price move ends, and a new price move begins.

Figure 2-24
As you can see in Figure 2-24, the low of the price bar was above the secondary trendline, indicating an advance. The low of the price bars are above the secondary trendline, arguing that this a legitimate trendline break, so prices should move up for a while.

So, while you can draw trendlines from different extremes, you can also take parallels of those lines, creating price channels. You can garner a lot of information from the simple approach I've outlined here.



Drawing the Triple Fan Trendline

Figure 2-25
Another technique that has been around a long time is the triple fan. As shown in Figure 2-25, triple fans have an origin point and three subsequent points, and trendlines are drawn from the origin to the initial extreme, to the secondary extreme, and then to the third extreme. A price break through the third trendline in a triple fan typically signals a significant price move.

Figure 2-26
I'll show you the triple fan approach in Figure 2-26, a gold weekly chart. The three points of the triple fan are three price highs, which show an initial trendline, a secondary trendline and a third trendline. The break of that third trendline typically signals a significant move in prices, which is exactly what gold did in this instance, rallying from about 330 up to about 390. It all began with that break of that final trendline. A legitimate trendline break is when the highs or lows of a price bar form above or below a trendline. So, when we saw the lows of the price bars form above the third trendline, we knew a change in trend was coming.

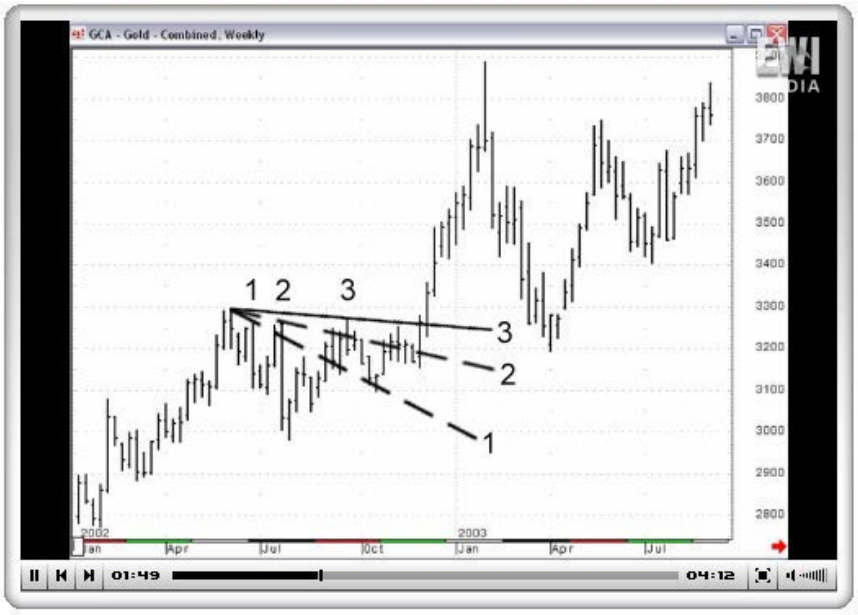


Figure 2-27
Notice in Figure 2-27, the same gold weekly chart, that if you continue the trendline over, it provided very nice support for the subsequent sell off.

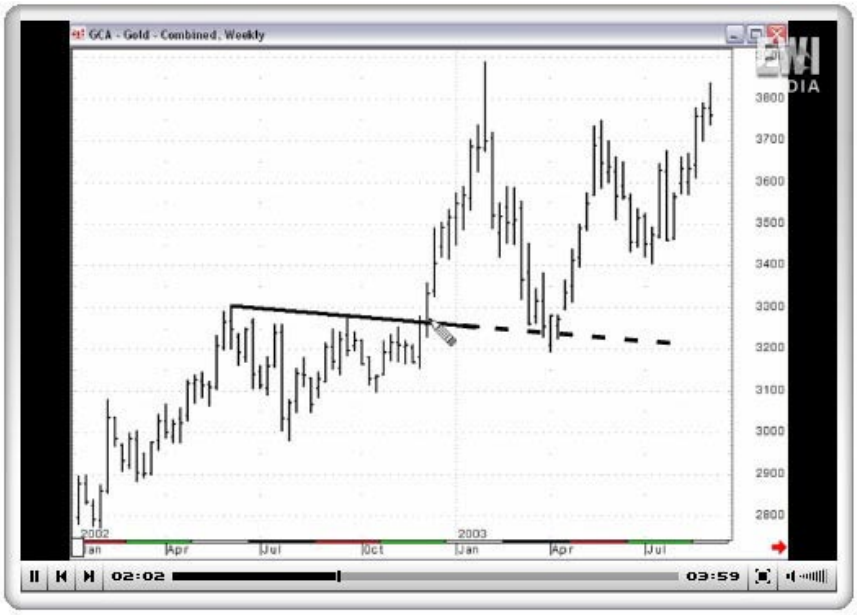


Figure 2-28
Figure 2-28 shows a decline from the low. When prices began closing above the trendline, especially where the lows are above that third trendline, prices moved substantially. Here, the move pushed up only modestly higher, from about 400 up to 430, but, still, it was something significant. Remember, this is a weekly price chart, so on an hourly or daily basis, this could have been a profitable price move.

Figure 2-29
In Figure 2-29, I've drawn the triple fan again. In this instance, prices were unable to penetrate the top line, so the triple fan really wasn't useful.

Figure 2-30
Check out another example in Figure 2-30. It's the third trendline that carries the most weight. When prices begin closing above it or moving above it, certainly on a high/low basis, prices moved significantly. By drawing a trendline, you could have been ahead of the crowd in identifying this price move.

Chapter Two Key Points

- Trendlines are one of the most powerful analytical tools available.
- The most simple way to draw trendlines is by connecting two extremes.
- Trendline breaks occur when there are new highs or new lows above or below the trendline.
- Triple fan trendline applications have an origin point and three subsequent points, and trendlines are drawn from the origin to the initial extreme, to the secondary extreme, and then to the third extreme.
- Price breaks through the third trendline in a triple fan typically signal a significant price move.
- Reactions in price will often occur at or near a trendline.

Chapter 3

Trendline Trade Setups

Trendlines offer several trade setups. In this chapter, I will explain two of my favorites.

Figure 3-1
A gap either above or below a trendline is one of the best trade setups that trendlines offer. For example, Figure 3-1 is an oats price chart, showing two lows and a line extended higher. In this illustration, prices gapped lower, which is what I consider a gap below a trendline. This is a very reliable trade setup.

Figure 3-2
Whenever I see a price gap below a trendline, I place a sell order one tick below the low of that bar. My stop is the high of the bar prior to the price gap. The price gap in this chart, Figure 3-2, alerted me to a potential short position in oats; in fact, prices pushed down to about 240.

Figure 3-3
Since that trade setup, there was no price gap above the trendline in Figure 3-3, so there really wasn't an opportunity to take a trade.

Figure 3-4
The trendline drawn against the extreme continued to go farther down in Figure 3-4, which created a price gap at one point. This alerts me to a buy-side trading opportunity. On the bar where the gap is up, I place an order one tick above the high of that bar, while the low of the preceding bar is my initial protective stop. The trade was subsequently triggered, and prices pushed on higher.

Figure 3-5
Even if I had not previously drawn that initial trendline and tried to employ what I mentioned in the previous section utilizing the triple fan, I have my first, second and third trendlines in Figure 3-5. Again, the gap above the trendline signals a highly reliable buy-side trading opportunity. My entry price is one tick above the higher bar that does the gapping, and my initial protective stop is the low prior to the gap, the lower bar.

Figure 3-6
For another example, look at the cotton chart in Figure 3-6. Simply connect two extremes, either two extreme lows or two extreme highs. Prices came down to the trendline shown and then broke lower. The bar indicated was, indeed, a gap below the trendline. Therefore, I would initiate a sell position on a break of the lower bar with an initial protective stop, the higher bar preceding the gap, which led to a very nice trade.

Figure 3-7
In Figure 3-7 there are two highs, and prices gapped above the trendline. So I would make my move above the high of the bar that does the gapping. That's where I put my order in to the buy side, and the low of the bar preceding the gap is where my initial protective stop would go.

Note: For additional examples, see Slides 97 and 98 of Jeffrey Kennedy's online trading course *Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends*.

Gaps and Retests: My Two Favorite Setups

Figure 3-8
Take a look at the soybean oil price chart in Figure 3-8, which shows a simple trendline connecting one high to another high. The circled situation is called a retest, which is my second-favorite trendline trade setup. Retests occur when prices penetrate the trendline, and then come back down and test it.

To trade in this situation, I usually like to wait until the high of the move that preceded the test is penetrated, rather than buy when prices are testing the trendline itself. In this case, I would have waited for prices to trade back through the high. My initial trendline connects two price highs. Prices come up through it and then come back down and test it. When prices trade back through the high of the move, the high of the initial breakout, I like to go long, in this instance, with a stop at the low.

Figure 3-9

For another example, look at the stock price chart in Figure 3-9. There are two price highs with a trendline connecting them; notice how prices penetrate the trendline. More importantly, notice that the lows of those two price bars are above it – and if you will recall from the previous section, what constitutes a valid trendline break? It's when the lows or highs of a price bar are actually above or below the trendline.

Figure 3-9 does show a legitimate trendline break. So next, I'm looking to go long if prices can trade back above the most recent swing high. The stock price came back down very briefly, tested the upper portion of the trendline and then began to rally. This is an example of a single trendline retest, and soon I'll be showing you a dual or a double retest.

Figure 3-10

Look at another example of a single line retest in Figure 3-10, a Canadian dollar chart. And, again, this is a single line retest connecting one high to another high. Prices trade above it, and the low of the two bars above the trendline constitutes a legitimate trendline breakout. Prices come back to the downside and begin turning up, so I buy on a break of the highs. My initial protective stop is the low of the move. This was all done simply with a pencil and ruler.

Figure 3-11

Next, we'll learn about dual tests in Figure 3-11, a stock chart. The trendline is drawn from two highs and prices trade above it, resulting in closing price action above the trendline. The lows of the two price bars are above the trendline, meaning it's a trendline break. The prices come back down once, which is a single line retest; they bounce up and then come back down again, which is a dual or a double trendline retest. Under the rules I follow for a single trendline retest, I would trade if prices move back above the high of the original breakout. However, on a dual test like this, I wait for the intermediate or interim high to be taken out, and the low of the second retest is my initial protective stop. In essence, a dual trendline retest starts when there's an initial trendline breakout. Prices come back down, are tested once, balance, come back down and are tested again.

Figure 3-12

See Figure 3-12 for another dual trendline trade setup, which shows a stock connecting two highs. Notice the first test and then the second test. The interim high there is where I like to go long in the market with my initial stop at the low or the extreme of the second retest.

Figure 3-13
Look at the example shown in Figure 3-13. The low of the bar is above the trendline, which indicates a legitimate trendline breakout. Then the prices came down. After a first test, they bounce. After the bounce, the prices came back down, and we tested that trendline again, which makes it a dual trendline retest trade setup. Once prices trade back through that level, I'd go long market, and my initial protective stop would be the extreme of the second retest.

Note: For two additional examples, see Slides 110 and 111 of Jeffrey Kennedy's online trading course *Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends*.

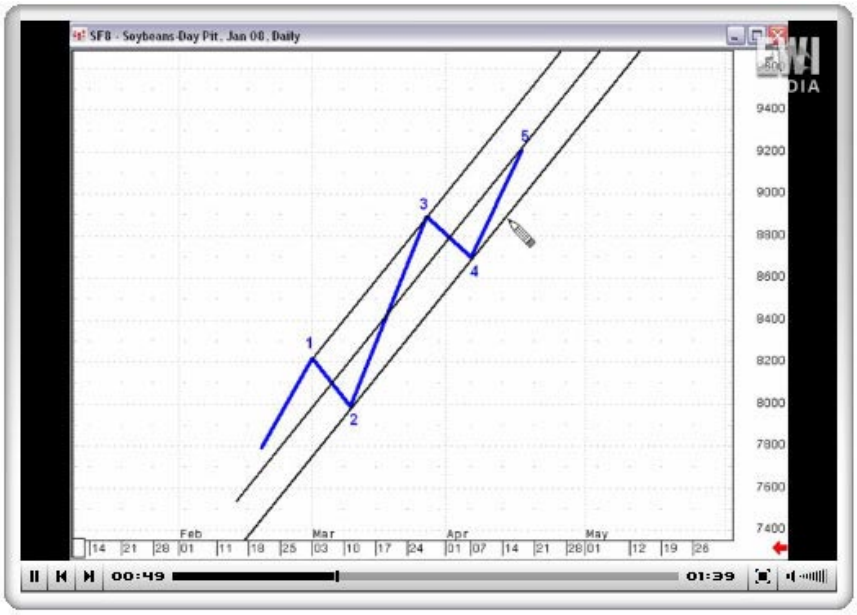
Chapter Three Key Points

- A gap either above or below a trendline is one of the best trade setups that trendlines offer.
- A gap above a trendline signals a highly reliable buy-side trading opportunity.
- Retests occur when prices penetrate the trendline, and then come back down and test it.
- A dual trendline retest starts when there is an initial trendline breakout. Prices come back down, are tested once, balance, come back down and are tested again.

Chapter 4

Trendlines and the Wave Principle

Figure 4-1



It's really simple to apply trendlines in conjunction with the Wave Principle. In fact, within the context of the Wave Principle, we have two types of price channels that we consistently work with: a temporary channel and a final channel. Connecting the extremes of waves 1 and 3 and then taking a parallel of that line off the extreme of wave 2 comprise the temporary channel. This usually identifies support for wave 4, as shown in Figure 4-1.

Sometimes price action in wave 4 penetrates the lower boundary line, which is called throw under. Then the next channel you see, which is the final channel, connects waves 2 and 4. You take a parallel of that line off the extreme of wave 3, which usually signals resistance for wave 5, either in the middle portion of the price channel or the upper portion. On occasion, prices penetrate the upper boundary line, which is called throw over.

Simply put, there are two price channels to look at when utilizing trendlines and the Wave Principle. The first one, again, is the temporary channel drawn between the extremes waves 1 and 3. Take a parallel of that line off the extreme of wave 2, and that will identify support for wave 4. When wave 4 is complete, draw the final channel, connect the extremes of wave 2 and 4, take a parallel of that line and connect it to the extreme of wave 3, which often establishes resistance for wave 5.

Figure 4-2
In the soybeans price chart in Figure 4-2, a temporary price channel is illustrated. Remember, draw a line from the extreme of wave 1 to the extreme of wave 3. Take a parallel of that line off the extreme of wave 2. As I said previously, throw under is when price action penetrates that lower boundary line.

Figure 4-3
Now, you can do a little trick to identify the extent of throw under – double the width of the price channel as shown in Figure 4-3. That line represents a parallel of the line drawn between the extremes of waves 1 and 3. In this instance, doubling the width provided support for the fourth wave pullback.

Figure 4-4
In Figure 4-4, the final channel pinpoints resistance for wave 5. I connected the extremes of waves 2 and 4 and take a parallel off the extreme of wave 3. Again, this is considered throw over. Often times, we'll see a brief penetration of the upper boundary line and then a reversal in price, as we did in this chart.

The initial or temporary price channel and the final price channel, originate from R. N. Elliott's work that explains defining support for waves 4 and resistance for wave 5. Or, if you're working in a downward market, this defines resistance for fourth waves and support for fifth waves.

Chapter 4 Key Points

- Throw over is when prices penetrate the upper boundary line.
- Throw under is when prices penetrate the lower boundary line.
- Sometimes when the lower boundary line of the initial or temporary price channel is penetrated, you can get an idea of the throw under extent by doubling the width of that price channel.

Chapter 5

The Kennedy Channeling Technique

In this section, I'll explain what I call the Kennedy channeling technique, which is a simple way of drawing trendlines that will help you identify Elliott waves. Specifically, my technique helps you discern between impulse waves and corrective waves.

Figure 5-1
Figure 5-1 shows a basic five wave, Elliott Wave advance. There's wave 1, wave 2, wave 3, a, b, and c for wave 4 and then wave 5. This is the classic impulse structure, according to the Wave Principle.

Figure 5-2
The first line or channel is the base channel, which is a line drawn from the origin of wave 1 to the extreme of wave 2, followed by a parallel of the trendline drawn against the extreme of wave 1. When I draw my channels, I like to have a midline separating or defining the midpoint of the channel, as shown in Figure 5-2. Beginning from the origin of wave 1, I drew a line to the extreme of wave 2 and took a parallel of that line, raised to the extreme of wave 1. I refer to the top line as the upper boundary line and the lower line as the lower boundary line. When price action moves through the upper boundary line, it's a third wave rally.

Figure 5-3

The second channel of the Kennedy channeling technique is the acceleration channel, which encompasses wave 3. In Figure 5-3, see wave 1, wave 2 and wave 3. The acceleration channel is important because it defines the progress or duration of wave 3. When prices break out of the lower boundary line of the acceleration channel, label the subsequent move as wave 4.

Figure 5-4

If you're familiar with my work in *Futures Junctures*, you know I often identify the corrective price channel, which stems from the channel we draw to identify wave 4. In Figure 5-4, look at wave a, wave b and wave c. As long this price move is contained by parallel lines, the price action is countertrend, and once complete, it will be more than fully retraced.

Figure 5-5

The last channel we'll apply is a terminating channel, shown in Figure 5-5. You're already familiar with this aspect of the Wave Principle because this is the channel that R.N. Elliott drew that applied to his wave structure. A terminating channel is a trendline drawn from the extreme of wave 2 to the extreme of wave 4, which identifies the resistance for the fifth wave.

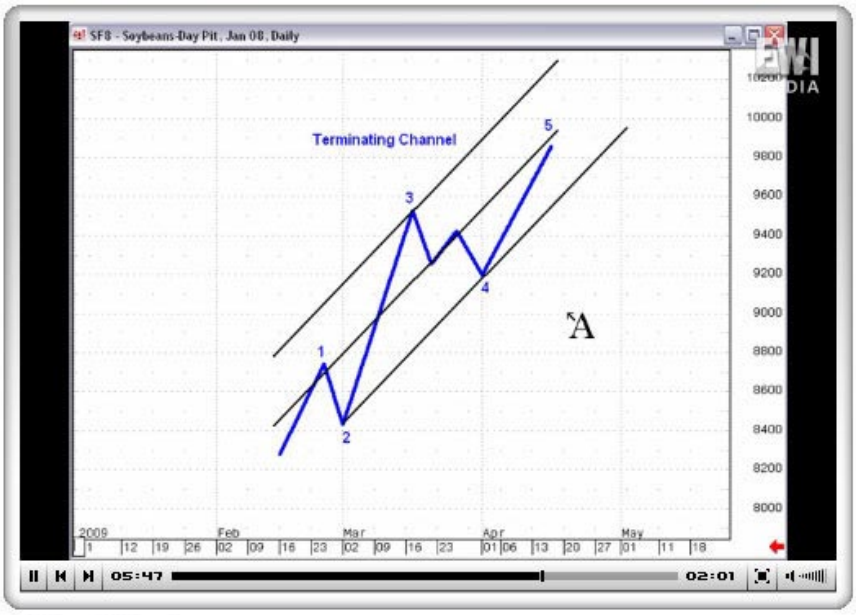


Figure 5-6

Notice when you're applying these price channels on real price charts, as shown in Figure 5-6, the upper boundary line of the base channel supports the fourth wave at either the upper boundary line, midline or lower boundary line. Then, as soon as wave 4 is in place and prices have broken above the upper boundary line of the deceleration channel, draw the final channel, the terminating channel, to identify resistance for wave 5. That's how the channeling technique works.

Figure 5-7
In Figure 5-7, the Kennedy channeling technique is applied to a real-time price chart. As you can see from the low in the chart, the Elliott waves are fairly pronounced. See waves 1, 2, 3, followed by a fourth wave decline and a fifth wave rally, which is followed by a three-way decline, A, B and C.

Figure 5-8
The channeling technique can be extremely dynamic. Look at the base channel in Figure 5-8, draw the initial line from the origin of wave 1 to the extreme of wave 2, take a parallel of that line and extend it upward to the extreme of wave 1. As soon as prices begin trading and penetrating the upper boundary line of the base channel, we know wave 3 is in progress. As you can see, the base channel clearly provided support for wave 4 here. We came down to the midpoint or the center line of the base channel and then turned up.

Figure 5-9

As wave 3 develops, the acceleration channel identifies or encompasses the price action within wave 3, as shown in Figure 5-9. Once the lower boundary line penetrates the acceleration channel, wave 3 is complete. When prices move above the upper boundary line of the base channel, we know we are in a third wave. Once prices break the lower boundary line of the acceleration channel, we know this is actually a fourth wave pullback. Since it's a fourth wave pullback, we also know to look for support for wave 4 at either the upper, mid, or lower boundary lines of the base channel.

Figure 5-10

At this point, we know this is a 1, 2, 3 into the high. There's not much price action to work with in this chart in relation to the deceleration channel, but just to give you a rough idea, it will encompass the bulk of wave 4 because, again, parallel lines usually contain corrective price action or a counter trend move. In Figure 5-10, see how the base channel lines provided support for the fourth wave pullback. We know wave 4 is complete because the upper boundary line of the deceleration channel or the corrective price channel is penetrated. Also, we knew wave 4 was complete when prices opened up the next day. Finally, the traditional terminating channel identifies resistance for wave 5.

Figure 5-11

Look at the example of the Kennedy channeling technique applied in Figure 5-11, a five-wave move in Feeder Cattle. The initial base channel is drawn off waves 1 and 2, and essentially, I'm viewing price action in those waves. I formed the acceleration channel by connecting the extreme of wave 1 and the extreme of wave 3 against the low of wave 2. When prices move out of the low and penetrate the lower boundary line of the acceleration channel, wave 4 is in progress. The base channel, in addition to identifying a third wave price move, also marks support for the fourth wave. In fact, prices spike down to the center point or the midline of the base channel. The deceleration channel contains wave 4 and lets you know when wave 4 is complete when it penetrates the upper boundary line.

Figure 5-12

Finally, when waves 1, 2, 3 and 4 are in place, draw the terminating price channel to identify resistance for wave 5, as seen in Figure 5-12. As you can see in this example, prices fell well short of the upper boundary line. But if we continued the center line, we might have gotten close to it later, but it fell short again.

Figure 5-13

Figure 5-13 is a fairly recent example, a current Treasury note move. As usual, the channeling technique begins with the base channel. I started from the origin of one, and waves 1 and 2 form the basis of the base channel. When prices move above the upper boundary line of the base channel, wave 3 price action is in force. Essentially, the subsequent price move is a third wave.

Figure 5-14

As soon as we have the base channel, draw the acceleration channel, which encompasses wave 3, as shown in Figure 5-14. Once prices begin to break below the lower boundary line of the acceleration channel, wave 4 is in progress. Then draw the deceleration channel by beginning from the origin of wave A, the extreme of wave B, against the extreme of wave A. You can see the three-wave move down. When prices break the upper boundary line of the deceleration channel, wave 5 is in progress.

Figure 5-15

Figure 5-15 shows the original base channel supporting the lower boundary line of the base channel, which prompted a reversal in prices. When prices began turning down, hit the lower boundary line of the base channel and subsequently closed above the upper boundary line of the deceleration channel, wave 5 is in progress in the T-note.

Figure 5-16

With three channels behind us, we only have to draw the terminating price channel, which will identify resistance for wave 5. It's shown in Figure 5-16. We've been trading a bit around the center line, but prices could still move higher and reach the upper boundary line of the price channel.

Figure 5-17

A monthly Euro price chart is my next example, as shown in Figure 5-17. It shows wave 1 and wave 2. Because we have a secondary low in this chart, I've marked A, B and C for wave 2. As you can see, penetration of the upper boundary line confirms the presence of third wave price action. The acceleration channel identifies the extent or duration of wave 3. Wave 4 is in progress as soon as prices broke below the lower boundary line. Then move on to the deceleration channel. Now, what you'll notice next is that prices in the fourth wave were well above the upper boundary line of the base channel. That will ring true when you have a very deep second wave retracement.

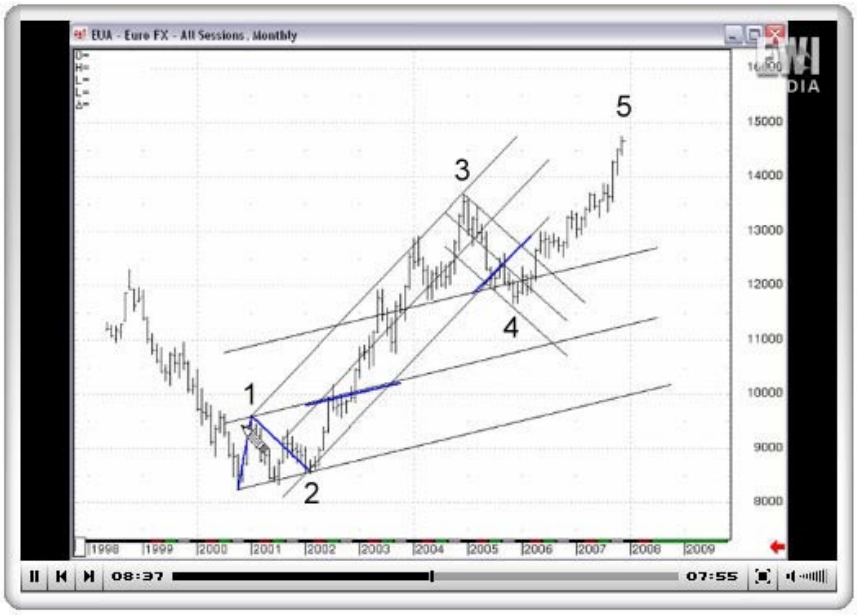


Figure 5-18

You can handle that situation by doubling the width of the initial base channel. In Figure 5-18, as soon as the upper boundary line of the corrective or deceleration price channel occurs, wave 4 finished and wave 5 was in progress. As you can see, we traded right or at near the midline of the terminating price channel, which would be an excellent spot for prices to begin a reversal. Bottom line, I find the channeling technique useful because it clearly discerns Elliott waves – waves 1, 2, 3, 4 and 5, as well as waves A, B and C.

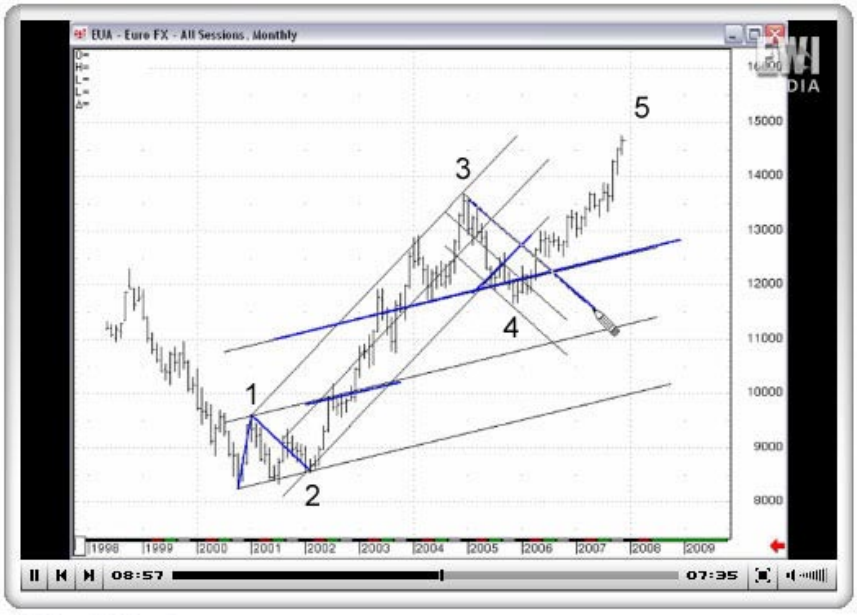


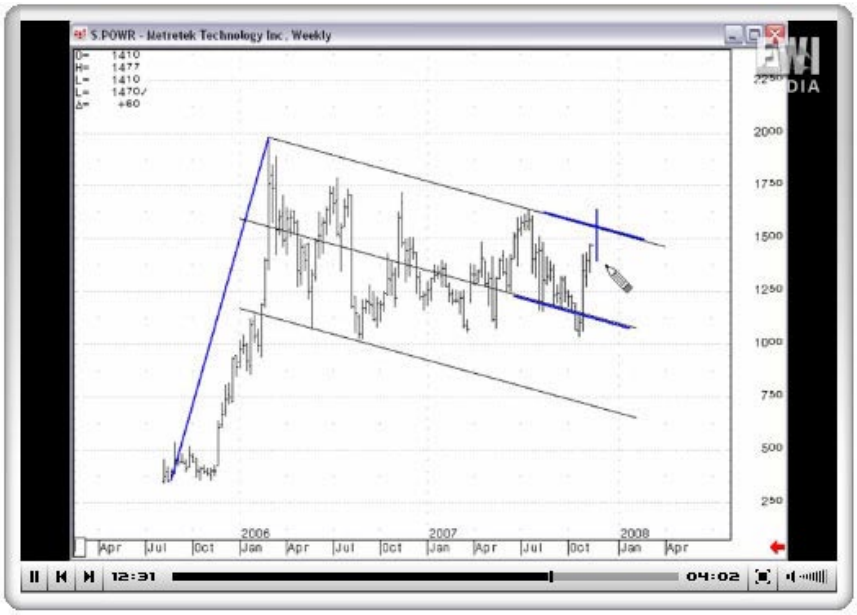
Figure 5-19

We've looked at a currency, and we've looked at a few commodities. Next, look at the stock in Figure 5-19, so I can prove how powerful and dynamic the channeling technique can be. Here's a three-wave move – wave A, wave B and wave C. The initial line is between the origin of wave A and the extreme of wave B. Take a parallel of that line and lower the line to the extreme of wave A: That identifies support for wave C, and it's a great place to look for a reversal in price, which is exactly what happened to this stock.

Figure 5-20

Figure 5-20 is a stock chart that clearly shows an impulse wave to the upside from either low extreme. Again, parallel lines typically contain countertrend price action. Prices moved outside the upper boundary line of the deceleration price channel, and then it provided support for the subsequent decline before turning prices up.

Figure 5-21
Or, look at the widest extreme, which is shown in Figure 5-21, the most recent swing high in this case, to see how the midpoint provided support or returned prices to the upside. Once prices penetrate the upper boundary line of the deceleration channel or the corrective price channel, I would expect prices to continue much higher because it identifies when the counter trend move is complete.



Note: For an additional example, see Slide 180 of Jeffrey Kennedy's online trading course *Trading the Line — How to Use Trendlines to Spot Reversals and Ride Trends*.

Chapter 5 Key Points

- The Kennedy channeling technique helps you identify Elliott waves and helps you discern between impulse moves or impulse waves and corrective waves.
- The Kennedy channeling technique utilizes a midline separating or defining the midpoint of the channel.
- The base channel is really the upper boundary line.
- The second channel, the acceleration channel, defines the progress or duration of wave 3.
- The terminating channel is a trendline drawn from the extreme of wave 2 to the extreme of wave 4, which identifies the resistance for the fifth wave.

I hope this eBook has given you a better idea of my channeling technique, how to apply it and how useful it is in helping you decipher between impulse waves and corrective waves. More importantly, it helps you identify when wave 3 has begun and when wave 3 ends. It also allows you to identify additional support levels for the fourth wave pullback, as well as targets for a fifth wave advance.

Chapter 6

Questions and Answers

Q. If prices move back into the base channel, does that mean we're not in wave 3?

Kennedy: Once prices penetrate the upper boundary line of a base channel, thereby confirming the presence of third wave price action, a revisit to the boundary line is acceptable. However, a break of the mid-line of the base channel implies that wave 3 is not in force.

Q. How do you know when wave 3 has ended?

Kennedy: You continuously redraw the acceleration channel as each new high is made. You do not know for sure that wave 3 is complete and wave 4 is underway until price movement penetrates the lower boundary line of the base channel.

Q. What's the difference between a single zigzag and a double zigzag?

Kennedy: To create a trend channel for a double zigzag, connect the origin of wave W with the termination point of wave X and then draw a parallel line that includes the termination point of wave W.

A single zigzag is a 5-3-5 structure, where wave A is a motive wave, wave B is a corrective wave and wave C is a motive wave. Therefore, a single zigzag always starts with a five-wave structure as opposed to a three-wave structure. A double zigzag, labeled W-X-Y, is composed of two single zigzags linked by an X wave. An X wave is a corrective structure. Therefore wave W of a double zigzag comprises three waves (the single zigzag) as opposed to the five waves in wave A of a single zigzag. By definition, wave W of a double zigzag is not comparable to wave A of a single zigzag, because wave W is a wave at a higher degree or larger time frame.

To anticipate whether a double zigzag will unfold, consider the context, the structure of the wave patterns and Elliott's rules and guidelines. Context refers to the wave at the next higher degree of which the zigzag is a part. For example, assume a single zigzag develops in wave 2, makes a shallow retracement of wave 1 and is followed by another corrective structure at the same degree that retraces less than 90 percent of the single zigzag. Since wave B of a flat retraces at least 90 percent of wave A, and triangles do not form second waves, we can eliminate those two scenarios. The only other possibilities for wave 2 are a combination or double/triple zigzag. Since combinations normally make shallow retracements, and second waves normally make deep retracements of first waves, the most likely outcome is a double zigzag. Triple zigzags are rare.

Q. After a "high-to-low" trade setup, should I add to my trade on a "gap trendline" setup?

Kennedy: It would be a good idea to add to your position with more contracts, provided that it did not compromise your risk tolerance parameters and capital management practices.

Q. What price data do you use for the "trendline gap" trade setup?

Kennedy: I use the "All Sessions" data for all of the above-mentioned markets because there's more volume. The "Pit Session" was viable years ago, but there's not as much volume today.

Q. How do I construct a deceleration channel if wave 4 is a contracting triangle?

Kennedy: The "deceleration" channeling technique does not apply to triangles. There are a number of other guidelines that you can use to estimate the end of a wave 4 triangle. You can use the "temporary" channeling technique by connecting the termination points of waves 1 and 3 and drawing a parallel line that includes the termination point of wave 2. The "base" channel helps to estimate resistance or support for wave 4. Within the triangle, constructing the A-C and B-D trendlines helps to estimate the end of wave E of the triangle.

Q. How do you channel corrective waves?

Kennedy: With respect to corrective waves, the guideline of channeling applies to zigzags. You draw a line that connects the origin of wave A with the termination point of wave B, and then draw a parallel line that includes the termination point of wave A. That will give you a trendline to estimate the termination point of wave C.

Q. Does wave 4 always find support at the base channel?

Kennedy: This is a guideline, not a rule. Most likely, wave 4 will find support at the upper, middle or lower boundary of the base channel, as long as that does not result in overlap with wave 1 at the termination point of wave 4.

Q. Is every wave that breaks the base channel an impulse wave?

Kennedy: Again, this is a guideline, not a rule. If there's a breach of the base channel, the structure is probably an impulse wave. A corrective wave structure would most likely not break the base channel. To better make these determinations, you need to consider the context, i.e., the wave structure at higher degrees, while applying all of Elliott's rules and guidelines.

Q. Upon a breach of the base channel, how do I know if it's all or part of wave 3?

Kennedy: After a breach of the base channel, to determine whether you have reached the end of wave 3 or have just completed part of wave 3, you have to look at the subdivisions and the current length of wave 3. Keep in mind that wave 3 is normally longer than wave 1 and is often extended. For example, after breaking the base channel, if you can count an initial five waves within wave 3 but still have not exceeded the length of wave 1, you've probably identified wave 1 within wave 3.

Q. How do I draw the base channel if wave 2 makes a new price extreme?

Kennedy: If wave 2 makes a new price extreme, you should construct two base channels. A break of the base channel that uses the orthodox end of wave 1 would signal that wave 3 is most likely in force. A break of the base channel that uses the new price extreme of wave 2 would be a stronger indication that wave 3 was in force.

Q. When should you use channeling versus a single trendline?

Kennedy: They're both useful. Channeling (parallel trendlines) is more useful for identifying a breakout of a wave 3 impulse and estimating termination points of waves 4 and 5 within impulse waves and wave C within zigzags. Trendlines that only connect highs or lows help to identify resistance and support levels over the respective time period.

Q. How do I combine the Wave Principle with the material in this course?

Kennedy: You should combine this course's trendline analysis with all of Elliott's rules and guidelines, especially Fibonacci relationships. For example, in wave 4 of an impulse wave, if a retest of a trendline occurs at a .382 retracement of wave 3, which is common for fourth waves, and in the area of the previous fourth wave at one lesser degree (guideline of depth), then that would likely confirm the end of wave 4. In a fifth wave extension, a retest of a trendline might occur at a point where wave 5 is equal to 1.618 times the length of the net distance traveled of waves 1 through 3, which is a common Fibonacci relationship. That would be a good indication that wave 5 had ended.

Q. What kind of charting system did you use?

Kennedy: For this particular course, the charting system was CQG. We also sometimes use GenesisFT.

EWI eBook

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