



Drummond Geometry- Picking Off Significant Market Turning Points

Chicago based bond and S&P trader Ted Hearne in Part 2 of a two part series on Drummond Geometry shows how to trade turning points with confidence and skill.

It happened in Asia during the 1997 economic crisis. It happened in Japan's Nikkei at the peak of the 1989 bubble. It happened in the US stock market in the October 1987 stock market crash and again most notably in the United States NASDAQ stocks in March of 2001. And it may be happening now. What are we talking about? Those times of high emotion and volatile movements that accompany big-time market turns. These are not ordinary market turns but days when panic runs through dealing rooms like a tidal wave, or like high euphoria causes champagne to be uncorked as if it were soda pop.

While these are easy to spot in hindsight, few traders understand the tools and techniques that permit them to trade such quick movements with confidence and skill.

This is the second of two articles on the school of technical analysis called "Drummond Geometry," based on the work of the legendary Canadian trader named Charles Drummond. The first article in ChartPoint's May/June 2002 issue talked about the basics. This time we'll talk about that rapid market movement called an "exhaust".

First, a moment of review. There are three fundamental elements to Drummond Geometry. The PLdot is a short-term moving average that represents the heart of current market opinion and is charted on the first upcoming bar—the future bar that has yet to trade, or that is trading currently. The second fundamental element is the use of short-term, two-bar trend lines. These "Drummond Lines" indicate areas of energy termination, where the market is likely to stop its movement. The coordination of support and resistance in different timeframes is the third major tool of Drummond Geometry.

Using Drummond Geometry is a several step process. First, you establish support and resistance levels in the immediate projected

future. Then you align support and resistance levels on various time frames and take action when they coincide, and avoid action when they do not reinforce each other.

One special strength of this methodology is its ability to call market turns. When the support and resistance areas line up in several different timeframes, traders can anticipate the end of a move. If the directional move is ending, that is obviously an excellent place to take profits and to initiate a new position in the opposite direction.

Because the patterns identified by Drummond Geometry work equally well in both the short term and in longer time frames, this methodology is an excellent tool for day-traders as well as for those multi-month or multi-year investors. In this article we talk about how to trade that market condition known as exhausts. We will give special attention to intraday trading, showing how to find exhausts that terminate into daily resistance or support.

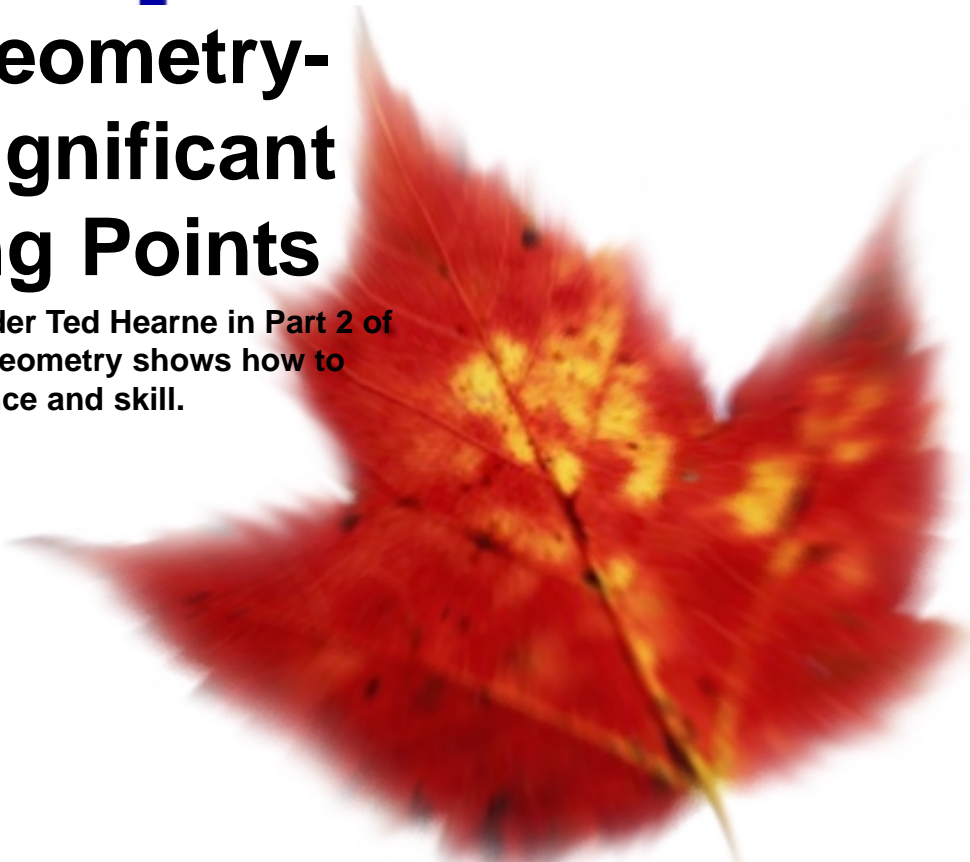
What is an exhaust? And when we have an exhaust, what happens?

An exhaust is a quick directional price move usually coming at the end of a trend, followed by a significant retracement. It is generally a move that is sudden, and sharp, and out-of-the-

ordinary. We call this special pattern an "exhaust" because when it hits the resistance or support that marks the extreme, it "exhausts its energy" and retraces rapidly and dramatically.

Let's think about this metaphorically for a moment. Sometimes a price move in the markets is like an airplane taking off, just rolling down the runway, with the wheels lifting off, and the shock absorbers extending, and then becoming airborne. There is a gradual change between being land-bound and flying. In this example the change in direction from horizontal to vertical is gradual and subtle.

An exhaust is the exact opposite. If we think about a stunt flyer in an air show, we can easily understand an exhaust. At some point in the show the stunt pilot will fly into a perfect vertical climb. Like a rocket he will be shooting straight up into the heavens until he can climb no further. Here the directional movement is clearly apparent, as we have a trend in full throttle. But then when gravity finally takes hold and the airplane can climb no further, and the engine can't run any harder, the stunt plane reaches an apex, turns, and falls directly back to earth. Everything changes direction all at once. That's an exhaust. The energy that drives the move is completely exhausted, and the turn in the opposite direction is quick and decisive.



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Note that in our analogy of the stunt flyer, the vertical climb of the plane is not exactly flying. When a plane is flying the wings support the plane and lift it through the air in comparatively gentle climbs and descents. But in this exhaust we have a powerful drive straight up, rammed through by the engine at full throttle, with the propeller pulling the plane vertically higher and higher. The sheer power of the engine running at full blast does the work.

Exhausts are like this. They manifest the end of a period of exceptionally strong market energy, and not the ordinary advance and retreat of a normal market oscillation.

Exhausts are creatures of a particular timeframe, and that is the key to their tradability. A powerful exhaust in one timeframe may look like a calm and normal oscillation in a higher timeframe. In fact, that insight will be our guide as we learn how to anticipate exhausts and how to predict where they will stop, and thus to be able to focus in on trading them.

Let's look at the characteristics of a market exhaust in more detail.

The first obvious point is that price "terminates" - that is, it stops moving in one direction. It is obviously running out of energy, or "exhausting" its energy. Thus, any time we see energy termination in any particular place, such as in a nearby support or resistance area, we can say we are seeing the market "stopping and exhausting."

The exhausts that we want to focus on are those with the greatest potential for profit, that is, those that are extra-ordinary. We want to identify those exhausts that occur outside the ordinary energy termination fields. The common garden-variety support and resistance that marks the high and low of every bar we might call the "near-at-hand" or "nearby" support or resistance. But we are interested in those situations where price breaks through this "near-at-hand" support or resistance and moves to the next level of support or resistance that lies further away. We can call this the "further out" support or resistance area.

So an exhaust is a market move that is out of the ordinary, that breaks through near-at-hand support or resistance and which terminates in the further-out support or resistance. Now here is a key point: The "further out" support or resistance of one time period is generally the nearby support or resistance of the next higher time-period.

Chart 1 S&P500



In Example 1 (Chart 1) drawn from the S&P 500 Index Futures we see the weekly near-at-hand support marked in green at "A". On the daily chart, this same weekly support area is marked as a green rectangle, and the daily near-at-hand support is marked in solid green ("B") and the daily further out support marked in solid red at "C". The support area at "B" broke during the day and price exhausted into the higher time period weekly support at "C." On the 60-minute chart we see this daily further out support exhaust area shown in red, and the 60-minute support lines shown in white. The 15-minute chart shows the daily further out support area in red.

Looking at the market action on this example, we see that the daily is exhausting into the nearby weekly support. On the weekly chart this market action looks like a normal oscillation, but we can see that on the daily chart this market action looks like a rather large, dramatic move to the downside, i.e. an exhaust. As price moved into this area, the trader would already know where the weekly and daily near-at-hand and further out support areas were located, and he or she would be alert to an exhaust and a rapid retreat. On the 60-minute chart we can see the 60-minute support lines start to hold on close, the first signal on that chart that an exhaust is occurring. The 15-minute chart would be already moving, ahead of the 60-minute. The 15-minute PLdot will start to push the market up as its support lines start to map out the 60-minute exhaust and the rapid move into the

daily exhaust, in nearby weekly support. The trader would see the rapid decline and rapid retreat on the 60-minute chart, and especially clearly on the 15-minute chart. Knowing in advance where the rapid movement is likely to stop and retrace gives the trader a strong leg up in his trading; he can act with confidence and take a position very, very near to the exact bottom of the move.

In trading the exhaust we are combining the concept of the "further out" support and resistance with the concept of "PLdot refresh." (See the article in the May/June 2002 ChartPoint for details on the PLdot refresh pattern.) These two concepts together will accommodate ninety percent of all exhaust trading.

Thus we say that price is in an exhaust when price moves beyond the normal flow of things, and has moved too far away from the happiness of the crowd, the PLdot. Exhausts have a direct relationship to the PLdot, because they are a reflection of the strength of the energy of the PLdot.

As we saw in the first article in this series, the PLdot represents the safety and security of the crowd, which is consensus opinion. If the PLdot creates enough energy as the crowd pushes price directionally, it will break through "nearby" support. The ordinary boundaries will not hold but will give way. (See "B" in example one. We speak only of a down move here but the principles apply to both an up-move breaking through resistance as well as support breaking in a down move.) Once the "nearby" support gives way, we are in an area where there is little support for the moment, and because there are few buyers then price can drop rapidly. When price reaches the next level of support, we will be alert to the possibility that the move will terminate its energy there and become an exhaust. (See area "C" in example one.) We call these areas the "further out" support or resistance areas. If the push of the crowd is strong enough, it can even cause these further out energy fields to break, in which case the exhaust will not terminate there but at some energy level that lies still further away.

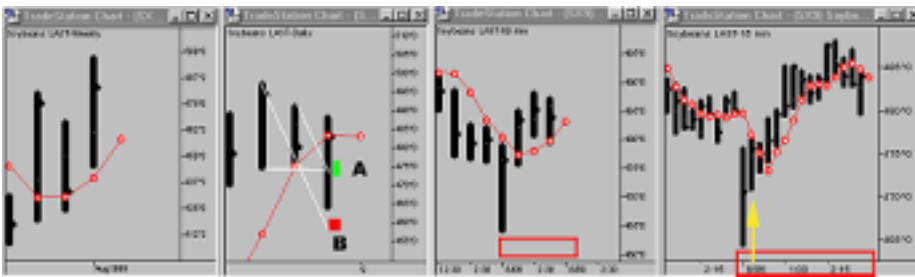
When prices move up to the resistance or support areas that are near at hand, that is, near to the previous price bars, that is what we normally expect. (See area "B" in example one.) That is "nearby" resistance or support. But when price breaks through this near resistance or support, and moves out into uncharted territory, then we are in the areas where exhausts occur.

At this point we look for support or resistance in the next higher-time period. (see "A" in example one.) When we see these support or resistance

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areas in a higher time period overlapping with the further out support or resistance areas on our focus time period, then we are in the area where we can anticipate an exhaust occurring.

Chart 2: Soybeans



Here is another example, this time from Soybeans (Chart 2).

In the first week of August the market had hit a peak and the weekly chart was starting to make a PLdot refresh move. On the daily chart on Friday, August 8th, nearby daily support (the green area at “A”) breaks on the opening and moves towards the further out daily support (the red area at “B”). The 60-minute chart shows an excellent upward close on the first hour, which signified that the first hour was indeed an exhaust. If it is an exhaust driven by the higher time periods, then the 15-minute bars will show excellent accumulation and we will expect a sustained upwards move, with the 15-minute nearby support continuously holding as the move progresses. The target of the move will be a daily PLdot refresh in the 485 area.

Characteristics

We note that exhausts have two essential characteristics.

The first characteristic is that prices do stop their directional move, and they generally stop at an extreme, often in support or resistance areas that lie a level or two beyond the normal support or resistance for the day in question (or more precisely put, for the time period in question.)

The second characteristic is that prices don't stay in that area but immediately and dramatically retreat, most usually to the PLdot or further.

So there are two things that we will look at in detail here. The first is the price-stopping activity of the support and resistance that is further away than normal from the day's activity. We need to know when an exhaust is likely. The second is the strength of the refresh or retracement activity. We need to know where prices are likely to retreat to when they stop their rapid directional activity.

How do we tell the difference between an exhaust and an ordinary move?

The speed of the move is fast, as the nearby support or resistance gives way and price breaks through to a new area. The space between the PLdots gets larger, as the slope of the trend and the momentum increased (use caution on this sign however, as the speed of a move taken alone can also mean the high energy of a new trend and not just the last hurrah of an old trend which is the typical exhaust.)

Exhausts happen suddenly and so in order to trade them well we must be nimble. Day-traders have frequent opportunities to see exhausts in action and to take advantage of them.

The most important element here is anticipation, because if we are to take action on short notice we must be ready to do so before the moment occurs, and then we must strike while the iron is hot. That means we must know ahead of time when we are in the area of the anticipated exhaust and be ready to take action. We must know what we expect to happen – that energy against the move will hold, and push price back into the retracement. We will see a PLdot Push (see first article in this series) on the lower time period in the direction of the retracement. All of this will happen rapidly, and if it does not happen rapidly, then we may not be looking at an exhaust.

Here is a checklist of the steps to successful exhaust trading. We use 60-minute bars against the daily bars for this example, but of course it could be any suitable intraday time-frame according to your preference, such as the 15-minute into the hourly bar. In this case we would be using the 15-minute

chart as a tool to monitor the events that are occurring on the 60-minute chart.

- Analyze the location of daily and weekly nearby and further out support and resistance.
- Analyze the locations of 60-minute nearby support and resistance as the 60-minute chart moves into the area of daily further-out support or resistance.
- Watch for situations when price breaks through the nearby 60-minute support or resistance and moves to 60-minute further out support or resistance, when those locations coincide with further out daily support or resistance.
- When you see a move that might be an exhaust, prepare to take action against the trend as it stops in higher time period (daily) further out support or resistance. Climb aboard in the opposite direction, looking first for a target of a retracement to the 60-minute PLdot. As the move continues, the 60-minute PLdot will start to push price towards the second target of the daily PLdot refresh or more. The 15-minute chart will confirm this move.

(These check points are as suitable for the longer-term trader as for the day-trader. Simply change the time period references to suit your trading style. A long-term trader might work with daily, weekly, monthly, and quarterly charts, for example. The principles are identical to the intraday trading guidelines given above.)

When we see the market act in this characteristic ways, and we see prices break nearby resistance (or support) and see them move to higher time period resistance (or support), then we take a position against the move. We are looking for a retracement that will at least carry us back to the PLdot, and may move much further.

Protection

What protection do we have against being wrong? Our protection is watchful monitoring on the lower time period, such as the 15-minute. If we are correct, and we have correctly identified an exhaust, then the first thing we will see is the market retrace to the 60-minute PLdot. If we are wrong, then we will see the market continue, and we will know that this is happening because the lower time period will show a characteristic “PLdot push” pattern that will continue through any HTP support or resistance (as discussed in article one of this series.)

Chart 3: Treasury Bonds



We always find it instructive to look at examples where the expected is NOT happening. In the next example (Chart 3), the 60-minute and 15-minute charts show how the daily is NOT exhausting into further out daily support or resistance. This is how things look when there is NO exhaust happening.

On the weekly chart there is a return to PLdot pattern at “A”, which could potentially create a daily exhaust down to it. On the daily chart we see nearby support (“B”) breaking, but so does further out daily support (the red area at “C”) as the weekly bar returns to its PLdot. We would be alert at area “C” to the possibility of an exhaust. But on the 60-minute chart we see that red rectangle showing further out daily support not holding. The 60-minute and the 15-minute charts slice right through this support, and it is clear that we are not seeing a rapid retracement building at that point. By monitoring the action on the 15-minute chart we can quickly and easily tell if the expected action we anticipate is occurring or not.

Reasons

Why do we like to trade exhausts? There are several reasons, all of them good.

First, exhausts represent unusual activity when the market moves in a more volatile and emotional manner. The bar that shows the exhaust has a greater range with more unusual activity than not. We like to take advantage of this unusual activity since it normally has high potential. If we are going to see a retracement, then we want to see one that will carry us a longer way.

Second, we like exhausts because it is an opportunity to go against the crowd and to pick off the tops and bottoms of a move. It may be that we have been long and then reverse at the top of the move. It may be that we have been standing aside and we take a new position against the move as the exhaust comes to an apex. In taking action at the apex of the move we are getting the best possible price for the return ride.

What is happening within the crowd as we see an exhaust form in the market?
What does it “feel” like to be within that crowd?

Generally speaking, an exhaust is a time of very high energy, and is usually accompanied by panic and desperation on the part of some and uncontrollable euphoria on the part of others.

Can exhausts be predicted or anticipated? Yes, they can. Exhausts are always contained within the context of a higher timeframe. ALWAYS. If we have a clear understanding of where the support or resistance lies, we can move from general anticipation towards the more firmly held ideas of actual, precise, and reliable prediction.

Big Exhausts

What about “big exhausts”? A “big exhaust” can occur when we see multiple time-frames lining up (Example 4). These can represent an especially productive trade opportunity. Say we see the daily and the weekly and the hourly exhausts all lining up. This is an excellent opportunity and well worth waiting for. Why? Because the move to the PLdot refresh can occur on several timeframes, and a PLdot refresh that is driven by the higher timeframe refresh can be a very substantial move indeed.

Drummond Geometry Seminar Outline

Singapore - 25 Oct to 26 Oct 2002
Hong Kong - 29 Oct to 30 Oct 2002
Sydney - 7 Nov to 8 Nov 2002

Pre-seminar Evening (7.30pm - 9.30pm)

A brief introduction to Drummond Geometry and the power of time-coordinated market analysis Questions and answers will follow Mr Hearne’s presentation.

Two-Day Seminar (8.30am - 5.00pm) “Predicting Highs and Lows with Drummond Geometry.”

Day One

Introduction and Overview

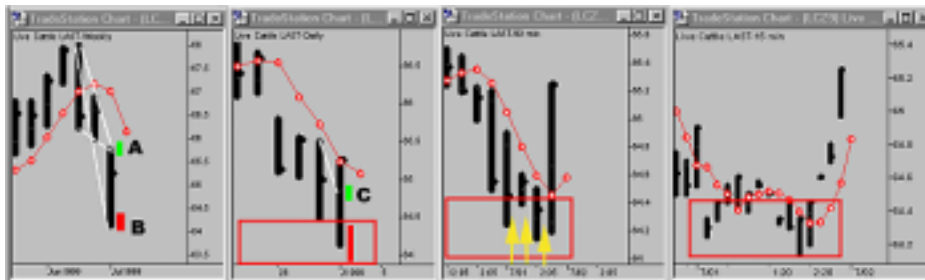
- Who is Charles Drummond?
- Track records and history
- What we will learn in the coming days
- Overview of the key elements: the Dot, the Lines, and Time-Periods
- Demonstration
- The fundamental concepts in detail
- The PLdot
- The termination lines
- The theory and practice of multiple time period coordination
- Projected support and resistance in multiple time periods
- Application and demonstrations
- Monitoring and market progression
- The envelope system
- Single time-period envelope
- Multiple time-period envelopes
- Monitoring tools and lines “breaking” or “holding”
- The “Types of Trading”
- Review of the day, forecast of tomorrow

Day Two

- Assembling support and resistance tools into zones
- What is “nearby” and what is “further out”
- Market “flow” and how to monitor it
- Putting it all together
- Trading plans
- The simple key to trading psychology: Man as a machine
- Money management, stops and personal management
- Software issues
- Three foolproof trading plans
- Trading timeframes: day-trading, swing-trading, monthly trades, and “Grand Scheme” trading
- Future plans and current research
- Educational opportunities
- Review of the material

For registration details, refer to page 13

Chart 4: Live Cattle



Example 4 (Chart 4) shows us a productive situation in Live Cattle. We see a weekly chart breaking through it's near by support and continuing to its further out support. This has a dramatic effect on the chart patterns for the lower time periods, especially the hourly and the 15-minute charts.

On the weekly chart, nearby support at "A" breaks during the week and towards the end of the week, the market moves towards the weekly further out support at "B" red area. At this time you would anticipate further out daily support to hold in this area and be an exhaust as well. On the daily chart in this example we can see the further out daily support set up in the red rectangle of further out weekly support. This sets up a return to the daily PLdot at the same time that we expect a return to the weekly PLdot. On the 60-minute chart we show the weekly and daily further out area with a red rectangle. The three yellow arrows show the hourly closing up off their lows, showing us that support was holding, and telling us that this was indeed an exhaust area. We would be anticipating a rapid move up, just as there was a rapid move down into this exhaust area. We see this hourly, daily, and weekly support all holding on the 15-minute chart, where we would be monitoring the action closely, watching for the rapid up-move that we anticipate coming. The day-trader using this methodology would be at the bottom of the move. As long as hourly support holds, the trade is intact.

So, in summary, an exhaust is a rapid movement in one direction followed by a sharp retracement. Exhausts exist in all timeframes and in all markets, and they are a reflection of a fundamental pattern of human behavior. Exhausts can be extraordinarily profitable and Drummond Geometry is especially well suited to help you take advantage of this market phenomenon.

Ted Hearne is a bond and S&P trader based in Chicago. The material in these articles is adapted from the 30 Lessons of the P&L School of Drummond Geometry (Copyright © 2000-2002 by Ted Hearne and Charles Drummond). Contact Hearne via the websites www.tedtick.com and www.pldot.com.

Ted Hearne will be conducting a 2-day seminar on Drummond Geometry in Singapore on Oct 25-26 2002, in Hong Kong on Oct 29-30 2002 and in Sydney on Nov 7-8. For further details please refer to page xx or visit www.chartpoint.biz or e-mail sales@chartpoint.biz.

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