THE SIGNIFICANCE OF TREND LINES

To draw an analogy from the science of physics, we might say that when a stock (or the market) is being accumulated, it is storing up a force (of demand) which, when later released, provides the motive power for the ensuing upward movement. And, when the force of this accumulative demand is finally released, it gives the price movement a certain momentum which it tends to hold until it is turned off its course by weakening of the original force or by a new force sufficient to compel a change of trend. An indication that the force of demand may be dying out on a rise or encountering a superior force of supply is given when the price movement evinces a tendency to flatten out or arch over.

Conversely, in a zone of distribution, a force of supply is being stored up which eventually overpowers the weakening force of demand, driving the price downward until the force of supply is exhausted or demand is revitalized and builds up sufficiently to bring about a state of comparative equilibrium (trading range). Thus, a downward movement also acquires a certain momentum which it[1] tends to hold until it is turned off its course by weakening of the original force of supply or by a new force sufficient to compel a change of trend. An indication that the force of supply may be dying out on a decline or encountering a superior force of demand is given when the price movement shows a tendency to level off or round upward.

The stride (i.e., the momentum) of an upward movement is reflected in the angular upward climb of the daily vertical bars on our vertical line charts; and the pace of a downward movement by their angular downward pitch. The eye may not always see the pitch of these angular swings clearly because of the confusing effect of minor irregularities of the price movement as recorded on charts. Therefore, it is frequently helpful to employ Trend Lines for this purpose. Thus, examination of the accompanying charts will show how the angle of ascent or descent of prices may often be visualized more clearly by drawing straight lines through the successive tops or bottoms of the price path established during the minor, intermediate and major moves.

Occasionally, the momentum produced by the forces of demand and supply will become so plainly marked as to develop a well defined zone of activity; that is, the alternating buying and selling waves form a price path or channel whose upper and lower limits are easily identified by a series of tops and bottoms confined within parallel, or nearly parallel, lines. (See Pg. 14.)

Lines drawn as explained in the two preceding paragraphs are called Trend Lines. And for the reasons given on the preceding page, these trend lines serve to define the stride of the price movement, thereby frequently directing our attention either to possibilities of an approaching change of trend or to an actual reversal. For instance, when it appears that a movement is beginning to level out in the vicinity of an established trend line, such action may be regarded as a gesture warning us to search for other possible indications of an impending change of pace or a change of trend. In like manner, the intersection of an established trend line by the price path of a stock or an average may be <u>one</u> of the symptoms of an actual reversal of trend.

To repeat the above in another way so you may grasp the idea clearly:

(1) The threatened violation of a trend line often (but by no means always) may signify that the force of demand or supply which was formerly in effect is now becoming exhausted. This may either mean that the price movement is merely changing its rate of progress, or it may mean that the trend is definitely in danger of being reversed. Our decision either way must depend upon the other factors which are pertinent to a complete diagnosis.

(2) The actual violation of a trend line often (but by no means invariably) may signify that the previously effective force of supply or demand has been overcome by a new force which is causing a new trend to develop. However, as before, we must look to the other accompanying symptoms for our decision as to whether this one indication alone (i.e., the violation of a trend line) may be accepted as true or false.

These instructions should be thoroughly understood because, unless you are careful, you may find you have a tendency <u>greatly to exaggerate</u> the importance of trend lines and an inclination to employ them in a purely mechanical way.

It is bad practice to buy a stock simply because it has penetrated an established supply line or broken out of an extended congestion area; or to sell it merely because it has violated a line of support or broken through the bottom of a trading zone, and for no other reason. <u>Do not forget</u>: The breaking of a trend line, by itself, is neither a conclusive nor an all-inclusive symptom. The significant thing is <u>HOW</u> the line is broken; the conditions under which the change of stride occurs. The behavior preceding such an indication must also be taken fully into account.

In short, the <u>quality</u> of the buying or the selling at and around the point of penetration determines whether the violation of an established stride may be regarded as evidence of a further movement in the direction of the breakthrough, or whether it means only temporary change. <u>This admonition applies equally to the violation of former tops and bottoms and old levels of resistance and support</u>.

After an average or a stock has moved some distance in a given direction, it may encounter sufficient resistance to that particular movement to cause it to modify its pace, or to rest. During the resting spell (lateral movement or trading range), the force that was originally operative may be renewed or even greatly strengthened with the result that the move will be resumed with greater momentum than before.

For instance, in the case of an advance, the angle of ascent may be leisurely for a time and then become pitched more sharply upward as the original force of demand is renewed by fresh buying from the sponsors of the move and the public, and perhaps by expanding enthusiasm of bullishly inclined traders and investors. Or, a rapid advance may be followed by further gains at a slower tempo.

Under these conditions it becomes necessary for us to relocate our trend lines to conform with the newly established stride. Thus it is apparent why you cannot accept the mere breaking of a trend line at its face value — why it is imperative for you to study contemporary technical manifestations in order to determine whether a conclusive indication is being given by the violation of the trend line alone.

You must also be careful to avoid drawing trend lines indiscriminately, especially on every minor move. The correct handling of trend lines calls for good judgment. With bad judgment, the use of trend lines will produce confusion and introduce fallacies into your reasoning.

The reason why you must be especially careful about trying to apply trend lines to minor moves is this: Every congestion area (horizontal formation) which develops on your charts cannot arbitrarily be regarded as either a zone of accumulation or distribution. <u>Many of these formations may be nothing more than trading ranges</u> which might be extended indefinitely; they may represent zones of comparative equilibrium; areas in which only small forces are at work, hence minor dips and bulges (small rallies and reactions) tend to neutralize each other. (See Sect. 14M, Pg. 12, Pars. 2, 3 & 5.) Bear in mind that a decisive price movement cannot be expected to occur until there is evidence that the forces of supply or demand have been built up, and then become unbalanced, sufficiently to generate a sustained swing. Therefore, take care to analyze the behavior of an average or a stock while it is forming these congestion areas to make sure that such formations actually do signify accumulation or distribution.

With the above mentioned controlling and modifying influences in mind, you will find an intelligent use of trend lines is frequently helpful in judging the points at which you may expect the price:- (1) To be supported on reactions; (2) to meet resistance on rallies; and (3) to approach a critical position in its travel from one level to another. They will also help you to foresee possibilities of an impending change of trend before it actually takes place.

Thus, as average prices, or prices of individual stocks, approach or touch these lines, we are given a strong hint to search for additional clues of a turning point. Special opportunities are frequently afforded the alert trader for buying or covering near a support line or an oversold position line; or for selling out or going short near a supply line or an overbought position line.

A Support Line is that line which identifies the angle of advance of a bull swing by passing through two successive points of support (the low points of two successive reactions). Example:- Lines A-C, E-G and N-P, Page 14.

A Supply Line is that line which identifies the angle of decline of a bear swing by passing through two successive points of resistance (top of rallies). Example:- Line J-L, Page 14.

An Oversold Position Line is that line which is drawn parallel to a supply line and passes through the first point of support (reaction low) which intervenes between two successive rally tops in a down trend. Example:- Line K-M, Page 14. Note that K is the first point of support intervening between the two successive tops, J and L.

An Overbought Position Line is that line which is drawn parallel to a support line and passes through the first point of resistance (rally top) intervening between two successive points of support in on up trend. Example:- Lines B-D, F-H, and O-R, Page 14.

Because of the greater sensitivity of vertical charts and the fact that the extremes of rallies and reactions, advances and declines, are shown to the last fraction on these graphs, it is always best to locate trend lines first on the vertical charts. Then, by observing the points on the figure charts which most nearly correspond with the <u>more important</u> of our vertical chart trend lines, we are able to duplicate the latter correctly on the figure charts. A more complete explanation of the relative merits of vertical chart versus figure chart trend lines will be set forth presently (Pg. 11).

Meanwhile, the following will illustrate further how to establish trend lines in a logical manner and how to use them in a practical way. For the purpose of our first illustration, we reproduce a portion of the chart appearing in Section 9M, page 9. Referring to this reproduction (Page 15, this Section), it will be seen that after the reaction to G, we are able to distinguish two well defined rally tops, the first at 35 5/8 (D) and the second at 33 7/8 (K). Accordingly, if we draw a straight line through the extreme tops of these two rallies the moment the second high point (K) is distinguishable — which would be when the price has reacted to 30 1/8, near L — we find that the extension of this supply line to the right, across the page, helps to define the approximate limits of subsequent rallies until the price develops sufficient sidewise movement (out to M) to indicate an impending change of stride.

To express this in a different way: When we see that the lateral movement beginning at L is stretching out to the right at M, we are able to decide in advance that any material rally, developing out of this sidewise movement at its right-hand extremity, would have the effect of pushing the price up through our previously established down trend supply line D-K. Such a break-through would imply a change of stride of some importance since the stock has been hovering dangerously close to a critical support level (the line of 30s) and appears now to have reached a position from which it must soon show ability to rally, for otherwise it will be vulnerable to a bearish attack (Sect. 7M, Pg. 16, Par. 1, and Sect. 16M, Pg. 13, Pars. 2-4). If, however, it is able to rise through the supply line with some degree of power, that is, either with increasing volume, or by a material gain in price, or both, we shall have a fairly conclusive indication that the force of demand generated in the range of 30-35 (A to M) is finally being released — that a worth while upward move is probably beginning.

It is important to note that we are able to <u>anticipate</u> just such a break-through before its actual occurrence and to take a long position <u>before</u> the advance begins because our study of the stock's behavior in the formation A to M has already led us to conclude that it was in preparation for a substantial rise. (See Sect. 10M, Pgs. 2 to 4.) And the sharp shrinkage in volume on the last dip to the supporting level at 30 (M), plus the quick rebound to 31 1/4 (N) tells us that the available supply now has been largely exhausted — offerings have become scarce at this level — the operator has succeeded in creating a set of conditions which are ripe for springing the force of the demand that has been steadily accumulating.

The advance to R enables us to establish the trend support line M-Q which represents the angle, or rate of acceleration, of the first phase of the bull campaign in this stock. Extending this line to the right, we find that after the rise is temporarily accelerated by a sharp run-up to 40 (T), the price recedes for three days toward this line of support in what we conclude is a normal corrective reaction. We reason that if it recedes further, we may expect the price to hold on or around this line of support. It does hold, for on the quick further dip to 35 7/8 (at U) there is an immediate rebound, marked by a closing at the high, as the price almost touches our established trend line. Thus our trend line has given us a helpful hint, in advance, as to the point at which we might reasonably look for new demand (support) and the probable place where this particular reaction should end.

After the mark-up to 46 7/8 (right of X), we must readjust our trend support line because the increasing momentum of the rise from X brings a new phase of the advance which implies that the operator may now be in a hurry to wind up his campaign. This new line, of course, runs from U to X, but, after penetrating the extension of this line (left of Z), the stock reacts only a little further and then quiets down, leaving us in doubt whether our trend line indication is a valid signal of weakness or whether it merely is evidence of a temporary condition requiring correction.

Meanwhile, we had an earlier warning that the swift pace of the advance from X to Y might not be sustained when the reaction to 47 1/2 broke the minor trend support line X-Y.

From Z onward we must wait until the stock gives some new decisive indications in the trading range 46-51 before we can again get any aid from trend lines because we have no basis for establishing new ones until another series of intermediate movements develop and we must avoid trying to establish trend lines on small fluctuation. To use trend lines on minor dips and bulges will introduce fallacies and lead to deceptive inferences.

Referring next to the vertical chart of American Tobacco B, Page 16, observe that the decline from the May 11th high point at A to the May 21st low at 60 proceeds at a downward angle whose pitch may be represented by a straight line drawn from A to the next rally top at B. Extending this line to C, we find that it helps call our attention to a possible change of trend when the sharp rally of June 14th penetrates this line decisively (at D).

Meanwhile, observe that after leaving 62 1/2 at B, the downward movement of the stock is sharply accelerated so it becomes necessary to draw a new trend supply line B-E to represent this change of pace. From the fact that this new decline is pitched almost perpendicularly, we conclude that the stock is dropping into an oversold position (Sect. 14M, Pg. 3, Par. 3). Hence, when the line is penetrated at F by a vigorous rally on heavy volume, after the down move reaches climactic proportions on June 1st, we have an indication that the force of the supply is being overcome by a superior force of demand and we may now anticipate the appearance of the customary technical rally which usually follows as a sequence of a selling climax (Sect. 7M, Pg. 3, Footnote). Note how this technical rally is checked (at G) as it approaches our initial supply line A-B-C, that is, within the limits of the initial down wave angle.

As shrinking volume is a normal characteristic of the technical rebound which follows a selling climax, when the price begins to hesitate at G in the vicinity of our supply line A-B-C, we are put on notice that this rally may be terminating. And so we are now prepared for the next normal sequence of events, namely, the appearance of a secondary reaction which will test the preliminary support around 44-45. This test may confirm the previous support (show that a good quality of demand exists around these levels), or it may show that support has been withdrawn (Sect. 7M, Pg. 3, Footnote). As volume remains low — or at least does not expand appreciably on the anticipated secondary reaction (June 7th and 8th) — and as the price makes no further progress on the down side during the next two days, and since the stock tends to enlist increasing volume on the rallies from higher support around 47 on June 9th and 10th, we have a set of indications implying that a broader base of support (accumulation) is forming: the force of demand is building up.

On our 1 point figure chart (pg. 17) there is now a base (across the 46 level) sufficient to sustain a possible 13 point recovery to 57-59. This indicates, in advance, that the next rally is likely to penetrate the supply line A-B-C on our vertical chart. If this expectation should be fulfilled, we shall have further confirmation of a change from technical weakness to technical strength.

In the meantime, having established a tentative support line from H to J, we note that the extension of this line is violated by the reaction of June 27th, at K. Is this a valid indication of further weakness? We are in doubt on June 27th because the volume increases somewhat sharply on the break-through. But since the increase <u>is</u> quite marked, we must consider whether this may prove to be a minor selling climax rather than a case of volume increasing on a decline. So we wait for a clearer indication. There is no follow through on the down side over the next few days. Instead, the price movement narrows, recording higher tops and bottoms; volume tends to increase on the rallies and decrease on recessions. Accordingly, we must conclude that the demand is still of better quality than the supply. Hence, when the price swings to a dead center on July 9th, having held for two weeks previously well above the June lows, we conclude definitely that the violation of our tentative support line H-J should be disregarded. The action of the stock shows accumulating strength, thereby saying that our first support line (H-J) merely represented a temporary rate of upward acceleration which could not be sustained until more energy (force) could be stored up — that is, until more of the floating supply of stock could be absorbed. This action, incidentally, again illustrates how other technical manifestations may deny the inferences which might be drawn from purely mechanical interpretation of trend lines.

After the confirmatory bullish indication is given by the rally of July 11th (Sect. 10M, middle of Pg. 4), we establish a new trend support line, H-K. But, meanwhile, note that if we have drawn a readjusted trend supply line through A and L, we are able to visualize clearly that the lateral movement of late June has had the effect of working the price into a broad apex, defined by the intersection of the supply line A-L and the support line H-K. Thus, in swinging to a dead center on July 9th, the stock is in a position to break away from this broad hinge position in a quick mark-up; it is stepping on the springboard ready to release the force of demand that has been accumulating in the range 44-54.

As previously explained (Pg. 6, Par. 1), trend lines should always be located first on the vertical charts. This is advisable because the three factors of Price Movement, Volume, and Price Movement-Volume Relationships (Sect. 16M, Pgs. 1 & 2) determine when and where trend lines may logically be applied} and when it is inadvisable to attempt to apply them.

Sometimes, however, trend lines on the figure charts may direct attention to significant developments more strikingly than on the vertical chart a. For example, on the 1 point figure chart of American Tobacco B (Pg. 17), the significance of the apex formed by the supply line A-L and the support line H-K is revealed more strikingly than on the vertical chart (Pg. 16). Hence, it is well to duplicate your trend lines on the figure charts <u>after</u> you have determined their proper positions according to the vertical chart indications (Pg. 6, Par. l). By comparing the supply line A-L on the vertical chart, Page 16, with the similarly lettered trend line of Pg. 17, and the support line H-K (vertical chart) with the corresponding trend line on the figure chart, you will see at once how to do this.

In case your figure chart trend line seems to give a different indication from that suggested by the corresponding vertical chart trend line, it is best to be guided by the inferences to be drawn from the .latter. Thus, note that the supply line A-B-G on the vertical chart of American, Tobacco B gives a correct impression of the technical position of that stock on the early June rally to G. The fact that this rally is checked in the vicinity of the supply line helps us to identify it as a probable technical rebound out of a selling climax (see Line 3, Pg. 9, through Par. l). On the other hand, the corresponding supply line on the figure chart seems to give a much more positive, but misleading, indication because on the figure chart the down stride line A-B-C is actually penetrated — apparently quite decisively.

Differences of this sort may result from the circumstance that figure charts do not take account of the time factor as accurately as the verticals.

The charts of U. S. Steel (Pgs. 20 & 21) show additional examples of trend lines, illustrating how price movements sometimes follow regular channels as between the supply line A-C and the corresponding oversold position line B-D. The latter is located by drawing a straight line through B parallel to A-C. In other words, as soon as the down swing from 41 (A) has been sufficiently developed to enable us to identify the next succeeding high point at 35 (C), we draw the supply line A-C to mark the angle of downward acceleration. Then, at the same time, we draw a second straight line B-D, parallel to A-C, taking this latter line through the intervening low, or temporary support, point at 34 (B); extending this line (to D) so it may thereafter indicate the points at which ensuing down swings may cause the stock to become oversold.

Similarly, after the support line M-O has been established, we draw a parallel through the intervening rally top at N. This second line (extended to the right as at P), for sometime thereafter marks the limit of subsequent up waves, that is, the points at which the stock tends to become overbought. Hence the line N-P is an overbought position line.

In general, trend lines applied to major and intermediate price movements, of course, are more important than minor trend lines. Which is to say, that a decisive violation of an intermediate trend line usually implies possibilities of a relatively more extensive continuation of the move in the direction of the break-through than in cases where a minor trend line is conclusively violated. A notable exception to this presumption occurs when the market, or a stock, has worked into a position where indications of a change in the minor trend would be likely also to signal the beginning of a new intermediate or major trend.

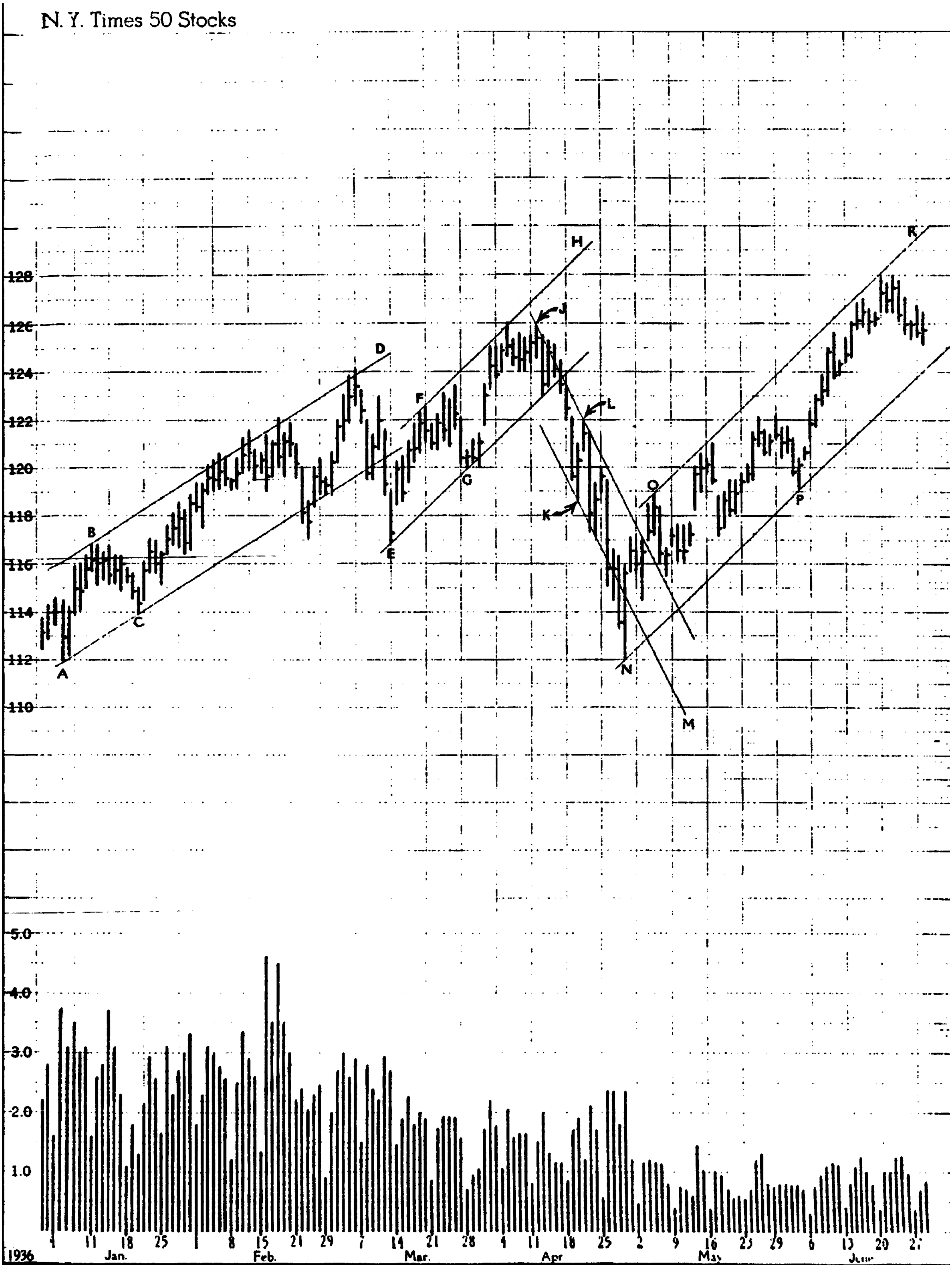
The figure chart of American Tobacco B (Pg. 19) illustrates the location of typical trend lines on a 3 point chart showing how the stride of intermediate and major swings may be quickly and conveniently observed on this type of graph, which condenses a great deal of history into a small space. On this chart, we begin with a tentative trend support line A-B but later we must add the support line B-C because of the increasing momentum of the next phase of the bull movement. Similarly, the supply line D-E represents the initial momentum of a bear cycle and the supply lines E-F and G-H the increased pitch of the angle of decline in its later phases. The line a-b is the overbought position line for the A-B advance, and the line m-n is an oversold position line for the M-N decline.

By studying the herein charts carefully, you will notice that when the price movement exhibits a tendency to stop short of, or pull away from an established oversold or overbought position line, such action frequently conveys a strong hint of an impending change of pace, or a change of trend. (See explanatory notes on charts, pages 32 to 35, Sect. 22M, for graphic illustrations of this principle.) However, the probable importance and extent of the implied change, as well as the validity of the indication, must be judged in the light of all other technical factors influencing the behavior of the stock (or average) under observation at the time the above mentioned action is observed.

Therefore, by employing discretion in the use of trend lines, taking care to weigh <u>all</u> of the factors involved in a <u>complete</u> diagnosis of market action, you will find that trend lines can be handled intelligently and to your advantage. But their principal value is in affording you hints, or clues, rather than positive indications.

<u>Never</u> undertake to draw conclusive deductions from trend lines alone.

Let other people employ them as mechanical panaceas if they wish. YOU are studying the correct principles of market forecasting because you do not want to be in that "sucker" class of calculating machine forecasters.



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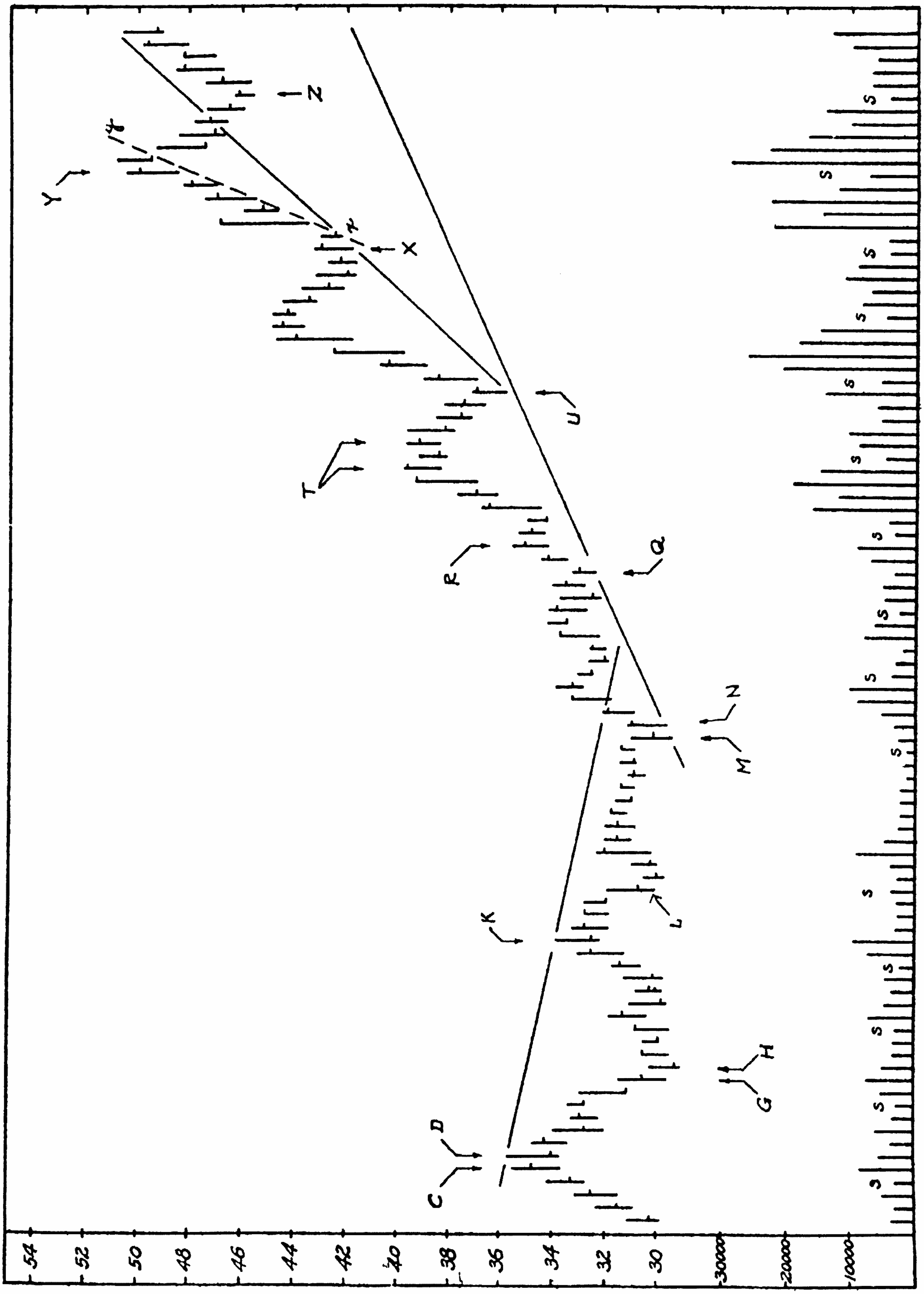
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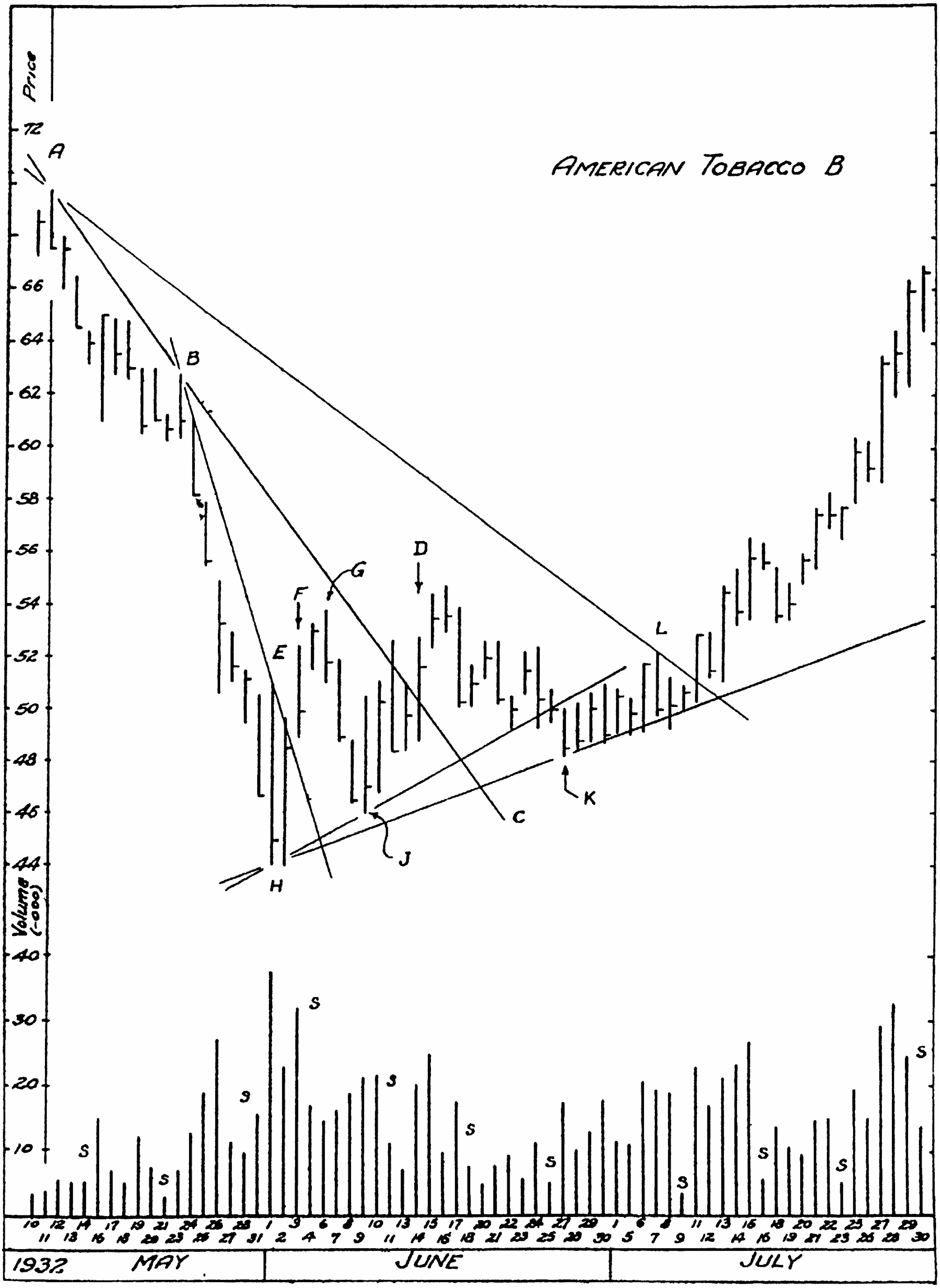
AMERICAN TOBACCO B
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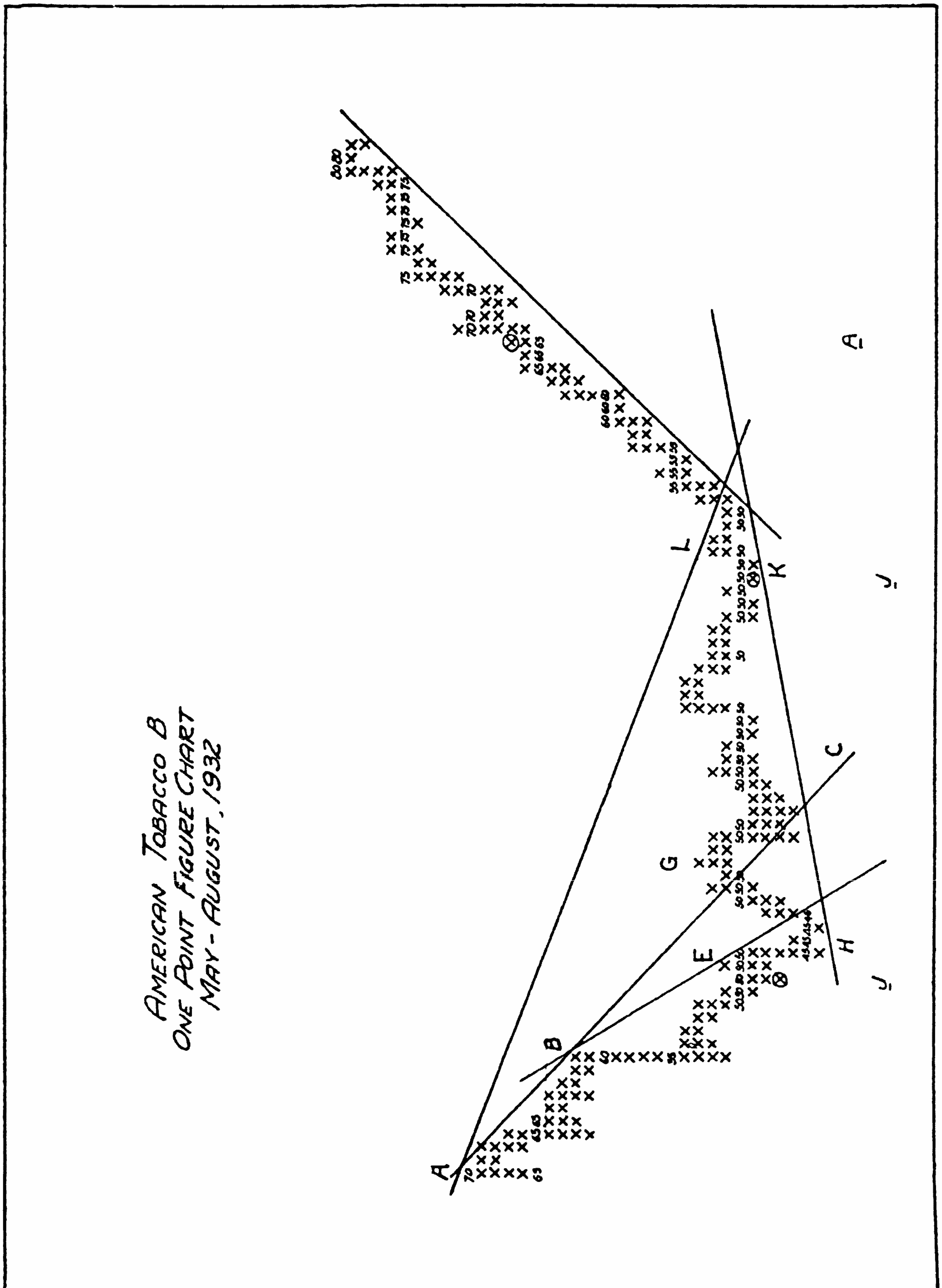

American Tobacco B
One Point Figure Chart
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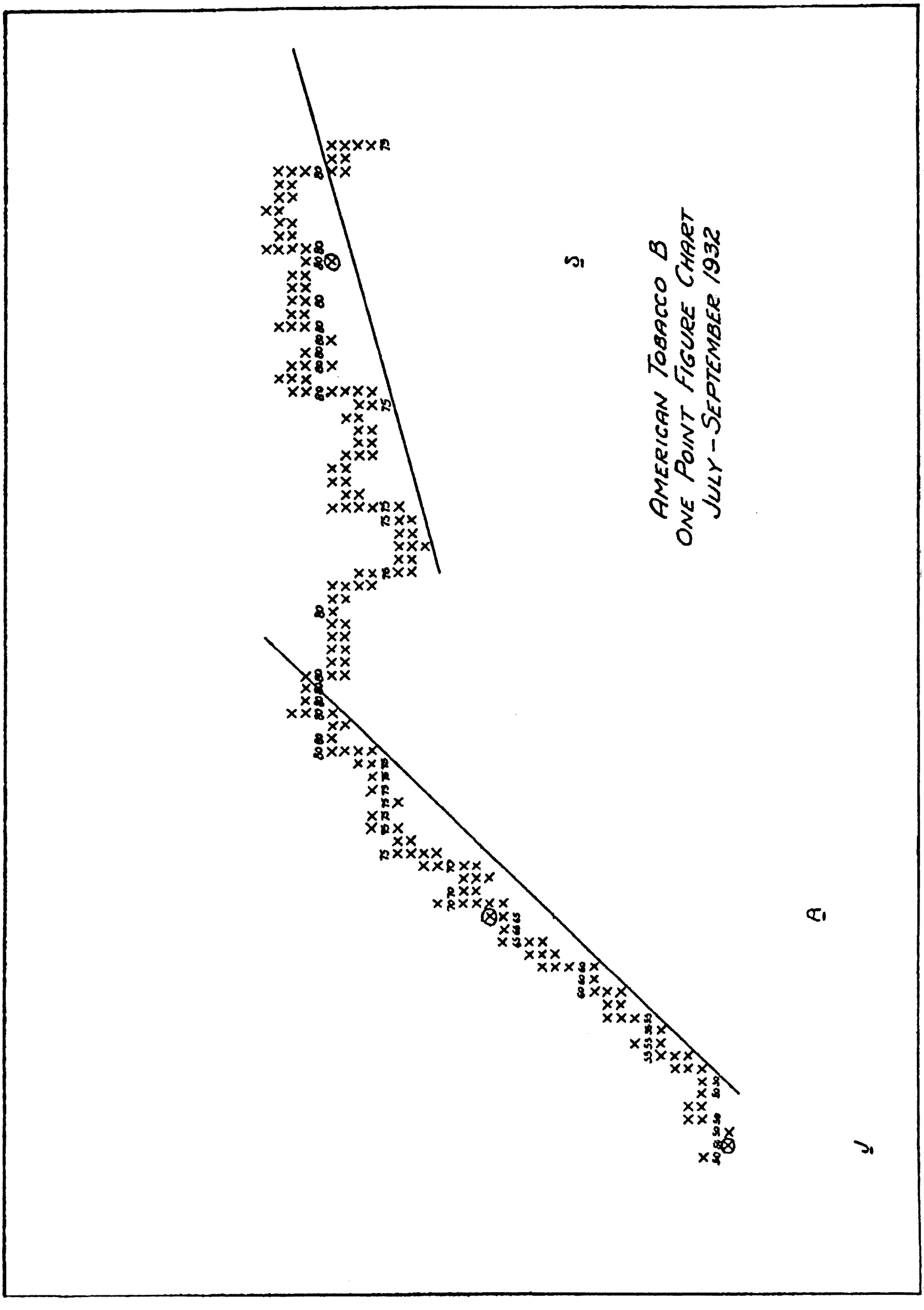
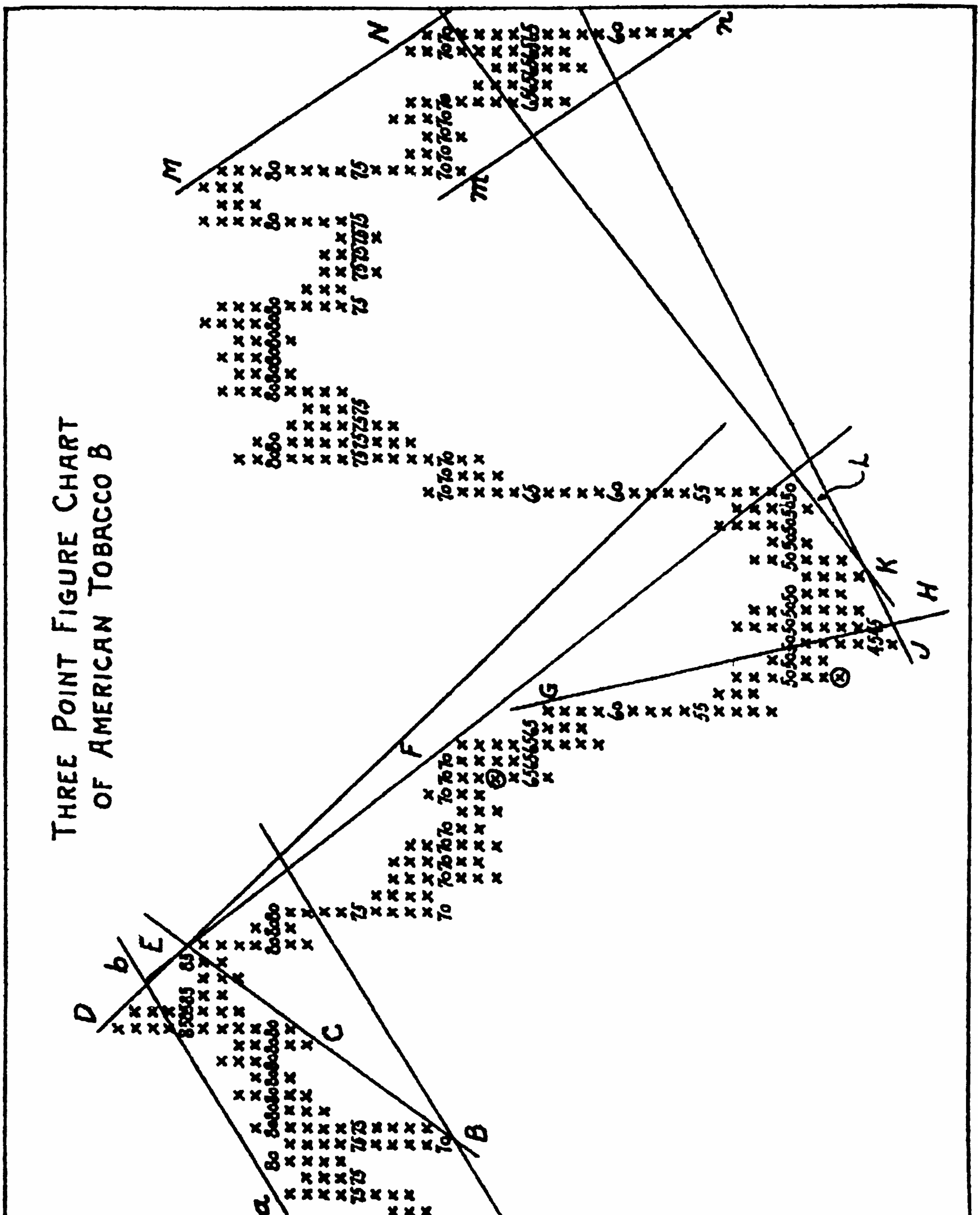

AMERICAN TOBACCO B
ONE POINT FIGURE CHART
JULY - SEPTEMBER 1932


THREE POINT FIGURE CHART
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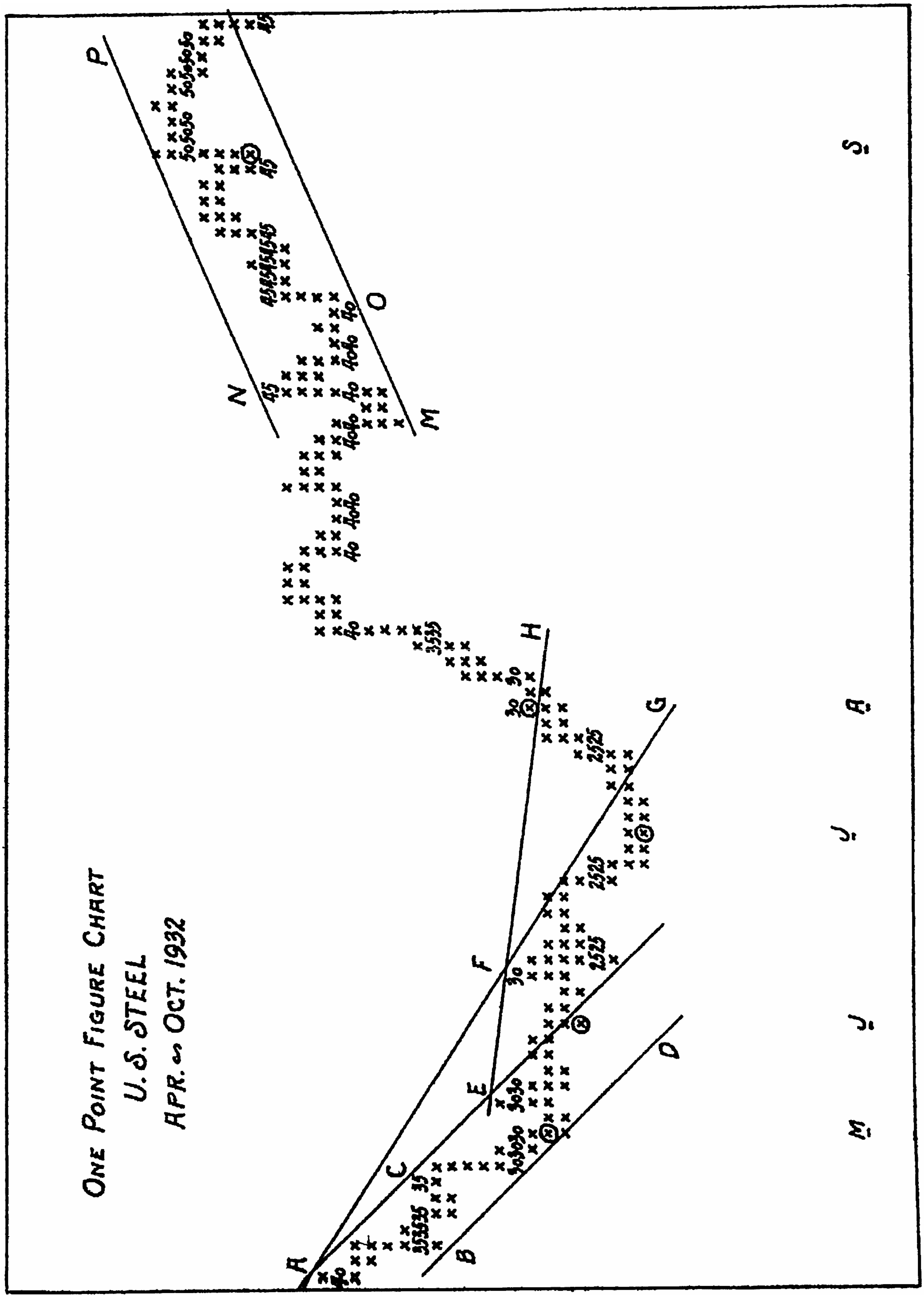
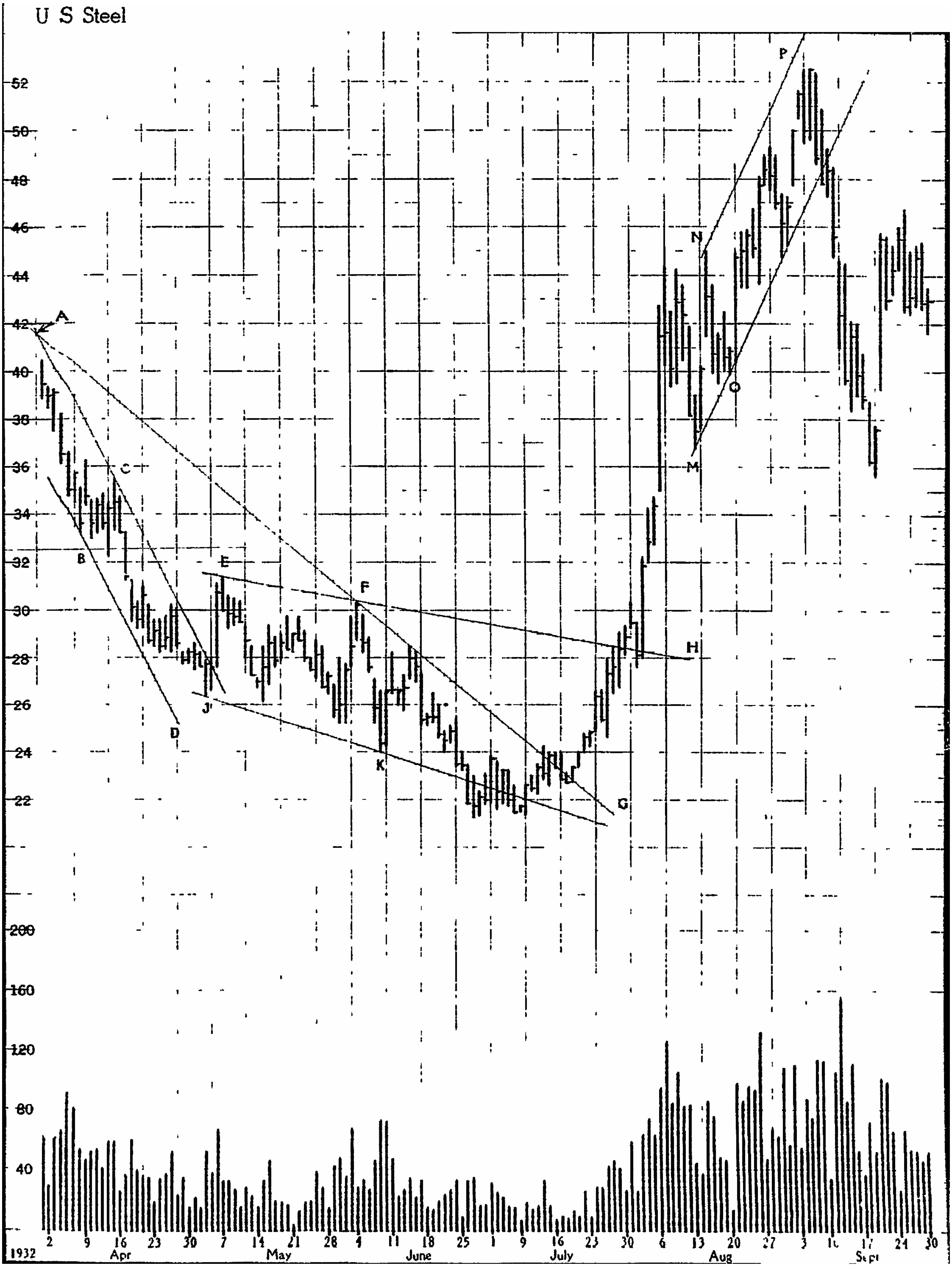

ONE POINT FIGURE CHART
U.S. STEEL
APR. – OCT. 1932


U S Steel
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