StockWatchIndex

TRADING INSIGHTS

SWI Continuing Education

October 2013

Trade Like A Pro

What is Technical Analysis?

Technical Analysis is the forecasting of future financial price movements based on an examination of past price movements. Like weather forecasting, technical analysis does not result in absolute predictions about the future. Instead, technical analysis can help investors anticipate what is "likely" to happen to prices over time. Technical analysis uses a wide variety of charts that show price over time.

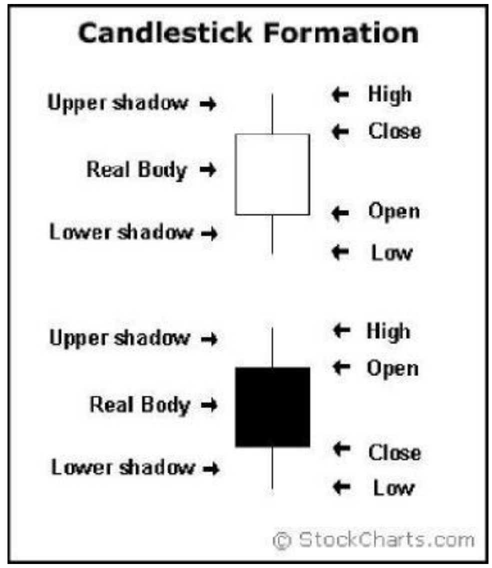
Technical analysis can be applied to stocks, indices, commodities, futures or any tradable instrument where the price is influenced by the forces of supply and demand. Price refers to any combination of the open, high, low or close for a given security over a specific period. The period can be based on intraday (1-minute, 5-minutes, 10-minutes, 15-minutes, 30-minutes or hourly), daily, weekly or monthly price data and last a few hours or many years. The time frame you choose will depend on the type of trader you want to be i.e. are you comfortable holding a security for a few minutes, hours, days or even weeks? This is a question you will have to address up front, however the answer will most likely surface as soon as you begin to trade and get a feel for the markets.

Before I go any further, I would like to make one thing very clear. The #1 rule in trading and is primarily in the process of becoming a great trader is, always paper trade until you are 100% comfortable with your own style of trading and have learned to keep your emotions in check!

You are probably wondering how long it takes to become a "great" trader. The answer to this question is so subjective it would be unfair to give a universal answer. As for my own personal experience, I paper traded (trading with fictional money) for well over 6 months before I went "live" and started putting my own money on the line. There are many factors that will determine your own timeline including, time available to devote to learning, risk tolerance, financial situation and your ability to stick to your strategy, among others.

Reading Candles

In order to create a candlestick chart, you must have a data set that contains open, high, low and close values for each period you want to display. The hollow or filled portion of the candlestick is called "the body" (also referred to as "the real body"). The long thin lines above and below the body represent the high/low range and are called "shadows" (also referred to as "wicks" and "tails"). The high is marked by the top of the upper shadow and the low by the bottom of the lower shadow. If the stock closes higher than its opening price, a hollow candlestick is drawn with the bottom of the body representing the opening price and the top of the body representing the closing price. If the stock closes lower than its opening price, a filled candlestick is drawn with the top of the body representing the opening price and the bottom of the body representing the closing price.



Take a few minutes to really study the chart to the left. Like reading a book, you should be able to quickly read the high, low, open and close of each candle without much effort. Of course, this takes time, but it is an essential first step on the path to becoming a great trader.

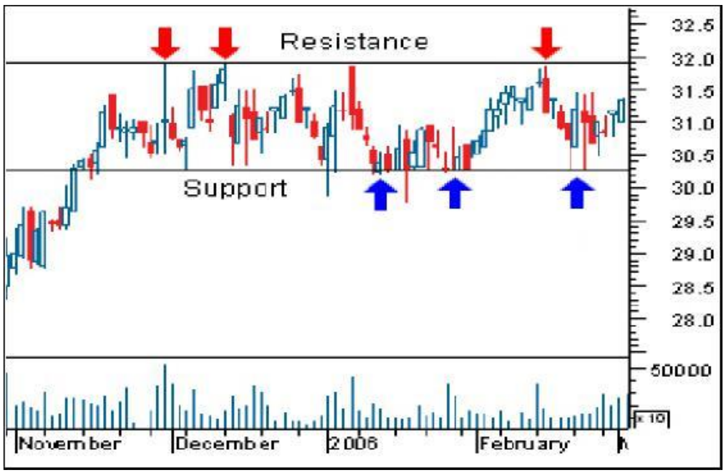
Support and Resistance

The most important thing to keep in mind when starting out is that price movements are not completely random. The levels and patterns I am about to show you can be used repeatedly in any market. Once you become proficient at this, you will be able to read a chart and determine the likely outcome within a matter of seconds.

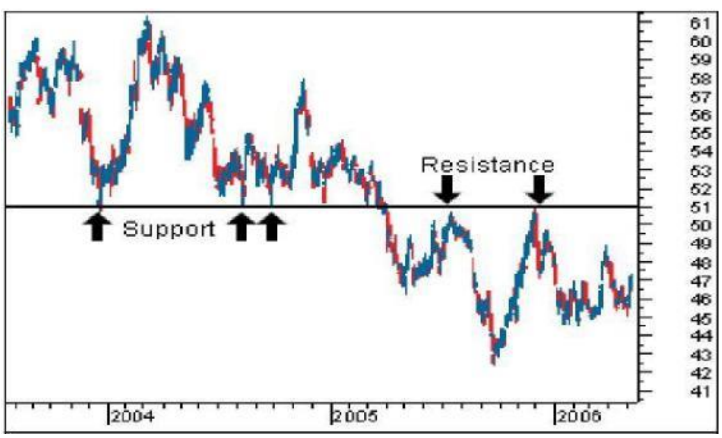
Below is a great example of support and resistance levels (I am going to call these SR levels). Notice how price respects these levels repeatedly. This type of SR pattern is also known as a channel. Channels can be directional (uptrend or downtrend) and can also be flat, or lateral, as is the case in the image below.

So why does this happen?

These support and resistance levels are seen as important in terms of market psychology and supply and demand. Support and resistance levels are the levels at which many traders are willing to buy the stock (in the case of a support) or sell it (in the case of resistance). When these trend lines are broken, the supply and demand and the psychology behind the stock's movements is thought to have shifted, in which case new levels of support and resistance will likely be established.



Below is a great example of an SR level that is often referred to as, “support turned resistance”. In this case, a strong support level quickly becomes resistance as soon as price breaks through to the downside.



Many traders who begin using technical analysis find this concept hard to believe and do not realize that this phenomenon occurs rather frequently, even with some of the most well-known companies. For example, as you can see in the image to the left, this support turned resistance formation is evident on the Wal-Mart Stores Inc. (WMT) chart between 2003 and 2006. Notice how the role of the $51 level changes from a strong level of support to a level of resistance.

This concept works the same in a resistance turned support scenario where price breaks to the upside of a strong resistance level, which then becomes support. Generally, as a trader, you want to find a “first time back” situation where a former resistance level is now acting as support for the first time. The first time back to an SR level is generally the best chance to trade from a strong support

Mind the Trend

As a trader, you have probably heard the old adage that it is best to trade with the trend, or the more popular saying, "the trend is your friend". This is sound advice as long as you know and can accept that the trend can end, at which point the trend is *not* your friend.

So the important question is, how can we determine the direction of the trend? I believe in the KIS rule, which says, "Keep it simple". Many traders will show you methods of determining the trend using moving averages, Moving Average Convergence Divergence (MACD), etc. I personally do not like to use these methods as I feel they are far too subjective and lagging. Instead I like to, "keep it simple". Take a look at the image below to see what I mean. Think you could quickly identify the trend and determine a likely direction of travel?

Now that we have identified the trend, we need to determine how likely it is that price will continue in that direction. We can use several methods, including:

1. MACD Negative Divergence

One of my favorite ways to identify a trend reversal is with the MACD indicator, which is probably *the* most popular indicator around. Divergences form when the MACD diverges from the price action of the underlying security. A bullish divergence forms when a security records a lower low and the MACD forms a higher low. The lower low in the security affirms the current downtrend, but the higher low in the MACD shows less downside momentum. Despite less downside momentum, downside momentum is still outpacing upside momentum as long as the MACD remains in negative territory. Slowing downside momentum can sometimes foreshadow a trend reversal or a sizable rally.

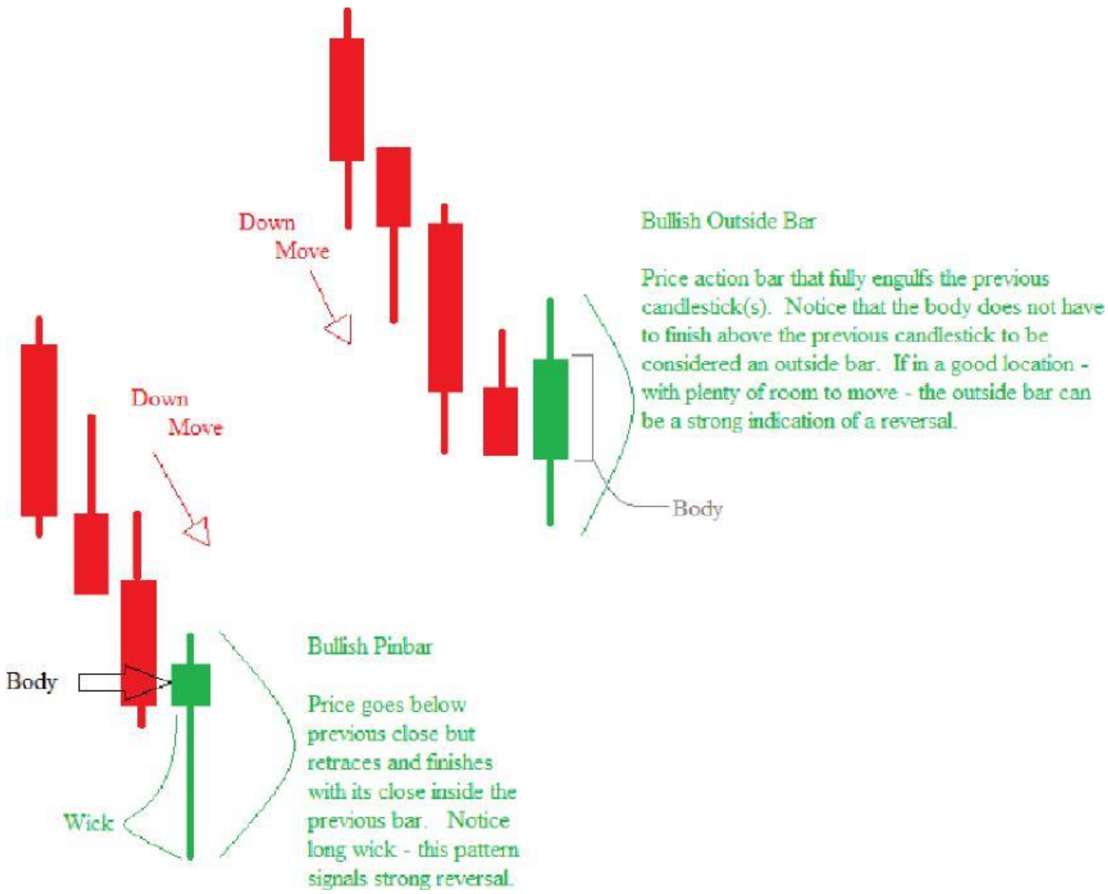
The next chart shows Google (GOOG) with a bullish divergence in October- November 2008. First, notice that we are using closing prices to identify the divergence. The MACD's moving averages are based on closing prices and we should consider closing prices in the security as well. Second, notice that there were clear reaction lows (troughs) as both Google and its MACD Line bounced in October and late November. Third, notice that the MACD formed a higher low as Google formed a lower low in November. The MACD turned up with a bullish divergence with a signal line crossover in early December. Google confirmed a reversal with resistance breakout.

2. Pin Bars and Outside Bars

The two most important price action patterns to recognize are the pin bar and the outside bar. Both these patterns can signal long-term change in price.

The pin bar is short for Pinocchio bar and is essentially telling the trader that the market could potentially change direction.

An outside bar is a price action pattern that has the current candlestick fully engulfing the previous candlestick(s). The high and low of the current candlestick went beyond the previous candle. This price action pattern is a strong reversal pattern and combined with support and resistance can be very effective.



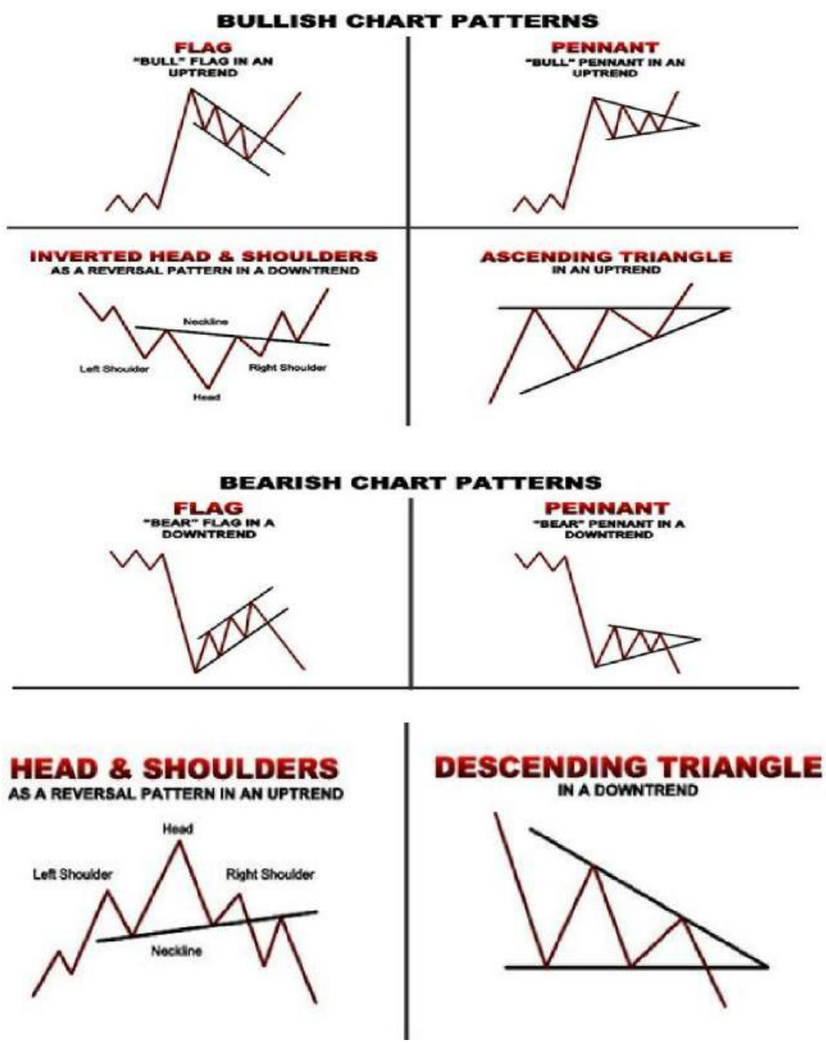
3. Exhaustion Gaps

An exhaustion gap in technical analysis is a price gap on a chart that usually appears on a strong uptrend. An exhaustion gap is an early warning sign that the current uptrend is losing steam and it is ready for a major retracement back to a reasonable level.

4. Support and Resistance

All of the above methods of identifying possible trend reversals should always be combined with support and resistance levels. Without using support and resistance, these formations may not be showing anything other than a coincidence in price action. It should also be noted that these methods, along with any other trading methods, only show the trader what is "likely" to happen and are never an exact prediction of the future.

Common Trading Patterns



Conclusion

Identification of key support and resistance levels is an essential ingredient to successful technical analysis. Even though it is sometimes difficult to establish exact support and resistance levels, being aware of their existence and location can greatly enhance analysis and forecasting abilities. If a security is approaching an important support level, it can serve as an alert to be extra vigilant in looking for signs of increased buying pressure and a potential reversal. If a security is approaching a resistance level, it can act as an alert to look for signs of increased selling pressure and potential reversal.

Combining what we now know about support and resistance with the other chart patterns and methods described in this eBook provides a strong foundation on your path to becoming a great trader.

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