Channeling: Charting a Path to Success

By Justin Kuepper
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The channel is a powerful yet often overlooked chart pattern and combines several forms of technical analysis to provide traders with potential points for entering and exiting trades, as well as controlling risk. The first step is to learn how to identify channels. The next steps include determining where and when to enter a trade, where to place stop-loss orders, and where to take profits.

Key Takeaways

- Trading channels can be drawn on charts to help see uptrends and downtrends in a stock, commodity, ETF, or forex pair.
- Traders also use channels to identify potential buy and sell points, as well as set price targets and stop-loss points.
- Ascending channels angle up during uptrends and descending channels slope downward in downtrends.
- Other technical indicators, such as volume, can enhance the signals generated from trading channels.
- How long the channel has lasted will help determine the trend's underlying strength.

Channel Characteristics

In the context of technical analysis, a channel occurs when the price of an asset is moving between two parallel trendlines. The upper trendline connects the swing highs in price, while the lower trendline connects the swing lows. The channel can slant upward, downward, or sideways on the chart.

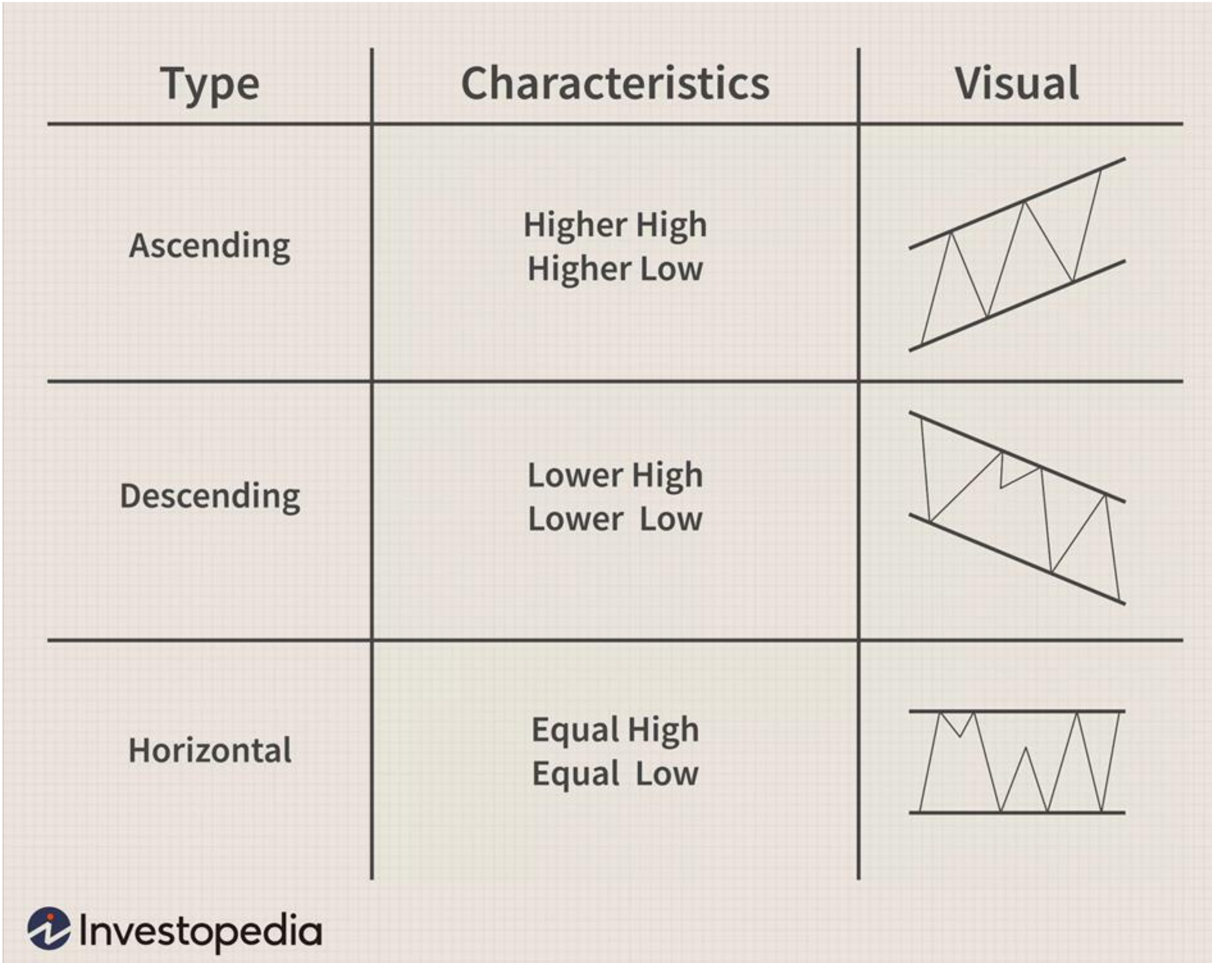
If price breaks out of a trading channel to the upside, the move could indicate that the price will rally further. For example, the chart below shows a channel and breakout in Hyatt Hotels Corporation (H) stock. If the price breaks below the bottom of the channel, on the other hand, the dip indicates that more selling could be on the way.

The trading channel technique often works best on stocks with a medium amount of volatility, which can be important in determining the amount of profit possible from a trade. For instance, if volatility is low, then the channel won't be very big, which means smaller potential profits. Bigger channels are typically associated with more volatility, meaning larger potential profits.

Types of Channels

A channel consists of at least four contact points because we need at least two lows to connect to each other and two highs to connect to each other. Generally speaking, there are three types:

1. Channels that are angled up are called ascending channels.
2. Channels that are angled down are descending channels. Ascending and descending channels are also called trend channels because the price is moving more dominantly in one direction.
3. Channels in which the trendlines are horizontal are called horizontal channels, trading ranges, or rectangles.



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Buying or Shorting the Channel

Channels can sometimes provide buy and sell points and there are several rules for entering long or short positions:

- When the price hits the top of the channel, sell your existing long position and/or take a short position.
- When the price is in the middle of the channel, do nothing if you have no trades, or hold your current trades.
- When the price hits the bottom of the channel, cover your existing short position and/or take a long position.

There are two exceptions to these rules:

1. If the price breaks through the top or bottom of the channel, then the channel is no longer intact. Do not initiate any more trades until a new channel develops.
2. If the price drifts between the channels for a prolonged period of time, a new narrower channel may be established. At this point, enter or exit near the extremes of the narrower channel.

During a rising channel, focus on buying near the bottom of the channel and exiting near the top. Be wary of shorting since the trend is up. For example, an ascending channel is depicted below in NVIDIA Corporation ([NVDA]()) shares.

During a descending channel, focus on shorting near the top of the channel and exiting near the bottom. Be wary of initiating longs in a falling channel since the trend is down.

Other forms of [technical analysis]() are sometimes used to enhance the accuracy of the signals from the channel and verify the overall strength of the up or down move. Some other tools to use while channel trading include:

- The [moving average convergence divergence]() (MACD) will often be near zero during horizontal channels. The MACD line crossing the signal line can also point out potential long trades near the bottom of a channel or short trades near the top of the channel.
- A [stochastic crossover]() may also signal a buying opportunity near the bottom of the channel or a selling opportunity near the top.

- Volume can also aid in trading channels. Volume is often lower in channels, especially near the middle of the channel. Breakouts are often associated with high volume. If the volume isn't rising on a breakout, there is a greater likelihood the channel will continue.

Determining Stop-Loss and Take-Profit Levels

Channels can provide built-in money-management capabilities in the form of stop-loss and take-profit levels. Here are the basic rules for determining these points:

- If you have bought at the bottom of the channel, exit and take your profits at the top of the channel, but also set a stop-loss order slightly below the bottom of the channel, allowing room for regular volatility.
- If you have taken a short position at the top of the channel, exit and take profit at the bottom of the channel. Also, set a stop-loss order slightly above the top of the channel, allowing room for regular volatility. Here is a descending channel in BCE Inc. (BCE) along with potential stop-loss and exit points.

Determining Trade Reliability

Channels provide the ability to determine the likelihood of success with a trade. This is done through something known as confirmations. Confirmations represent the number of times the price has rebounded from the top or bottom of the channel. These are the important confirmation levels to remember:

- 1-2: Weak channel (not tradeable)
- 3-4: Adequate channel (tradeable)
- 5-6: Strong channel (reliable)
- 6+**:** Very strong channel (more reliable)

Estimating Trade Length

The amount of time a trade takes to reach a selling point from a buy point can also be calculated using channels. This is done by recording the amount of time it has taken for trades to execute in the past, then averaging the amount of time for the future. This estimate is based on the assumption that price movements are roughly equal in terms of time and price. However, it is only an estimate and may not always be accurate.

Trading channels can look different depending on the time frame selected. For example, a channel on a weekly chart might not be visible on a daily chart.

The Bottom Line

Channels provide one way to buy and sell when the price is moving between trendlines. By "encasing" an equity's price movement with two parallel lines, buy and sell signals, as well as stop-loss and target levels, can be estimated. How long the channel has lasted helps determine the channel's strength. The amount of time a price usually takes to move from high to low (or low to high) provides an estimate of how long trades may last.