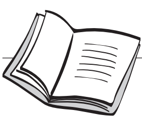
CHAPTER 1

Introduction to Technical Analysis

Pursuing Profit in the Financial Markets



After reading this chapter, you will be able to:

- Understand the general concept of technical analysis.
- Discern the basic differences between technical analysis and fundamental analysis.
- Recognize some of the key tools and methods of technical analysis.
- Know what concepts will be discussed throughout the rest of this book.

What Is Technical Analysis?

Technical analysis is the study of how past and present price action in a given financial market may help determine its future direction. At the same time, however, technical analysis should not be considered a crystal ball. Rather, the skills of a technical analyst are used primarily to help determine the highest-probability reactions to past and current price movement, as well as likely future price movement. Therefore, technical analysis is less about actually predicting the future and more about finding high-probability potential opportunities to trade in the financial markets.

The primary tool used by technical analysts is the ubiquitous price chart, which generally plots prices over a given period of time. The various major chart types are discussed in detail in Chapter 4, which covers the basics of technical analysis. Different analysts/traders may choose to use different types of charts at different times, whether it is a line chart, a bar chart, a candlestick chart, a point-and-figure chart, or any of a number of other chart types.

Technical versus Fundamental

When many people in the financial world refer to technical analysis, it is often in direct contrast to the other major school of market analysis, fundamental analysis. The contrast between the two is clear and distinct.

Fundamental analysis focuses on what the underlying reasons may be for market movement. In the stock market, this would consist of news and financial information (e.g., earnings) that are directly associated with a particular publicly traded company. In the futures market, it would consist of substantive market information regarding a specific commodity (e.g., wheat or oil) or financial market/index (e.g., S&P 500). In the foreign exchange, or currency, market, fundamental analysis would be primarily concerned with international economies, central bank policy, interest rates, and inflation.

Fundamental analysis stands in stark contrast to the world of technical analysis. Instead of concerning itself with the underlying reasons for price movement, technical analysis focuses on the price movement itself and how mass human behavior is manifested in price action. Technical analysts believe that all fundamental information and economic factors that can cause price movement are already reflected in price action. Therefore, technical analysis purists generally avoid looking at earnings or crop reports or international economic conditions. Instead, the two primary tools of price and volume as depicted on a financial chart are sufficient for most analysts of the technical persuasion. Of these two tools, price is universally more important.

Here is another way to describe the distinction between fundamental analysis and technical analysis: While fundamental analysis may concern itself with the myriad reasons "why" price moves, technical analysis is single-mindedly focused on "how" price moves and the way in which that might affect future price movement. Technical analysis consists of a broad methodology through which traders can identify trading opportunities and make all of their most important trading decisions. This includes trade entries, trade exits, stop-loss placement, profit target placement, trade sizing, risk management, and more.

While some traders and investors are strict adherents to either fundamental analysis or technical analysis, and completely exclude consideration of the other, many use a combination of both.

Executive Insight

Robert Prechter, Jr., CMT

In a written interview with the author, Robert Prechter, Jr., publisher of *The Elliott Wave Theorist* since 1979 and founder/president of Elliott Wave International (elliottwave.com), discusses being a pure technician. Legendary for his market timing and trading acumen utilizing Elliott Wave principles, Prechter has won numerous major accolades from the media and financial community over an illustrious, decades-long career. He has authored many books, several of which were instrumental in bringing Ralph Nelson Elliott's groundbreaking Elliott Wave Principle into the forefront of financial market analysis. More about Robert Prechter, Jr., and his considerable contributions to the development of technical analysis can be found in Chapter 2.

Prechter states:

> Most analysts are not technicians. But it is also true that most self-described technicians are not pure technicians. They talk about Federal Reserve policy, political action, economic news and other such events as causal to the market's movement. If such events are causal, then technical indicators would not be potent, because randomly occurring outside events would be creating the supposed patterns, making them spurious. Any new event could make the market go contrary to what a pattern or indicator suggested. To be a hybrid analyst is to be theoretically inconsistent. Either outside events move the market or market behavior is patterned. One cannot have it both ways.
>
> A pure technician is someone who believes that the stock market's causality derives from unchanging aspects of human behavior. Only if this is true can a head-and-shoulders pattern, a trend line, or a wave form be reliable. Otherwise such things are simply artifacts of random movement. True technicians are those who rely solely on technical indicators and models such as price trends, cycles, volume patterns, momentum readings, sentiment indicators, Elliott Waves, Edwards and Magee patterns, and Dow theory.

Fundamentalists look for outside causes and try to predict them, reasoning from those predictions to market predictions. Technicians study patterns relating to market behavior and make decisions on that basis alone. Fundamentalists study everything but the behavior of the market. Technicians study only the behavior of the market.

Methods

The methods of utilizing technical analysis are many and varied. They include such ubiquitous concepts as head and shoulders, support and resistance, trends, moving averages, and double-tops. But they also include concepts that are less popularly known, such as linear regression, bullish engulfing patterns, Elliott Wave, and point-and-figure charts. All of these elements of technical analysis, and much more, are discussed in the pages of this book.

The main focus of this book is to provide the essential knowledge about technical analysis that is necessary to begin serious analysis of any major financial market. With that goal, this book outlines and describes the primary tools used by technical analysts and traders. Of course, technical analysis is a huge subject that is growing every day, and no book could ever hope to cover all of the information within the field adequately. Therefore, this book provides substantial coverage of the essentials, as the title suggests, while necessarily omitting some of the more esoteric concepts in the field.

What to Expect

After this introduction, Chapter 2 begins with a concise history of the most pivotal events in the development of technical analysis—

from the Japanese rice markets in Osaka; to the revolutionary tenets of Dow theory; to the development and mainstream adoption of charting; to the advent of Elliott Wave theory; to the emergence of trend following; and finally to the automated, systematic trading of today.

Then the most important aspect of technical analysis, price action, is described in detail in Chapter 3. Price action, or the patterned behavior of price that can give clues as to potential future direction, is truly the basis for the study of technical analysis as we know it today.

The book then jumps straight into the primary basics of technical analysis—charts. These are the primary tools of technical analysts and traders, whether the chart of choice is a line chart, a bar chart, a candlestick chart, a point-and-figure chart, or some other manner of graphically depicting price action. All of these chart types are presented and discussed in Chapter 4, including their structures and methods of interpretation.

After these basics are covered, Chapter 5 is devoted entirely to what is arguably the single most important concept within technical analysis and the heart of the discipline: trend. The definitions and characteristics of uptrends, downtrends, and no trend are covered, as well as methods to identify trend conditions.

After the heart of technical analysis is discussed, Chapter 6 talks about another vital aspect of the field that can be considered the soul of technical analysis: support and resistance. These twin concepts are the basis for much of the technical analysis that is published in the media as well as for many technical trading methods and strategies.

The chapter on support and resistance is followed by a discussion of the practical drawing tools necessary for depicting both trends and support/resistance levels. These important drawing tools include trend lines, trend channels, and horizontal support and resistance lines. Chapter 7 covers how these lines are customarily drawn and interpreted by technical analysts and traders.

Moving on to Chapter 8, the discussion then turns to the key topic of chart patterns. This includes the most prevalent and important bar chart shapes, such as triangles, wedges, flags, pennants, head and shoulders, and the like. The chapter also includes descriptions of the most common Japanese candlestick formations, such as hammers, shooting stars, doji, engulfing patterns, and the like.

Chapter 9 covers the world of moving averages, those wavy lines that can reveal so much about a market's trending conditions and support/resistance areas. Moving averages also play a pivotal role in many technical trading strategies, as well as in market analysts' commentaries.

Besides moving averages, many other important technical indicators are mathematically derived from price. The most common and important of these indicators, which include a special subcategory called oscillators, are presented and described in Chapter 10.

From there, this book moves into the more advanced concepts of Fibonacci and Elliott Wave theories in Chapter 11. These unique perspectives on market price action are often used by more sophisticated technical traders, and they can provide extremely valuable insight into the structure of price and how to reap potential benefit from it.

Chapter 12 covers yet another unique perspective on price action: point-and-figure charting. Significantly different from its line, bar, and candlestick cousins, point-and-figure analysis concentrates exclusively on the market's price action, excluding all other factors, including time and volume. Because of this fact, many consider point-and-figure trading to be the purest form of price action trading.

Although volume is customarily excluded on point and figure charts, it is the star of Chapter 13. Used primarily by stock market traders, volume is considered both a leading indicator as well as a confirming indicator. When trading equities, volume can be a vital tool for providing important confirmation of price action. Confirmation is a key concept within technical analysis.

Chapter 14 brings together all of the tools, methods, and concepts of technical analysis discussed up to that point and describes specific trading methods and strategies used by professional technical traders. This discussion includes information on both manual and automated trading and on how each strategy covered is suited to either mode of trading. The strategies and methods described in Chapter 14 comprise the culmination of all the building blocks of information found throughout the rest of the book.

Finally, Chapter 15 discusses one of the most important aspects of any trading plan: risk control and money management. Although it is not nearly as enthusiastically embraced a topic as trade entry strategies, at least with many novice traders, most successful and professional traders/investors would likely agree that risk control and money management are the keys to consistent success in the financial markets. Without these vital components of a sound trading plan, failure can almost be assured. Chapter 15 covers some of the most important aspects of a good risk and money management plan.

By the end of this book, the goal is for the reader to be well on his or her way to becoming well rounded and knowledgeable on the art and science of technical analysis. To truly master any of the concepts discussed in this book will require further study and a lot of practical, hands-on experience. But once that mastery occurs, one invariably finds that it is always well worth the effort to get there. This book is meant to serve as an essential guide pointing the way to eventual mastery of technical analysis concepts and applications.

Summary

This chapter delved into the basic concepts of technical analysis, including a core definition and the differences between technical analysis and the other main school of financial market study, fundamental analysis.

The sharp contrast between technical analysis and fundamental analysis is useful in helping those who are new to the financial markets understand how each discipline may fit into one's overall market outlook. Fundamental analysis is more concerned with "why" price may move, while technical analysis focuses on "how" price moves. Technical analysis helps traders and investors to identify trading opportunities, which include trade entries, exits, risk management, and more.

This introductory chapter then went on to describe what is covered in each subsequent chapter. All of the essentials of technical analysis for financial markets are covered in these chapters.