

**“A trend should be assumed to continue in effect until such time as its reversal has been definitely signaled.”**

**- The Dow Theory**

By Christopher Terry



# The Ocean's Tide and the Market's Trend... The Dow Theory Still Holds Water

The challenge of the stock and futures markets is multi-faceted. Each trader has his own interpretation of the trend, individual reasoning as to what support and resistance levels may be, what continuation patterns and reversals are, and what constitutes a meaningful chart formation versus what does not.

The “Dow Theory,” which came to light around 100 years ago, offers an incredible wealth of information for the technical trader, and these

concepts and rules are truly as valid today as they were back at the turn of the 20<sup>th</sup> century.

The intention of this article is to educate the reader on some of the basic concepts of The Dow Theory, a philosophy that has defined the foundations for technical analysis since the early 1900s. The goal here is really quite simple — to help improve the reader’s work by applying multiple time frame analyses to the rules of the theory and, in essence, to give

a good feel for timing important turning points in a trend.

## **Dow Theory and Technical Analysis**

Charles H. Dow in the late 1800s and until his death in 1902 wrote editorials in *The Wall Street Journal* outlining his theories by observing that averages of both the primary industrial and the rail stocks acted as a barometer for the nation’s economy.

Dow's successor, William P. Hamilton, for the next 27 years continued the development of Dow's theories and principals and crystallized them into his own version of what we know today as "The Dow Theory."

The pioneering work of Dow and Hamilton became the foundation of the discipline that led to the groundbreaking work that helped launch the "Technical Analysis" revolution. Richard Schabacker's *Technical Analysis and Stock Market Profits* (1934) paved the way for Edwards and Magee's *Technical Analysis of Stock Trends* (1948). Their books have stood the test of time and are considered to be some of the most important work ever on technical analysis.

Technical analysis in its purest form, of course, is the study of price and the use of charts as a tool to discover patterns and to learn the trend of a market. When using the term "technical analysis," some of the first visions that come to mind would be various types of chart-patterns, both continuations and reversals. Some of the more popular are triangles, wedges, head and shoulders, flags and pennants.

## The Theory and Foundation of Trends

Realizing the price of stocks and futures quite often trade in trends, a basic understanding of what makes up those trends will be the foundation necessary for a trader to identify the type of market in which he is trading. By gaining a broad understanding of the Dow Theory and technical analysis, a trader will gain confidence in chart reading and, ultimately, will enhance his ability to spot and trade trends successfully.

The Dow Theory concentrates on three types of trends: primary, secondary and minor. Below is a description of each type of trend with a subsequent chart that visually simplifies the concept. The most easily understood definition of trends, of course, is that an up trend exhibits "higher highs" and "higher lows," and a downtrend exhibits "lower lows" and "lower highs."

### The Primary or Major Trend

When each intermediate rally (advance in price) rises above the high of the prior rally (higher highs), and each "correction" down or "secondary" reaction stops above the low of the previous correction and price reverses back up (higher lows), the primary trend is up. This is bullish.

When each intermediate decline (decrease in price) takes prices below the low of the previous decline (lower lows), and each "rally" or "secondary" reaction stops below the high of the previous rally and price reverses back down (lower highs), the primary trend is down. This is bearish. **Figure 1** shows this very clearly.

The original theory refers to the primary trend on a very large time frame, but today traders can and do utilize multiple time frame analyses to qualify a primary trend. For example, a primary trend could be on a daily chart, with the secondary trend on a 60-minute chart. Or a primary trend could be a 60-minute chart, with the secondary trend on a 15-minute chart. There is ample flexibility to determine a trend using multiple time frame chart analyses.

### The Secondary or Intermediate Trend

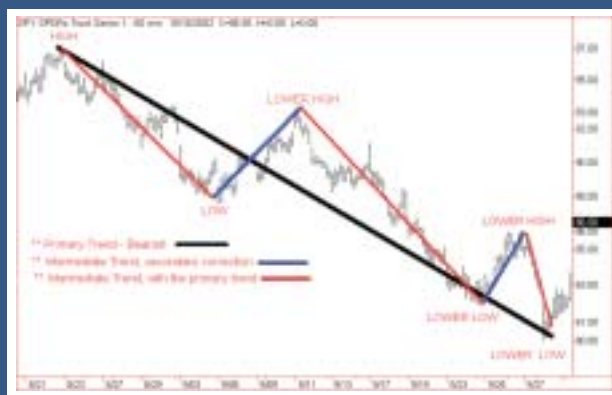
Secondary trends are significant reactions that disrupt the development of the primary direction. These reactions are the declines in a bullish trend and rallies in a bearish trend, also known as "retracements."

An intermediate trend is also considered a smaller segment of the primary trend. For example, if you break down a primary trend into two

components, each of those intermediate-term *segments* — whether primary or secondary in direction — is an intermediate trend.

Typically, the "retracement" levels for these secondary trends are a minimum of 38 percent to a maximum of 62 percent, and many times they stop at around 50 percent. These retracement levels are just probabilities because, for instance, there are times in which prices never reach the 38-percent level and also times in which prices correct more than 62 percent.

Figure 1 – SPY SPDRs Trust Series – 60 min chart  
Primary and Intermediate Trends



Credit: TradeStation.com

As seen, the primary bearish trend for this tracking index is down, with lower highs and lower lows.

Figure 2 – SPY SPDRs Trust Series – 60 min chart  
Secondary Corrections of a Primary Trend



Credit: TradeStation.com

This chart clearly shows two examples of secondary corrections of a primary trend; note how one example retraced all the way to 62 percent, and one example just touched 38 percent.

### The Minor/Short-Term Trend

Very simply, minor or short-term trends are a series of three or more "distinguishable" short-term waves that make up an intermediate swing, within either the primary or the secondary trend.

**Figure 3** shows that the minor trends within the direction of the primary trend have lower lows and lower highs and, conversely, that minor trends within the secondary trend have higher highs and higher lows.

A trader would generally assume that a minor trend rally within the scope of a down primary trend would have a high probability of failing and continuing lower and, thus, minor trend retracements in the secondary trend would have a high probability failing and continuing higher.

A trader must also be aware of the primary trend when trading the minor trends. Also in **Figure 3**, one can see that trading minor waves in the direction of the secondary trend holds greater risk as the primary trend can resume at any time.

**Figure 3 – SPY SPDRs Trust Series – 60 min chart  
Primary Trend, Intermediate and Minor Trends**



Credit: TradeStation.com

The red broken lines on this chart indicate the primary trend of the market. The blue broken lines indicate the secondary trend, which is considered a corrective price retracement within the primary trend. The solid lines on this chart indicate minor trends, which are typically a series of shorter-term waves that occur within both the primary and secondary trends. See **Figure 4** for a 15-minute time frame example detailing a segment from **Figure 3**.

**Figure 4 – SPY SPDRs Trust Series – 15 min chart  
The Minor Trend**



Credit: TradeStation.com

This example shows a segment of the intermediate trend from September 12 to September 25, 2002, detailing the minor trend with a series of lower lows and lower highs.

## The Theory Compares the Ocean's Tide and the Market's Trend

*“The tide, the wave and the ripple represent, respectively, the primary or major, the secondary or intermediate, and the minor trends of the market.”*

Though this may be a bit trite, it's nonetheless apropos of market trends in their various states of importance. If we take a close look at the market's **primary trend**, it is similar in respect to the ocean's tide. The bullish market can be compared to a rising tide where the waves continue to push further up the beach each time the water rises until a high tide sets in. The reverse is true for a bearish market or an ebb tide, where the ocean's tide continues to recede, and each push of waves onto the beach falls short of the mark of the last preceding wave.

The **intermediate or secondary trend** is compared to waves. Each wave is an intermediate trend, either primary or secondary depending on whether its movement is with or against the direction of the tide. And, finally, a **minor trend**, the shortest type of trend, can be likened to the surface water being constantly agitated by wavelets, ripples and “cat-paws” moving with or against or across the trend of the waves.

## Tools of the Trade for Today's Technical Chart Analyst

*“Like a carpenter who uses blueprints and a wide assortment of tools to properly build a house, a trader also needs the proper tools to do his job correctly. A trader uses these tools to determine recognizable chart patterns and spot trends across multiple time frames as short as a one-minute chart or as long a weekly chart.”*

**Pivot highs and pivot lows** are important chart points. Depending on which time frame the trader is watching will determine that chart's pivot high or low. Twenty-day highs and lows are considered important chart points, as well as weekly highs and lows for showing major chart point support and resistance levels. A basic example is shown in **Figure 1**, in which each high/higher high and low/lower low are pivot highs and lows.

Regarding retracement levels, today's charting program trend line tools allow the trader to plot a “support/resistance;” these are 38-50-62% lines plotted on the chart from significant highs and lows. (**Figure 2** shows the use of these retracement levels.)

## Patterns, Volume and Confirmation

The trader's toolbox includes a good variety of tools, and they can be used in combination or individually. Some are used more than others. The theory considers trading volume and its relationship to price, indexes and their relationship to each other, reversal and confirmation patterns, and chart patterns to help analyze the trend. In later charts, we'll put all of these tools into play, but initially, let's take the four of them one at a time.

You've heard that **“volume goes with the trend,”** and it's true. Trading volume is one of the best tools to help confirm a trend, but also is one of more misunderstood areas of technical analysis. In a bullish trending market, as prices rise, volume activity increases to confirm the advance in prices for the direction of the primary trend. The reverse is true for a bearish trending market. As prices decline, volume will rise to confirm the bearish trend. In a secondary correction of a bullish trend, prices decline against the primary trend and volume typically dries up. In a bearish trend, secondary recoveries or

rallies in price will see the same decrease in volume. (Figure 5 shows this very vividly.)

**“Lines may substitute for secondaries.”** A line in terms of the Dow Theory is considered a sideways movement in which prices trend in a narrow range for an extended period of time. For instance, a daily chart may trend sideways in a “line” from as little as two weeks to as much as three months. If using a shorter-term time frame, a 15-minute chart, for example, the time frame of the “line” would be hours sideways in a narrow range.

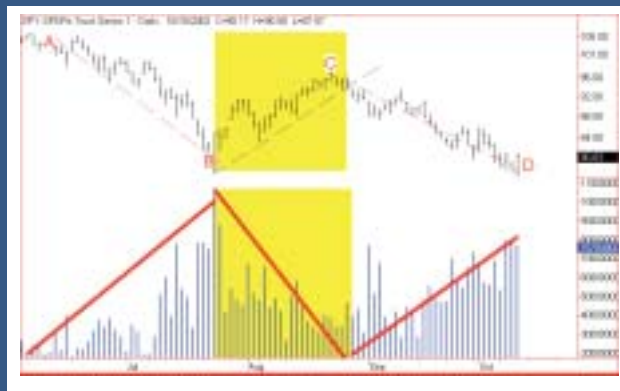
The longer and narrower the “line” is, the greater the possibility for a more substantial breakout. “Lines” may occur at tops or bottoms, but typically they take place during consolidation areas in the progress of an established primary trend. A “line” may form in lieu of a normal secondary reaction. One average, the NASDAQ for example, may form a “line” while the S&P has a normal secondary reaction. A breakout up through the “line” is bullish, and a break down through the “line” is bearish. It’s hard to predict in most cases the direction of the breakout of the line in advance. (See Figure 6)

**“The two averages must confirm.”** This theory was based upon the primary industrials average and the railroad average around the turn of the century. The present day primary indexes are the Dow, S&P and NASDAQ, and are used in terms of confirmation and non-confirmation of the primary trend. Confirmation would be the three indexes all making new highs or lows together. Non-confirmation would be one index not confirming the other two. For example, the Dow and the NASDAQ make new highs and S&P does not. Non-confirmation of indexes is also called a “price divergence.” (See Figure 7)

Then there are the continuation and reversal patterns. **“A trend should be assumed to continue in effect until such time as its reversal has been definitely signaled,”** is perhaps one of the most important lynchpins in the entire Dow Theory. Many a trader has heard the term, “the trend is your friend” or “don’t buck the trend.” Therefore, a trend with momentum has a greater probability of continuing as opposed to failing and reversing sharply. Some examples of continuation patterns are bull flags, bear flags, bull pennants, and bear pennants, rising and falling wedges. Some examples of reversal patterns are broadening, head and shoulders, and double tops and bottoms. These will be discussed in greater detail in a subsequent article. (See Figure 8 for a continuation pattern and Figure 9 for a reversal pattern.)

*continued on page 88*

Figure 5 – SPY SPDRs Trust Series – Daily Chart Volume As an Indicator



*Credit: TradeStation.com*

*This figure shows a detailed view of how volume “goes with the trend.” The increased volume with the primary trend is shown between points A and B and between points C and D. Volume dries up on its secondary reaction (B to C).*

Figure 6 – SPY SPDRs Trust Series – Weekly chart  
The Sideways “Line”



*Credit: TradeStation.com*

*The thick red line crosses through almost all of the bars in a sideways line, indicating a narrow range on the time frame that lasted from early November 2001 until early June 2002. The eventual breakdown from the “line” was a bearish signal that led to an eventual loss of nearly 20 percent of its value in less than two months.*

Figure 7 – SPY SPDRs, QQQ and DIA – Daily chart  
Confirming Averages

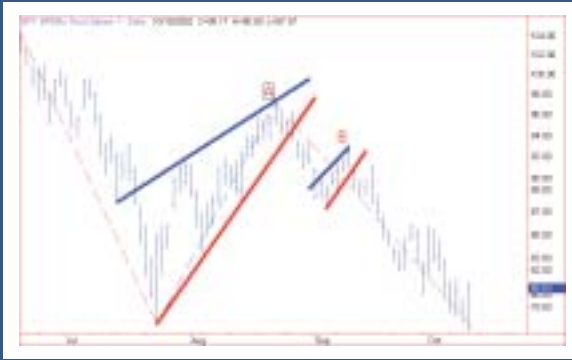


*Credit: TradeStation.com*

*This daily chart shows that the new lows in the QQQ were not confirmed by the SPY and DIA as they made higher lows.*



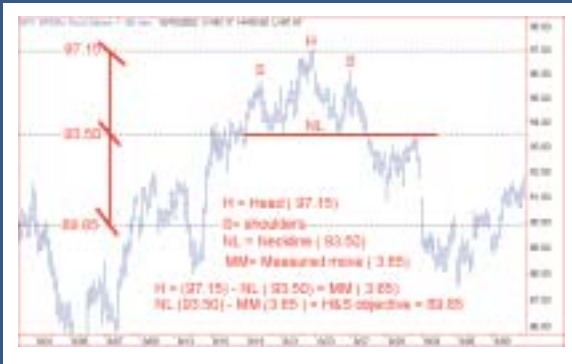
**Figure 8 – SPY SPDRs Trust Series – Daily chart Continuation Pattern**



Credit: TradeStation.com

These continuation patterns, also considered “secondary and minor trends,” confirm the direction of the primary trend. The figure shows a rising wedge at point A and a bear-flag pattern at point B.

**Figure 9 – SPY SPDRs Trust Series – 60 min chart Head & Shoulders Pattern**



Credit: TradeStation.com

A head & shoulders (H&S) pattern is a reversal pattern and can be used for both tops and bottoms of a trend. H&S patterns forecast a measured move, for a topping pattern, using the high of the head (in this case using 97.15), subtracting the value of the neckline (93.50), with the resulting number, in this case, 3.65. Subtracting that number from the neckline will give a “measured move” objective; in this case, it is 89.85.

## Basic Examples of the Dow Theory at Work

The following charts will show how the reader could improve his market timing using the concepts we have discussed.

**Figure 10 – SPY SPDRs Trust Series – Daily chart Larger Picture of Primary Trend from May 2002 – October 2002**



Credit: TradeStation.com

Figure 10 shows the larger-term primary trend From May 2002 into October 2002. The red lines indicate that the primary trend was down, and the blue line indicates that the secondary trend was up. The following examples in Figures 11 and 12 illustrate an even more detailed view of this chart.

## Putting It All Together

By combining a few tools, such as a retracement zone of 38 to 62 percent, volume, a bearish chart pattern, and a shorter-term reversal pattern, the trader will have an easier time of effectively timing the market turning points with increased accuracy, or it will allow him to enter into the direction of the trend properly once the market turns in favor of the primary trend again.

## The Dow Average

Most suppose that Charles Dow, who posthumously was credited as the inventor of the Dow Theory, was either a financier or a high-powered corporate executive. In fact, he was neither, confining his business talents to anonymous journalism in the *Wall Street Journal* and a way to make sense of a confusing market.

In 1884, he began his stock average with a dozen stocks, mostly railroads, since the iron horses were the sturdy leaders of the day. By 1896, he had introduced the industrial average as well. His theory, which really was seated in

the fundamental school, was that if industrial stocks were headed upward, investors must have seen the potential. Likewise, if the railroad stocks were rising, the potential for them was good, too. And, the two were linked, he reasoned, because the railroads were in the business of transporting products of industry. Pretty simple stuff, actually.

Over the years, of course, the average has changed dramatically just as railways have given way to airplanes. The number of components included in the average has increased from 12 to 20 to 30 as the U.S. economy has

expanded. Further, the Dow's focus has shifted from agricultural products and basic materials such as coal, iron, lead, rubber and leather to technology companies, financial services providers, manufacturers, and retailers. And while some question the composition of the un-weighted Dow as not being broad enough to be representative of the market, it does indeed represent each important sector in the stock market.

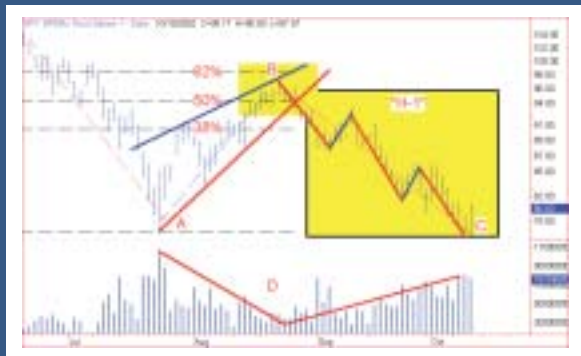
Had Dow lived a longer life, he might have been surprised to see that his namesake today includes no transportation issues.

In **Figure 11**, the letters “A” through “C” illustrate chart points from which the chart reader can take away a wealth of information. A reference to each chart point with the notes below will help give the reader a detailed breakdown, based on the tenets of the Dow Theory.

**A few notes on Figure 11:**

- “A” to “B” is a secondary correction against the primary trend; “B” to “C” is an intermediate trend in the direction of the primary trend.
- “A” is an important “pivot low;” leading to that low, there was increased volume that confirms the primary trend, and the price low also had the highest volume day in months.
- “B” - Market retraces up to around the 50-percent retracement level of its previous secondary trend high.
- “A to B” shows a rising wedge pattern (from Figure 8/Figure 11) and the highlighted area “B” is a head and shoulders topping pattern on a 60-minute chart (from Figures 9 and 12).
- “C” shows the re-test of the pivot low, support from “A.”
- “D” - Volume increased into pivot low “A,” subsequently dried up as prices rose into “B,” and again increased as prices tested into “C.”
- “H-1” shows a segment of the primary trend, as originally detailed in Figures 1, 2 and 3.

**Figure 11 – SPY SPDRs Trust Series – Daily chart  
Putting the Tools Together**



Credit: TradeStation.com

*This chart pulls a number of the pieces of the Dow Theory together and details how the various tools are used to help confirm the trend and reversal zone. (Also see Figure 12, showing reversal pattern on shorter-term time frame.)*

**Figure 12 – SPY SPDRs Trust Series – 60 min chart  
Head & Shoulders Pattern (from Figure 9) Combined with  
Larger-Term Chart Pattern & Rising Wedge (from Figure 8)**



Credit: TradeStation.com

*This figure shows a Head and Shoulders topping pattern, a reversal pattern on a shorter-term 60-minute chart. Combine this with a rising wedge (bearish) on a larger-time frame – daily – and see how the two time frames and patterns mesh to give traders some market direction.*

It would be a massive undertaking to give a chart example and an explanation for each and every rule of the Dow Theory. My intention, though an abbreviated one, was simply to give an *overview* of the Dow Theory and to educate the reader on its basic concepts, as well as to give various examples of some of these rules and show how they can be applied in *multiple* time frames. In essence, these principles should assist traders in their chart analysis. Credit for the analysis of these time-tested technical principles is given to **Technical Analysis of Stock Trends** (7th edition), by Robert D. Edwards and John Magee, the book that outlines “The Dow Theory.” These theories serve for the basis of my trading and for the trading of countless others.

In closing, readers should understand that before applying any of these concepts and risking trading capital, they must have a full understanding of the tools they are using, the time frame or frames involved and a feel for market conditions. Armed with that knowledge, they should have a considerably easier time making sense of their charts and what those might portend. **SFO**

*Christopher Terry is a full-time stock and index futures trader. In addition to his trading, Chris and his partner, New Market Wizard Linda Bradford Raschke, provide a real-time online trading service that provides entry and exit signals for stock traders at [www.lbrcapital.com](http://www.lbrcapital.com).*

*This article includes text from “The Dow Theory” from **Technical Analysis of Stock Trends, 7th Edition** by Robert Edwards and John Magee.*