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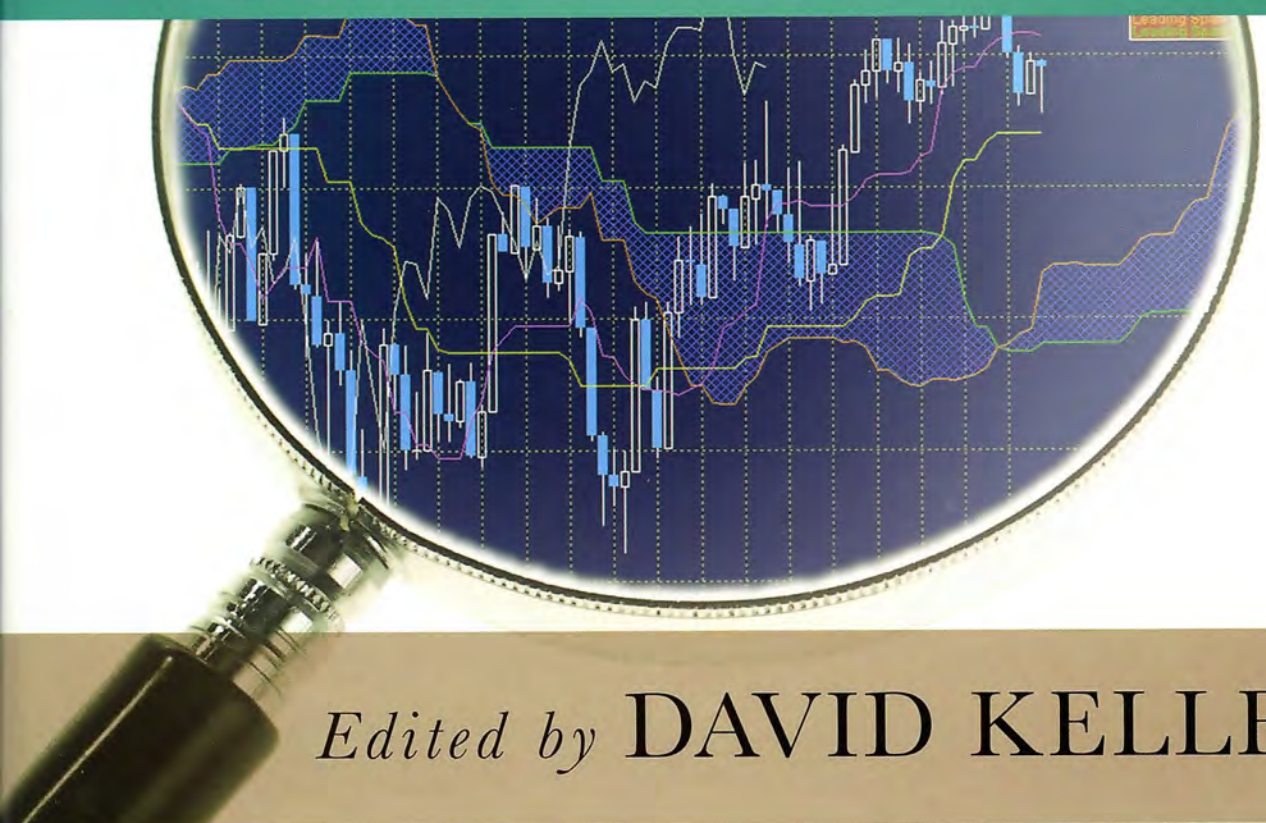


Edited by DAVID KELLER

CHAPTER 1

Drummond Geometry: Picking Yearly Highs and Lows in Interbank Forex Trading

TED HEARNE

What if you could predict the yearly high and the yearly low in a major currency? If, at the start of the year, you could have a definite idea where the high will form in the Japanese yen or the Canadian dollar or the euro? Or if you knew where the market was headed many months ahead of time? Making an educated, accurate forecast of next year's high and low in every currency is surely the dream of every trader—a fantasy of omniscience and unlimited power over the markets.

In trading, as in war or building suspension bridges or performing transplant surgery or creating a new auto design or any complex undertaking, success is a function of many different elements—a combination of having the proper tools, the necessary knowledge, and the appropriate personal characteristics. If you would like to be one of the few who make accurate, high-probability, long-term forecasts about market highs and lows, then read on, because there are some little-known tools and a coherent body of knowledge that can help you.

Drummond Geometry

The practice of technical analysis has a few commonly accepted assumptions. Drummond Geometry builds on these with its own unique point of view:

1. Charts have patterns that can be identified and will reoccur.
2. Similar chart patterns exist in different time frames.
3. Prices in a given time frame will center on a consensus value, and when price moves away from that consensus, it will tend to revert to a mean. But this mean itself will be moving and changing as the market unfolds.
4. Support and resistance are real phenomena, and can be measured, predicted, and projected.
5. Time frame charts are interrelated, move simultaneously, and can be visualized as existing within each other.
6. Historical price charts of freely traded financial markets are the visual

representation of human crowd psychology in action.

7. Support and resistance in different time frames react to price in predictable ways. The shorter time frames will react first, and then progressively longer time frames kick in.

These statements are simple, but when logically applied to the broadest context, using a coherent set of analytic tools, the implications are staggering. The trading theories and methodology I discuss here are based on the writings of Charles Drummond, the legendary Canadian trader who is emerging as one of the major market theorists of the twentieth century. He is not only a major theorist but also a hugely successful private trader who has the personal track record to back up the theory.

Drummond's substantial body of writings, privately published and distributed under nondisclosure agreements to his growing body of students, constitutes a major step forward in technical analysis. Many aspects of the work remain proprietary and not accessible in a public medium, but some of the main principles and underlying concepts, as well as their application to the long-term Forex markets, are free to be discussed in forums such as this chapter.

The methodology has come to be known as Drummond Geometry and consists of three main elements, or components:

- The identification of resistance and support and their projection into the future
- A description of the market's current state and its next anticipated state
- Multiple time period analysis, coordinating the first two elements in two, three, four, or more time frames

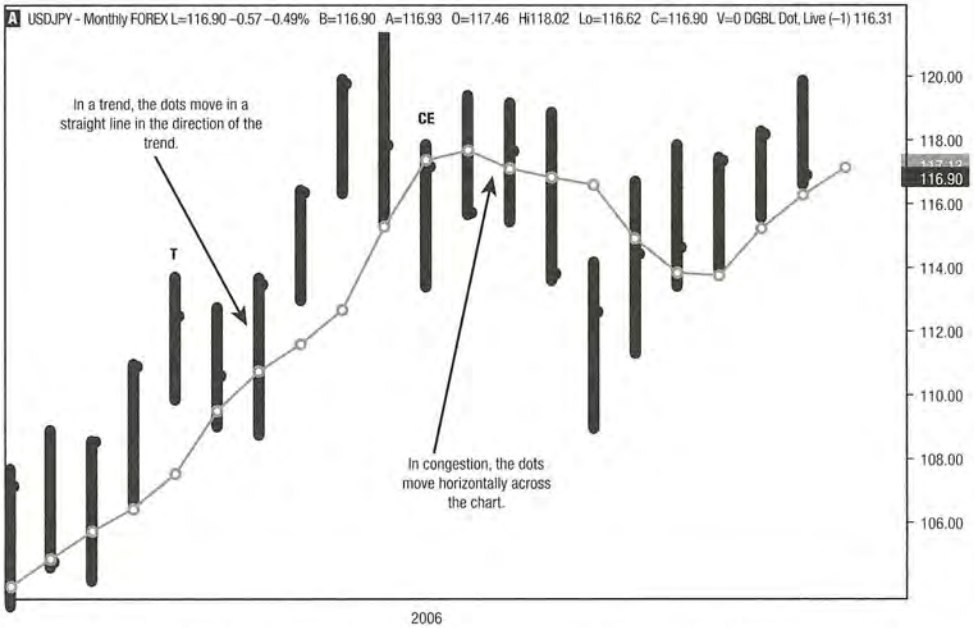
In Drummond Geometry, these three elements are combined into a coherent whole with specific rules for entries and exits, a methodology for monitoring and evaluating market moves, and a way to project viable turning points and targets within each time frame.

Projecting Resistance and Support

The idea of resistance and support is a key concept of technical analysis. Resistance is when buying peters out and selling increases, stopping and reversing an upward move; support is the reverse, when selling abates and buying begins, forcing price upward. Conventional technical analysis looks backward at where resistance and support have been located in the past and suggests that the

FIGURE 1.1

The PLdot



Source: Ted Hearne Associates, Inc.

same levels will be used in the future.

Drummond Geometry takes a different approach. Although it constructs these levels out of conventional tools such as moving averages and trend lines, it projects constantly evolving resistance and support areas into the future and watches how price reacts to these levels as the market moves forward.

The core building block of Drummond Geometry is a short-term moving average called "the PLdot" (see **Figure 1.1**). The PLdot was developed in response to the search for a tool that would distinguish between trend and congestion and run in a straight line sloped upward or downward in a trend but that would quickly and responsively indicate changes in market situation. The tool was empirically derived, and investigations resulted in the moving average known as the "Drummond Dot," or the PLdot.

The PLdot (PL stands for point and line) is a short-term moving average based on three price bars of data, which captures the trend/nontrend activity of the time frame that is being charted. The PLdot from the last three bars is plot-

ted as a dot, or line, on the space where the next bar will appear.

The PLdot has a simple formula: the average of the average of the high, low, and close of the last three bars.

$$\text{PLdot} = \frac{\{\text{Avg}[H(1),L(1),C(1)] + \text{Avg}[H(2),L(2),C(2)] + \text{Avg}[H(3),L(3),C(3)]\}}{3}$$

The PLdot can be applied to any chart of any commodity, future, or stock. The first thing to note is that the dot is always there. It is a polestar in a constantly shifting universe, something that bears a constant relationship with the immediate past, capturing the recent energy of the hour, of the day, or of whatever period the trader is looking at.

What is so special about this particular moving average, the PLdot, that sets it apart from other moving averages? The characteristics of the dot prove to be useful in analysis. It moves across the chart horizontally in congestion, and when a trend develops, it immediately changes into a straight line slanted in the direction of the trend with very little lag. It is extraordinarily sensitive to trending markets; very quick to register the change of a market out of congestion into trend and sensitive to a trend that is ending, as well.

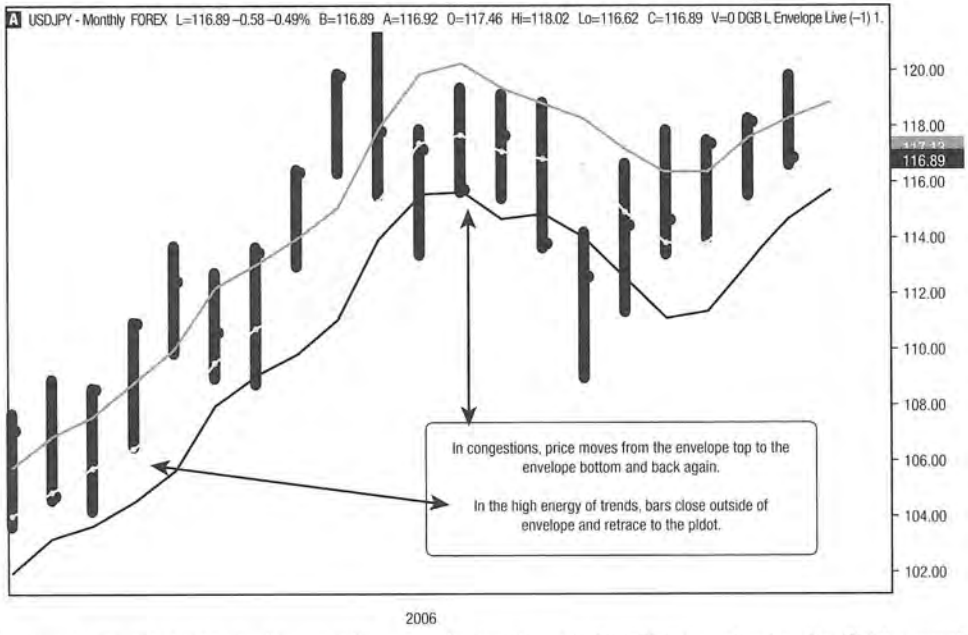
The PLdot captures the heart of market activity on the last three bars. In Drummond Geometry, this point would be thought of as the center of energy and represents the consensus of the crowd. But additional tools are needed to gauge the strength of moves away from this consensus. For this, other moving averages are added. To give the methodology greater muscle, Drummond added a simple envelope system constructed of a constant mathematical relationship based on the components of the dot. The resulting structure is illustrated in Figure 1.2.

Unlike many envelope systems, the objective here is not to contain all price activity within the envelope but to offer a constant, or a matrix, against which market moves can be measured. This turns out to be of great value when trying to tailor trading techniques to different market conditions.

The envelope system is also useful as a constant against which to measure the strength of recent and current market energy. When the market is in congestion, price tends to oscillate from one side of the envelope to another; thus, the trader has a pretty good idea of where the buying and selling zones will be placed in the market. But when the market is in a strong trend, the envelope functions dif-

FIGURE 1.2

The PLdot and Envelope in Trends and Congestion



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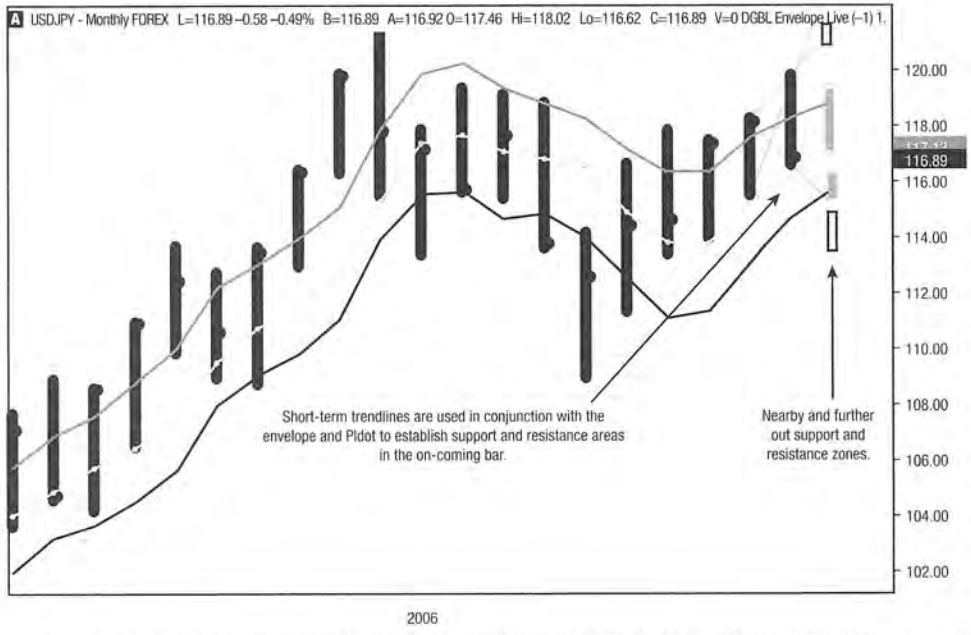
ferently. The PLdot can be seen as "pushing" price in a trend, and the envelope top or bottom will be broken in the direction of the trend, with price bars often closing outside the envelope, and the envelope itself functioning as support or resistance. Price retracements in a trend will not move to the opposite side of the envelope but instead tend to stop at the level of the PLdot. In a strong trend, the bars will close outside of the envelope until the trend pauses or has finished, at which point they will move back inside the envelope.

Both the PLdot and the envelope are useful elements in determining support and resistance levels, but by themselves they are not sufficient. To these elements, Drummond analysis adds a series of short-term, two-bar trend lines that flag areas where price is likely to terminate. In the full methodology, there are a significant number of these lines; here just a few are shown.

In **Figure 1.3**, we can see how these short-term trend lines contribute to the definition of nearby support and resistance areas (shown by a gray box) and the further out support and resistance areas (shown by a black-outlined box). Note also

FIGURE 1.3

Short-Term Trend Lines



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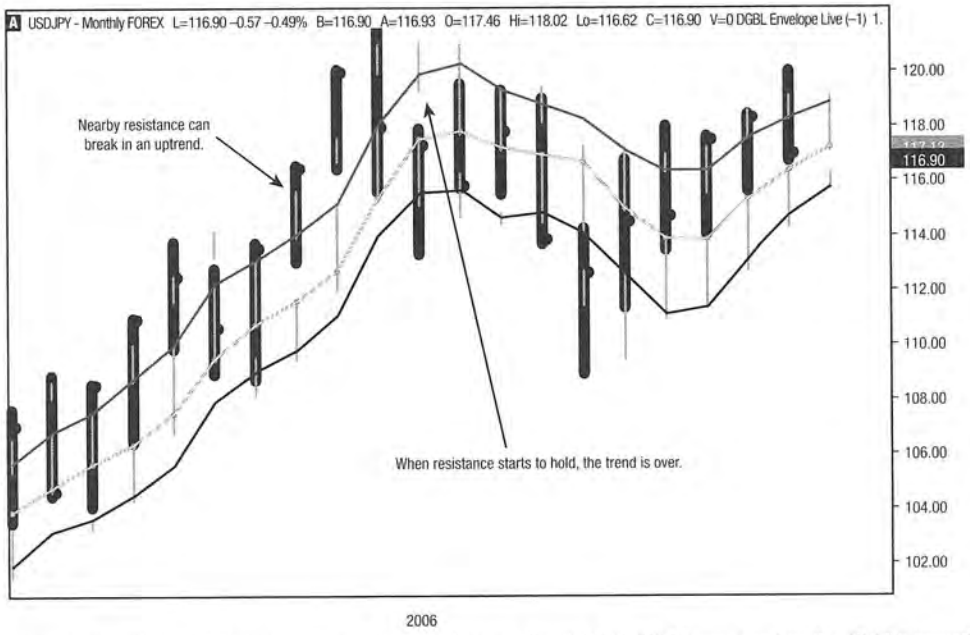
that these lines, along with the PLdot and the envelope, are projected into the near-term future, so that the trader always knows where the support and resistance areas are that the market is moving into. The trader does not focus on areas that existed in the past but is always oriented toward the developing future.

If we apply these elements to a chart, we see the full envelope system together with the support and resistance zones established by the envelope, the dot, and the short-term trend lines, with these tools all projected into the future, onto the bar that has not yet formed. This setup constitutes the basic chart framework for any single time frame in Drummond Geometry. In **Figure 1.4**, we can see this full set of tools applied to a chart. Note the resistance and support areas plotted on top of each bar, along with the envelope and the PLdot. The price bars are plotted using a heavyweight "fat" bar so that the resistance and support tools can be plotted on top of them without obliterating the price bars themselves. The critical point is that these elements are projected forward into the future so that the trader always sees them coming up at him, on the right-hand side of the chart

FIGURE 1.4

Computer-Generated "Nearby Support" and Resistance Areas



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as time ticks forward and market activity unfolds.

Now let's stop and consider these few components of the first major section of Drummond Geometry. We have the definition of support and resistance; we have a means of monitoring market energy (placement and movement within and outside of the envelope system), a means of determining current market direction and future shifts in that direction (dot direction and slope), and a means of determining where price energy will terminate (where price is likely to stop for a given bar). All of these elements are extremely valuable to the trader. But as helpful as these tools are, by themselves they are not enough for success.

Predicting the State of the Market

Now let's look at the second leg of this three-legged stool. We need to know what the market is doing *now*, and we need to know what we expect the market to do *next*. We need to understand and predict the "state" of the market.

In essence, we must establish the market's internal decision-making tree for

possible future actions. It's as if we could step inside the mind of the market, determine its present state of mind, and then determine the choices that are available to it for the immediate future. Applying a bit of logic, we can see that there are only a limited number of actions that the market can take. If the market is in a trend, for example, it has a very simple choice ahead of it. It can do only one of two things: continue that trend or enter congestion. If the market is in congestion, it can do only two things: continue that congestion or start to exit congestion into another trend. If you can develop clear and unambiguous definitions of trend and congestion, then determining the market's present type of trading and its next anticipated type of trading is a matter of quick and simple analysis. Knowing that the next type of trading will be one of two choices means that the trader can focus attention on the specific characteristics of the anticipated next type of trading and thus have a clear understanding of whether the pattern is actually occurring. And if it is not, then the trader knows that the alternate choice is occurring. This makes monitoring market action much more efficient and effective because the checkpoints and checklists to be watched are clear and easily identified.

Types of Trading

In Drummond Geometry there are only five types of trading:

- Trend
- Congestion entrance
- Congestion action
- Congestion exit
- Trend reversal

Each type is clearly defined: trend trading, for example, describes a situation in any given period when three successive price bars close on the same side of the PLdot. Thus, looking at the market at any point, we know whether that market is in a trend or not. Congestion entrance trading is characterized by the following: the market has been in a trend—that is, at least the last three bars have closed on one side of the PLdot—but the next bar closes on the opposite side of the PLdot. In Figure 1.1, the bar marked *T* (fifth bar from the left on the chart) defines the start of a trend because it is the third bar in a row that closes above the PLdot. The market remains in a trend until it reaches the bar marked *CE*, which is the first close on the opposite side of the PLdot; at that point, the market is in congestion entrance trading. Similar, unambiguous definitions cover con-

gestion action, congestion exit, and trend reversal trading. These unambiguous definitions put traders in the driver's seat, because they can watch for exactly the action that will be required to change the basic orientation or "state" of market action. The trader can monitor for precisely those elements that are expected to occur.

Multiple Time Period Analysis

The first two major elements of Drummond Geometry—the definition of future support and resistance and the definition of the anticipated market state, or next type of trading—give traders a leg up, because with them they can start to identify the potential turning points at support and resistance levels as the market moves forward. To these major elements Drummond Geometry adds the concepts of "dot push" and "dot refresh," which describe movement away from the dot and market movement returning to the dot, respectively. We can say that dots push trends, support and resistance areas terminate trends, and the market moves from one type of trading to another type of trading in a regular, predictable manner.

In Figure 1.4, we can see how the dots push a strong trend upward and that as the market moves upward, the dots act as support for the trend, the price bars close over the top of the envelope, and the price bars can break nearby resistance and move into the resistance areas further out. When the trend stops, nearby resistance becomes strong and holds, and the dots start to move sideways as the market churns through its congestion areas, oscillating between the nearby support and resistance areas, which tend to hold and not break.

These are excellent advances, but they are still not enough to provide a successful, reliable, and consistent approach to trading. To ensure success, we need one more major enhancement, and that constitutes the third leg of this three-legged stool of Drummond Geometry.

It is not enough to know where support and resistance lie in the near future. We must also know whether that support or resistance will be strong or weak. If it is strong, it will hold, causing the market to change direction and turn back; if it is weak, it will break and give way, letting the market proceed farther in the same direction.

Determining the relative strength of support or resistance is a bit of a dilemma because there is nothing on the conventional single time period chart that can tell a trader if resistance or support will be strong or weak. And yet this is often the most important information a trader could have, because it commonly

is the determining factor in deciding direction. If a trader has a firm handle on direction, then many of the other challenges fall into place and steady success is achievable. So if there is nothing that can be derived from conventional charting to provide this information, it must come from another source. In Drummond Geometry, that source is the chart of the same symbol viewed in a larger time resolution—a longer time frame—than the trading chart.

If, for example, the market has been trending upward in an hourly chart and the trader thinks it may turn around and enter congestion, he may indeed be correct. But without additional information there is no way to confirm this suspicion until after the market has made its move. However, if the trader places the hourly chart and its projected future support and resistance within the matrix of the daily chart's projected support and resistance areas, the context becomes clear. If the trader can see that hourly resistance has reached the anticipated daily resistance and daily resistance is anticipated to be strong based on the daily's position within the weekly and monthly matrix, then he can take action

FIGURE 1.5

Longer Time Period on a Shorter Time Period Chart

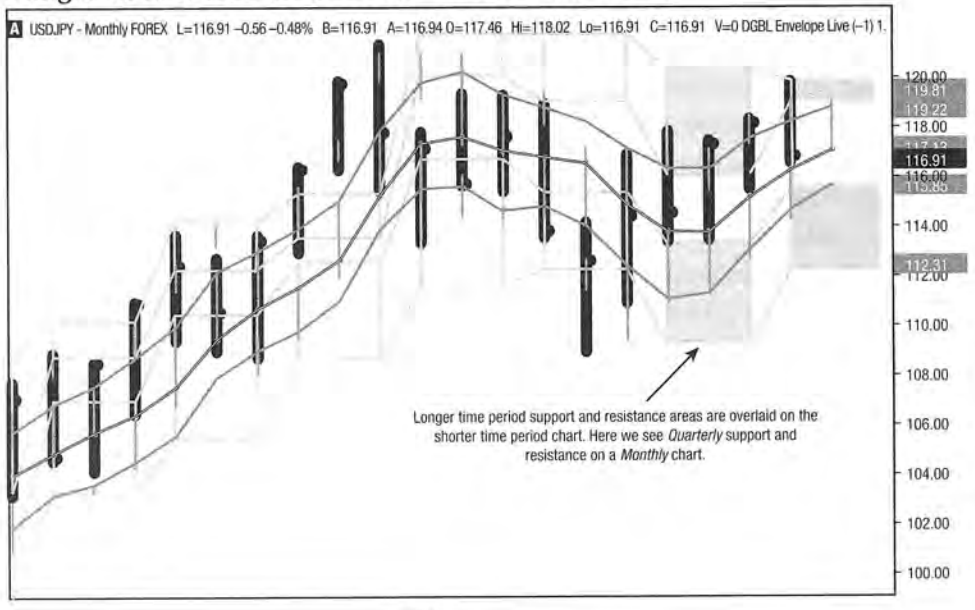


Chart created on TradeStation 8.2 using Drummond Geometry Long-Term Overlays.

Source: Ted Hearne Associates, Inc.

with about three times the confidence that would otherwise be warranted for this trading situation. That's a huge advantage.

Figure 1.5 shows the same USDJPY Forex monthly chart that is featured in the first four figures, in which each bar represents one month of market activity. But a new element has been added, namely the support and resistance areas from the *quarterly* USDJPY chart. These areas are represented by the thin white lines behind the price bars. To make the last two quarters' support and resistance areas more visible, I have made them gray blocks. Note how useful this can be. Not only do we see where the projected monthly support and resistance are, we also see the projected quarterly resistance overlaying the monthly chart. With this information, we can see that for the last bar of this chart, which represents the month of October 2006, the high formed above the month's nearby resistance but exactly at the top of the quarterly resistance. A Drummond Geometry trader looking at this chart at the beginning of October would have a strong indication that selling at that point would be a very good idea.

Applying Drummond Geometry to a Long-Term Forex Trade

I suggest that charts from all time periods have similar patterns that occur and reoccur, and all time frames are related. In other words, a market top on an hourly chart will of necessity be reflected by a market top on the five-minute chart of the same symbol. Traders generally recognize that it can be useful to look at hourly charts and daily charts of a market, although the techniques of coordinating the time frames may not be widely understood. But it is a rare trader indeed who understands that the patterns in long-term charts such as monthly, quarterly, yearly, two-and-a-half-year, and five-year charts are all similar and can be profitably included in the trader's analysis.

If I were to show you a long-time-frame chart but without the time designations on the horizontal axis or the price designations on the vertical axis, there would be nothing to indicate whether you were looking at a fifteen-minute chart, an hourly or a daily chart, or a weekly or monthly chart. By now you can guess where I'm going with this: it could also be a quarterly chart, in which each bar represents the market activity in one quarter; or a yearly chart, in which each bar represents one year's market activity; or an even longer-term chart, in which

each bar represents two and a half years' activity, or five years', or ten. On each of these charts, we can see trends, congestion, types of trading, dot pushes, terminations, and so forth. And on each chart the support and resistance levels can be projected into the future.

Why is this useful? A moment's reflection will make that clear. If we can project resistance and support on a yearly basis, then we have an advantage in predicting and monitoring market turns in those areas. If, for example, we can determine the market's yearly high or low in a major Forex market, then we can potentially take advantage of long-term moves with immense profits built into them. In the currency markets, with the eye-popping 400-to-1 leverage available even to small traders, very large profits are available.

Let's take a look at some charts and analyze these yearly charts and their shorter time frame components—for it is on the shorter time frames that we will first see the evidence of the yearly low or yearly high setting up and terminating energy in support and resistance.

In the tool chest of Drummond Geometry, there are concepts that can be used to structure many different kinds of trades. I will detail one entry signal here as an example, so that we can follow a sample trade on the long-term charts coming up. In **Figure 1.6**, we see a daily chart that shows what we call an "exhaust" and the entry signal that follows it. An exhaust is a market move of very high energy that breaks through nearby support or resistance and then reverses, much like a column of water in a fountain that has been pushed up and then tumbles back on itself when the energy that pushed it up can no longer hold up the weight of the water. For a trader, the challenge is to identify that exact moment when the push that sends price in one direction or the other has exhausted itself and the retracement has begun. Drummond Geometry offers the technical tools to identify this phenomenon. In Figure 1.6, we see this pattern: First the market breaks the nearby support level and the bar closes in that area. Then, in the following bar, the nearby support area holds and does not break. This pattern is an "exhaust buy" signal, and we will see many examples of this signal in the following chart analysis.

In **Figure 1.7**, we see three price charts of the USDJPY, which show how Drummond Geometry sets up time frame correlation. The support and resistance areas from the longer time frame chart are overlaid on the chart of the next shorter time frame. The left-hand chart is a two-year bar chart, in which each bar represents two years of activity. The large arrow shows how the nearby resistance for that bar is overlaid onto the chart to the right, which is a one-year

FIGURE 1.6

The Exhaust Buy Signal

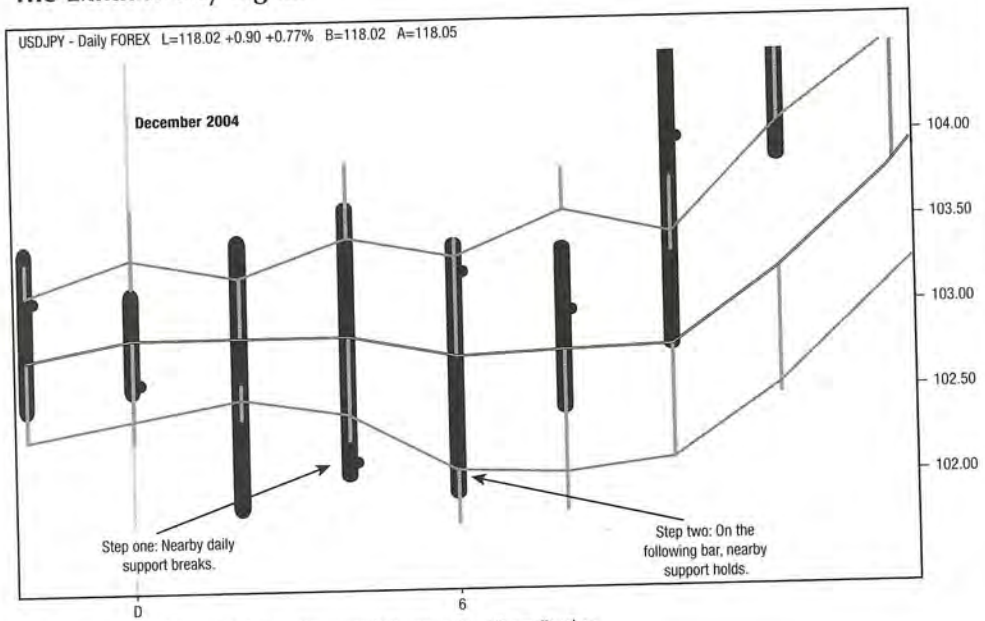


Chart created on TradeStation 8.2 using Drummond Geometry Long-Term Overlays.

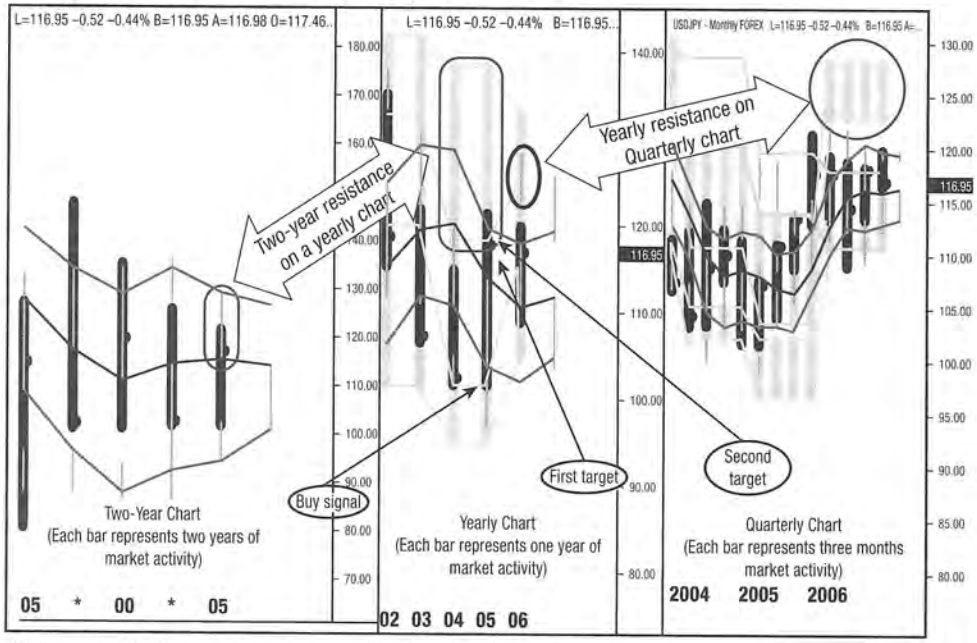
Source: Ted Hearne Associates, Inc.

bar chart. On the one-year chart, the two-year resistance is plotted as light gray bars positioned behind the one-year price bars. Similarly, the nearby resistance and support areas from the yearly chart are overlaid onto the quarterly chart on the right-hand side of this figure. At this point, it becomes clear how this correlation of time periods can be graphically represented. I have also shown on this yearly chart an exhaust buy signal, which occurred in the USDJPY at the very beginning of 2005. Although the time frame is radically different—one year bars in Figure 1.7 versus the daily bars of Figure 1.6—the technical pattern of the exhaust trade is identical.

In addition to the buy signal in Figure 1.7, I have marked two target areas for this long-term trade. How do I establish these areas? According to Drummond Geometry theory, the market will move from resistance to support, and when it reaches support, it will move back to resistance, and that pattern will occur in all time frames. Resistance and support will either be weak and break through to a secondary level of resistance or support, or they will hold and be strong, kicking prices back in the opposite direction.

FIGURE 1.7

Long-Term U.S. Dollar/Japanese Yen Charts



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If we have a yearly low, then what is the target for this currency? Where can we expect it to go on a yearly basis? The yearly target, like targets in other time frames in Drummond Geometry, depends on where the market is when it starts.

If the price starts from:

- far above the envelope, then the first target is the envelope top
- at the envelope top, then the target is the other side of the envelope, depending on what happens to the PLdot
- inside the envelope, then the target is the other side of the envelope or lower

In the case of the yearly chart in Figure 1.7, because the close of the price bar for 2004 was near the envelope bottom as projected for 2005, the target for 2005 will be the PLdot, and if that breaks and the market continues to the upside, then the secondary target would be the opposite side of the envelope system. Note

FIGURE 1.8

Trading the 2005 Yearly Bar

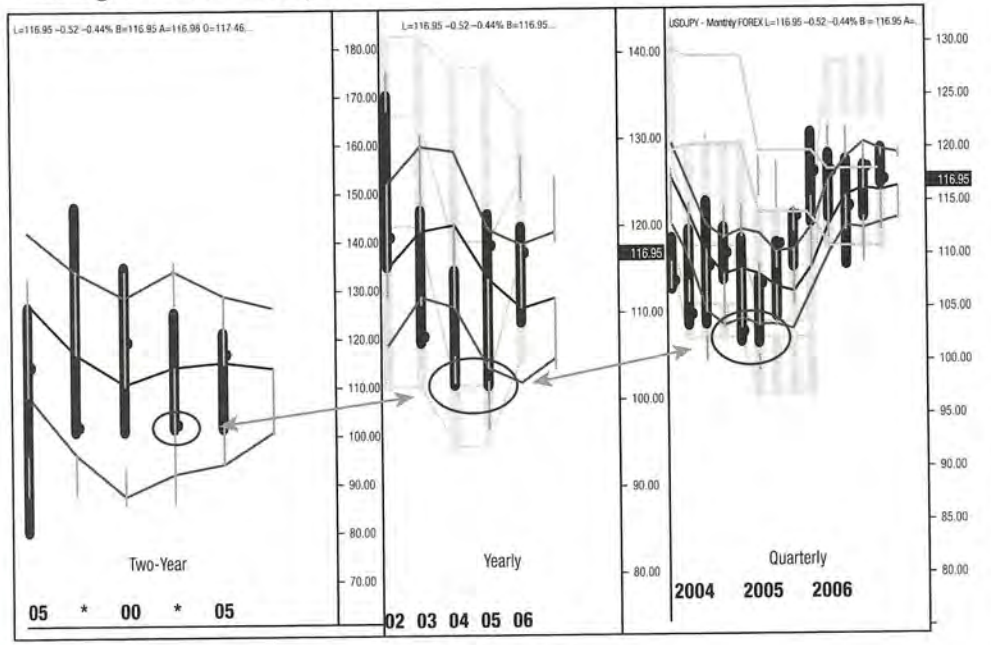


Chart created on TradeStation 8.2 using Drummond Geometry Long-Term Overlays.

that these targets are determined far in advance, at the close of December 2004, and projected out for 2005.

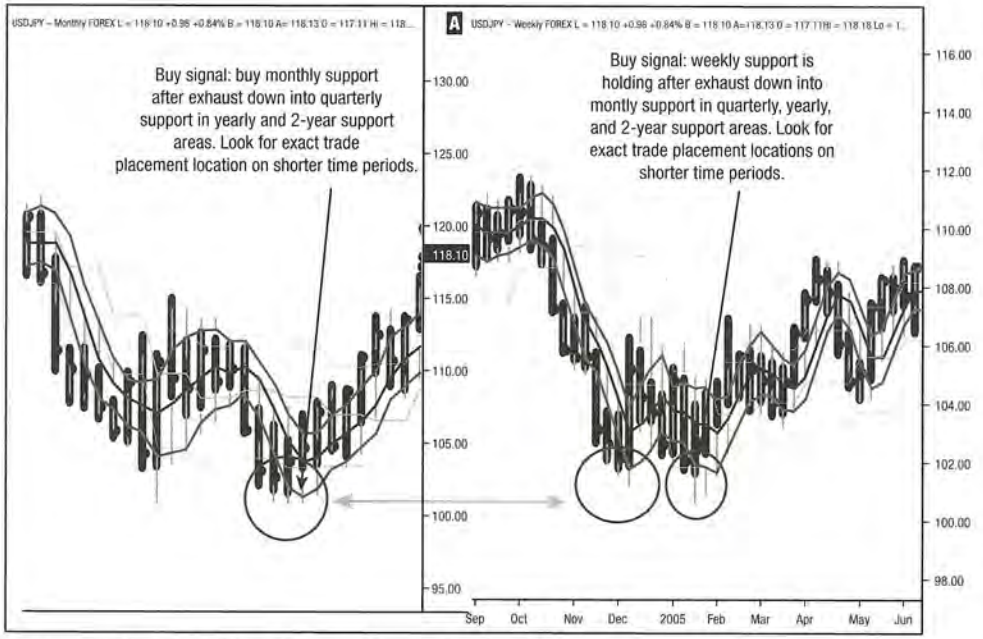
If we can say that it's likely that price, once it goes inside a channel, will go to the PLdot line or the opposite side of the channel, then we have a target for the year. And when the market gets to that target, then we reassess and make a judgment about the market's next goal.

Suppose that at the end of 2004, we were watching the U.S. dollar/Japanese yen exchange rate and were applying Drummond Geometry analysis to the market. What would we have been seeing? **Figure 1.8** (two-year, yearly, and quarterly charts) and **Figure 1.9** (monthly and weekly charts) lay out the basic dynamics, and **Figure 1.10** shows the exact entry points on a daily chart. From two-year bar charts all the way to daily charts—that's quite a span. But each contributes to the total picture and sets up a compelling case for a major market turn to the upside starting in December 2004 and January 2005.

(These last charts contain a lot of information and are a bit difficult to render

FIGURE 1.9

Trading the 2005 Yearly Bar: Monthly/Weekly Buy Signals



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in the black-and-white format necessary for print reproduction; on the computer screen, however, the use of color makes them easy and quick to read.)

Here is a breakdown of what we would have seen by applying this analysis:

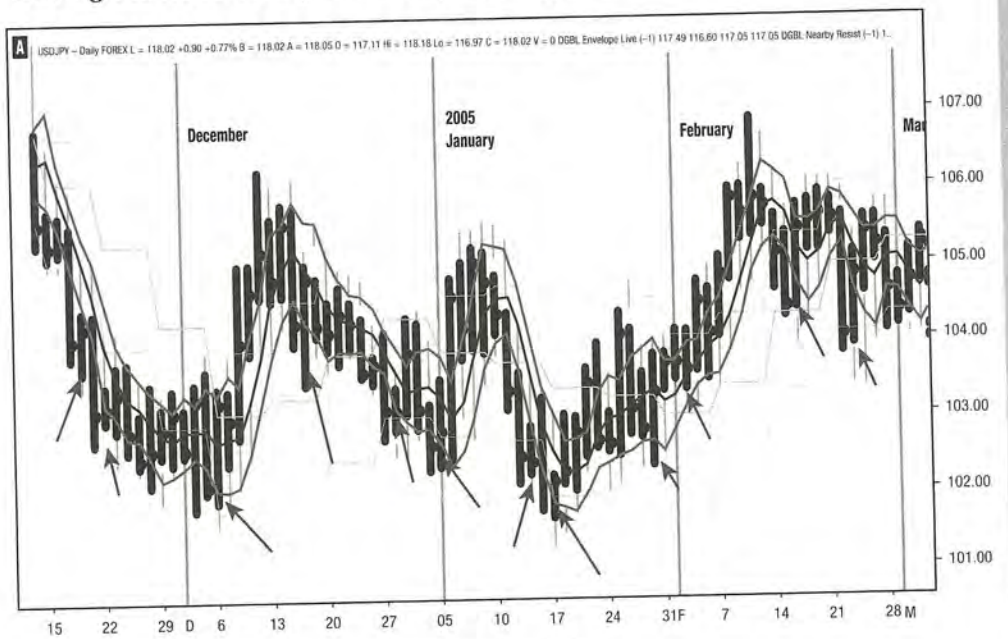
On the two-year chart. The market was in congestion (successive price bars were closing on opposite sides of the PLdot), and the PLdot was moving sideways across the page. We were in the middle of two-year nearby support.

On the one-year chart. The market was in a trend rundown, with the next anticipated type of trading being congestion entrance to the upside. We were a long way below the yearly envelope bottom, and so we were looking for a move back up at least to the envelope bottom, and probably to the yearly PLdot, and possibly to the yearly envelope top. We were in yearly support and in two-year support, with a significant bias for a move to the upside. In January 2005, we would be watching to see if nearby yearly support would hold and become strong, and thus flag a yearly exhaust entry.

On the quarterly chart. We were in yearly support, and in quarterly further-

FIGURE 1.10

Trading the 2005 Yearly Bar: Daily Buy Signals



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out support, and a potential exhaust pattern was setting up for a strong return to the quarterly PLdot. In the first quarter of 2005, we would have been monitoring the move away from quarterly nearby support to validate the exhaust buy signal.

On the monthly chart. On the left-hand side of Figure 1.9, we see exhaust entry signals as the market's downtrend stalls in monthly, quarterly, yearly, and two-year support. Monthly nearby support is holding and is showing to be strong.

On the weekly chart. On the right-hand side of Figure 1.9, we are again seeing multiple exhaust buy signals as the market tests support, bounces off, comes back for a retest, and then starts off to the upside with more conviction. The Drummond Geometry trader can take action on these exhaust buy signals with some confidence because he can see that we are in two-year, yearly, quarterly, monthly, and now weekly support, and all with definite upside targets.

On the daily chart. Taking all of this information into consideration, we

come to the daily chart (Figure 1.10) and again see multiple exhaust buy signals as the dollar/yen exchange rate tests the major bottom that's being put in. If the trader has a long-term perspective, he could build a large position, buying on the dips. The multiple daily exhausts into multiple longer time period support during December 2004 and January 2005 provide the opportunity.

Of what value is the long-term chart analysis? In 2005, the dollar/yen exchange rate ran from approximately 101.67 to 121.39. That's a huge move in these markets, and Drummond Geometry had a set of indicators that helped the trader get in near the very start of this move. What's more, the methodology provides tools that help establish reasonable targets and monitor the position. The trader knows at all times what the market has to do if this trade is going to work out.

Monitoring

How do we know if our predictions and analysis are correct? The possibility of being wrong is always present because we're human, and so we need to have some means of monitoring the market activity to tell us if our predictions are on target and accurate or not.

The element of monitoring is essential to Drummond Geometry trading. To monitor effectively, we need to recognize the quality of market flow and to understand what the market looks like when it's moving successfully toward a goal, and what it looks like when that progress has slowed or changed. Flow can be defined in a number of ways. The simplest way is to note how the market is dealing with resistance and support on a shorter time frame. If resistance is holding and support giving way on the shorter time period, then the flow is down. If the reverse is true, the market is headed up. The methodology also includes more sophisticated definitions of flow using range, position of close relative to the high and low, progress through the envelope system, and advance/decline measures. But the bottom line is how the shorter time period handles resistance and support; if the weekly and monthly consistently break resistance and hold nearby support, then the quarterly and yearly bars are headed up, and the quarterly and yearly upside targets should be kept in sight.

The world is a complicated place. Huge geopolitical forces shape the global currency markets. Exchange-rate charts are the graphic reflection of massive changes as the fortunes of countries and peoples rise and fall. When major shifts occur—changes in interest rate policies, wars, shifts in national priorities, or changes in regimes—the relative values of the currencies of different countries

can be on the move in a major trend for a significant period of time. Although it's not possible for the individual trader to know or understand all possible fundamental information, it *is* possible to make reasonable predictions about the extremes of yearly price action, to monitor those assumptions, and to trade them successfully, picking off the yearly highs and lows and thus preserving capital or building wealth, depending on your goals.

Trading is a difficult business. It requires both on-target perceptions and mental strength. First you have to see the opportunity. Then you have to take the opportunity. You have to stick with your decisions through thick and thin as you monitor the trade, knowing exactly what *has* to happen if you are wrong and what has to happen if you are right.

Trading the Forex with an eye on long-term Drummond Geometry charts can help the trader keep the market in context and withstand the many wide countertrend oscillations that will shake out the trader who is not equipped with the long-term perspective that yearly and quarterly charts provide. Seeing the yearly bar develop lets the trader watch the background, not just focus on the foreground. To be better than the rest in trading, as in so many fields, we have to do something different from the rest. In trading the global currency markets, one tool that can make a real difference is a careful analysis of the big picture, using the multiple time period analysis of Drummond Geometry.