Technical Analysis and Charting

Contents

- Logic behind Technical Analysis
- Stock Charts
- Trends
- Volume
- Patterns and Indicators
- Moving Averages
- Support and Resistance
- Japanese Candlestick Charting
- Dow Theory
- Elliott Waves Theory Basics
- Multiple Time Frame
- Trendline and Trendlines
- External Relative Strength

I. The Logic Behind Technical Analysis

Let me first say that I do not now engage in technical analysis; nor, have I ever engaged in **technical analysis**. I do not believe doing so would be a productive use of my time.

Having said that, I do not claim technical analysis has no predictive value. In fact, I suspect it does have some predictive value. The Efficient Market Hypothesis is flawed. It is based upon the (unwritten) premise that data determines market prices. As Graham so clearly put it in **"Security Analysis":**

"…the influence of what we call analytical factors over the market price is both partial and indirect – partial, because it frequently competes with purely speculative factors which influence the price in the opposite direction; and indirect, because it acts through the intermediary of people's sentiments and decisions. In other words, the market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion."

I've seen a lot of people cite this quote, without bothering to notice what's really being said. Graham had a very broad mind, much broader than say someone like Buffett. That's both a blessing and a curse. At several points in Security Analysis (and to a lesser extent in his other works), Graham can not help but explore an interesting topic more deeply than is strictly necessary for his primary purpose. In this case, Graham could have said what many have since interpreted him as saying: in the short run, stock prices often get out of whack; in the long run, they are governed by the intrinsic value of the underlying business. Of course, Graham didn't say that. Instead he chose to describe the stock market in a way that should have been of great interest to economists as well as investors.

Data affects prices indirectly. The market is a lot like a fun house mirror. The resulting reflection is caused in part by the original data, but that does not mean the reflection is an accurate representation of the original data. To take this metaphor a step further, the Efficient Market Hypothesis is based on the idea that the original image acts on the mirror to create the reflection. It does not recognize the unpleasant truth that one can interpret the same process in a very different way. One could say it is the mirror that acts on the original image to create the reflection. In fact, that is often how we interpret the process. We say an object is reflected in a mirror. We rarely use the active "an object reflects in a mirror".

For some reason, when we talk about the market we like to use inappropriate metaphors. We talk about wealth being destroyed when prices fall. Yet, no one talks of wealth being destroyed when the price of some product falls. When the market rises, we talk about buyers, as if there wasn't a seller on the other side of the trade. Above all else, we talk about "the market" not as a mere aggregation of trades, but as some sort of object all its own.

The Efficient Market Hypothesis does not recognize the true importance of interpretation. Saying that data (publicly available information) acts on market prices omits the key step. After all, the same data is available to every blackjack player. Casinos just don't like the way a card counter interprets that data.

The Efficient Market Hypothesis is not the only argument against **technical analysis**. There is also empirical evidence that questions the utility of technical analysis. However, empirical evidence alone is not sufficient to prove technical analysis has no predictive power. If most knuckleball pitchers had limited success, the knuckleball might be an inherently ineffective pitch, or there might be a better way to throw it. The same is true of technical analysis.

The adjective "random" is a very strange word. Although it is rarely the definition given, the most appropriate definition for random would have to be "having no discernible pattern". The word discernible can not be omitted. If it is, we will take too high a view of science and statistics. There's a great introduction to economics written by Carl Menger which begins:

"All things are subject to the law of cause and effect. This great principle knows no exception, and we would search in vain in the realm of experience for an example to the contrary. Human progress has no tendency to cast it in doubt, but rather the effect of confirming it and of always further widening knowledge of the scope of its validity."

All things are subject to the law of cause and effect; therefore, nothing is truly random. A caused event must have a pattern – though that pattern needn't be discernible. Even if one argued there is such a thing as an uncaused event, who would argue that stock price movements are uncaused? We know that they are caused by buying and selling. Stock prices are the effects of purposeful human actions. Several sciences study the causes of purposeful human action; so, it would be hard to argue any human action is uncaused. Furthermore, each of our own internal mental experiences suggests that our purposeful actions have very definite causes. We also know that the actions of some market participants are based in part on price movements. Many investors will admit as much. They may be lying. But, there is plenty of evidence to suggest they aren't.

If the actions of investors cause price movements, and past price movements are a partial cause of the actions of investors, then past price movements must partially cause future price movements.

Technical analysis is logically valid. Not only is it possible that some form of technical analysis might have predictive power; I would argue it necessarily follows from the above assumptions that some form of technical analysis must have predictive power.

So, why don't I use technical analysis? I believe **fundamental analysis** is a far more powerful too. In fact, I believe fundamental analysis is so much more powerful that one ought not to spend any time on technical analysis that could instead be spent on fundamental analysis. I also believe there is more than enough fundamental analysis to keep an investor occupied; so, he shouldn't devote any time to technical analysis. Personally, I feel I am much better suited to fundamental analysis than I am to technical analysis. Of course, there is no reason why this argument should hold any weight with you. I also believe there is sufficient empirical evidence to support the idea that fundamental analysis is a far more powerful tool than technical analysis.

Even though I believe there must be some form of **technical analysis** that does have predictive power, the mental model of investing which I have constructed does not allow for such a form of technical analysis. In other words: logically, there must be an effective form of technical analysis, but practically, I pretend there isn't.

Why? Because I believe that's the most useful model. One should adopt the most useful model not the most honest model. I'm willing to pretend technical analysis does not work, even though I know some form of it must work.

Really, this isn't all that strange. In science, I'm willing to pretend there are random events, even though I know there must not be random events. In math, I'm willing to pretend zero is a number, even though I know it must not be a number. A model with random events is useful. In most circumstances, a refusal to allow for random events would be harmful rather than helpful. The model with random events is simpler and more workable. The situation is much the same with zero. It isn't a number. To include zero as a number, you would have to put aside the principles of arithmetic. So, we don't do that. In school, you were taught that zero is a number, but that there are certain things you must never do with zero. You accepted that, because it was a simple, workable model.

I propose you do much the same in the case of technical analysis. You should recognize the logical validity of **technical analysis**, but create a mental model of investing in which technical analysis has no utility whatsoever.

Return to Contents

II. Basics of Technical Analysis for Trading Strategies

New to Trading and Technical Analysis? Learn the Basics of Technical Analysis of Indian Stocks and Stock Market Trend Stock Charts and Trends.

1.Stock Charts

Stock Charts

Stock charts gained popularity in the late 19th Century from the writings of Charles H. Dow in the Wall Street Journal. His comments, later known as "Dow Theory", alleged that markets move in all kinds of measurable trends and that these trends could be deciphered and predicted in the price movement seen on all charts.

FUNDAMENTAL ANALYSIS seeks to determine future stock price by understanding and measuring the objective "value" of an equity. The study of stock charts, known as TECHNICAL ANALYSIS, believes that the past action of the market itself will determine the future course of prices.

A stock chart is a simple two-axis (x-y) plotted graph of price and time. Each individual equity, market and index listed on a public exchange has a chart that illustrates this movement of price over time. Individual data plots for charts can be made using the CLOSING price for each day. The plots are connected together in a single line, creating the graph. Also, a combination of the OPENING, CLOSING, HIGH and/or LOW prices for that market session can be used for the data plots. This second type of data is called a PRICE BAR. Individual price bars are then overlaid onto the graph, creating a dense visual display of stock movement.

Stock charts can be created in many different time frames. Mutual fund holders use monthly charts in which each individual data plot consists of a single month of activity. Day traders use 1 minute and 5 minute stock charts to make quick buy and sell decisions. The most common type of stock chart is the daily plot, showing a single complete market session for each unit.

Stock charts can be drawn in two different ways. An ARITHMETIC chart has equal vertical distances between each unit of price. A LOGARITHMIC chart is a percentage growth chart. It has equal vertical distances between the same percentages of price growth. For example, a price movement from 10 to 20 is a 100% move. A move from 20 to 40 is also a 100% move. For this reason, the vertical distance from 10 to 20 and the vertical distance from 20 to 40 will be identical on a logarithmic chart.

Stock chart analysis can be applied equally to individual stocks and major indices. Analysts use their technical research on index charts to decide whether the current market is a BULL MARKET or a BEAR MARKET. On individual charts, investors and traders can learn the same thing about their favorite companies.

Return to Contents

2.Trends

Trends

Use the stock chart to identify the current trend. A trend reflects the average rate of change in a stock's price over time. Trends exist in all time frames and all markets. Day traders can establish the trend of their stocks to within minutes. Long term investors watch trends that persist for many years.

Trends can be classified in three ways: UP, DOWN or RANGEBOUND.

In an uptrend, a stock rallies often with intermediate periods of consolidation or movement against the trend. In doing so, it draws a series of higher highs and higher lows on the stock chart. In an uptrend, there will be a POSITIVE rate of price change over time.

In a downtrend, a stock declines often with intermediate periods of consolidation or movement against the trend. In doing so, it draws a series of lower highs and lower lows on the stock chart. In a downtrend, there will be a NEGATIVE rate of price change over time.

Rangebound price swings back and forth for long periods between easily seen upper and lower limits. There is no apparent direction to the price movement on the stock chart and there will be LITTLE or NO rate of price change.

Trends tend to persist over time. A stock in an uptrend will continue to rise until some change in value or conditions occurs. Declining stocks will continue to fall until some change in value or conditions occurs. Chart readers try to locate TOPS and BOTTOMS, which are those points where a rally or a decline ends. Taking a position near a top or a bottom can be very profitable.

Trends can be measured using TRENDLINES. Very often a straight line can be drawn UNDER three or more pullbacks from rallies or OVER pullbacks from declines. When price bars then return to that trendline, they tend to find SUPPORT or RESISTANCE and bounce off the line in the opposite direction.

A famous quote about trends advises that "The trend is your friend". For traders and investors, this wisdom teaches that you will have more success taking stock positions in the direction of the prevailing trend than against it.

Return to Contents

3.Volume

Volume

Volume measures the participation of the crowd. Stock charts display volume through individual HISTOGRAMS below

the price pane. Often these will show green bars for up days and red bars for down days. Investors and traders can measure buying and selling interest by watching how many up or down days in a row occur and how their volume compares with days in which price moves in the opposite direction.

Stocks that are bought with greater interest than sold are said to be under ACCUMULATION. Stocks that are sold with great interest than bought are said to be under DISTRIBUTION. Accumulation and distribution often LEAD price movement. In other words, stocks under accumulation often will rise some time after the buying begins. Alternatively, stocks under distribution will often fall some time after selling begins.

It takes volume for a stock to rise but it can fall of its own weight. Rallies require the enthusiastic participation of the crowd. When a rally runs out of new participants, a stock can easily fall. Investors and traders use indicators such as ON BALANCE VOLUME to see whether participation is lagging (behind) or leading (ahead) the price action.

Stocks trade daily with an average volume that determines their LIQUIDITY. Liquid stocks are very easy for traders to buy and sell. Illiquid stocks require very high SPREADS (transaction costs) to buy or sell and often cannot be eliminated quickly from a portfolio. Stock chart analysis does not work well on illiquid stocks.

Breakouts accompanied by volume much higher than the average for that stock are healthy for the continuation of the price movement in that direction. But after long rallies or declines, stocks often have a day of very high volume known as a CLIMAX. During these days, the last of the buyers or sellers take positions. The stock then reverses as there are no longer enough participants to cause price to move in that direction.

Return to Contents

4.Patterns and Indicators

Patterns and Indicators

How can you organize the endless stream of stock chart data into a logical format that doesn't require rocket science to interpret? Charts allow investors and traders to look at past and present price action in order to make reasonable predictions and wise choices. It is a highly visual medium. This one fact separates it from the colder world of value-based analysis.

The stock chart activates both left-brain and right-brain functions of logic and creativity. So it's no surprise that over the last century two forms of analysis have developed that focus along these lines of critical examination.

The oldest form of interpreting charts is PATTERN ANALYSIS. This method gained popularity through both the writings of Charles Dow and ***Technical Analysis of Stock Trends***, a classic book written on the subject just after World War II. The newer form of interpretation is INDICATOR ANALYSIS, a math-oriented examination in which the basic elements of price and volume are run through a series of calculations in order to predict where price will go next.

Pattern analysis gains its power from the tendency of charts to repeat the same bar formations over and over again. These patterns have been categorized over the years as having a bullish or bearish bias. Some well-known ones include HEAD and SHOULDERS, TRIANGLES, RECTANGLES, DOUBLE TOPS, DOUBLE BOTTOMS and FLAGS. Also, chart landscape features such as GAPS and TRENDLINES are said to have great significance on the future course of price

action.

Indicator analysis uses math calculations to measure the relationship of current price to past price action. Almost all indicators can be categorized as TREND-FOLLOWING or OSCILLATORS. Popular trend-following indicators include MOVING AVERAGES, ON BALANCE VOLUME and MACD. Common oscillators include STOCHASTICS, RSI and RATE OF CHANGE. Trend-following indicators react much more slowly than oscillators. They look deeply into the rear view mirror to locate the future. Oscillators react very quickly to short-term changes in price, flipping back and forth between OVERBOUGHT and OVERSOLD levels.

Both patterns and indicators measure market psychology. The core of investors and traders that make up the market each day tend to act with a herd mentality as price rises and falls. This "crowd" tends to develop known characteristics that repeat themselves over and over again. Chart interpretation using these two important analysis tools uncovers growing stress within the crowd that should eventually translate into price change.

Return to Contents

5.Moving Averages

Moving Averages

Moving averages are one of the oldest and most popular technical analysis tool. This section describes the basic of moving average and interpretation.
Nowadays you get moving averages readily available on most of the websites.
To brief you moving average is calculated by adding the closing prices of a stock for most recent 15 days and then dividing by 15 the result what you get is the 15 day moving average.

How to trade on moving average

Suppose If the stock price is above its 25 day moving average, it means that investor's current expectations (the current price of the stock) are higher than their average expectations over the last 25 days, and that investors are becoming increasingly bullish on this stock and result is that the stock price may go up.
Conversely, if today's price is below then its 25 day moving average, it shows that current expectations are below average expectations over the last 25 days and this may bring stock price lower.
The moving average is used to observe changes in prices. Investors typically buy when a stock price rises above its moving average and sell when the price falls below its moving average.
The most popular technical indicator for studying stock charts is the MOVING AVERAGE. This versatile tool has many important uses for investors and traders.

Take the sum of any number of previous CLOSE prices and then divide it by that same number. This creates an average price for that stock in that period of time. A moving average can be displayed by recomputing this result daily and plotting it in the same graphic pane as the price bars. Moving averages LAG price. In other words, if price starts to move sharply upward or downward, it will take some time for the moving average to "catch up".

Plotting moving averages in stock charts reveals how well current price is behaving as compared to the past. The

power of the moving average line comes from its direct interaction with the price bars. Current price will always be above or below any moving average computation. When it is above, conditions are "bullish". When below, conditions are "bearish". Additionally, moving averages will slope upward or downward over time. This adds another visual dimension to a stock analysis.

Moving averages define STOCK TRENDS. They can be computed for any period of time. Investors and traders find them most helpful when they provide input about the SHORT-TERM, INTERMEDIATE and LONG-TERM trends. For this reason, using multiple moving averages that reflect these characteristics assist important decision making. Common moving average settings for daily stock charts are: 20 days for short-term, 50 days for intermediate and 200 days for long-term.

One of the most common buy or sell signals in all chart analysis is the MOVING AVERAGE CROSSOVER. These occur when two moving averages representing different trends criss-cross. For example, when a short-term average crosses BELOW a long-term one, a SELL signal is generated. Conversely, when a short-term crosses ABOVE the long-term, a BUY signal is generated.

Moving averages can be "speeded up" through the application of further math calculations. Common averages are known as SIMPLE or SMA. These tend to be very slow. By giving more weight to the current changes in price rather than those many bars ago, a faster EXPONENTIAL or EMA moving average can be created. Many technicians favor the EMA over the SMA. Fortunately all common stock chart programs, online and offline, do the difficult moving average calculations for you and plot price perfectly.

For further reading on Moving averages (available in this CD itself) **click here**

Return to Contents

6.Support and Resistance

Support and resistance represent key junctures where the forces of supply and demand meet. In the financial markets, prices are driven by excessive supply (down) and demand (up). Supply is synonymous with bearish, bears and selling. Demand is synonymous with bullish, bulls and buying. As demand increases, prices advance and as supply increases, prices decline. When supply and demand are equal, prices move sideways as bulls and bears slug it out for control.
Support and Resistance prices are very important in stock market and in technical analysis.
Support - The support level is considered when the stock is falling down. The support is the level at which the stock price gets support when the stock is falling down, and if the support breaks then that stock may witness further down movement.
Resistance - The Resistance is taken into picture when stock price is moving up. The resistance level is the price at which stock price get stoppage and if this stoppage/resistance breaks then further upside is expected in that stock price.
Generally, stocks comes to support and resistance points and get constant before further movement and further movement either down side or upside depends on buyers expectation and other technical aspects. The breaking of support and resistance levels can also be triggered by fundamental changes, and that is up to investor expectations (fundamental changes like changes in profits, expansion, takeover, management etc).

Support and Resistance

The concept of SUPPORT AND RESISTANCE is essential to understanding and interpreting stock charts. Just as a ball bounces when it hits the floor or drops after being thrown to the ceiling, support and resistance define natural boundaries for rising and falling prices.

Buyers and sellers are constantly in battle mode. Support defines that level where buyers are strong enough to keep price from falling further. Resistance defines that level where sellers are too strong to allow price to rise further. Support and resistance play different roles in uptrends and downtrends. In an uptrend, support is where a pullback from a rally should end. In a downtrend, resistance is where a pullback from a decline should end.

Support and resistance are created because price has memory. Those prices where significant buyers or sellers entered the market in the past will tend to generate a similar mix of participants when price again returns to that level.

When price pushes above resistance, it becomes a new support level. When price falls below support, that level becomes resistance. When a level of support or resistance is penetrated, price tends to thrust forward sharply as the crowd notices the BREAKOUT and jumps in to buy or sell. When a level is penetrated but does not attract a crowd of buyers or sellers, it often falls back below the old support or resistance. This failure is known as a FALSE BREAKOUT.

Support and resistance come in all varieties and strengths. They most often manifest as horizontal price levels. But trendlines at various angles represent support and resistance as well. The length of time that a support or resistance level exists determines the strength or weakness of that level. The strength or weakness determines how much buying or selling interest will be required to break the level. Also, the greater volume traded at any level, the stronger that level will be.

Support and resistance exist in all time frames and all markets. Levels in longer time frames are stronger than those in shorter time frames.

What is Support?

Support is the price level at which demand is thought to be strong enough to prevent the price from declining further. The logic dictates that as the price declines towards support and gets cheaper, buyers become more inclined to buy and sellers become less inclined to sell. By the time the price reaches the support level, it is believed that demand will overcome supply and prevent the price from falling below support.

After a support level is penetrated, it often becomes a resistance level; this is because investors want to limit their losses and will sell later, when prices approach the former level.

Chart of Hind. petroleum showing long term support levels

What is Resistance?

Resistance is the price level at which selling is thought to be strong enough to prevent the price from rising further. The logic dictates that as the price advances towards resistance, sellers become more inclined to sell and buyers become less inclined to buy. By the time the price reaches the resistance level, it is believed that supply will overcome demand and prevent the price from rising above resistance.

After a resistance level is penetrated, it often becomes a support level; this is because buyers who didn't buy at that price before it went up are now willing to buy at that price.

Chart of BHEL showing long term resistance levels

The concept of SUPPORT AND RESISTANCE is essential to understanding and interpreting the markets. Just as a ball bounces when it hits the floor or drops after being thrown to the ceiling, support and resistance define natural boundaries for rising and falling prices.

Buyers and sellers are constantly in battle mode. Support defines that level where buyers are strong enough to keep price from falling further. Resistance defines that level where sellers are too strong to allow price to rise further. Support and resistance play different roles in uptrends and downtrends. In an uptrend, support is where a pullback from a rally should end. In a downtrend, resistance is where a pullback from a decline should end.

Support and resistance are created because price has memory. Those prices where significant buyers or sellers entered the market in the past will tend to generate a similar mix of participants when price again returns to that level.

When price pushes above resistance, it becomes a new support level. When price falls below support, that level becomes resistance. When a level of support or resistance is penetrated, price tends to thrust forward sharply as the crowd notices the BREAKOUT and jumps in to buy or sell. When a level is penetrated but does not attract a crowd of buyers or sellers, it often falls back below the old support or resistance. This failure is known as a FALSE BREAKOUT.

Support and resistance come in all varieties and strengths. They most often manifest as horizontal price levels. The length of time that a support or resistance level exists determines the strength or weakness of that level. The strength or weakness determines how much buying or selling interest will be required to break the level. Also, the greater volume traded at any level, the stronger that level will be.

Support and resistance exist in all time frames and all markets. Levels in longer time frames are stronger than those in shorter time frames.

How can Support & Resistant Levels help you make profitable trading decisions?

Identification of key support and resistance levels is an essential ingredient to successful and profitable trading. Being aware of the support and resistant levels of stocks and indices 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.

If a support or resistance level is broken, it signals that the relationship between supply and demand has changed. A resistance breakout signals that demand (bulls) has gained the upper hand and a support break signals that supply (bears) has won the battle

Return to Contents

III.TECHNICAL ANALYSIS BY DEFINED MEANS

1.Preliminary Explanations

This technical analysis will be very useful for those who are new to technical analysis in share market.
The following points will explain how to make use of different types of indicators, support level, resistance level etc.
If proper technical analysis is done then the investment strategies will improve drastically.
This article has all basic terms of technical analysis but this will give you better idea of the share market

Candlestick charts

A candlestick chart displays stocks open high, low, and closing price.
These type of charts are the most popular type of all charts.
As shown below the top of each vertical bar represents the highest price of the stock and the bottom of the bar represents the lowest price of the stock it reached on that day. A closing price (last price) is displayed on the right side of the bar.
The red bar indicates that stock has closed lower then its open price and white bar indicates that the stock has closed above its open price. At the bottom you can see time frame.

Supply and demand

There is nothing strange about support and resistance levels. It is just supply and demand.
The supply is the number of shares that sellers are willing to supply (sell) at a given price.
The demand is the number of shares that buyers are willing to buy at a given price.
The investor expectations keeps on changing and so do the prices of stocks.
A breakout above a resistance level is evidence of an upward move as more buyers (demand) are willing to buy at higher prices. Similarly, the failure of a support level indicates that more supply (seller) is available and ready to sell at lower levels.
The Basic foundation of technical analysis tools is in the concept of supply and demand. So Charts provide us the best view and analysis of these levels in action.

Traders Regret (unhappy) Level

After the break out of a support/resistance level, it is common for stock traders to think on the new price levels, whether this price is suitable or not which results in further upward or downward movement. So in other words we can call this as traders regret. So due to this the price may come back to support/resistance level.
In such scenarios one of the two things can happen. Either the stock prices will move back to their previous level OR investors/traders will accept the new price and the stock price will keep moving up in the direction of breakout

How to understand what is going to happen and when?

A breakout generally happens with the support of huge volumes. If the price breaks through the support/resistance level with a large increase in volume and the traders regret period is on relatively low volume then this indicates that the new price up lift will keep ongoing.
Conversely, if the breakout is on moderate volume and the traders regret period is on increased volume then this indicates that very few investor expectations have changed and hence return to the original price.
Changes in price are the result of changes in investor expectations of the stocks future price.

Trends

We have already seen how support and resistance levels can be penetrated by a change in investor expectations which results in shifts of the supply/demand and hence change in stock price. This type of a change is always based on News.
In this TRENDS section, we will see what is trend and how it influences stock prices.
A trend represents a consistent change in prices. A trend is different from support/resistance levels. Trends represent change, whereas support/resistance levels represent barriers to change.
Upper Trend = A rising trend is defined as stock prices keep touching higher prices. A rising trend can be thought of as a rising support level and the bulls are in controls which are pushing the stock prices higher and higher.
Falling trend = It is defined as stock prices keep touching lower prices. A falling trend can be thought of as a falling

resistance level and bears are in controls which are pushing the stock prices lower and lower.
The break out takes place when investor's expectations change in support with increase in volumes.
As in support/resistance, in trend lines also Volumes plays a major role in continuing the trend or in break out of the trend.

Indicators

Indicators are used to predict or analyze future changes in stock price.
There are hundreds of indicators but in this section we will discussed the indicators which are most widely used and important ones.

MACD

This is one of the widely used indicator. MACD stands for Moving Average Convergence Divergence.
This indicator is based on moving averages
Nowadays MACD is readily available on any web sites. No need to sit and calculate. But just to understand let us brief about it.
The MACD is calculated by subtracting a 26-day moving average (long term) of a security's price from a 12-day moving average (short term) of its price. The result is that MACD is an indicator that goes above and below zero.

How to trade on MACD indicator?

Have a look on following chart of MACD -
Red line is short term moving average and blue line is long term moving average.
When the short term moving average crosses above the long term moving average (as shown in following chart) in the **upward direction**, it means investor expectations are becoming bullish and there may be rise in stock price. As it is shown in following chart with green lines how price increases.
When the short term moving average crosses below the long term moving average (as shown in following chart) in the **downward direction**, it means investor expectations are becoming bearish and there may be decrease in stock price. As it shown in following chart with red lines lines how orice decreases.

Relative Strength Index (RSI)

The RSI is another one of the most used and well-known leading momentum indicators in technical analysis. The main use of RSI is used to find whether the stock is overbought or oversold.
The RSI indicator is plotted in a range of between 0 and 100. If RSI is reached above 70 then it is considered that stock is overbought and if it reaches below 30 then it is considered that the stock is oversold.
The bullish signal

How to trade on RSI Indicator

Basically the RSI is a price-following indicator used to look for a divergence in which the stock is making a new high, but the RSI is failing to exceed its previous high. This divergence is an indication of an impending reversal. When the RSI then turns down and starts falling.
To put more light, have a look on following chart.

2.Japanese Candlestick Charting

Introduction…a New Way to Look at Prices

Would you like to learn about a type of commodity futures price chart that is more effective than the type you are probably using now? If so, keep reading. If you are brand new to the art/science of chart reading, don't worry, this stuff is really quite simple to learn.

Technical Analysis…a Brief Background

Technical analysis is simply the study of prices as reflected on price charts. Technical analysis assumes that current prices should represent all known information about the markets. Prices not only reflect intrinsic facts, they also represent human emotion and the pervasive mass psychology and mood of the moment. Prices are, in the end, a function of supply and demand. However, on a moment to moment basis, human emotions…fear, greed, panic, hysteria, elation, etc. also dramatically effect prices. Markets may move based upon people's expectations, not necessarily facts. A market "technician" attempts to disregard the emotional component of trading by making his decisions based upon chart formations, assuming that prices reflect both facts and emotion.

Standard bar charts are commonly used to convey price activity into an easily readable chart. Usually four elements make up a bar chart, the Open, High, Low, and Close for the trading session/time period. A price bar can represent any time frame the user wishes, from 1 minute to 1 month. The total vertical length/height of the bar represents the entire trading range for the period. The top of the bar represents the highest price of the period, and the bottom of the bar represents the lowest price of the period. The Open is represented by a small dash to the left of the bar, and the Close for the session is a small dash to the right of the bar. Below is a standard bar chart example.

chart8.gif (2206 bytes)

Candlestick Charts Explained

You may be asking yourself, "If I can already use bar charts to view prices, then why do I need another type of chart?"

The answer to this question may not seem obvious, but after going through the following candlestick chart explanations and examples, you will surely see value in the different perspective candlesticks bring to the table. In my opinion, they are much more visually appealing, and convey the price information in a quicker, easier manner.

What is the History of Candlestick Charts?

Candlestick charts are on record as being the oldest type of charts used for price prediction. They date back to the 1700's, when they were used for predicting rice prices. In fact, during this era in Japan, Munehisa Homma become a legendary rice trader and gained a huge fortune using candlestick analysis. He is said to have executed over 100 consecutive winning trades!

The candlesticks themselves and the formations they shape were give colorful names by the Japanese traders. Due in part to the military environment of the Japanese feudal system during this era, candlestick formations developed names such as "counter attack lines" and the "advancing three soldiers". Just as skill, strategy, and psychology are important in battle, so too are they important elements when in the midst of trading battle.

What do Candlesticks Look Like?

Candlestick charts are much more visually appealing than a standard two-dimensional bar chart. As in a standard bar chart, there are four elements necessary to construct a candlestick chart, the OPEN, HIGH, LOW and CLOSING price for a given time period. Below are examples of candlesticks and a definition for each candlestick component:

chart.gif (2870 bytes)

chart.gif (2844 bytes)

- The body of the candlestick is called the *real body*, and represents the range between the open and closing prices.
- A black or filled-in body represents that the close during that time period was lower than the open, (normally considered bearish) and when the body is open or white, that means the close was higher than the open (normally bullish).
- The thin vertical line above and/or below the real body is called the *upper/lower shadow,* representing the high/low

price extremes for the period.

Bar Compared to Candlestick Charts

Below is an example of the same price data conveyed in a standard bar chart and a candlestick chart. Notice how the candlestick chart appears 3-dimensional, as price data almost jumps out at you.

chart20.gif (2037 bytes)

(3a)

chart.gif (2020 bytes)

(3b)

The long, dark, filled-in *real bodies* represent a weak (bearish) close (3a), while a long open, light-colored *real body* represents a strong (bullish) close (3b). It is important to note that Japanese candlestick analysts traditionally view the open and closing prices as the most critical of the day. At a glance, notice how much easier it is with candlesticks to determine if the closing price was higher or lower than the opening price.

Common Candlestick Terminology

The following is a list of some individual candlestick terms. It is important to realize that many formations occur within the context of prior candlesticks. What follows is merely a definition of terms, not formations.

- The *Black* Candlestick -- when the close is lower than the open.

chart10.gif (1853 bytes)

- The *White* Candlestick -- when the close is higher than the open.

chart12.gif (1768 bytes)

- The *Shaven Head* -- a candlestick with no *upper shadow.*

wpe53.jpg (3377 bytes)

- The *Shaven Bottom* -- a candlestick with no *lower shadow.*

chart15.gif (1768 bytes)

- *Spinning Tops* -- candlesticks with small *real bodies*, and when appearing within a sideways choppy market, they represent equilibrium between the bulls and the bears. They can be either *white* or *black*.

chart17.gif (1638 bytes)

- *Doji Lines* -- have no *real body*, but instead have a horizontal line. This represents when the Open and Close are the same or very close. The length of the *shadow* can vary.

chart18.gif (1656 bytes)

Candlestick Reversal Patterns

Just as many traders look to bar charts for double tops and bottoms, head-and-shoulders, and technical indicators for reversal signals, so too can candlestick formations be looked upon for the same purpose. A reversal does not always mean that the current uptrend/downtrend will reverse direction, but merely that the current direction may end. The market may then decide to drift sideways. Candlestick reversal patterns must be viewed within the context of prior activity to be effective. In fact, identical candlesticks may have different meanings depending on where they occur within the context of prior trends and formations.

- *Hammer* -- a candlestick with a long *lower shadow* and small *real body*. The *shadow* should be at least twice the length of the *real body*, and there should be no or very little *upper shadow*. The *body* may be either *black* or *white*, but the key is that this candlestick must occur within the context of a downtrend to be considered a *hammer*. The market may be "hammering" out a bottom.

- *Hanging Man* -- identical in appearance to the *hammer*, but appears within the context of an uptrend.

- *Engulfing Patterns* -- Bullish -- when a *white, real body* totally covers, "engulfs" the prior day's *real body*. The market should be in a definable trend, not chopping around sideways. The shadows of the prior candlestick do not need to be engulfed.

- - *Bearish* -- when a black, real body totally covers, "engulfs" the prior day's real body. The market should be in

a definable trend, not chopping around sideways. The shadows of the prior candlestick do not need to be engulfed.

- *Dark-Cloud Cover(bearish)* -- a top reversal formation where the first day of the pattern consists of a strong *white, real body.* The second day's price opens above the top of the upper shadow of the prior candlestick, but the close is at or near the low of the day, and well into the prior *white, real body.*

- · *Piercing Pattern* (bullish) -- opposite of the *dark-cloud cover*. Occurs within a downtrend. The first candlestick having a black, real body, and the second has a long, white, real body. The white day opens sharply lower, under the low of the prior black day. Then, prices close above the 50% point of the prior day's black real body.

Stars

These candlestick formations consist of a small real body that gaps away from the real body preceding it. The real body of the star should not overlap the prior real body. The color of the star is not too important, and they can occur at either tops or bottoms. Stars are the equivalent of gaps on standard bar charts.

wpe3C.jpg (9809 bytes)

Stars make up part of four separate reversal patterns:

Morning Star

Evening Star

Doji Star

Shooting Star (Inverted Hammer)

- *Morning Star* -- this is a bullish bottom reversal pattern. The formation is comprised of 3 candlesticks. The first candlestick is a tall black real body followed by the second, a small real body, which gaps (opens), lower (a star pattern). The third candlestick is a white real body that moves well into the first period's black real body. This is similar to an island pattern on standard bar charts.

- *Evening Star* -- a bearish top reversal pattern and counterpart to the Morning Star. Three candlesticks compose the evening star, the first being long and white. The second forms a star, followed by the third, which has a black real body that moves sharply into the first white candlestick.

- *Doji Stars* -- When a doji gaps above a real body in an uptrend, or gaps under a real body in a falling market, that particular doji is called a *doji star*. Two popular doji stars are the *evening star* and the *morning star*.

- *Evening Doji Star* -- a doji star in an uptrend followed by a long, black real body that closed well into the prior white real body. If the candlestick after the doji star is white and gapped higher, the bearishness of the doji is invalidated.

chart19.gif (3302 bytes)

- *Morning Doji Star* -- a doji star in a downtrend followed by a long, white real body that closes well into the prior black real body. If the candlestick after the doji star is black and gapped lower, the bullishness of the doji is invalidated.

- *Shooting Star* -- a small real body near the lower end of the trading range, with a long upper shadow. The color of the

body is not critical. Not usually considered a major reversal sign, only a warning.

· *Inverted Hammer*-- not really a star, but does look like a shooting star. When occurring within a downtrend, may be a turning signal. Body color is not critical.

Final Thoughts and Credits

It is important to realize that this introduction is just that, an introduction to candlestick analysis. After having read this, you will have merely scratched the surface of the many patterns and variables that can go into candlestick analysis. No attempt was made to provide a thorough analysis of each and every pattern. In fact, many formations were left out as they cross the border into more complicated analysis. For a more complete overview of candlestick analysis, it is highly recommended that you read the book that is referred to below.

A large portion of the material in this introduction is taken from an excellent book called Japanese Candlestick Charting Techniques: A Contemporary Guide to the Ancient Investment Techniques of the Far East. In some cases, sentences were taken almost verbatim, as there was no better way to say what Mr. Steve Nison, the author, already said. In his book, Mr. Nison, completely explains candlesticks and their formations, but more importantly explains how to combine candlestick analysis with traditional technical analysis. It is highly recommended that you consider purchasing this book.

As traders, we need as many trading tools in our arsenal, and a basic knowledge of candlesticks provides a trader much needed ammunition. Also remember that no matter what the trading tool, no matter how advanced or ancient, it is only effective when put into practice properly. This is, of course, your job as the trader.

.

Return to Contents

---

3. Dow Theory

The ideas of Charles Dow, the first editor of the Wall Street Journal, form the basis of technical analysis today.

Dow created the Industrial Average, of top blue chip stocks, and a second average of top railroad stocks (now the Transport Average). He believed that the behavior of the averages reflected the hopes and fears of the entire market. The behavior patterns that he observed apply to markets throughout the world.

Dow Theory

Three Movements

Markets fluctuate in more than one time frame at the same time:

Nothing is more certain than that the market has three well defined movements which fit into each other.

- The first is the daily variation due to local causes and the balance of buying and selling at that particular time (Ripple).
- The secondary movement covers a period ranging from days to weeks, averaging probably between six to eight weeks (Wave).
- The third move is the great swing covering anything from months to years, averaging between 6 to 48 months. (Tide).

- Bull markets are broad upward movements of the market that may last several years, interrupted by secondary reactions. Bear markets are long declines interrupted by secondary rallies. These movements are referred to as the primary trend.
- Secondary movements normally retrace from one third to two thirds of the primary trend since the previous secondary movement.
- Daily fluctuations are important for short-term trading, but are unimportant in analysis of broad market movements.

Various cycles have subsequently been identified within these broad categories.

Dow Theory

Primary Movements have Three Phases

Look out for these general conditions in the market:

Bull markets

- Bull markets commence with reviving confidence as business conditions improve.
- Prices rise as the market responds to improved earnings
- Rampant speculation dominates the market and price advances are based on hopes and expectations rather than actual results.

Bear markets

- Bear markets start with abandonment of the hopes and expectations that sustained inflated prices.
- Prices decline in response to disappointing earnings.
- Distress selling follows as speculators attempt to close out their positions and securities are sold without regard to their true value.

Ranging Markets

- A secondary reaction may take the form of a ‘line’ which may endure for several weeks.
- Price fluctuates within a narrow range of about five per cent.

Breakouts from a range can occur in either direction.

- Advances above the upper limit of the line signal accumulation and higher prices;
- Declines below the lower limit indicate distribution and lower prices;
- Volume is used to confirm price breakouts.

Dow Theory

Trends

Bull Trends

A bull trend is identified by a series of rallies where each rally exceeds the highest point of the previous rally. The decline, between rallies, ends above the lowest point of the previous decline.

Successive higher highs and higher lows.

The start of an up trend is signaled when price makes a higher low (trough), followed by a rally above the previous high (peak):

Start = higher Low + break above previous High.

The end is signaled by a lower high (peak), followed by a decline below the previous low (trough):

End = lower High + break below previous Low.

What if the series of higher Highs and higher Lows is first broken by a lower Low? There are two possible interpretations - see Large Corrections.

Bear Trends

Each successive rally fails to penetrate the high point of the previous rally. Each decline terminates at a lower point than the preceding decline.

Successive lower highs and lower lows.

A bear trend starts at the end of a bull trend: when a rally ends with a lower peak and then retreats below the previous low. The end of a bear trend is identical to the start of a bull trend.

What if the series of lower Highs and lower Lows is first broken by a higher High? This is a gray area - see Large Corrections.

Dow Theory

Large Corrections

A large correction occurs when price falls below the previous low (during a bull trend) or where price rises above the previous high (in a bear trend).

Some purists argue that a trend ends if the sequence of higher highs and higher lows is broken. Others argue that a bear trend has not started until there is a lower High and Low nor has a bull trend started until there is a higher Low and High.

For practical purposes: **Only accept large corrections as trend changes in the primary trend:**

- A bull trend starts when price rallies above the previous high,

- A bull trend ends when price declines below the previous low,
- A bear trend starts at the end of a bull trend (and vice versa).

Return to Contents

4.Elliott Waves Theory Basics

about Elliott Waves Theory Basics

The Elliott Wave Theory is named after Ralph Nelson Elliott. Inspired by the Dow Theory and by observations found throughout nature, Elliott concluded that the movement of the stock market could be predicted by observing and identifying a repetitive pattern of waves. In fact, Elliott believed that all of man's activities, not just the stock market, were influenced by these identifiable series of waves.

Elliott based part his work on the Dow Theory, which also defines price movement in terms of waves, but Elliott discovered the fractal nature of market action. Thus Elliott was able to analyze markets in greater depth, identifying the specific characteristics of wave patterns and making detailed market predictions based on the patterns he had identified.

Definition of Elliott Waves

In the 1930s, Ralph Nelson Elliott found that the markets exhibited certain repeated patterns. His primary research was with stock market data for the Dow Jones Industrial Average. This research identified patterns or waves that recur in the markets. Very simply, in the direction of the trend, expect five waves. Any corrections against the trend are in three waves. Three wave corrections are lettered as "a, b, c." These patterns can be seen in long-term as well as in short-term charts. Ideally, smaller patterns can be identified within bigger patterns. In this sense, Elliott Waves are like a piece of broccoli, where the smaller piece, if broken off from the bigger piece, does, in fact, look like the big piece. This information (about smaller patterns fitting into bigger patterns), coupled with the Fibonacci relationships between the waves, offers the trader a level of anticipation and/or prediction when searching for and identifying trading opportunities with solid reward/risk ratios.

There have been many theories about the origin and the meaning of the patterns that Elliott discovered, including human behavior and harmony in nature. These rules, though, as applied to technical analysis of the markets (stocks, commodities, futures, etc.), can be very useful regardless of their meaning and origin.

Simplifying Elliott Wave Analysis
Elliott Wave analysis is a collection of complex techniques. Approximately 60 percent of these techniques are clear and easy to use. The other 40 are difficult to identify, especially for the beginner. The practical and conservative approach is to use the 60 percent that are clear.

When the analysis is not clear, why not find another market conforming to an Elliott Wave pattern that is easier to identify?

From years of fighting this battle, we have come up with the following practical approach to using Elliott Wave principles in trading.

The whole theory of Elliott Wave can be classified into two parts:

Elliott Wave Basics — Impulse Patterns
The impulse pattern consists of five waves. The five waves can be in either direction, up or down. Some examples are shown to the right and below. The first wave is usually a weak rally with only a small percentage of the traders participating. Once Wave 1 is over, they sell the market on Wave 2. The sell-off in Wave 2 is very vicious. Wave 2 will finally end without making new lows and the market will start to turn around for another rally.

The initial stages of the Wave 3 rally are slow, and it finally makes it to the top of the previous rally (the top of Wave 1).

At this time, there are a lot of stops above the top of Wave 1.

Traders are not convinced of the upward trend and are using this rally to add more shorts. For their analysis to be correct, the market should not take the top of the previous rally.

Therefore, many stops are placed above the top of Wave 1.

The Wave 3 rally picks up steam and takes the top of Wave 1. As soon as the Wave 1 high is exceeded, the stops are taken out. Depending on the number of stops, gaps are left open. Gaps are a good indication of a Wave 3 in progress. After taking the stops out, the Wave 3 rally has caught the attention of traders.

The next sequence of events are as follows: Traders who were initially long from the bottom finally have something to cheer about. They might even decide to add positions.

The traders who were stopped out (after being upset for a while) decide the trend is up, and they decide to buy into the rally. All this sudden interest fuels the Wave 3 rally.

This is the time when the majority of the traders have decided that the trend is up.

Finally, all the buying frenzy dies down; Wave 3 comes to a halt.

Profit taking now begins to set in. Traders who were long from the lows decide to take profits. They have a good trade and start to protect profits.This causes a pullback in the prices that is called Wave 4.
Wave 2 was a vicious sell-off; Wave 4 is an orderly profit-taking decline.
While profit-taking is in progress, the majority of traders are still convinced the trend is up. They were either late in getting in on this rally, or they have been on the sideline.
They consider this profit-taking decline an excellent place to buy in and get even.

On the end of Wave 4, more buying sets in and the prices start to rally again.
The Wave 5 rally lacks the huge enthusiasm and strength found in the Wave 3 rally. The Wave 5 advance is caused by a small group of traders.
Although the prices make a new high above the top of Wave 3, the rate of power, or strength, inside the Wave 5 advance is very small when compared to the Wave 3 advance.
Finally, when this lackluster buying interest dies out, the market tops out and enters a new phase.

Elliott Wave Basics — Corrective Patterns

Corrections are very hard to master. Most Elliott traders make money during an impulse pattern and then lose it back during the corrective phase.

An impulse pattern consists of five waves. With the exception of the triangle, corrective patterns consist of 3 waves. An impulse pattern is always followed by a corrective pattern. Corrective patterns can be grouped into two different categories:

Simple Correction (Zig-Zag)

There is only one pattern in a simple correction. This pattern is called a Zig-Zag correction. A Zig-Zag correction is a three-wave pattern where the Wave B does not retrace more than 75 percent of Wave A. Wave C will make new lows below the end of Wave A. The Wave A of a Zig-Zag correction always has a five-wave pattern. In the other two types of corrections (Flat and Irregular), Wave A has a three-wave pattern. Thus, if you can identify a five-wave pattern inside Wave A of any correction, you can then expect the correction to turn out as a Zig-Zag formation.

Fibonacci Ratios inside a Zig-Zag Correction

Wave B
Usually 50% of Wave A Should not exceed 75% of Wave A
Wave C
either 1 x Wave A or 1.62 x Wave A or 2.62 x Wave A

A simple correction is commonly called a Zig-Zag correction.

Complex Corrections (Flat, Irregular, Triangle)
The complex correction group consists of 3 patterns:

Flat Correction
In a Flat correction, the length of each wave is identical. After a five-wave impulse pattern, the market drops in Wave A. It then rallies in a Wave B to the previous high. Finally, the market drops one last time in Wave C to the previous Wave A low.

Irregular Correction
In this type of correction, Wave B makes a new high. The final Wave C may drop to the beginning of Wave A, or below it.

Fibonacci Ratios in an Irregular Wave
Wave B = either 1.15 x Wave A or 1.25 x Wave A
Wave C = either 1.62 x Wave A or 2.62 x Wave A

Triangle Correction
In addition to the three-wave correction patterns, there is another pattern that appears time and time again. It is called the Triangle pattern. Unlike other triangle studies, the Elliott Wave Triangle approach designates five sub-waves of a triangle as A, B, C, D and E in sequence.

Triangles, by far, most commonly occur as fourth waves. One can sometimes see a triangle as the Wave B of a three-wave correction. Triangles are very tricky and confusing. One must study the pattern very carefully prior to taking action. Prices tend to shoot out of the triangle formation in a swift thrust.

When triangles occur in the fourth wave, the market thrusts out of the triangle in the same direction as Wave 3. When triangles occur in Wave Bs, the market thrusts out of the triangle in the same direction as the Wave A.

Alteration Rule
If Wave Two is a simple correction, expect Wave Four to be a complex correction. If Wave Two is a complex correction, expect Wave Four to be a simple correction

Click here for Comprehensive Course on Elliot Waves Theory Principles

---

Click here to read on
'Discovering How To Use The Elliott Wave Principle '

Click here to read on:
Ultimate Technical Analysis Hand-book – an e-book by Elliot Wave International

---

A small brochure on how to use Wave Principle for your Trading

---

Return to Contents

5.Multiple Time Frame

When deciding on a trade or investment, be it short, intermediate or long term, multiple time frame analysis can help clear the noise and offer a balanced view.

Multiple time frame analysis!?! It sounds complicated and fancy, but it simply refers to the same chart with more than one time compression (e.g. daily or weekly). When both the weekly and the daily charts are in harmony, the chances of success can be greatly enhanced.

The essence of the strategy is easy: Use the higher time frame price activity to define the tradable trend as well as potential support and resistance levels.

Markets exist in several time frames simultaneously. They exist on a 10 minute chart, an hourly chart, a daily chart, a weekly chart, and any other chart. Traders often feel confused when they look at charts in different time frames and they see the markets going in several directions at once.

The market may look for a buy on a daily chart and a sell on the weekly chart, and vice versa. The signals in different time frames of the same market often contradict one another. Which of them will you follow? Most traders pick one time frame and

close their eyes to others – until a sudden move outside of “their” time frame hits them.

Daily charts are great, but participants can get caught up in the move of the moment. Even though daily charts can contain random movements, they do have their strengths. Once an underlying trend is identified, daily charts can be useful to pick entry and exit points. On the other hand, weekly charts filter out the random movements and can help identify the stronger under currents that are driving the price.

The same idea applies if you are trading any security on a daily basis, in which case, the weekly bars will be the basis for the trend as well as the important support and resistance points. That is the foundation of multiple time frame trading. Besides the effectiveness of using a method based on a multiple time frame approach, another advantage is the method need not be complicated. A trader can make his or her method as simple or as complicated as desired. For us at www.TradersEdgeIndia.com, the simpler the application, the better the results.

The proper way to analyze any market is to analyze it in at least two or three time frames. If you analyze daily charts, you must first examine the weekly charts and so on..

Look at the daily chart of NSE Nifty below. What does it tell you. Most traders would say that it is just the beginning of a downtrend and would be happy to short the market all thro’ way down. Well, most traders are not successful! To be successful in trading any market, one has to first examine the trend on a higher time frame.

Daily Chart of NSE Nifty 50

Now look at the chart below of the same security. This is a chart of one time frame higher than the one above. What does it tell you? Simply, that the long term trend is bullish, and I should be looking to go long rather than short.

Weekly Chart of the NSE Nifty 50

By incorporating the multiple time frame trading method in our newsletter services, you as our subscribers will take only those trades with the most profitable potential and to stay out situations where there is marginal or least profitable potential.

Return to Contents

6.Trendline and Trendlines for trading Indian Stock share market

Trendlines are an important tool in technical analysis for both trend identification and confirmation.

What is a Trendline?

- A **trendline** is a sloping line that is drawn between two or more prominent points on a chart.
- A **trendline** is a straight line that connects two or more price points and then extends into the future to act as a line of support or resistance.
- A **trendline** helps identify the trend as well as potential areas of support and resistance.
- A **trendline** is a straight line that connects two prominent peaks or troughs in the price action of an underlying tradable.
- **Trendlines** illustrate the direction of the market movement and provide a primary consideration in any analysis.

Rising trends are defined by a trendline that is drawn between two or more troughs (low points) to identify price support.

Falling trends are defined by trendlines that are drawn between two or more peaks (high points) to identify price resistance.

Up Trendline
An up trendline has a positive slope and is formed by connecting two of more low points. The second low must be higher than the first for the line to have a positive slope. Up trendlines act as support and indicate that net-demand (demand less supply) is increasing even as the price rises. A rising price combined with increasing demand is very bullish and shows a strong determination on the part of the buyers. As long as prices remain above the trendline, the uptrend is considered solid and intact. A break below the up trendline indicates that net-demand has weakened and a change in trend could be imminent.

Down Trendline
A down trendline has a negative slope and is formed by connecting two or more high points. The second high must be lower than the first for the line to have a negative slope. Down trendlines act as resistance and indicate that net-supply (supply less demand) is increasing even as the price declines. A declining price combined with increasing supply is very bearish and shows the strong resolve of the sellers. As long as prices remain below the down trendline, the downtrend is considered solid and intact. A break above the down trendline indicates that net-supply is decreasing and a change of trend could be imminent.

Interpretation

- A principle of technical analysis is that once a trend has been formed (two or more peaks/troughs have touched the trendline and reversed direction) it will remain intact until broken.
- That sounds much more simplistic than it is! The goal is to analyze the current trend using trendlines and then either invest with the current trend until the trendline is broken, or wait for the trendline to be broken and then invest with the new (opposite) trend.
- One benefit of trendlines is they help distinguish emotional decisions ("I think it's time to sell...") from analytical decisions ("I will hold until the current rising trendline is broken"). Another benefit of trendlines is that they almost always keep you on the "right" side of the market. When using trendlines, it's difficult to hold a security for very long when prices are falling just as it's hard to be short when prices are rising--either way the trendline will be broken.

In analyzing trends on the charts, the most useful tool is the trendline. One of the biggest mistakes made by amateurs and professionals alike is inconsistently defining and drawing the trendline.

The correct or right way to draw a trendline

For an **uptrend**, draw a line from the lowest low, up to the highest minor low point preceding the highest high so that the line does not pass through prices between the two low points.

How to draw an up trendline

For a **downtrend**, draw a line from the the highest high point to the lowest minor high point preceding the lowest low so that the line does not pass through prices between the two high points.

Return to Contents

7.External Relative Strength

IT'S NOT JUST KNOWING *WHEN* TO GET IN. IT'S KNOWING *WHAT* YOU'RE GETTING INTO.

One of the most difficult aspects of investing in the stock markets is selecting the BEST PERFORMING STOCKS!

If the above two sentences hold true for you, then its about time you start paying more attention to studying the ***external relative strength***.

Over the course of time there have been few financial activities that occupied the time of more people with less success than attempting to beat the market. So many people have tried and failed, that it has become a popular belief that no one can consistently outperform the market averages.

Nothing could be further from the truth.

Everyone cannot beat the market, because everyone in the market is the market. But that does not eliminate the possibility that some investors, if armed with the proper tools to monitor the market and an investment strategy which takes advantage of the information available to them, can realize returns on their investments above the market averages.

External Relative Strength

External Relative Strength is the measure of how a security has performed versus all other securities. This is superior to comparing a security to an index since most indexes are weighted by market cap or price.

External Relative Strength (ERS) is a technical analysis strategy to help investors sort through all the recommendations and to identify trends of individual stocks. When the upward trends of stocks are identified early enough, the stocks may be purchased and a profit may be realized by a continuance of the trend. Although past performance is not necessarily a determining factor in future performance of a stock, using Relative Strength Analysis for stock selection has proven to be a profitable strategy over time.

This selection, which is used to compare all of the stocks that are being followed, will sort them by their strength rating of the previous week placing a rank on them and then sorting them by the current week's strength rating.

This report is one of the most valuable tools of the trader. The report will show you which stocks are stronger and how much they are stronger than the previous. It provides you with a means of analyzing hundreds of issues without having to look at each of the individual charts to make comparisons. This tool has provided superior returns in testing and in actual practice. The idea is to buy stocks that are experiencing strong upward momentum with the expectations that the stocks will continue to be strong. These can be found within the top 10 or 20 issues.

The End