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The article can be found at: http://www.futuresmag.com/industry/references/demark1097.html (Clay)

High-quality entries

In the first of a series of articles, Tom DeMark discusses the importance of applying a set of breakout qualifiers on a trendline breakout before entering a trade.

By Tom DeMark and T.J. DeMark

When a trendline breakout is anticipated and obvious, invariably it will fail, but when the breakout is unexpected, it generally is valid. The explanation for this phenomenon is if a breakout is presumed obvious, then collectively traders already have been positioned for this break and have "spent" their investments. A lack of additional funds will make it difficult for the breakout to sustain itself.

However, if a breakout is unexpected and the requisite breakout qualifier occurs, the impetus for a valid breakout exists. Typically, the market then accelerates in the direction of the new trend once there is a realization and an admission of the breakout.

So by introducing a set of breakout qualifiers, a trendline breakout will become an ideal entry price level for a trade in the direction of the new trend. Alternatively, if the breakout fails to meet any of the qualifiers, it will enable the astute trader to trade against the anticipated trend (see "Do the right thing") [at the end of this article -- Clay].

This also provides you with an opportunity to participate in positive "price slippage" if a market order is placed because the trading public usually is aggressive with market orders when it expects price to break out. But because a subsequent breakout eventually will be qualified, it's essential to install a close stop loss. Alternatively, you can use a practice of exiting on the close of the entry bar. In both cases, the possibility of trading against the prevailing trend and capitalizing on short-term price swings exist if you're alert.

Trendlines A critical phase in this process is the selection of the correct price points required to draw a trendline. Fundamental information influences market perceptions. It's important the price level selection process be sufficiently sensitive to adapt to and identify these fluctuations, achieved by connecting the two most recent price pivot points required to construct a trendline. To do this properly, figuratively speaking, select the two trendline price points "from right to left" rather than referring to the left side of a price chart and arbitrarily connecting one price point to another price point to the right of that value.

To construct a demand line, identify the two most recent low price points that immediately precede the price bar before and immediately succeed the price bar after with higher price lows. If the low is equal to the low of the prior price bar, then refer to the bar immediately before the

first of the two equal lows to determine whether a valid TD Point low has been identified. The most recent of the two price bars then should be selected as the TD Demand Point. Once the most recent TD Point low (demand point) has been selected, refer back in time to the next most recent lower TD Point low and connect the two points to construct a TD Demand Line. As new TD Point lows are formed, continue to reconstruct the demand line (see "Qualified work") [at the end of this article].

Conversely, to draw a supply line, select the two most recent high price points, which immediately are preceded by the price bar before and immediately succeeded by the price bar after by lower price highs. Again, if the high is equal to the high of the prior price bar, then refer to the bar immediately before the first of the two equal highs to determine whether a valid TD Point has been identified. The most recent of the two price bars then should be selected as the TD Supply Point. Once the most recent TD Point high (supply point) has been selected, refer back in time to the next most recent higher TD Point high and connect the two points to construct a TD Supply Line. As new TD Points high are formed, continue to redraw the supply line (see "Qualified work").

Another consideration relates to the confirmation of a TD Supply or TD Demand Line. This is accomplished by providing an option, which requires not only the highs of a TD Supply Line be descending but also the respective closes or lows for the same price bars be declining. Conversely, for a TD Demand Line, not only must the lows be ascending, but the respective price bars' closes or highs should be too. Such requirements enable you to deal with inconclusive trendlines that previously had been the bane of most conventional technicians because they are drawn basically flat.

As you can see, the trendline process can be made objective and mechanical. Drawing trendlines no longer becomes a subjective hit-or-miss exercise. In fact, by methodically defining the point selection and introducing a set of qualifiers, you can calculate price projections, as well as determine whether a breakout is legitimate or illegitimate and therefore should be "faded."

Qualifiers Qualifier #1 provides that if an upside breakout above a TD Supply Line were to occur, the closing price one trading bar before the breakout must be less than the closing price two trading bars before the breakout. Conversely, Qualifier #1 provides that if a downside breakout below a TD Demand Line were to occur, the closing price one trading bar before the breakout must be greater than the closing price two trading bars before the breakout. Establishing this closing price relationship and subsequently recording a breakout indicates the trading community likely will be skeptical of the breakout intrabar and will not participate until the close of the breakout bar. By reviewing those factors present when the closing price confirmed the intrabar breakout, you're often able to avoid the price forfeiture that arises when you fail to enter the trade at the intrabar breakout and await the breakout bar's close. But by not fulfilling Qualifier #1, you are not precluded from entering the trade intrabar because additional qualifiers can be fulfilled instead, which will provide similar justification for intrabar breakout entry.

If Qualifier #1 is not met, then Qualifier #2 may justify intrabar breakout entry. Qualifier #2 provides that: 1) the open be greater than the TD Supply Line for an upside breakout or below the TD Demand Line for a downside breakout; 2) the open be greater than the previous price

bar's close for an upside breakout or less than the previous day's close for a downside breakout; and 3) price advance one or two ticks above the opening price subsequent to the open for a upside breakout or price decline one or two ticks below the opening price for a downside breakout.

Qualifier #2 indicates the supply/ demand relationship has changed sufficiently since the previous price bar's close to suggest a valid breakout and intrabar entry. To confirm the breakout and to prevent entering on the opening, which might coincide with a price exhaustion caused by news, specialists, floor traders or big block activity, price also must follow through in the direction of the breakout by one or two ticks. In addition, this will eliminate the risk of exiting a trade in the wrong direction on an intra-bar opening price spike.

If the first two qualifiers are not met, then Qualifier #3, which utilizes a simple measure of market demand and supply, is an option that can justify intrabar entry. A measure of market demand (or buying pressure) can be determined by calculating the difference between the closing price and that same price bar's true low (that price bar's low or the previous day's close, whichever is less). A threshold level then could be calculated by adding the previous bar's buying pressure to its closing price. If the TD Supply Line is above this level while the current price bar's high is able to exceed the buying pressure threshold (and then surpass the TD Supply Line), the implication is that the intrabar breakout above the TD Supply Line is legitimate.

Similarly, a measure of market supply (or selling pressure) can be determined by calculating the difference between a closing price and that same price bar's true high (that price bar's high or the previous day's close, whichever is greater). A threshold level then could be calculated by subtracting the previous bar's selling pressure from its closing price. If the TD Demand Line is below this level while the current price bar's low is able to exceed the selling pressure threshold (and then surpass the TD Demand Line), then the implication is that the intrabar breakout below the TD Demand Line is legitimate.

Usually, if the demand threshold is above the TD Supply Line or the supply threshold is below the TD Demand Line, the likelihood of the market exceeding both the TD Line and then the previous bar's expression of demand or supply is less likely. This is because the TD Line serves as such formidable resistance or support, it makes it virtually impossible for the price to exceed the calculated threshold level as well.

Other tools Another possible qualifier, currently being tested to determine its effectiveness, relates the breakout level to the true price range of the price bar before the breakout. Often, when a market records a one-price bar move from the previous bar's close greater than 1.8 times the previous bar's true price range, a short-term overbought (if the move is up) or oversold (if the move is down) condition is recorded. Consequently, if subsequent to a TD Line breakout this move is accomplished, then an exit should be taken at that time. If the TD Line breakout for the same price bar occurs subsequent to a 1.8-times price move, then the TD Line breakout is not qualified (see "Working on it") [at the end of this article -- Clay].

Although it is not a qualifier in itself, the TD Line Gap (a combination of a TD Line and a TD Gap) also has been effective in identifying breakouts. By connecting the most recent TD Point

with the first subsequent price gap (low failing to intersect the previous price bar's high upside or high failing to intersect the previous price bar's low downside), breakouts can be identified simply. The application lends credence to the fact that price gaps must be considered in market timing analysis because they identify instances in which the supply and demand equilibrium becomes distorted. These conclusions were the result of an extended analysis of price vacuums (gaps) conducted many years ago.

In the case of a gap to the downside, the TD Line Gap connects the recent TD Point high with the high of the gap bar. Alternatively, in the case of a gap to the upside, the TD Line Gap connects the recent TD Point low with the low of the gap bar. This technique also can be used in case of a so-called price lap (low intersecting the previous bar's high but failing to intersect the previous bar's close or high intersecting the previous bar's low but failing to intersect the previous bar's close). Just as with traditional TD Lines, TD Breakout Qualifiers and TD Price Projections techniques can be applied effectively as well.

Exits Once a position is taken, there are three ways to cancel the trade. We'll review these in the context of an upside breakout above a TD Supply Line, which can be reversed for a downside breakout beneath a TD Demand Line. Cancellation #1 refers to those instances when the opening of the price bar immediately succeeding the breakout is below the TD Supply Line, thereby implying that the breakout has been reversed. The recognition of the importance of the ensuing price bar's opening price as a breakout confirmation was the catalyst for it being referred to as the TD Critical Qualifier.

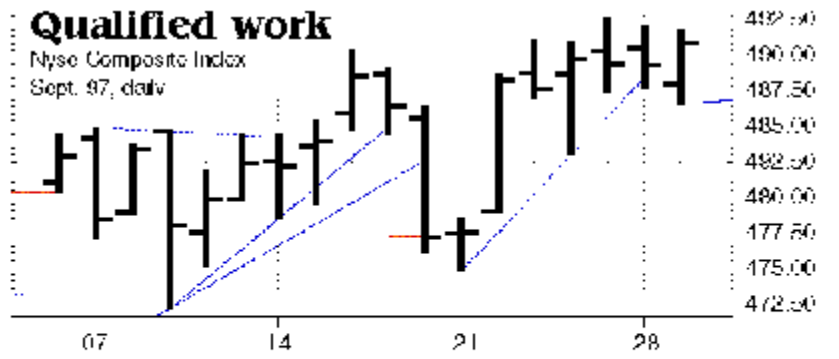
The second cancellation is introduced when the opening of the price bar immediately succeeding the breakout is less than the breakout bar's close, and the close that same bar is below the TD Supply Line. Cancellation #3 applies to those instances when the high of the price bar immediately succeeding the upside breakout fails to exceed the high of the breakout bar. Any one or all three of these cancellations can be introduced at any time.

Price projections Price symmetry is pervasive throughout the markets. Often the price movement beneath a TD Line is replicated once a qualified TD Line is broken upside and the reverse is observed when broken downside. There are three methods to calculate price objectives based upon qualified TD Line breakouts. The recommended method to calculate an upside price objective subsequent to a qualified TD Line upside breakout requires that a trader calculate the difference between the lowest, most extreme price beneath a TD Supply Line and the TD Supply Line immediately above it beginning from the left most TD Point through the price breakout bar and then adding that difference to the breakout price (see "Symmetrical moves") [at the end of this article].

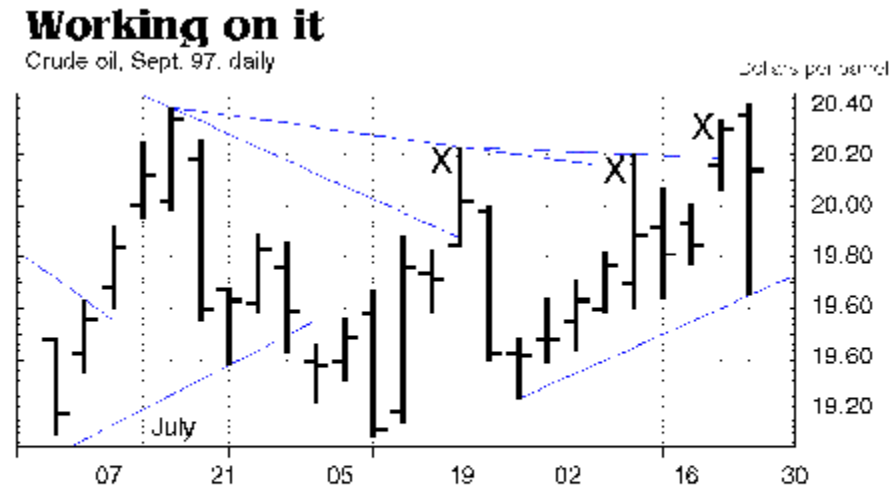
Conversely, to calculate a downside price objective subsequent to a qualified TD Line downside breakout requires you to calculate the difference between the highest, most extreme price above a TD Demand Line and the TD Demand Line immediately beneath it beginning from the left most TD Point through the price breakout bar and then subtract that difference from the breakout price (see "Do the right thing") [at the end of this article]. Although it is common to retain a price objective until it has been satisfied, it is obvious that once a contradictory TD Line has been

broken, the dynamics of the market have shifted sufficiently to warrant reversing a position and ignoring the price objective that subsequently has been canceled.

Note how these disqualified TD Lines repelled price. Also, note that in each instance none of the TD Qualifiers were met.

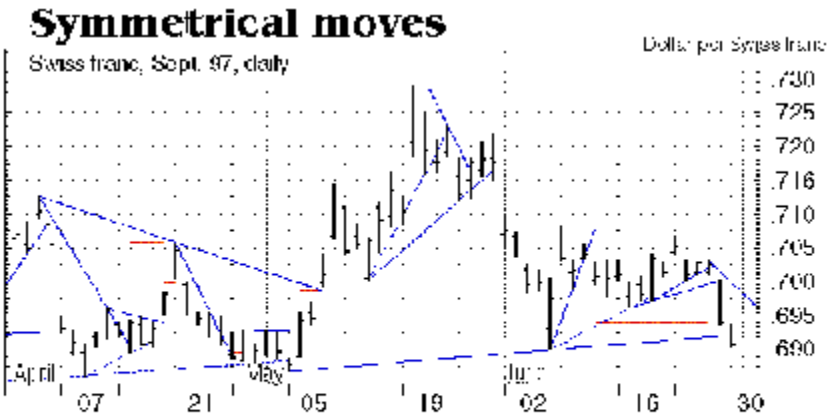


This chart displays both Qualified (solid) and Disqualified (dotted) TD Lines. By using the right set of qualifiers, the cunning trader can avoid being caught napping.



The Xs mark short-term overbought levels. When price reaches these levels on the same price bar as the breakout the trader should exit the trade.

Source: CQG



On this chart various qualified TD Line breakouts (blue lines) are identified with their price objective zones (red lines).

Source: CQG

Tom DeMark is the author of The New Science of Technical Analysis *and* New Market Timing Techniques *(John Wiley & Sons). T.J. DeMark is a futures broker with Merrill Lynch in Chicago. TD Line, TD Point, TD Supply Line, TD Demand Line, TD Breakout Qualifiers, TD Line Gap, TD Critical Qualifier and TD Price Projections are registered trademarks.*