Trending, Inside and Outside Bars

This article was written some years ago, but is very relevant to today. The charts used to illustrate the text are now somewhat dated, but still relevant for the present purpose of teaching a technique.

Many of the best strategies for trading the stockmarket are based on exploiting a trend. This stands to reason, because the basic idea behind trading is to buy a stock that is trending upwards and hold it until that trend is finished. The problem is that what is very simple to state can be quite difficult to do.

The difficulties arise because many beginners do not know how to recognise when a trend starts and when it finishes. Charting is not an exact science. It is a skill that is based on judgement, which is developed from experience. It is not difficult to teach the knowledge, but it takes time and effort to gain the experience that imparts sound judgement.

Critics might take this to mean that trading using charts is a black art akin to magic. This criticism is common and derives from a lack of understanding of the task. It is easy to define a trend. However, within a trend there will be periods of non-trending price action. Sometimes they will be precursors to the end of a trend, but at other times the trend will continue after a pause. The skill comes in to knowing how to recognise and manage these non-trending periods.

A perfect uptrend is a series of price bars whose highs are above the highs of the previous bar and whose lows are also above the lows of the previous bars. These bars might be for periods as short as one minute, but most commonly, traders will be working with price bars for one day and investors will be working with price bars for one week.

This idea of a perfect uptrend is a simple one. Ideally, a good uptrend will go higher every day than it went the day before and will not fall back on any day as low as it fell the day before. This is describing what buyers and sellers are doing:

- The high of a day is the maximum extent of the commitment of buyers. If the trend is up, we would like to see buyers being keen enough to take prices higher today than they did yesterday.

- The low of the day is the maximum extent of the commitment of sellers. If the trend is up, we would like to also see that sellers are reluctant to sell today at lower prices than they offered at the point of their lowest commitment yesterday.

In other words, buyers are prepared to bid prices higher and sellers are also no longer prepared to offer their shares at prices as low as they did yesterday. What we are seeing in the price bars is not just prices, but what buyers and sellers are prepared to do.

A downtrend is simply the reverse of an uptrend. Each price bar in a perfect downtrend has a lower high and a lower low than the price bar before it.

Identifying the start of a trend is easy. If we see a bar that has a higher high and a higher low than the bar before it, prices are trending upward. This says that an uptrend is present. It does not say anything about how long it will last. It will last until we can see a downtrend. It may be the next bar or it may be many bars later.

If we see a bar appear that has a lower high and a lower low than the previous bar, prices are now trending downward. Like the uptrend, this says the downtrend is present, but tells us nothing about how long it will last. It will last until we see an uptrend.

If a trend lasts for many bars, it is possible to make good profits, if we have the skills to trade that trend. However, if the trend does not last for long, it is unlikely that we will have a good trading experience. So, identifying the trend is the easy part. The difficult bit is dealing with non-trending bars.

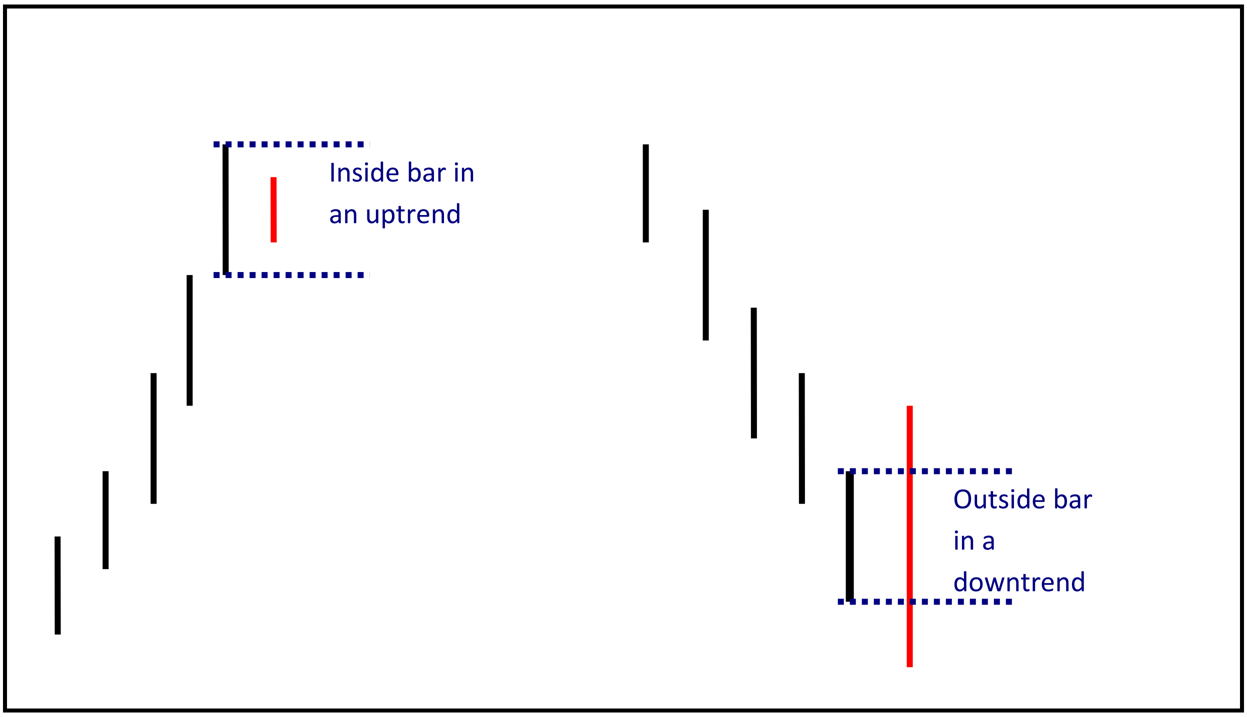
Non-trending bars are those that are not trending bars. Logically, there are a limited number of basic types of non-trending bars. The two key types of non-trending bars are called inside bars and outside bars:

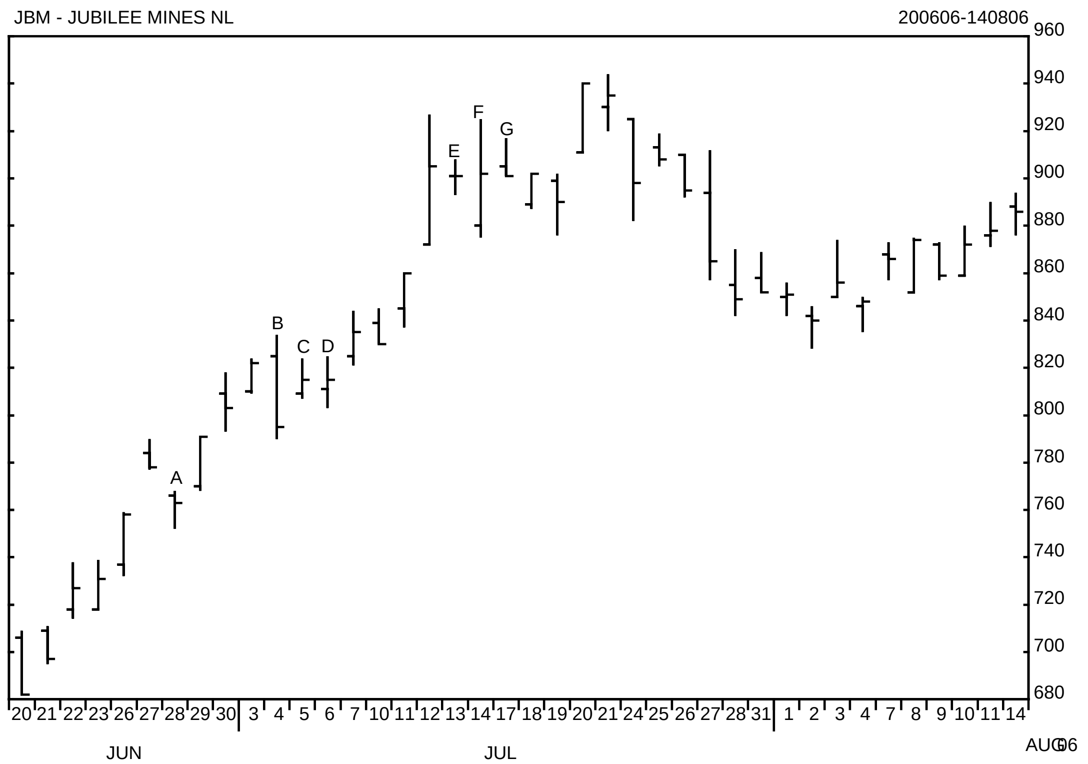
An inside bar is one whose high is lower and whose low is higher that the previous bar. This is a clear signal of weakness in the trend. Weakness is evident because in an uptrend, buyers are less keen than they were the day before. However, it is no more than weakness, because sellers are still basically bullish, as evidenced by not being prepared to offer their shares at prices as low as they did the day before. In a downtrend, the situation is reversed. An inside bar still denotes weakness in the trend, but this time it is the sellers who have showed indecision by not offering their shares as low as they did the bar before. The buyers are still basically bearish because they have not been prepared to bid for shares at prices even as high as they did the previous day.

An outside bar is one whose high is higher and whose low is lower than the previous bar. This is also a clear sign of indecision or weakness in the trend. Weakness and indecision is evident because buyers are prepared to bid for shares at higher prices, but sellers are also prepared to offer their shares at lower prices than in the previous bar. So, one side is still committed to the trend, but the other side is not as committed as it was.

Weakness, as exhibited by either inside or outside days, should be respected. The trend may well continue after a pause, but the risk is now higher that the weakness is a harbinger of a reversal of the trend. The diagram below shows the two basic non-trending bars.

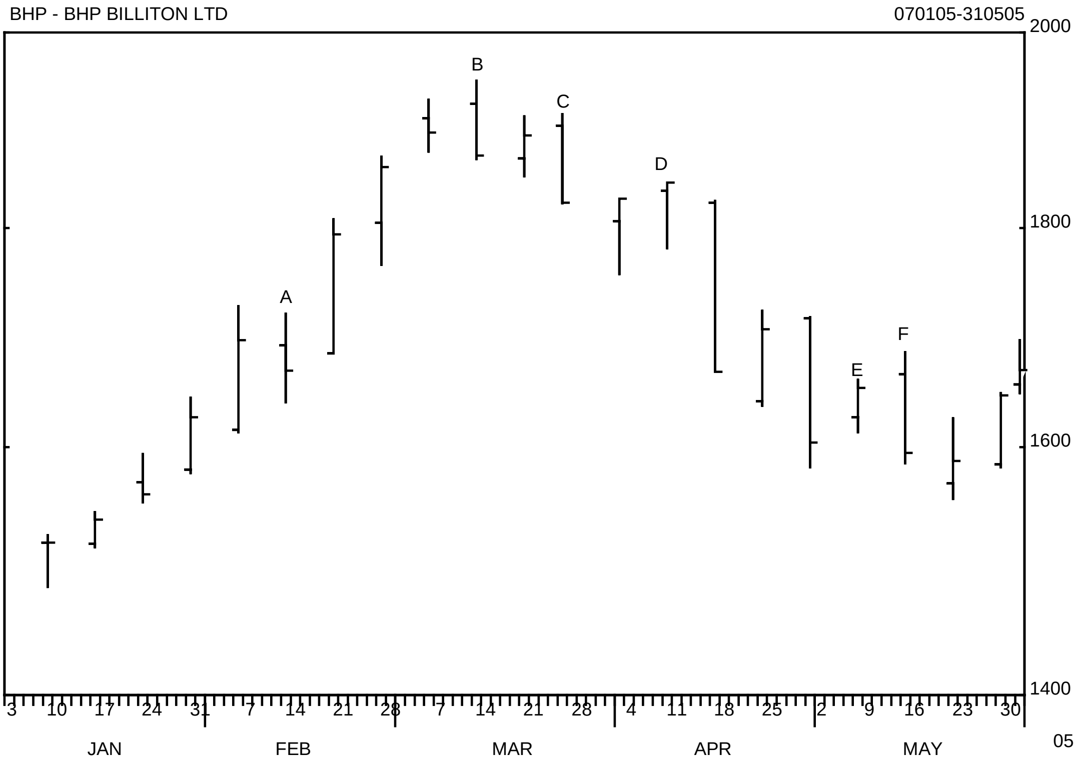
There are a number of other possible non-trending bars, which are special borderline cases. These are when one extreme of an inside or outside bar is not below or above the previous bar, but equal to it. These are not true inside or outside bars, because one extreme of the bar is not inside or outside the previous bar, but equal to it. Their meaning is similar to the pure inside or outside bars, but the strength of the indication is somewhat weaker.





Daily bar chart Jubilee Mines

This example shows how the suggestion of weakness by inside and outside days may be warning that a pause is in progress mid-trend. Later, a similar indication of weakness forewarned the end of the trend. The daily bar chart of Jubilee Mines shows an uptrend starting in June 2006. There was a temporary trend change at A, which may have seen traders exit and then have to buy back the next day. B saw weakness exhibited by an outside bar, followed by an inside bar C and another outside bar D. After this pause, when traders might have closed up their stop-loss levels, but held on, the trend resumed. Precursors of the end of the trend were seen in the form of an inside bar at E, followed by an outside bar at F and yet another inside day at G. The trend then tried one last hurrah, before a mild correction set in. Traders who were aware of the need to respect weakness should have been on guard on both occasions and prepared to act if the trend failed.



Weekly bar chart BHP Billiton

This example shows how investors could use the same knowledge. The weekly bar chart of BHP Billiton shows an uptrend beginning in January 2005. An inside bar at A gave a warning of what turned out to be only a one-week pause in a strong uptrend. The trend ran nicely to March, when an outside bar at B gave single week's warning of a correction. Another outside bar at C, suggested lack of commitment by sellers and this was reinforced by a one-week change of trend at D. Then the downtrend resumed. The warning that the end of the correction may be near came in the form of an inside bar at E, followed by an outside bar at F. Investors who understood that this weakness may present an imminent buying opportunity, should have been ready to act at the end of May, when the major uptrend resumed.