StockWatchIndex
Rise Above the Noise

SWI White Papers Volume 2

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. Instead, it can help investors anticipate what is "likely" to happen to prices over time. Technical analysis uses a variety of charts to show prices over time. Traders often develop their own strategies based on their observations of market patterns and trends, frequently adapting their approaches as they gain more experience. Chart patterns, indicators, and volume analysis are some of the tools used in this practice.

Technical analysis can be applied to stocks, indices, commodities, futures, or any tradable instrument where the forces of supply and demand influence the price. 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-minute, 10-minute, 15-minute, 30-minute, 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 weeks? This is a question you will have to address upfront. However, the answer will most likely surface once you begin to trade and get a feel for the markets.

Ultimately, success in trading often involves continuous learning, adapting to market conditions, and managing risk effectively.

Traders and investors widely use technical analysis. It is often combined with fundamental analysis to provide a more comprehensive market view. However, this analysis method is not foolproof, and market conditions can be unpredictable. While technical analysis focuses on price action, combining it with fundamental analysis, which considers economic factors, financial statements, and industry conditions, can offer a more rounded view.

"No analysis method is foolproof. "

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1. **Charts**: The primary technical analysis tools are charts that display price movements over time. Standard charts include line charts, bar charts, and candlestick charts. Candlestick charts are viral as they provide more information, such as opening and closing prices.

2. **Trends**: Identifying whether a market is in an uptrend, downtrend, or ranging (sideways) is crucial. Trends

are defined by higher highs and higher lows (uptrend), lower highs and lower lows (downtrend), or a lack of direction (ranging).

3. **Support and Resistance:** Support refers to price levels at which a stock tends to stop falling and may bounce back up, while resistance refers to the levels at which prices stop rising and may reverse downward. These levels can be derived from historical price points.

4. **Indicators and Oscillators:** Various mathematical formulas and plots are used to analyze market conditions. Common examples include Moving Averages, the Relative Strength Index (RSI), and the moving Average Convergence Divergence (MACD). These tools help traders identify potential entry and exit points based on price momentum.

5. **Volume Analysis**: Volume refers to the number of shares or contracts traded in a security or market during a period. Analyzing volume helps traders understand whether a price movement is strong or weak; for instance, a price rise on low volume may not be sustainable.

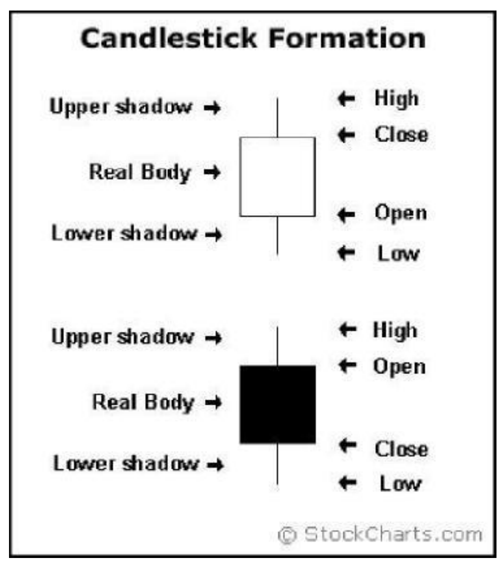
6. **Chart Patterns**: Price patterns, such as head-and-shoulders, double tops, bottoms, flags, and triangles, can indicate future price movements. Recognizing these patterns can assist traders in making predictions about market action.

7. **Risk Management**: Technical analysis also includes strategies for managing risk, such as setting stop-loss orders to limit potential losses and determining the trade size based on the trader's risk tolerance.

These are the critical tools for your Analysis.

Reading Candles

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 top of the upper shadow marks the high, 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 representing the closing price. If the stock closes lower than its opening price, a filled candlestick is drawn with the top and bottom of the body representing the opening price.



Take a few minutes to study the chart to the right. 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 to becoming a great trader.

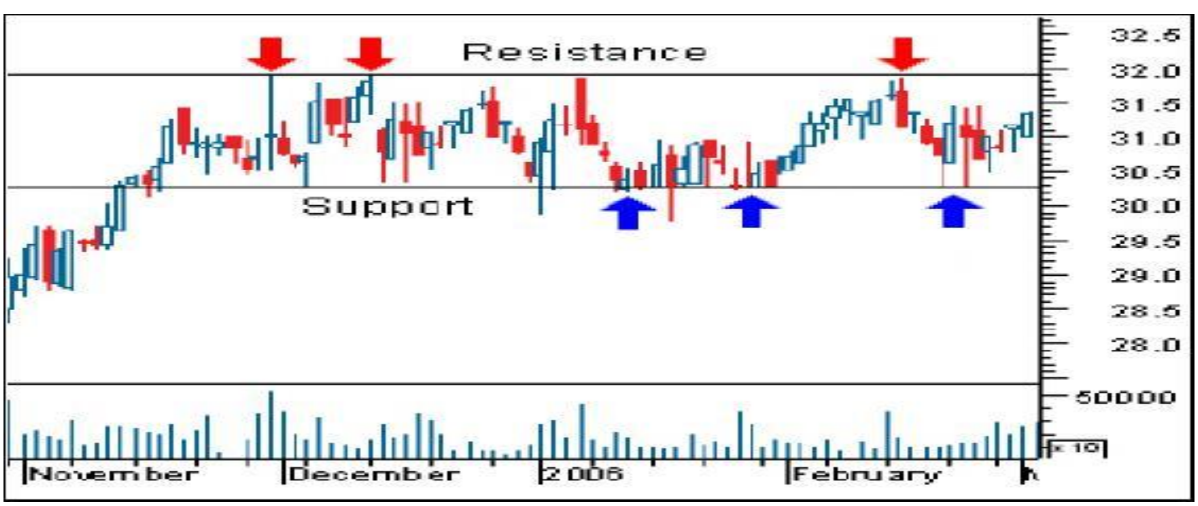
Support and Resistance

When starting, the most important thing to remember is that price movements are not entirely random. The levels and patterns I will show you can be used repeatedly in any market. Once you become proficient, you can read a chart and determine the likely outcome within seconds.

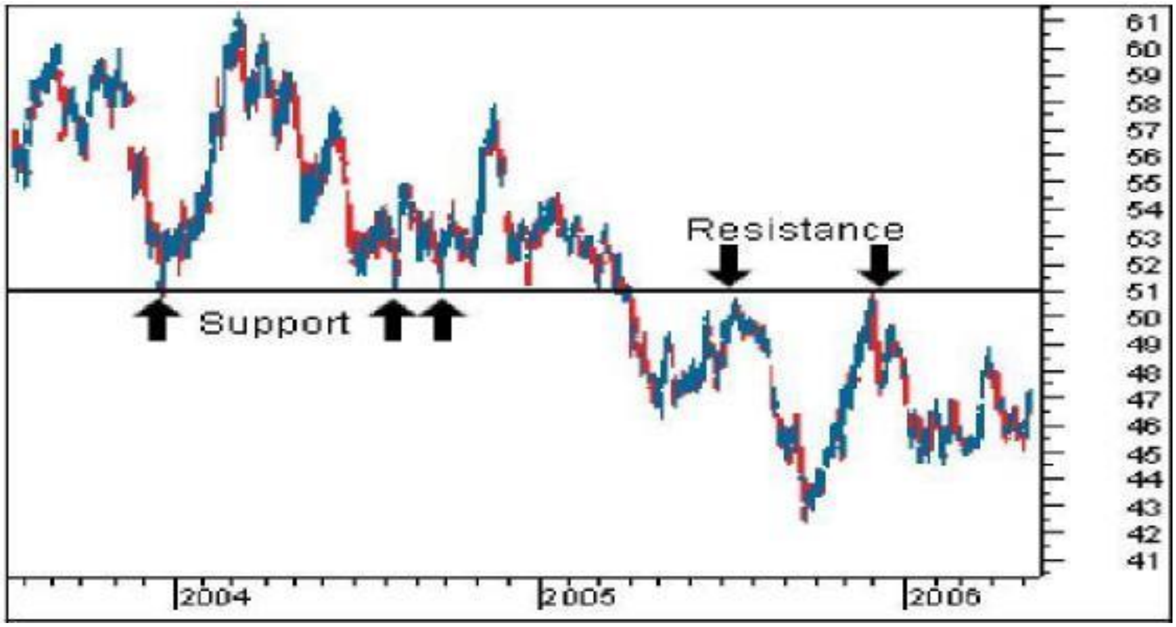
Below is an excellent example of support and resistance levels (I will call these SR levels). Notice how the price repeatedly respects these levels. This type of SR pattern is also known as a channel. Channels can be directional (uptrend or downtrend), flat, or lateral, as in the image below.

So why does this happen?

These support and resistance levels are necessary regarding 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 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 are thought to have shifted; in this case, added support and resistance levels will likely be established.



Below is an excellent example of an SR level often called "support turned resistance." In this case, a dedicated support level quickly becomes resistant when the price breaks through to the downside.



Many traders who begin using technical analysis find this concept hard to believe and need to realize that this phenomenon occurs relatively 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 the 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 solid support.

Mind the Trend

As a trader, you have probably heard the adage that it is best to trade with the trend, or the more famous 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 critical question is, how can we determine the direction of the trend? I believe in the KIS rule, "Keep it simple." Many traders will show you methods of determining the trend using moving averages, Moving Average Convergence Divergence (MACD), etc. I do not like using these methods because they are far too subjective and lagging. Instead, I like to "keep it simple." Please take a look at the image below to see what I mean. Could you quickly identify the trend and determine a likely direction of travel?

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

MACD Negative Divergence

One of my favorite ways to identify a trend reversal is with the MACD indicator, probably *the* most famous indicator. 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 security level affirms the current downtrend, but the higher low in the MACD shows less downside momentum. Despite less downside momentum, downside momentum still outpaces upside momentum as long as the MACD remains in negative territory. Slowing downside momentum can sometimes foreshadow a trend reversal or a sizable rally.

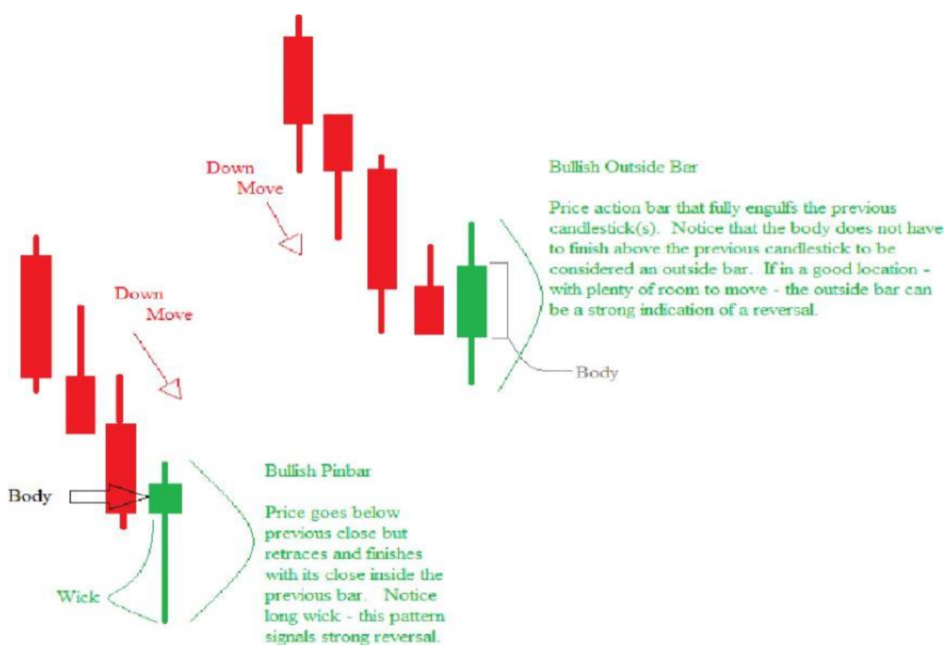
The following chart shows Google (GOOG) with a bullish divergence in October- November 2008 as a good example. First, notice that we are using closing prices to identify the divergence. The MACD's moving averages are based on closing prices, and we should also consider closing prices in the security. Second, 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, while Google formed a lower low in November. The MACD ended with a bullish divergence with a signal line crossover in early December. Google confirmed a reversal with a resistance breakout.

Pin Bars and Outside Bars

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

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

An outside bar is a price action pattern in which the current candlestick fully engulfs the previous candlestick(s). The high and low of the current candlestick go beyond the previous candle. This pattern is a strong reversal and can be highly effective when combined with support and resistance.



3. Exhaustion Gaps

In technical analysis, an exhaustion gap is a price gap on a chart that usually appears during a solid, significant price movement, often at the end of a prevailing trend, either an uptrend or a down. It is an early warning sign that the current uptrend is losing steam and is ready for a significant reversal, typically found after a long trend (either bullish or bearish). This was followed by increased trading volume, indicating strong market participation. Often leads to a rapid price change, followed by consolidation or reversal.

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4. Support and Resistance

The above methods of identifying possible trend reversals should always be combined with support and resistance levels. Without support and resistance, these formations may not show 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.

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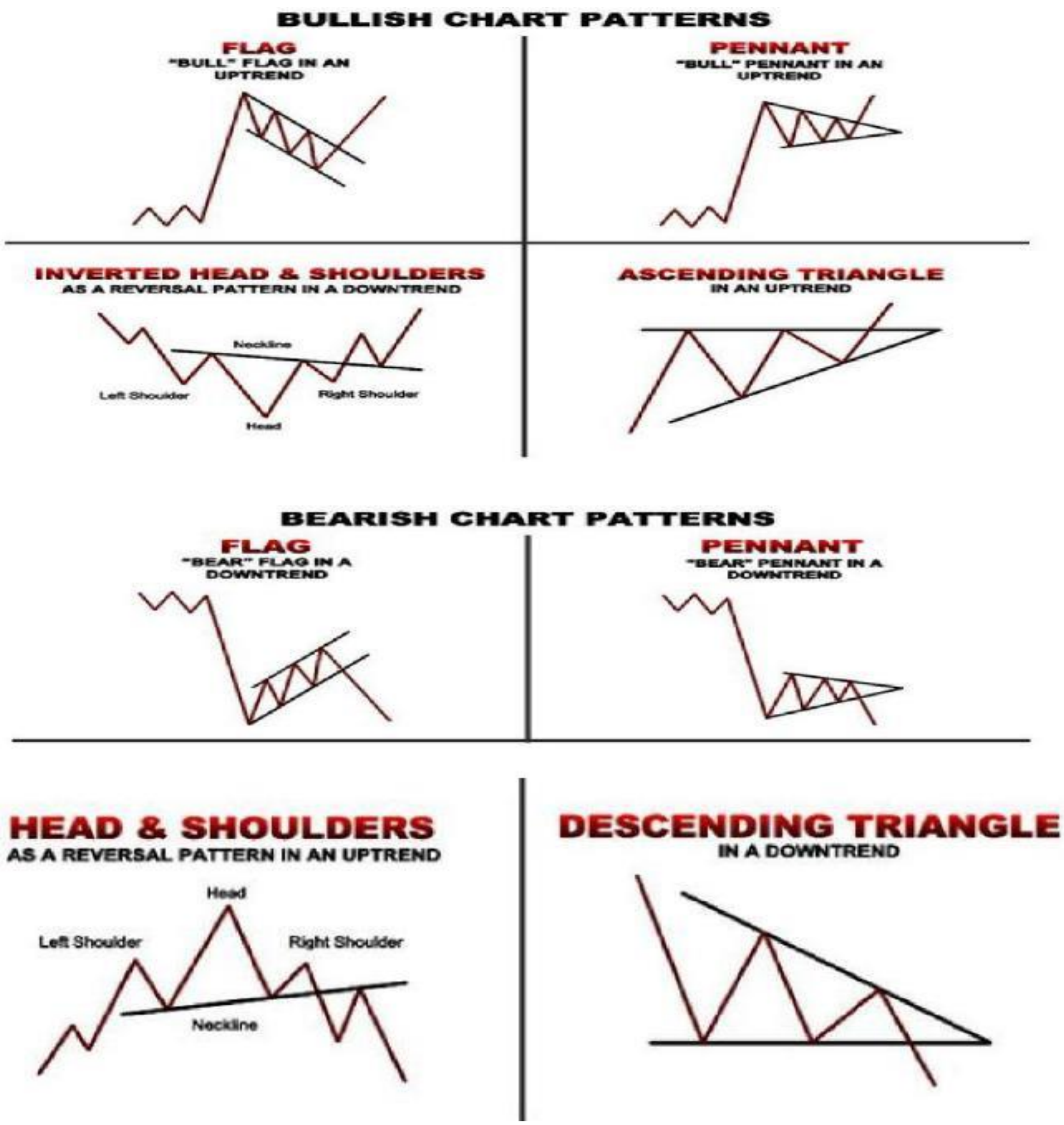
Common Trading Patterns



Conclusion

In summary, a deep understanding of critical support and resistance levels is paramount for anyone engaging in technical analysis. While pinpointing these levels can sometimes prove challenging, their recognition can significantly bolster one's analytical and predictive skills in the market. When a security nears a critical support level, it may signal a prospective rebound, urging investors to observe for signs of heightened buying activity. Conversely, as a security approaches a resistance level, it may indicate a forthcoming downturn, prompting traders to look for increased selling pressure.

Success in trading is not just about picking the right tools but about continuous learning, adapting, and, most importantly, effective risk management. So, whether you are a market newbie or a seasoned trader, there is always something new to learn and strategies to refine.

By integrating the knowledge of support and resistance with various chart patterns and methodologies outlined in this eBook, traders can build a robust strategy that enhances their trading acumen. Mastery of these concepts not only aids in making informed decisions but also contributes to greater confidence in navigating the complexities of the market landscape.

Technical Analysis #1 following soon

About StockWatchIndex (SWI)

SWI's websites, newsletters, and publications are published to inform, educate, and empower its users, providing a competitive edge in trading in today's fast-moving stock market. SWI provides market awareness services for small public companies to improve their market position and support their market awareness activities focused on investor relations, syndicate relationships, and access to its expansive social media network. SWI works with its corporate clients to enhance shareholder value, help companies set realistic goals, and establish performance measures to monitor progress against the goals to ensure continued success.

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