

# Wicked Stocks Support Series



**How to Construct Price Channels**

# Introduction

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- A price channel is a charting technique where the stock is bound between two parallel lines, known as a channel.
- Channels are known for being continuation patterns, meaning when a channel is formed, as a technical analyst you assume the stock will continue to trade in between these parallel lines.
- Channels can be horizontal, ascending (bullish trend), or descending (bearish trend).
- Understanding channels can be a very useful tool as a technical analyst. Here's a step-by-step guide on how to construct and trade channels.



# What Are Channels?

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- **Channel Top:** This is the upper boundary of the price channel and represents a level of resistance. When a stock or index reaches the channel top, it often encounters selling pressure that could push its price back down within the channel.
- **Channel Bottom:** Conversely, this is the lower boundary of the price channel and acts as a support level. When the price touches the channel bottom, it may find buying interest that can cause the price to move higher within the channel.
- Traders use channels to identify potential buy and sell points. When the price is near the bottom of the channel, they may consider it an opportunity to buy, anticipating that the price will rise following the established pattern.
- Similarly, when the price approaches the top of the channel, they might see it as a chance to sell or go short, anticipating that the price will drop following the established pattern.



# Constructing an Ascending Channel

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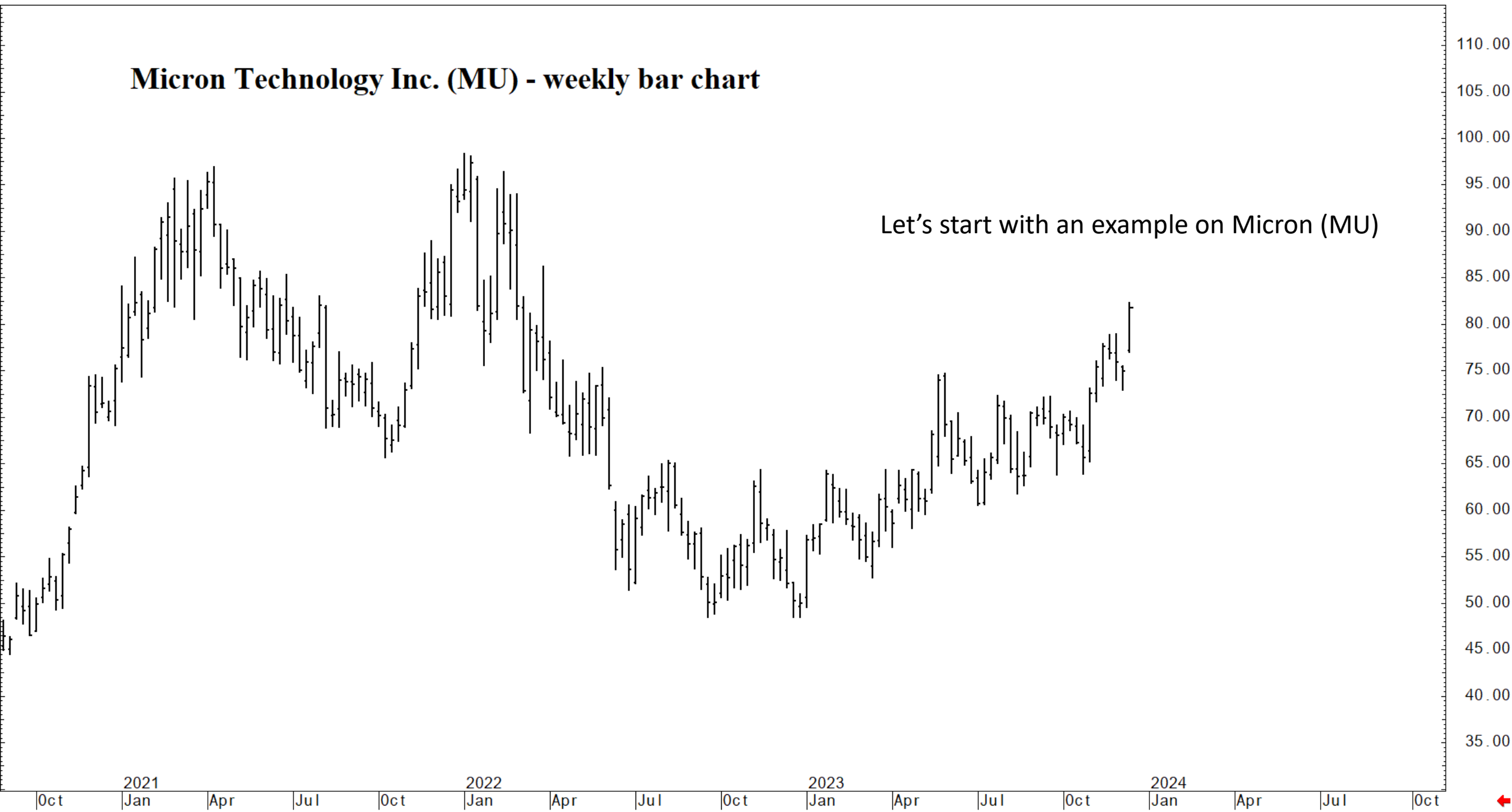
## Let's Find The Channel Top For an Uptrend:

- 1. Identify the Trend:** Confirm that the stock is in an uptrend by looking for higher highs and higher lows in the price action.
- 2. Draw the Basic Trendline:**
  - Locate the extreme lows (the low points in the trend where price reversed higher).
  - Connect these lows with a straight line. This is your basic uptrend line.
  - Important note: Select the absolute lowest points that define the length of the uptrend without cutting through any other low points.
- 3. Create the Channel Line:**
  - Next, find the first prominent peak (the high point from which price reversed lower) in the uptrend.
  - Draw a parallel line to the basic uptrend line starting from this peak. This is your channel line and acts as resistance.



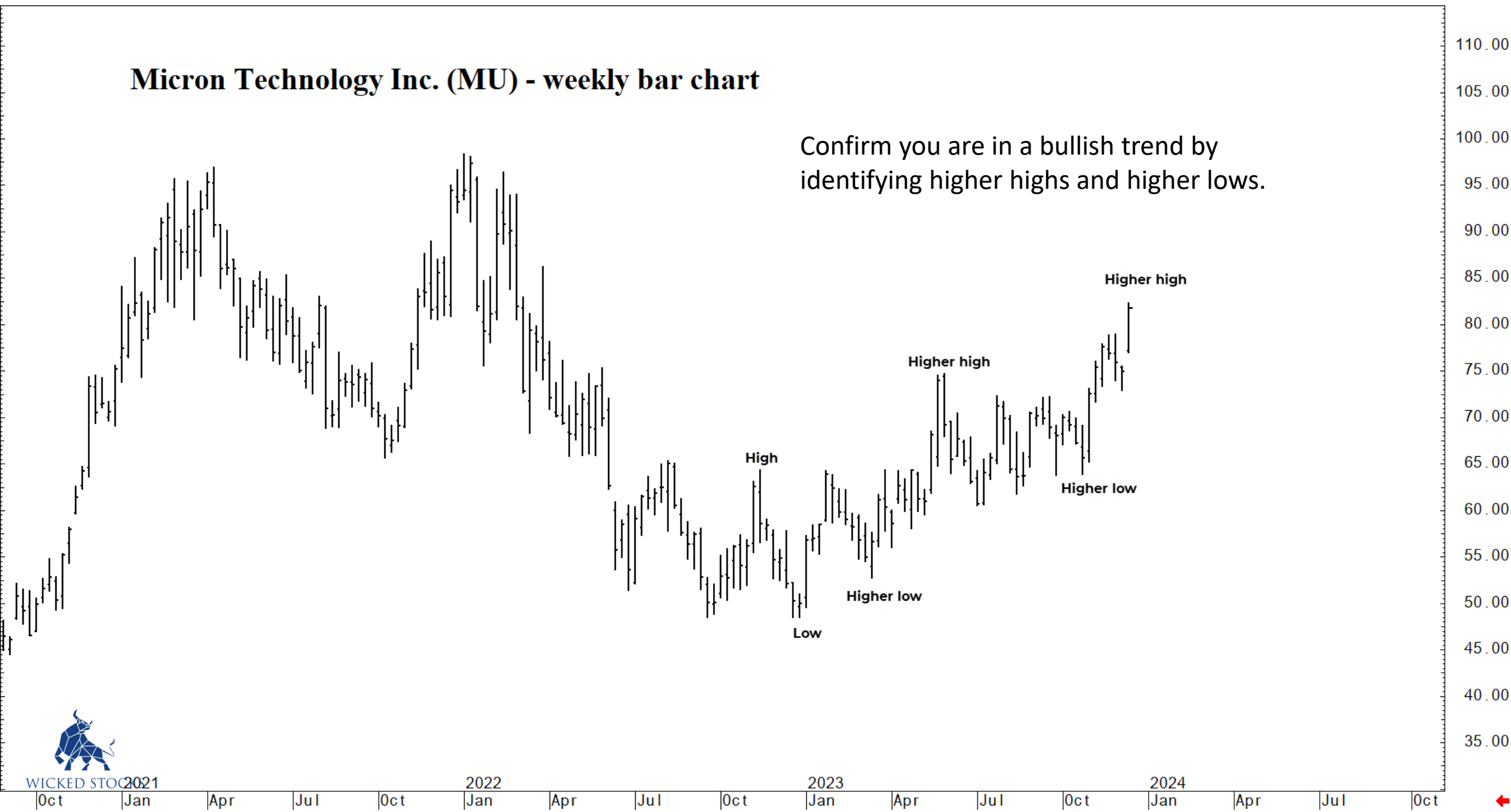
# Micron Technology Inc. (MU) - weekly bar chart

Let's start with an example on Micron (MU)



# Micron Technology Inc. (MU) - weekly bar chart

Confirm you are in a bullish trend by identifying higher highs and higher lows.



# Micron Technology Inc. (MU) - weekly bar chart

Locate the **extreme lows** of the trend. Connect them with a trendline. The trendline should NOT intersect any other lows.

By connecting the **extreme lows**, you are creating the outer most boundary of the stock's trading range.



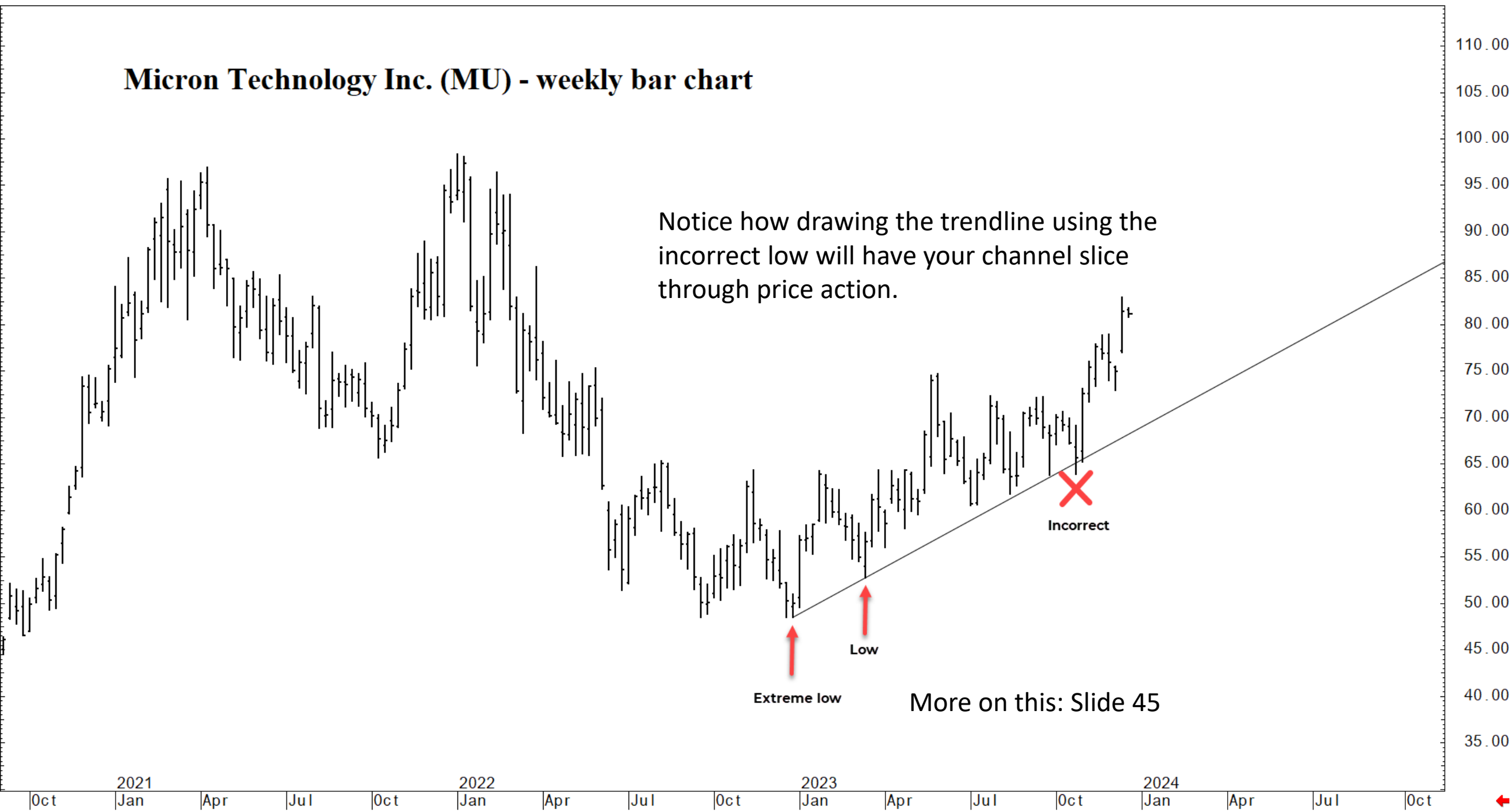
Extreme low

Extreme low

More on this: Slide 36



# Micron Technology Inc. (MU) - weekly bar chart



Notice how drawing the trendline using the incorrect low will have your channel slice through price action.



Incorrect



Extreme low



Low

More on this: Slide 45

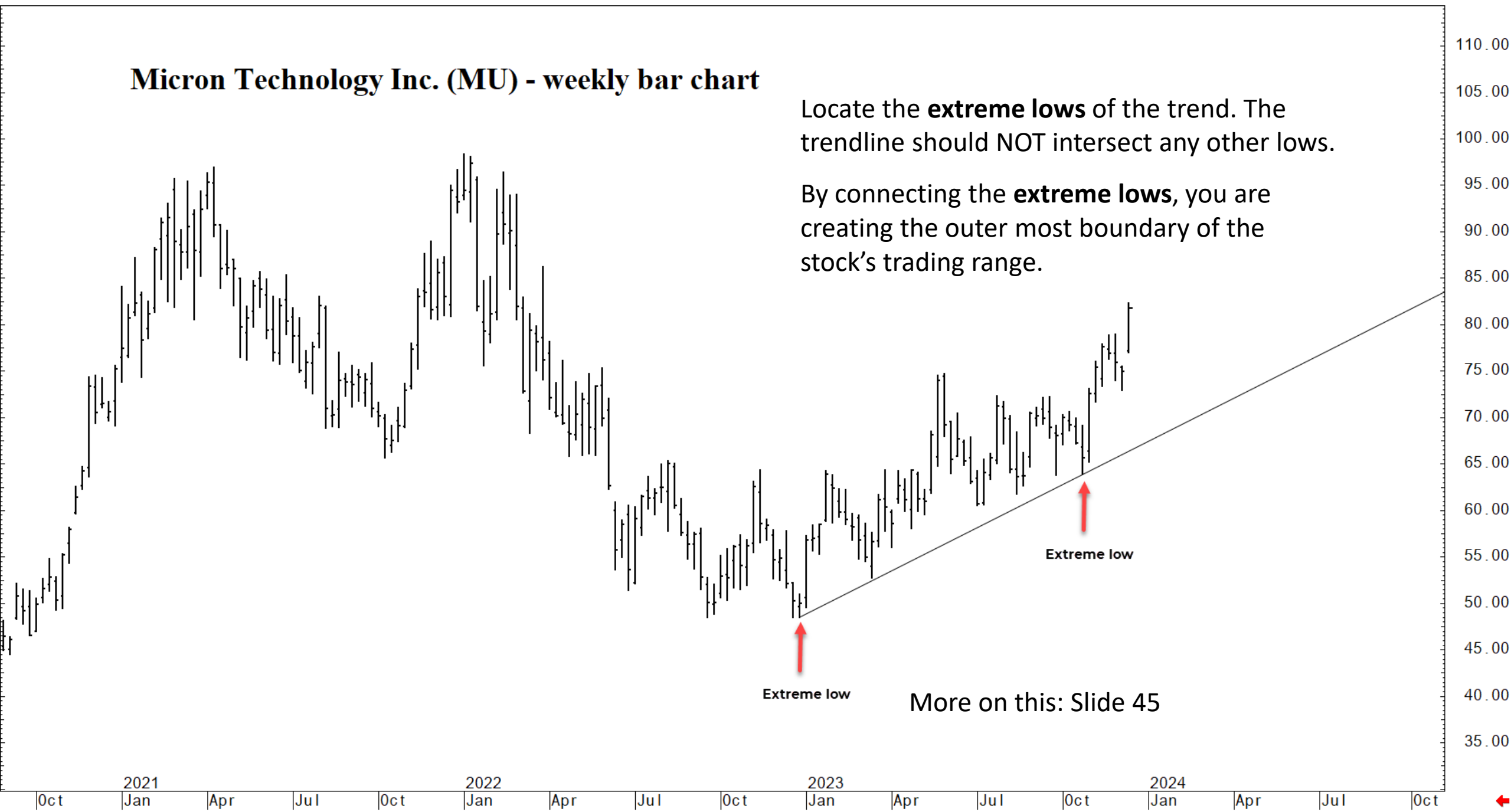




# Micron Technology Inc. (MU) - weekly bar chart

Locate the **extreme lows** of the trend. The trendline should NOT intersect any other lows.

By connecting the **extreme lows**, you are creating the outer most boundary of the stock's trading range.



Extreme low

Extreme low

More on this: Slide 45



# Micron Technology Inc. (MU) - weekly bar chart



# Micron Technology Inc. (MU) - weekly bar chart



Draw a line that is parallel to your trendline onto the extreme high.

Extreme high

Extreme low

Extreme low



# Micron Technology Inc. (MU) - weekly bar chart



# Micron Technology Inc. (MU) - weekly bar chart



You have now created the correct **channel top** of this stock's trading range. Expect the **channel top** to act as resistance.

Channel top is now resistance



# Micron Technology Inc. (MU) - weekly bar chart



Now let's say you wanted to find reliable support for this stock's trading range.

Channel top is now resistance

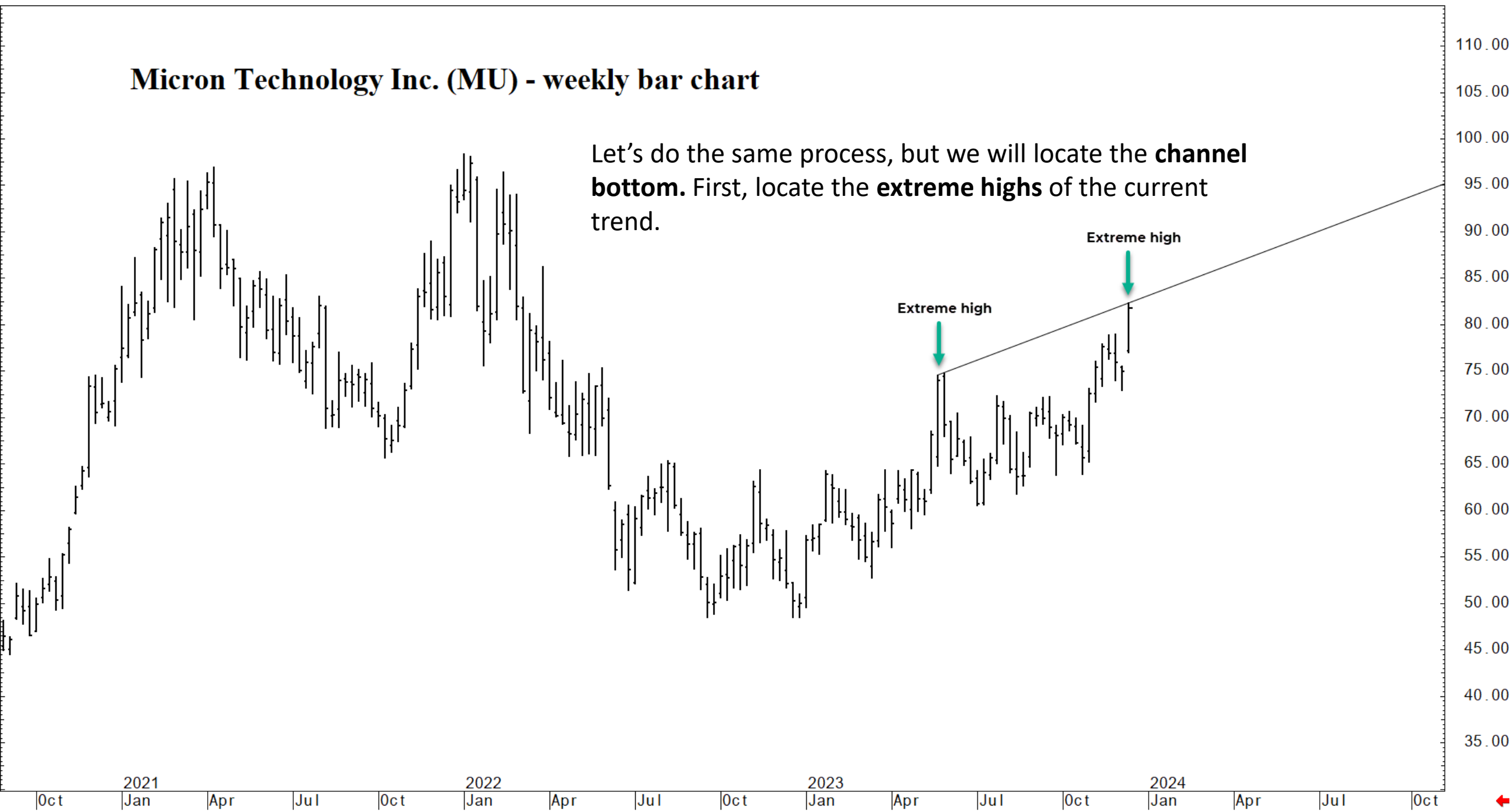


We do not use trendline as support. Instead, we draw the **channel bottom** that defines the most recent trend.



# Micron Technology Inc. (MU) - weekly bar chart

Let's do the same process, but we will locate the **channel bottom**. First, locate the **extreme highs** of the current trend.



# Micron Technology Inc. (MU) - weekly bar chart





# Micron Technology Inc. (MU) - weekly bar chart



Draw a line parallel to the trendline onto the **extreme low**.

Extreme high

Extreme high

Extreme low

Notice how the channel line does not intersect any other lows in between the extreme highs.

2021

2022

2023

2024

Oct

Jan

Apr

Jul

Oct

Jan

Apr

Jul

Oct

Jan

May

Jul

Oct

Dec

h

Apr

Jul

Oct



# Micron Technology Inc. (MU) - weekly bar chart

You have now created the **channel bottom** for this stock's current trading range.



# Micron Technology Inc. (MU) - weekly bar chart



Expect this **channel bottom** to act as support.

Channel bottom is now support



# Constructing a Descending Channel Bottom

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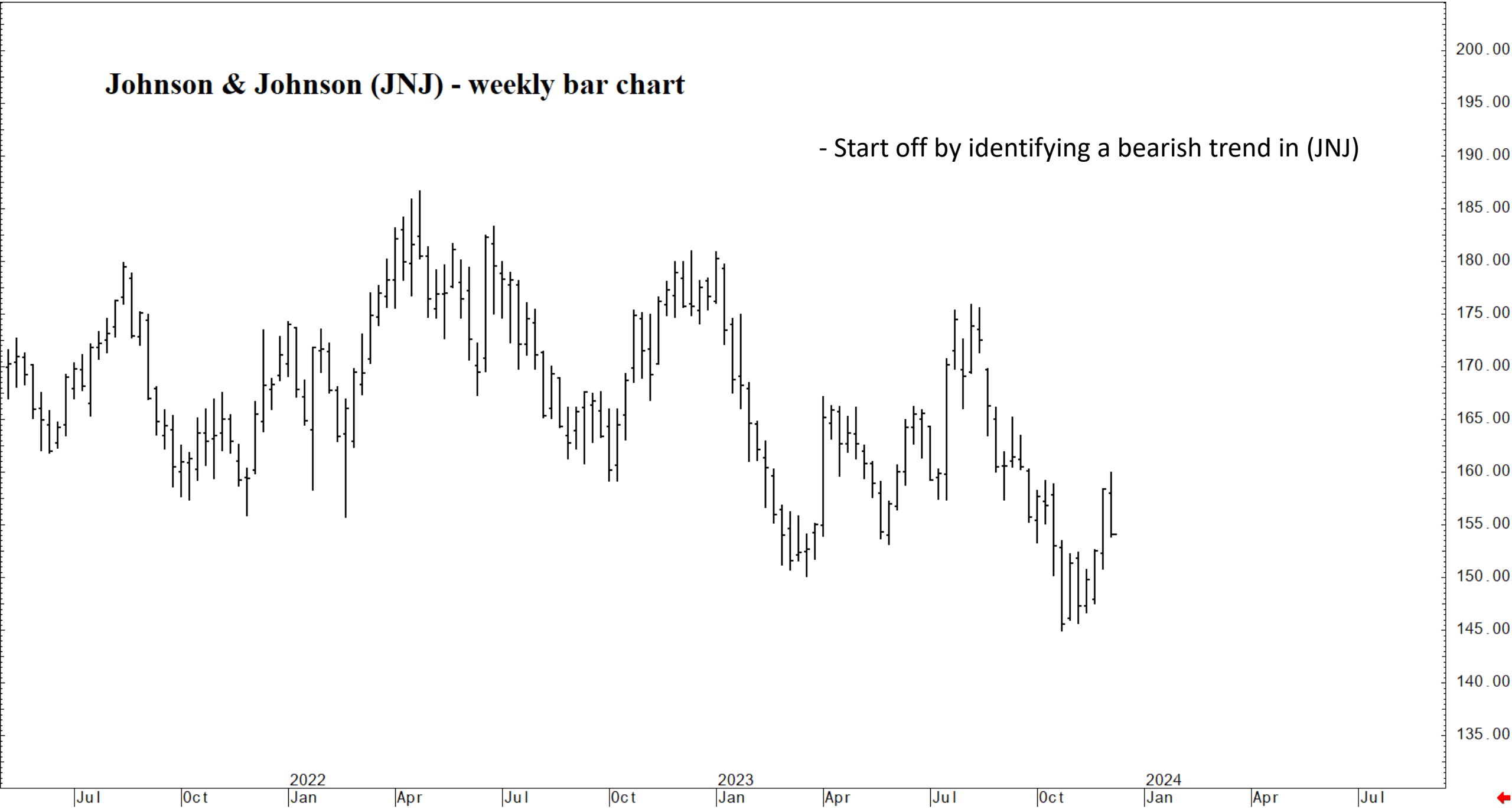
## Let's Find a Channel Bottom For a Downtrend:

- 1. Identify the Trend:** Confirm that the stock is in a downtrend with a pattern of lower highs and lower lows in the price chart to ensure that the stock is in a downtrend.
- 2. Draw the Basic Trendline:**
  - Locate the extreme highs (the high points in the trend where the price reversed lower).
  - Draw a straight line connecting these highs. This becomes your basic downtrend.
  - Important note: Select the absolute highest points that define the length of the downtrend without cutting through any other high points.
- 3. Create the Channel Line:**
  - Find the first prominent low (the low point from which price reversed higher) in the downtrend.
  - Draw a line parallel to the basic downtrend line starting from this low. This is your channel line and acts as support.



# Johnson & Johnson (JNJ) - weekly bar chart

- Start off by identifying a bearish trend in (JNJ)



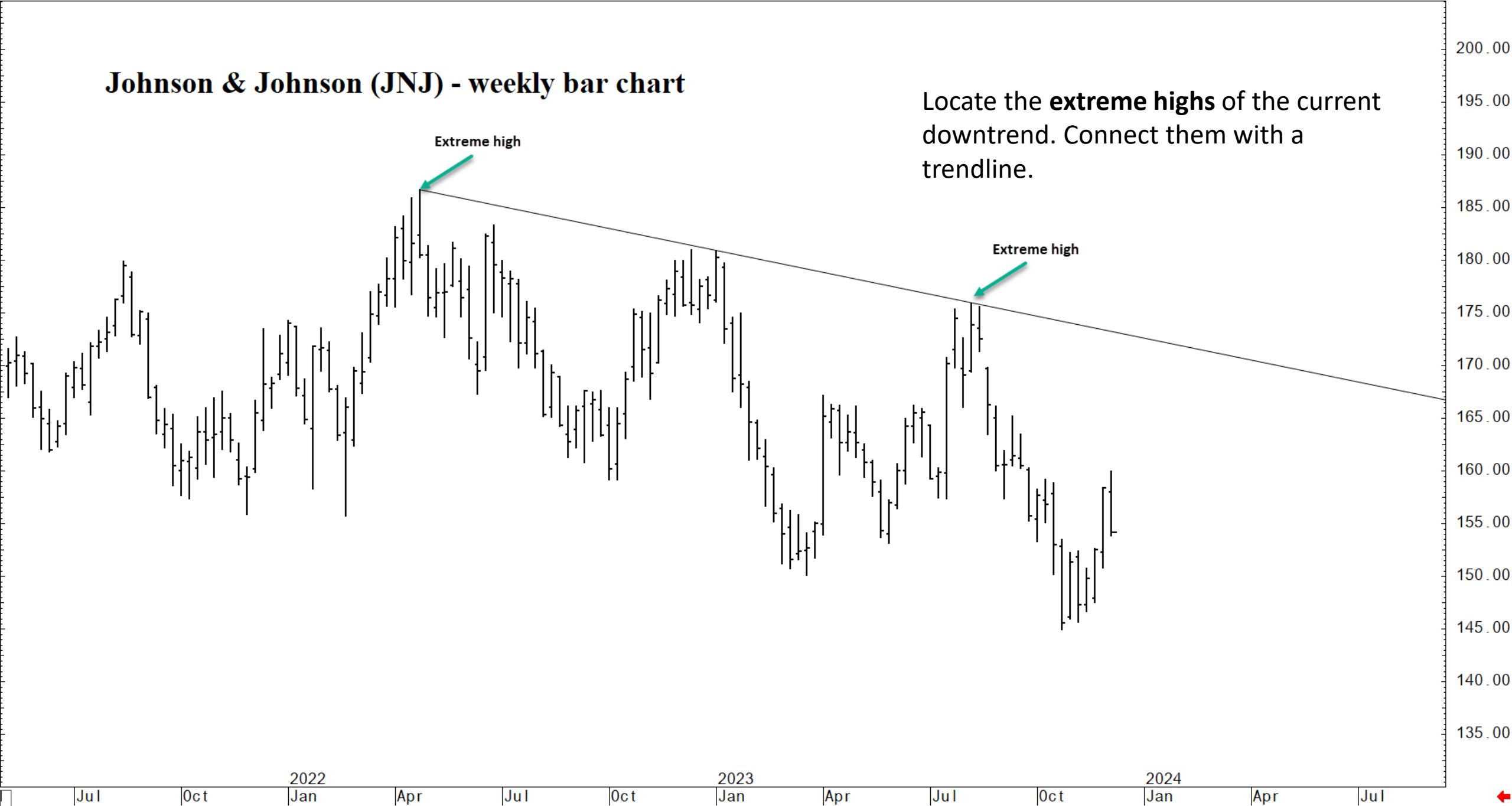
# Johnson & Johnson (JNJ) - weekly bar chart

Confirm that the stock is in a downtrend by identifying lower highs and lower lows.

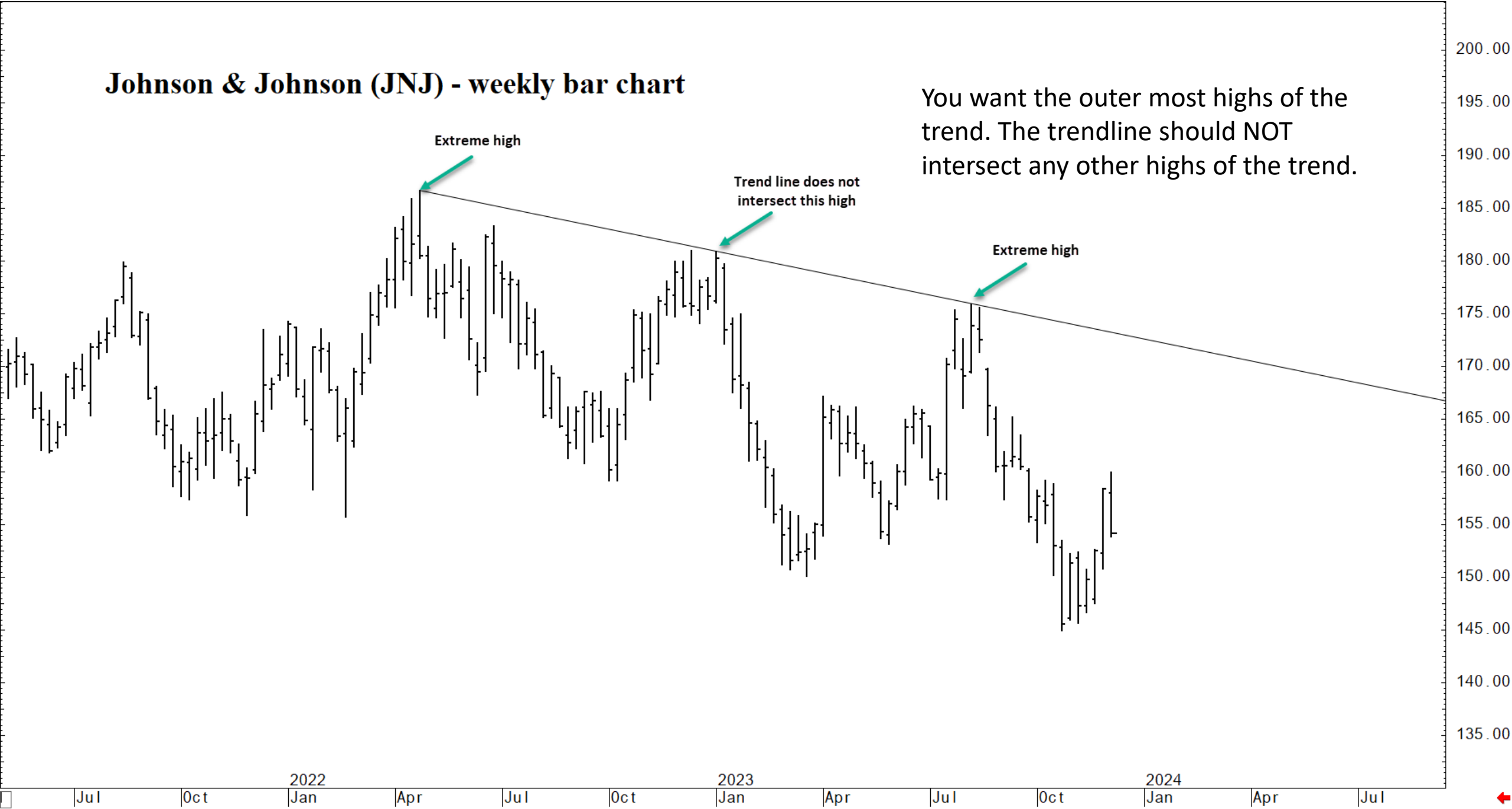


# Johnson & Johnson (JNJ) - weekly bar chart

Locate the **extreme highs** of the current downtrend. Connect them with a trendline.



# Johnson & Johnson (JNJ) - weekly bar chart



You want the outer most highs of the trend. The trendline should NOT intersect any other highs of the trend.

Extreme high

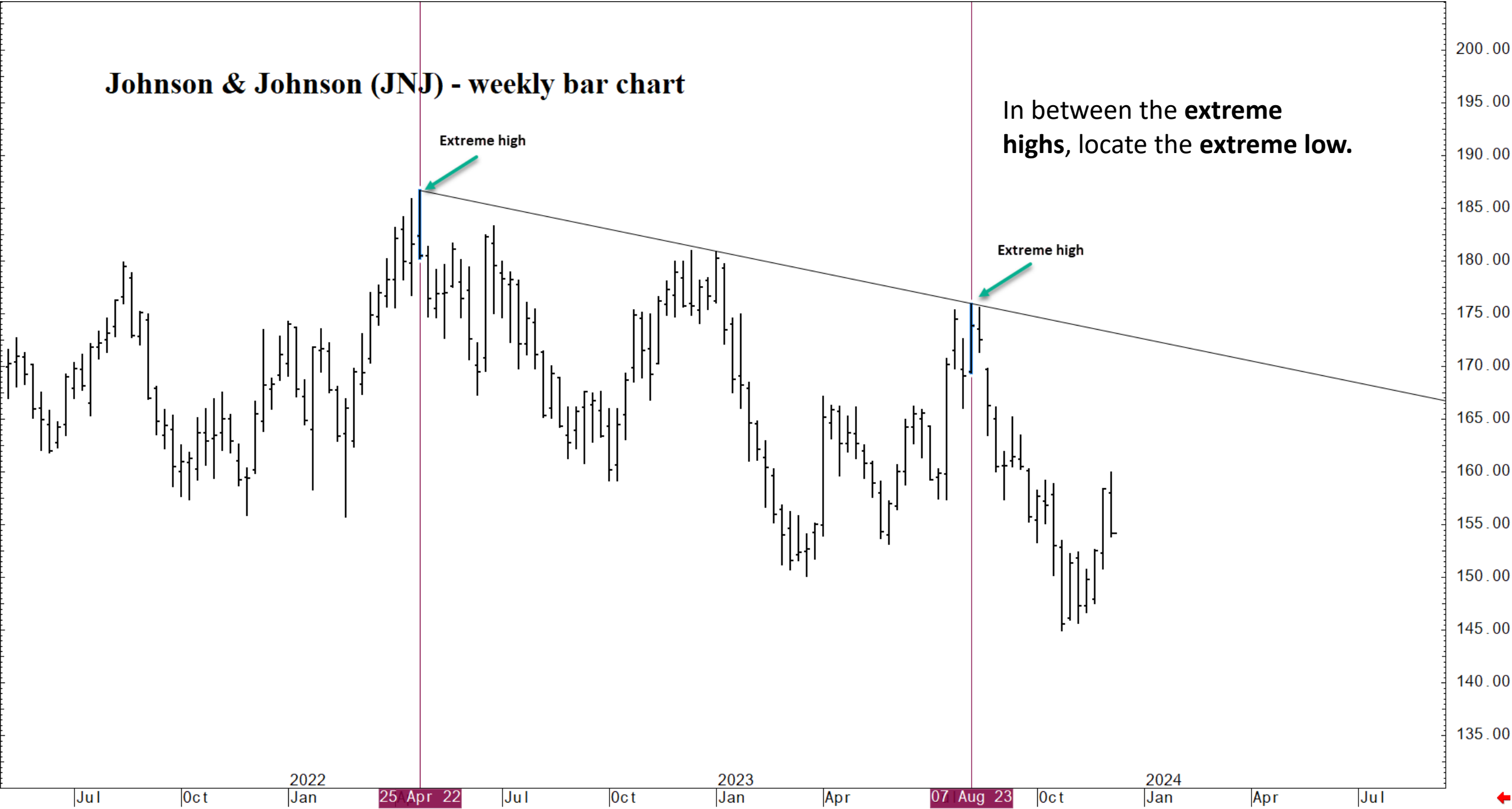
Trend line does not intersect this high

Extreme high





# Johnson & Johnson (JNJ) - weekly bar chart



In between the **extreme highs**, locate the **extreme low**.

Extreme high

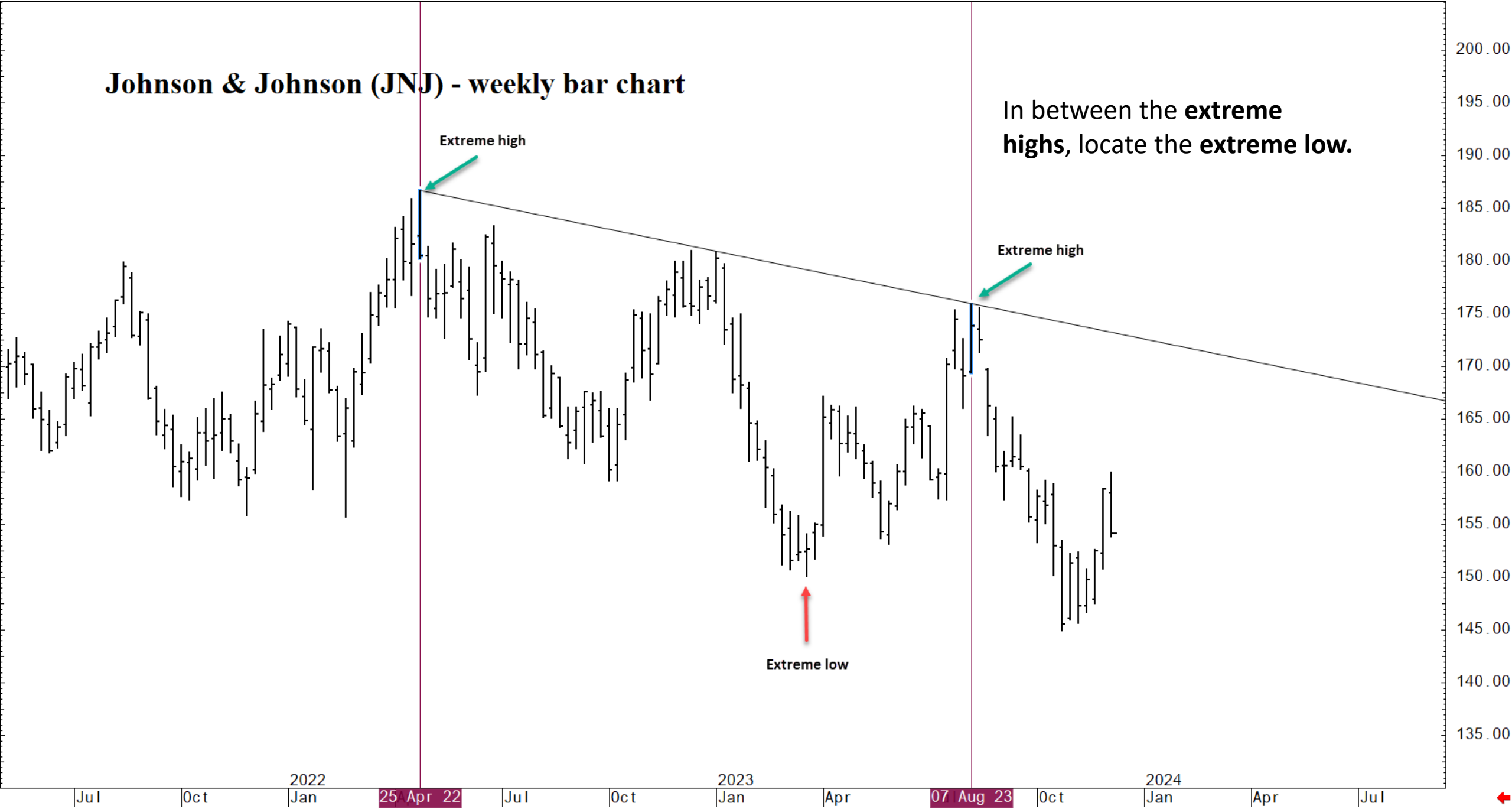
Extreme high

25 Apr 22

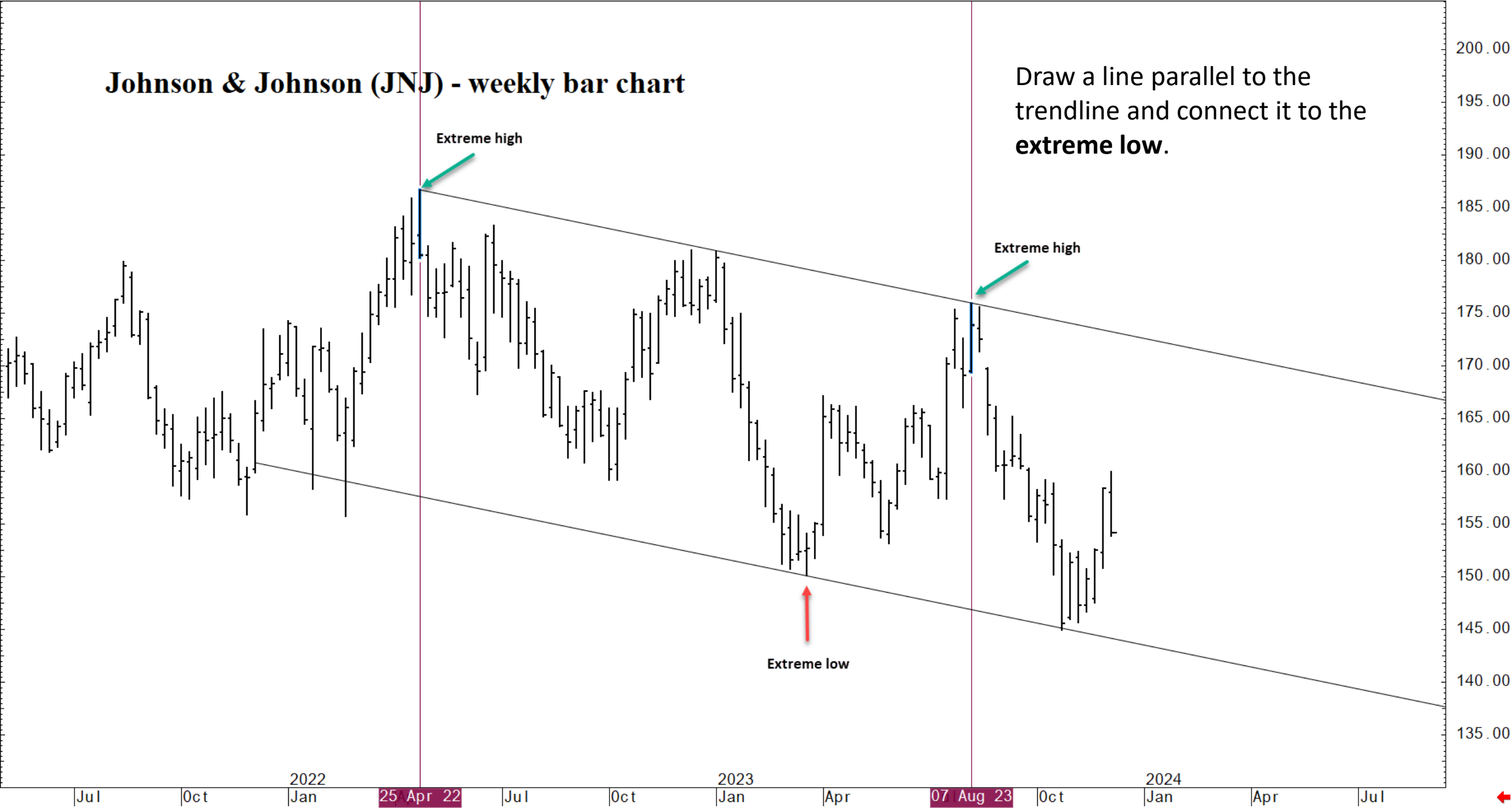
07 Aug 23



# Johnson & Johnson (JNJ) - weekly bar chart



# Johnson & Johnson (JNJ) - weekly bar chart



# Johnson & Johnson (JNJ) - weekly bar chart

You have now created the **channel bottom** of the stock's current trading range.



# Johnson & Johnson (JNJ) - weekly bar chart

Expect the **channel bottom** to act as support.



Channel bottom is now support

# Johnson & Johnson (JNJ) - weekly bar chart

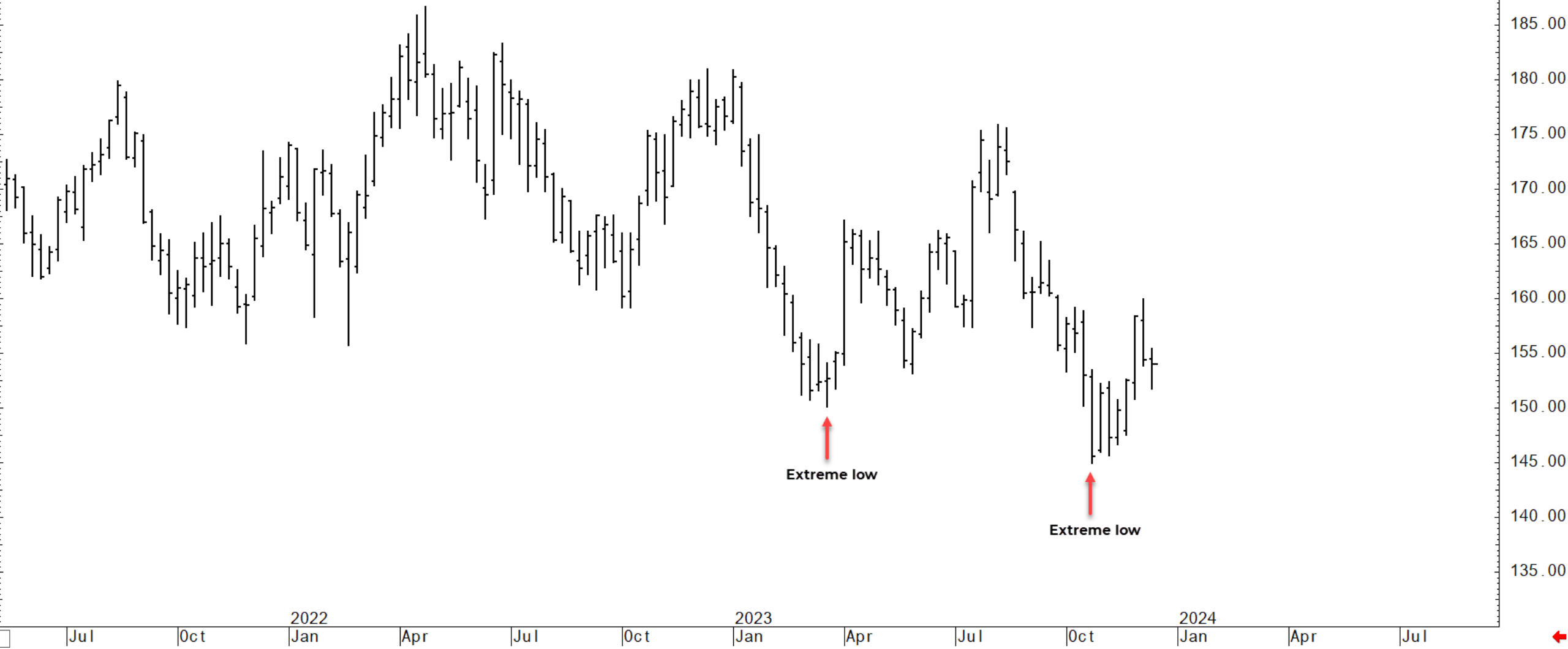
Now let's say you want to find the resistance of this stock's current trading range.

We do not use the trendline we created off the **extreme highs**, instead we draw the **channel top**.



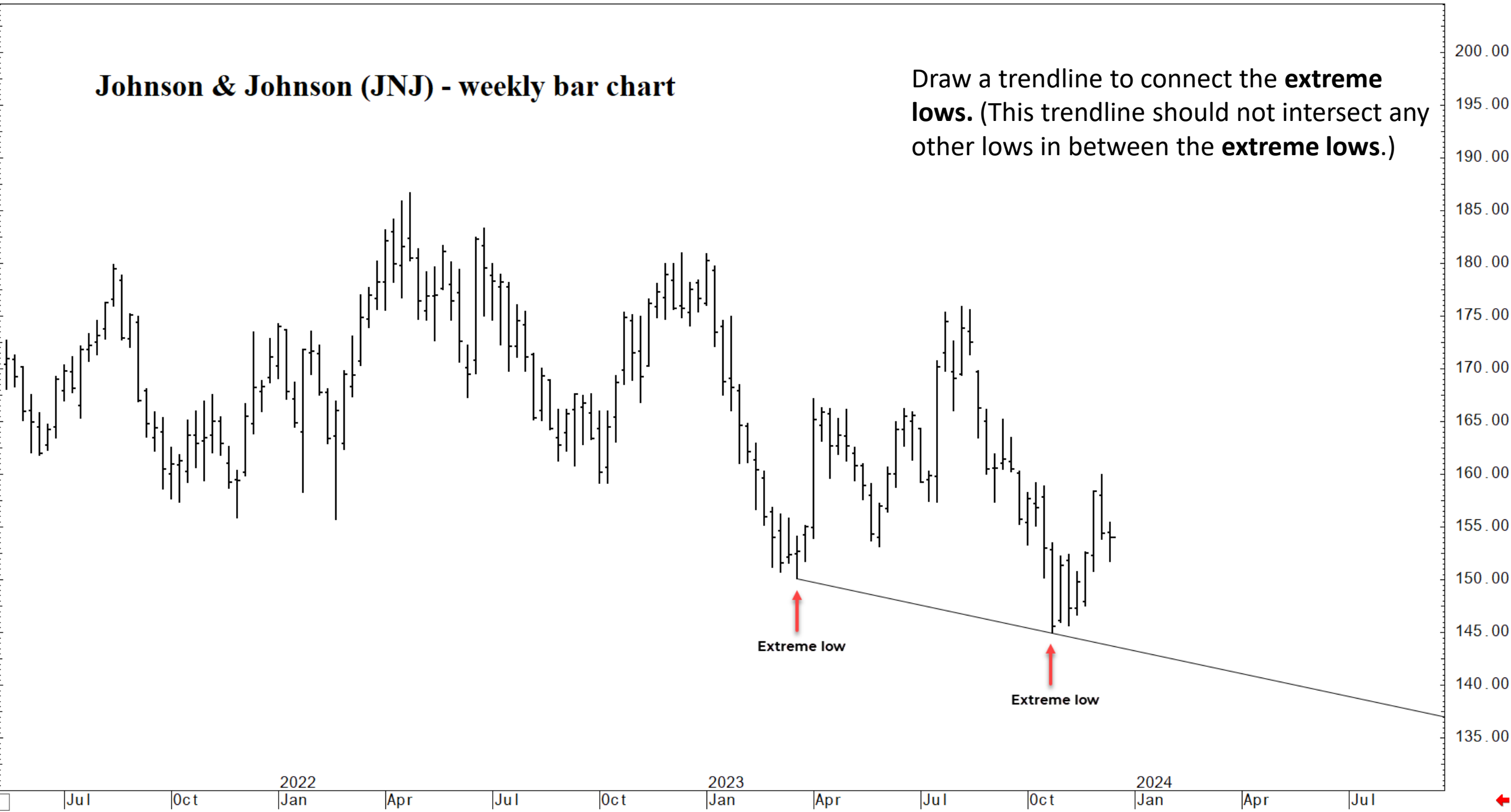
# Johnson & Johnson (JNJ) - weekly bar chart

Of the stock's current trading range, locate the **extreme lows**.



# Johnson & Johnson (JNJ) - weekly bar chart

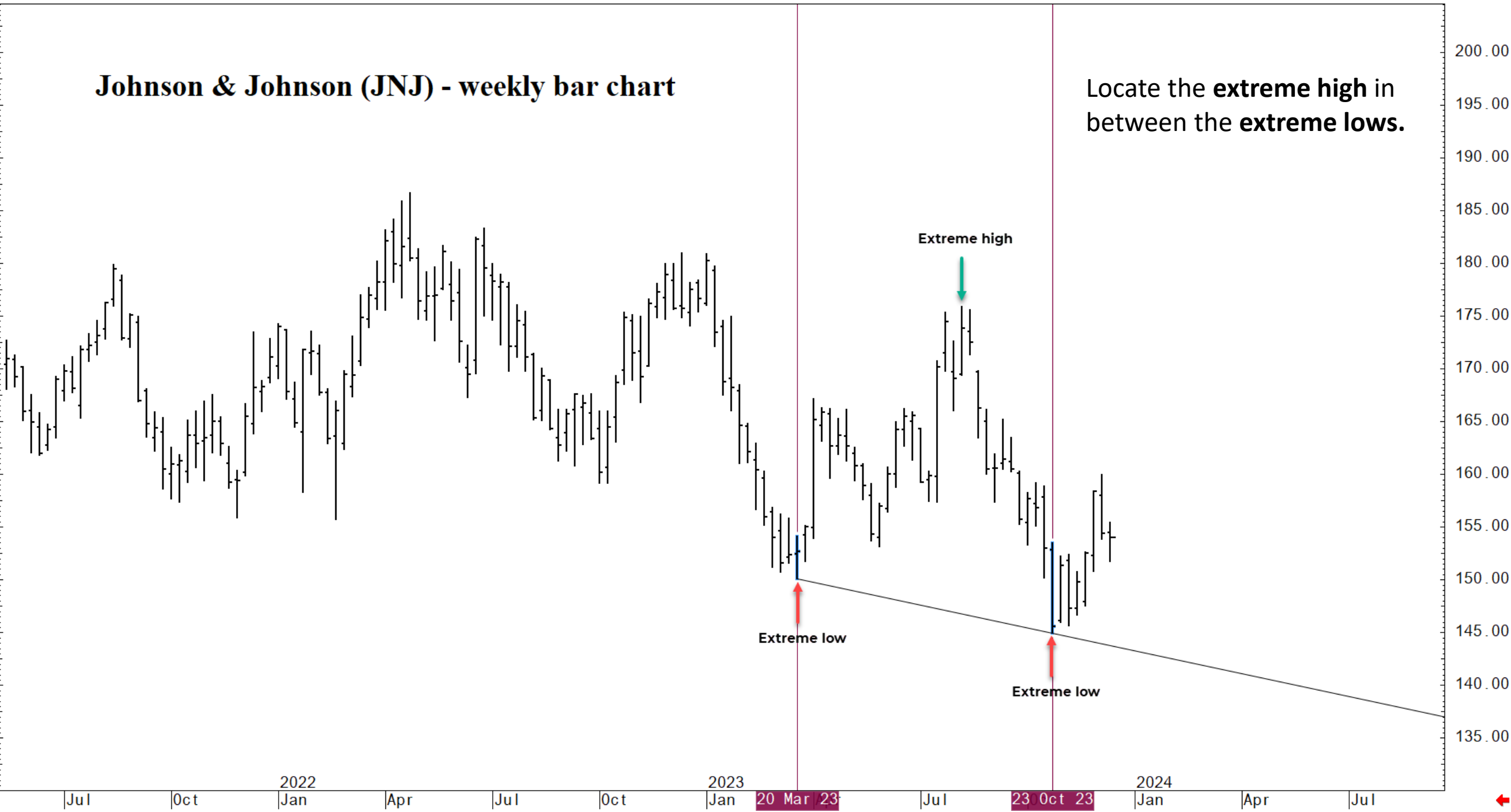
Draw a trendline to connect the **extreme lows**. (This trendline should not intersect any other lows in between the **extreme lows**.)





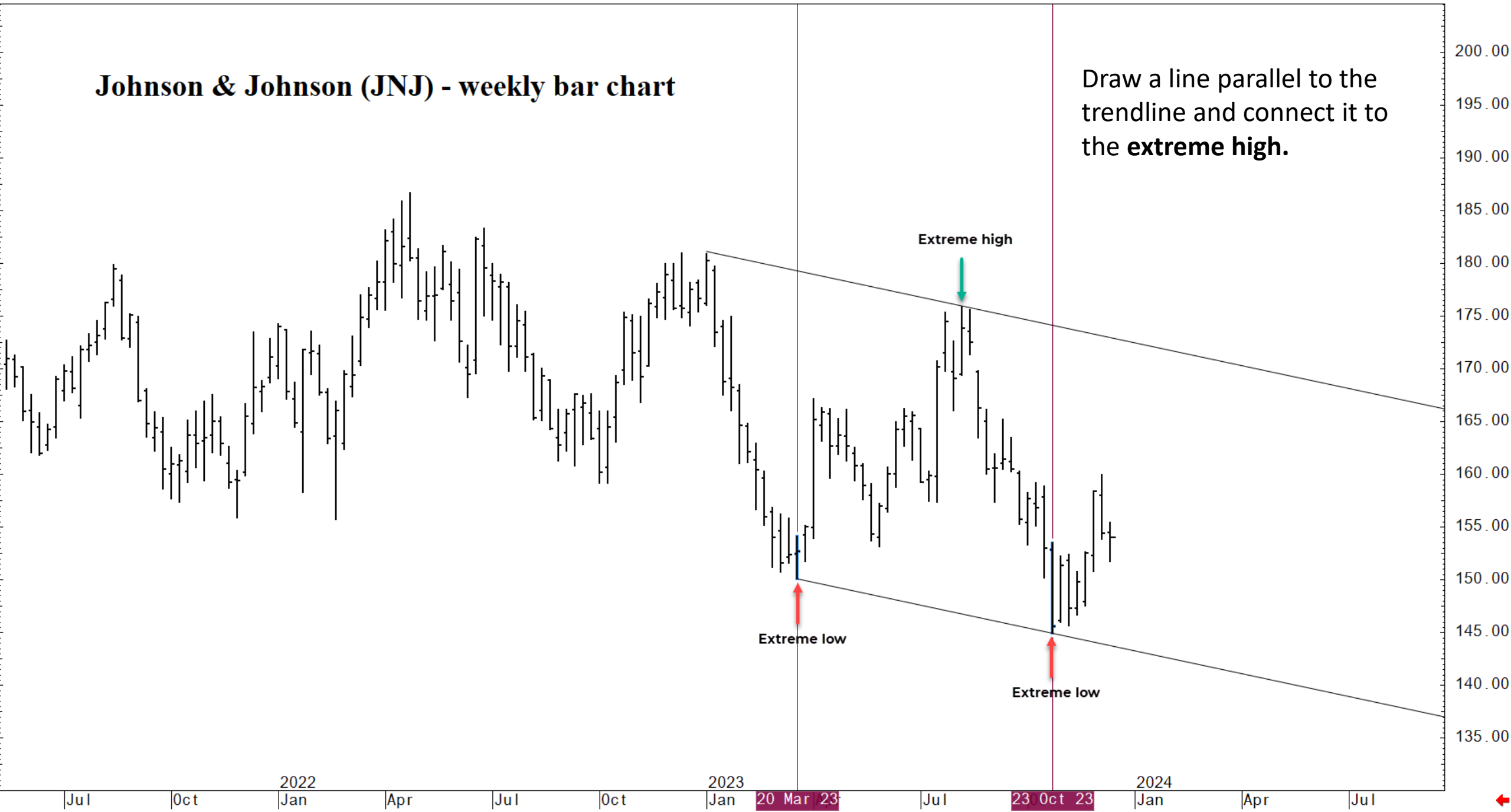
# Johnson & Johnson (JNJ) - weekly bar chart

Locate the **extreme high** in between the **extreme lows**.



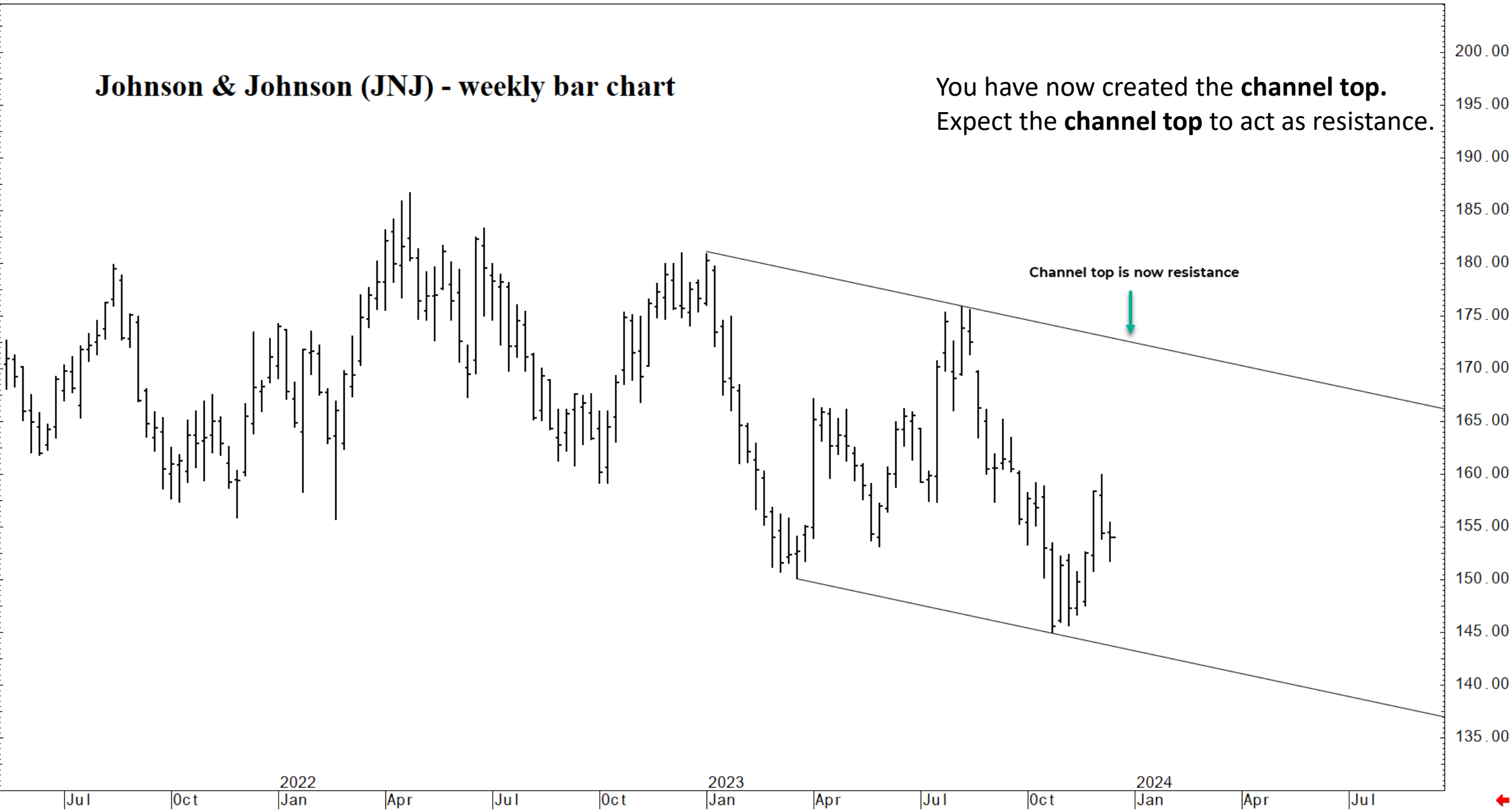
# Johnson & Johnson (JNJ) - weekly bar chart

Draw a line parallel to the trendline and connect it to the **extreme high**.



# Johnson & Johnson (JNJ) - weekly bar chart

You have now created the **channel top**.  
Expect the **channel top** to act as resistance.



# Why The Extreme Highs and Lows?

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## Why This Method?

- 1. Creating the Outermost Channel:** By using the extreme highs and lows, you are creating the outer boundaries of the stock's trading range. This is important because it shows the widest possible area the stock might fluctuate within.
- 2. Reliable Trading Signals:** Using the outer most channel gives a clearer and more reliable indication of when the stock price might change direction. If the price reaches or crosses this boundary, it could signal a significant move, offering a potential trading opportunity.



# Why The Extreme Highs and Lows?

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Importance in Trading:

- 1. Risk Management:** Knowing the outermost boundaries helps in identifying the most reliable floor of support and the most reliable ceiling of resistance. This is crucial in understanding where to buy/sell your position to minimize potential losses and maximize potential gains.
- 2. Predicting Price Movements:** By understanding where the price is in the channel, traders can make more informed predictions about whether it's likely to rise or fall.
- 3. Trend Confirmation:** This method can confirm the strength of a trend. If the price stays within the boundaries of the channel, the trend is likely still strong.



# Concluding Thoughts

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- In summary, channel studies using extreme reaction highs and lows help in defining the broadest possible price movement range in a trend, offering valuable insights for making trading decisions. This technique is crucial for both predicting future price movements and managing risk effectively.
- As with any analytical tool, channel studies should not be used in isolation.
- They work best when combined with other technical analysis tools.

