3 Ways to Identify a Trend

In the foreign exchange markets, like in many other markets, there are two basic types of trading environments – a ***trend*** and a ***range.*** A trend can be defined as a general move in one direction while a range is an oscillation in price between two broad levels. In stocks, we typically try to "buy low" (at a value) and "sell high"; this is actually the foundation of range trading.

Currencies, however, trend more often than they range. Witness the near vertical move in the EUR/USD chart from 1.20 in January 2006 to 1.60 by July 2008 as prices climbed steadily with very little retracement. Trends can last for weeks, months and even years. As indicated in the chart below, it is much easier to look for opportunities to join a trend than to fight it.

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In this report, we attempt to outline three simple methods to identify a trend:

» Bollinger Bands
» Moving averages
» ADX

Source: DealBook®

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BOLLINGER BANDS

Bollinger Bands basically plot standard deviations above and below a moving average. They were developed in the early 1980s by John Bollinger and are typically used to determine volatility. At GFT, however, we like to use Bollinger Bands to help us gauge a trend.

In the chart below, we plotted a set of standard Bollinger Bands using the settings 20,2 (which mean two standard deviations away from the 20-day moving average) and then added a set of 20,1 Bollinger Bands (one standard deviation away from the 20-day moving average). This helps us to create our ***buy zone*** and ***sell zone.***

Typically, when an uptrend in a currency pair is very strong, it will remain in the buy zone, the zone between the upper Bollinger Band of two standard deviations and the upper Bollinger Band of one standard deviation, for some time. When the downtrend is very strong, the currency pair will remain within in the sell zone, the zone between the lower Bollinger Band of two standard deviations and the lower Bollinger Band of one standard deviation. If the currency pair closes below the buy zone or above the sell zone, we say that it has entered the ***range trading zone.***

Bollinger Bands are great tools to use to help determine when a currency pair enters or exits a trend. For those traders who like to pick tops and bottoms, a good way to do so is to wait for the currency pair to exit the buy or sell zones.

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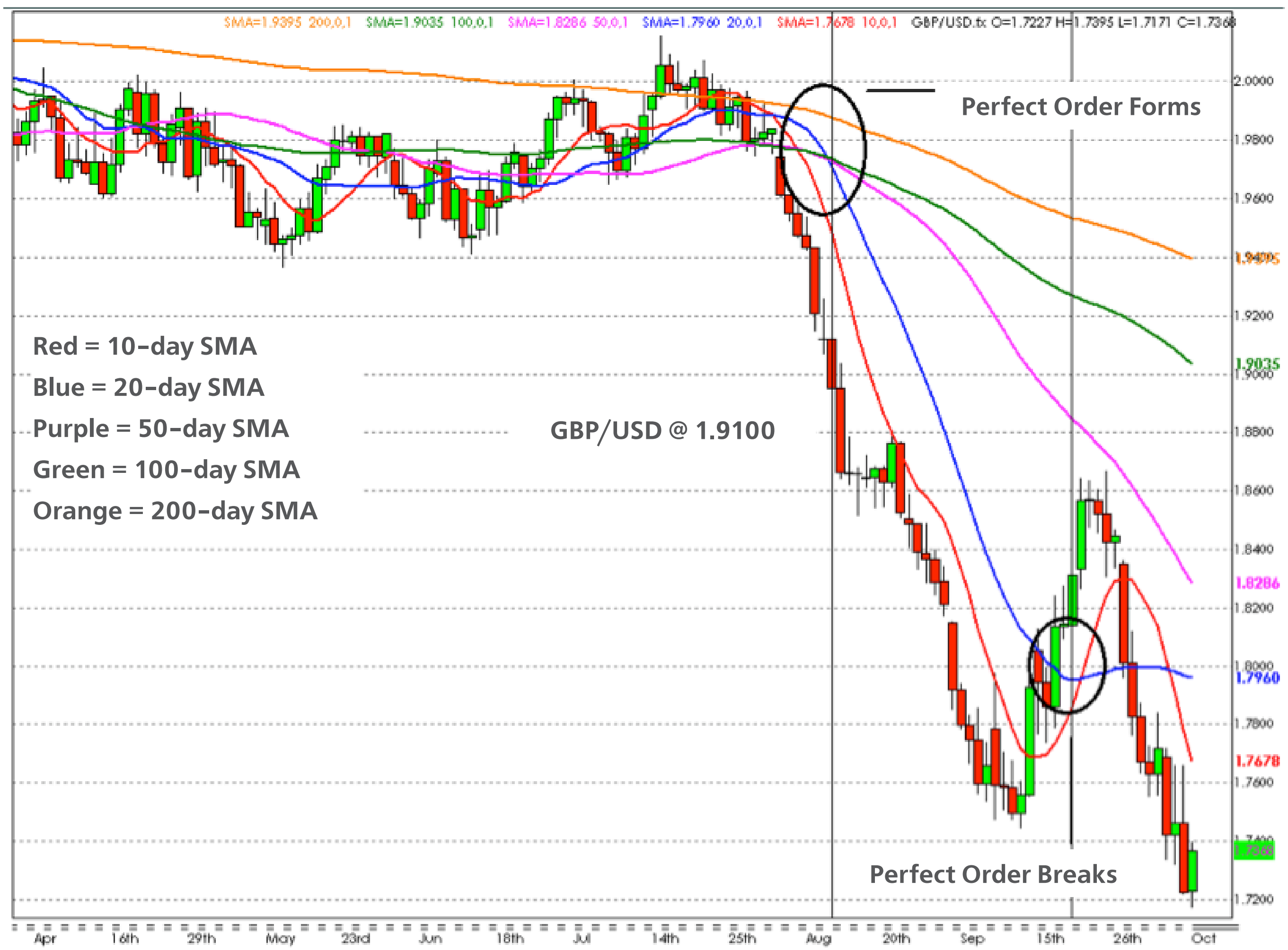
MOVING AVERAGES

Moving averages is another great tool for identifying a trend in the currency market. By definition, moving averages track the average price of a currency pair over a specified period of time. A 20-day Simple Moving Average (SMA), for example, tracks the average price of a currency pair over the past 20 days.

One way to identify trends with moving averages is to look for a perfect order. This occurs when all of the shorter term moving averages are above the longer term moving averages in an uptrend and the longer term moving averages are above the shorter term moving averages in a downtrend. We usually see a new and powerful trend emerge when these perfect orders form after a period of range trading.

Here is an example in the GBP/USD pair where moving averages are lined up in a perfect order. As you can see in the chart below, the 10-day SMA is below the 20-day SMA, which is below the 50-day SMA and those are below the 100-day and 200-day SMAs. We have also highlighted the day that the perfect order formed (August 11, 2008). At that time, the GBP/USD was trading at 1.9100. Forty days later when the perfect order breaks ranks on September 22, 2008, the GBP/USD was trading at 1.8572 or 500 pips lower.

Perfect orders do not form often, but when they do, they can provide a powerful sign that a new trend has emerged.



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ADX (AVERAGE DIRECTIONAL INDEX)

The ADX is short for the Average Directional Index, which is a classic measure of a trend's strength. Unlike Bollinger Bands and moving averages which can help define the direction of the trend, the ADX simply measures whether the trend is strong or weak. The index is displayed as an oscillator in a separate box below the price charts on a scale of 0 to 100.

As a rule of thumb, if the ADX is greater than 30, a trend is strong; if ADX is below 20, a trend is weak. In a strong trend, we want to see the ADX sloping upwards. In the following EUR/USD chart, we inserted vertical lines to represent the times when ADX crosses the 30 mark.

Back in March 2008, for example, the ADX crossed above the 30 mark when the currency pair was trading at 1.52. Over the next month, the currency pair gained strength at a relatively rapid pace and ended up hitting a high above 1.60. When the ADX crossed back below the 30 mark, the currency pair ended up range trading for the next few months before breaking lower in the middle of July.

Source: DealBook®

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