# A Primer On Technical Analysis

Written by

Available at

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# Overview

## Technical Analysis (Versus Fundamental Analysis)

Technical analysis is a method of forecasting price movements by looking at purely market-generated data. A trader who uses technical analysis (sometimes called a technician or chartist) is essentially concerned with two things;

1) what is the current price?
2) What is the history of price movement?

Most will also keep a close watch on technical indicators, which provide feedback on both the price and market (e.g. moving average, volume, momentum, volatility, open interest, etc). Ultimately, technical analysis utilizes the information captured by the price to interpret what the market is saying with the purpose of forming a view on the future.

Almost every trader uses some form of technical analysis. Even the most reverent follower of market fundamentals is likely to glance at price charts before executing a trade. At their most basic level, these charts help traders determine ideal entry and exit points for a trade. They also provide a visual representation of the historical price action of whatever is being studied. As such, traders can look at a chart and know if they are buying at a fair price (based on the price history of a particular market), selling at a cyclical top, or perhaps throwing their capital into a choppy, sideways market. These are just a few market conditions that charts identify for a trader. Depending on their level of sophistication, charts can also help much more advanced interpretation of the markets.

On the surface, it might appear that technicians ignore the fundamentals of the market while focusing only on charts. However, a technical trader will tell you that all of the fundamentals are already represented in the price. They are not so much concerned that a natural disaster or an awful inflation number caused a recent spike in prices as much as how that price action fits into a pattern or trend. And much more to the point, how that pattern can be used to predict future prices.

### The "WHAT" Is More Important Than the "WHY"

Ultimately, price is the end result of the battle between the forces of supply and demand. The objective of analysis is to forecast the direction of the future price. By focusing on price and only price, technical analysis represents a direct approach. Fundamentalists are concerned with why the price is what it is. For technicians, the why portion of the equation is too broad and many times the fundamental reasons given are highly suspect. Technicians believe it is best to concentrate on what and never mind why. Why did the price go up? It is simple, more buyers (demand) than sellers (supply). After all, the value of any asset is only what someone is willing to pay for it. Who needs to know why?

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Price Discounts Everything

# Technical Analysis Is Based On Three Major Conclusions About The Market:

1. Price Discounts Everything:

The price is a sum reflection of all the market forces and participants ("The market knows everything"), including commercial banks, investment banks, central banks, portfolio managers, buy-side analysts, sell-side analysts, market strategist, traders, investors, technical analysts, fundamental analysts and many others. Since all market fundamentals are depicted in the actual market data, the actual market fundamentals and various factors, such as the differing opinions, hopes, fears, and moods of market participants, need not be studied.

2. Price Moves In Trends.

Technicians typically do not believe that price fluctuations are random and unpredictable. However, most technicians also acknowledge that there are periods when prices do not trend. If prices were always random, it would be extremely difficult to make money using technical analysis. A technician believes that it is possible to identify a trend, invest or trade based on the trend and make money as the

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trend unfolds. Because technical analysis can be applied to many different timeframes, it is possible to spot both short-term and long-term trends.

3. Price Movements Are Historically Repetitive.

This result's in periodical emerging of the similar price patterns and technical indicators (based on price patterns). These patterns, generated by price movement, often signify what type of movement is to come in the near future. The goal in technical analysis is to identify and use these price patterns in the current market to predict what will happen in the future by examining and quantifying their regular effects in the past.

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# Analyzing the Market

In the ProSignal trading system, the way we analyze the market is by focusing our attention on the past and current price action of a particular currency pair we want to trade. We do this by looking at candlestick PRICE PATTERN FORMATIONS and PRICE RANGES (distances price will move) at different time-frames for that particular currency, all of which will be explained to you in this manual.

## Tools Of The Trade

All the building blocks of technical analysis are in the price charts. Market patterns and behaviors, and various types of market data (technical indicators) are used to determine the strength and sustainability of a particular trend, the maturity or stage of the current trend, reward to risk ratio of a new position, and potential entry levels for new position.

We accomplish these things by:

- Identifying the short, medium and long-term trends for market direction.
- Identifying the levels of support and resistance to determine where price is likely to change direction.
- Identifying price (or Chart) patterns that indicate reversals or the continuation of a trend.
- Using technical indicators to reveal useful market forces behind the price to predict future movements and determine good points of entry and exit.

In the remaining part of this section we will introduce you to some of the basic elements of theses tools before moving on to Part IV when you will begin applying them using the ProSignal trading system.

## Charts

A price chart is a sequence of prices plotted over a specific time-frame, providing an easy-to-read graphical representation of price movement.

On the chart, the vertical axis represents the price (or exchange rate) and the horizontal axis represents the time scale. Prices are plotted from left to right across the horizontal axis with the most recent plot (current price) being the furthest right.

There are three basic types of charts; line chart, bar chart and candlestick chart. Each has a different graphical interface in which is shows price movement. ProSignal's charts default to candlesticks, which we feel are, by far, the easiest and most informative to use (you can change your chart to these others but we do not recommend it).

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PLEASE NOTE: The price-feed that ProSignal uses in its past-performance records and training material is the S&P Comstock price feed, which is an average price from about 10 major banks that participate in the forex market. There will be some discrepancy between the S&P Comstock price-feed and the prices on the trading platform, as each brokerage firm is an independent market-maker and is free to set its own spreads & prices. However, every brokerage firm should be within just a few pips of each other at any given time.

# Candlesticks

The type of chart we use with the ProSignal trading system is a Candlestick Chart where each candlestick represents the value a currency (its price) over a specific period of time. Each candlestick can represent anywhere from one minute to multiple hours, a day, week, or month. The top and bottom levels of the solid ″body″ of the candlestick show the opening price and closing price. If the closing price was lower than the opening price, it's a red candle (showing a drop in price). If the closing price was higher than the opening price, it is a blue candle (showing an increase in price). Red Candle = Price dropped, Blue Candle = Price went up.

The line sticking out of the top of the candle is called a "Wick" and represents the highest price the market made during that candle's time-period. The line sticking out from the bottom of the candle′s body is called a "Tail" and represents the lowest price the market made during that candle's time-period.

If the candle has no body and looks like a "T", cross (+), or a dash (-), it means that the opening and closing price was the same during that candle′s time-period.

Candlestick charts are read from left to right and each new candle begins on the right side of the chart. The current open candle will be active and moving according to fluctuations in price and is off-color from the rest of the candles. A gold-colored candle (as in the example below) indicates that price has dropped since the opening of the candle while a light-blue candle means that price has gone up since the opening of the candle. As soon as the time-frame for the current candle closes, it will become a solid red or blue candle and a new candle will open.

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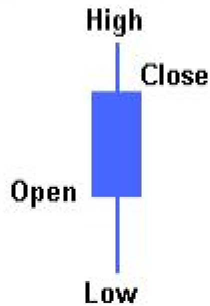
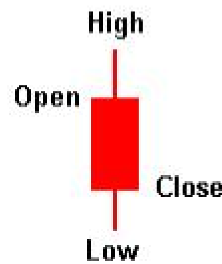
# How to Read a Candlestick Chart

A Daily Candlestick Chart. Each Candlestick = 1 Day (24 hours)

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# Trends & Trend Lines (Support and Resistance)

## Trends:

Reading your chart from left to right:

A bullish market is indicated by progressively higher highs and higher lows, also called an up-trend.

A bearish market is indicated by progressively lower highs and lower lows, also called a down-trend.

A neutral, or consolidating market is indicated by little movement up or down and often a narrowing of price ranges, otherwise known as a sideways-trend.

## Trend lines:

Trends are easily identified by drawing a straight (trend) line from one price low to another price low or, from one price high to another price high. Trend lines are important because they act as a barrier that the currency's price has not gone above or below or has difficulty going above or below. By extending these lines into the future, you can use them as guidelines to determine future movements in price or to identify areas of potential trend-reversals.

Every trend line provides a level of support or resistance. Usually, the longer the trend line, the stronger the level of support or resistance it provides. In an up-trend, the trend line (drawn along the bottom of price lows) acts as the level of support, this generally prevents price from dropping below that level.

A trend line can be drawn to touch many of the price highs or lows along the trend. Depending on the time frame of your charts and the length of your trend lines, you will often find trends within a trend. For example, within a longer-term trend, price will sometimes form either a steeper congruent or opposing shorter-term trend. A steeper "congruent" trend within a larger trend is known as an Accelerated Trend as it makes a more accelerated move in the overall trend direction. Note the Accelerated Trend Lines in the following examples.

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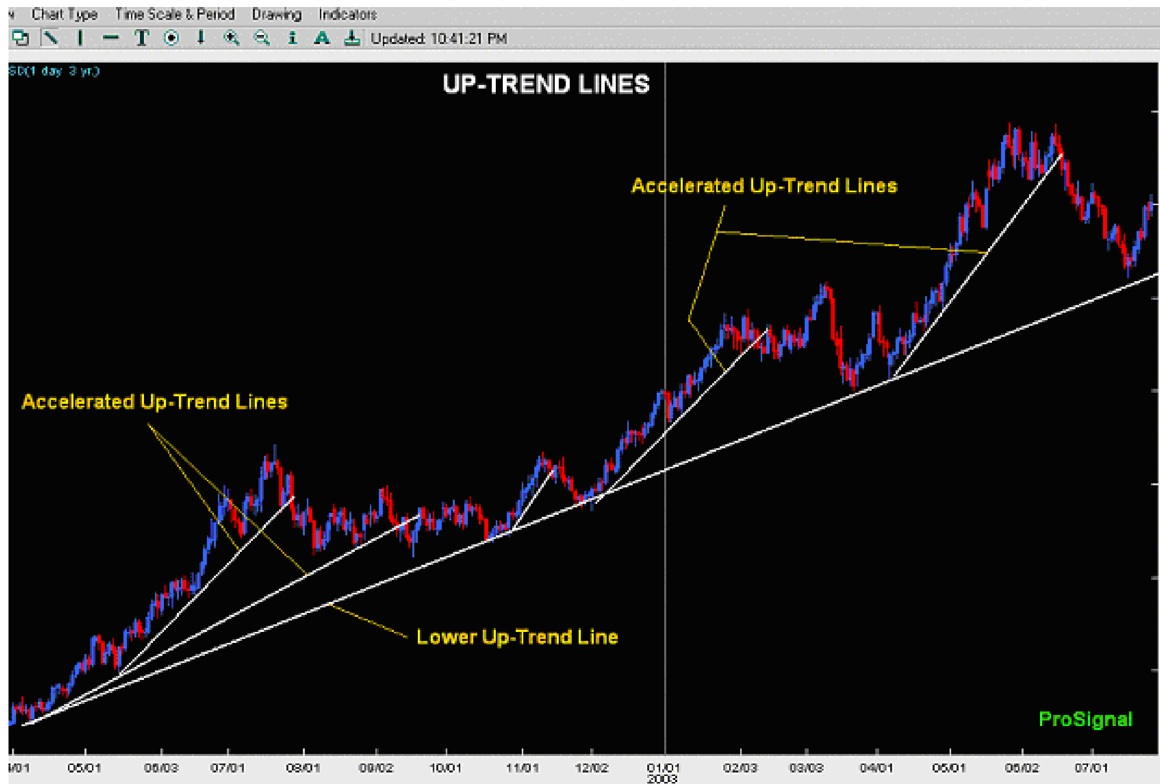
An Up Trend with Up-Trend Lines & Accelerated Up-Trend Lines

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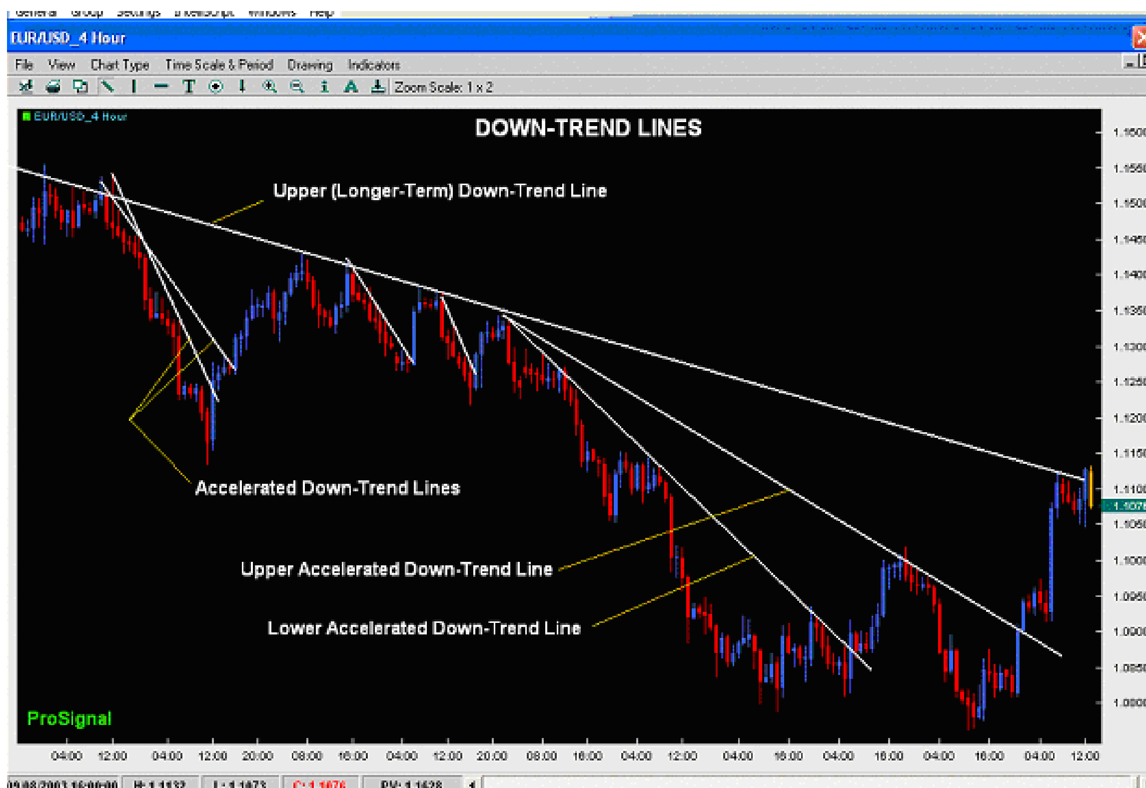
In a down-trend, the trend line (drawn along the tops of the price highs) acts as the LEVEL OF RESISTANCE which generally restrains price from rising above that level.

A Down-Trend With Down-Trend Lines & Accelerated Down-Trend Lines




It is especially important to study the trends on the longer-term charts, such as the Daily/3-year or Weekly/3-year charts to see where the long-term trend lines (levels of support and resistance) are located. This will give you a good overall feel for the market in terms of where it's been and likely headed in the long run.

NOTE: When drawing trend lines, be very careful to draw them as accurately as possible on whichever price points you use. The trend line should be touching as many price highs or lows as possible. The more price highs or lows that your trend line touches, the stronger it becomes. Sometimes drawing your trend line to touch the most price highs or lows as possible can result in cutting off the tips of some candlestick wicks & tails. This is ok, but in a new trend you should also draw your trend lines so that they are just touching the highest or lowest point of price, which can give you two possible trend lines. At some point, price should begin to acknowledge one and ignore the other which will establish the dominant trend line to watch. Also note that a slight change in the degree of your angle can translate into a large price difference as your trend lines get projected into the future - effecting predictions you're making on price movement.

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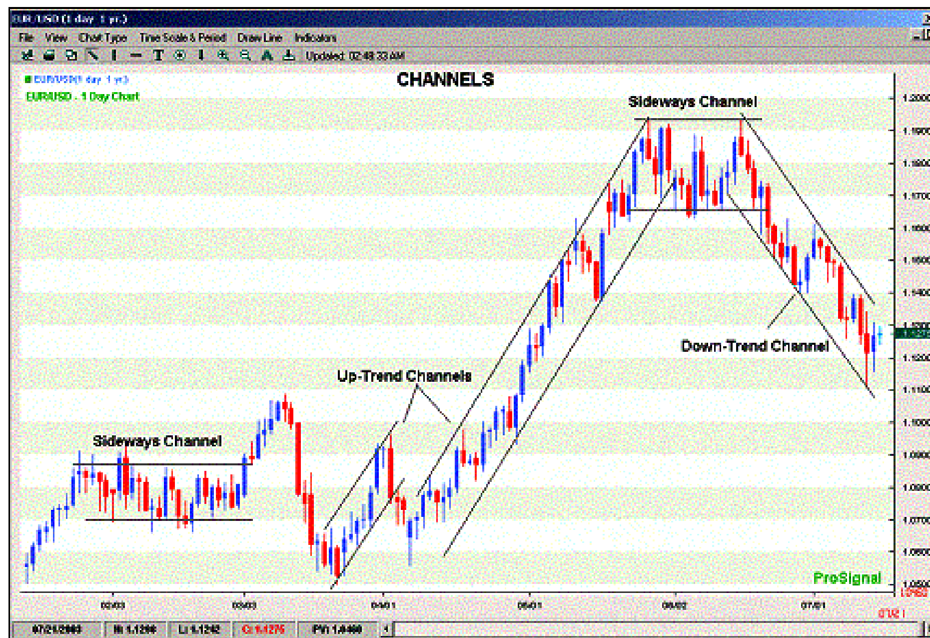
**Channels:**

A channel is a chart pattern that has price movements contained between two parallel lines. You need at least 4 points to draw a channel.

Channels can be horizontal (in a neutral market or consolidating market) or slant up or down when price is trending.

Channels provide both an upper level of resistance and a lower level of support. They can also serve very well to help establish trends.

Channels




Price Movement and Trend Lines (or Channels):

Price will tend to bounce off a trend line and move away from it. However, if price breaks through a trend line, it will often continue moving until it hits the next longer-term trend line (if one exists). If price breaks through all of the possible trend lines, it's either establishing a new low or high point on the trend or it may, in fact, be reversing its trend all together.

If price has made a considerable break through a channel line, this is often an indication of a breakout and a large move will often follow in the same direction of the breakout. However, price will often slightly break outside of the channel line (or trend line) and then return back into the channel. This is known as a false breakout.

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The longer a trend line remains unbroken, the stronger level of support or resistance it provides. When price gets wedged between two trend-lines (i.e. a shorter-term down-trend is meeting up against a longer term up-trend), you can usually anticipate the weaker "shorter-term" trend-line to break.

IMPORTANT NOTE: Until you are an advance trader, you should be extremely cautious about ever trading against a trend. Ideally, you should be trading with the longest-term trend on the charts. If you are trading with a shorter-term trend, be sure you know where the longer-term trend lines are and the current price relationship to them. To help you decide whether or not trade against a longer-term trend, we have established some simple guidelines to follow which will be discussed in more detail later in this manual.

Long-Term Up-Trend Line Providing a Strong Level of Support

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The following chart is the same Daily/3-year chart as above but at a later date and zoomed out to show all the way back to March, 2002. As you can see, after the upward breakout following July17, 2003, price became wedged into another triangle formation but this time broke downward.

Long-Term Trend Line with Breakouts

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# Chart Patterns

Chart Patterns are formed by support and resistance levels and by trend lines.

Chart patterns put all buying and selling into perspective by consolidating the forces of supply and demand into a concise picture. As a complete pictorial record of all trading, chart patterns provide a framework to analyze the battle raging between bulls and bears. More importantly, chart patterns and technical analysis can help determine who is winning the battle, allowing traders and investors to position themselves accordingly.

Chart pattern analysis can be used to make short-term or long-term forecasts. The data can be intraday, daily, weekly or monthly and the patterns can be as short as one day or as long as many years.

Two Dominant Groups

Two basic tenets of technical analysis are that prices trend and that history repeats itself. An uptrend indicates that the forces of demand (bulls) are in control and a down-trend indicates that the forces of supply (bears) are in control. However, prices do not trend forever and as the balance of power shifts, a chart pattern begins to emerge. Certain patterns, such as a parallel channel (either up or down), denote a strong trend. However, the vast majority of chart patterns fall into two main groups: reversal and continuation. Reversal patterns indicate a change of trend and can be broken down into top and bottom formations. Continuation patterns indicate a pause in trend and indicate that the previous direction will resume after a period of time.

Just because a pattern forms after a significant advance or decline does not mean it is a reversal pattern. Many patterns can be classified as either reversal or continuation.

For now we will focus on a few very powerful pattern formations. As a member of ProSignal, we will, from time to time, provide you with other patterns we have tested that you can add to your repertoire.

1. Trend Continuation Patterns

    a. Flags (Ascending Flags and Descending Flags)
    b. Triangles (Ascending, Descending and Symmetrical)

2. Trend Reversal Patterns

    a. Flags (Ascending and Descending Flags appearing together)
    b. Double or Triple Tops/Bottoms
    c. Triangles (Occasionally – Symmetrical more often then Ascending or Descending)

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# Flags

A flag is a short-term channel whose parallel lines slant in the opposite direction of the overall trend and sometimes horizontally. However, a flag's channel lines do not have to be perfectly parallel. Flags come in all shapes and sizes, they're easy to spot and are commonly seen as brief pauses in a trend as if the market has paused or pulled back to catch its breath before making its next run in the direction of the larger trend. To create the top channel line of a flag, simply draw a trend line across all of the price highs. To draw the lower channel line of a flag, simply draw a trend line across all of the price lows. Your channel lines do not need to line up perfectly with all the price highs & lows. There will be an occasional high or low which sticks out from the rest and may poke through your channel line. This is known as a false breakout. Simply ignore it and draw your line across a majority of the price highs and lows.

### Descending Flags:

A downward drift against an UP-trend is called a Descending Flag because it is descending against the overall up-trend. For example, when in an UP-trend, price will often drift downward after a large upward move. The TOP channel line of a Descending Flag will usually slant downward (from left to right) but may sometimes be horizontal or flat on top. The top channel line is the most important line and acts as the level of resistance that must be broken prior to price's next large upward move. When price breaks through this top flag line, a large upward move usually follows (also known as a flag breakout).

Below is a 4-hour chart of EUR/USD with many Descending Flags in the middle of a massive long-term up-trend. Price made the largest moves immediately following a breakout from the top channel line of the descending flags. This chart represents a 1300 pip move from 4/07/03 to 5/27/03. Many breakouts moved well over 100 pips in a single move, some as much as 300 pips.

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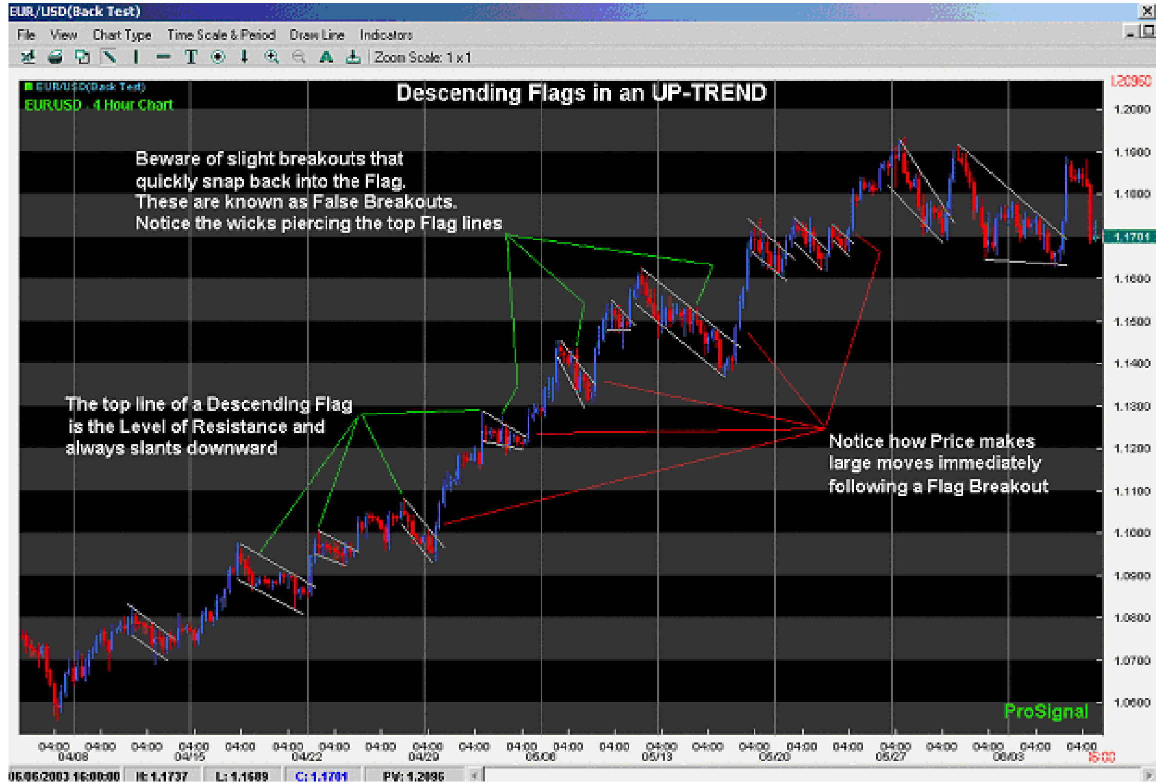
Descending Flags in an Up-Trend

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## Ascending Flag:

An upward drift against a down-trend is called an Ascending Flag because it is ascending against the overall down-trend. The same rules apply for an Ascending Flag as for a Descending Flag but in reverse. For example, the bottom channel line of an Ascending Flag (which slants upward from left to right, and sometimes horizontally) is the most important line and acts as the level of support within the flag. When the Ascending Flag's bottom channel line is broken, it is usually followed by a large downward price move.

The following chart is a 4-hour USD/CHF chart in a down-trend during the same time period as the previous EUR/USD chart. Quite often, ProSignal's charts will generate a signal alert on the 15-Minute or 1-hour chart just prior to a flag breakout.

Ascending Flags in a Down-Trend

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# Triangles

A triangle formation is a congestion area where the upper and lower boundaries converge on the right. Like flags, triangles usually indicate a continuation in the overall trend direction; although they can sometimes indicate a reversal. Small triangles, especially, usually indicate a continuation pattern. There are three major categories that triangles can be divided into; Ascending, Descending and Symmetrical.

## Ascending Triangle:

The upper boundary is close to horizontal and the lower boundary angles upward. An ascending triangle usually results in the market having an upside breakout.

Ascending Triangles

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## Descending Triangle:

The lower boundary is close to horizontal while the upper boundary angles downward. A descending triangle usually leads to a downside breakout.

Descending Triangle

## Symmetrical Triangle:

The upper and lower boundaries converge at about the same angle. Whatever degree the upper line is inclined to, the lower line will be declined to the same degree relative to horizontal. They usually serve as continuation patterns.

Symmetrical Triangle

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# Double or Triple Tops & Bottoms

Double/Triple Tops & Bottoms are significant to short-term & long-term traders alike, as they often indicate a reversal in trend.

The double or triple top, as its name implies, is a pattern made up of two consecutive peaks that are roughly equal, with a trough in between. The double/triple bottom is a mirror formation of a double/triple top, made up of two consecutive lows that are roughly equal, with a trough in between.

Double or Triple Tops establish levels of Resistance.

Double or Triple Bottoms establish levels of Support.

These patterns reflect the premise that multiple attempts to break support or resistance are failures and it is likely to lead to a powerful trend-reversal in the opposite direction.

This pattern can be used on all time-frames.

The higher the time-frame and the more times price bounces off a previous high or low, the stronger the support or resistance it provides.

If price breaks through these points of support or resistance, it will likely continue to move in the same direction.

In a Double/Triple Top, stop-losses are typically placed just above the price highs, as a move above the highs would negate the premise of the pattern. Likewise, in a Double/Triple Bottom, stop-losses are typically placed just below the price lows, for the same reason.

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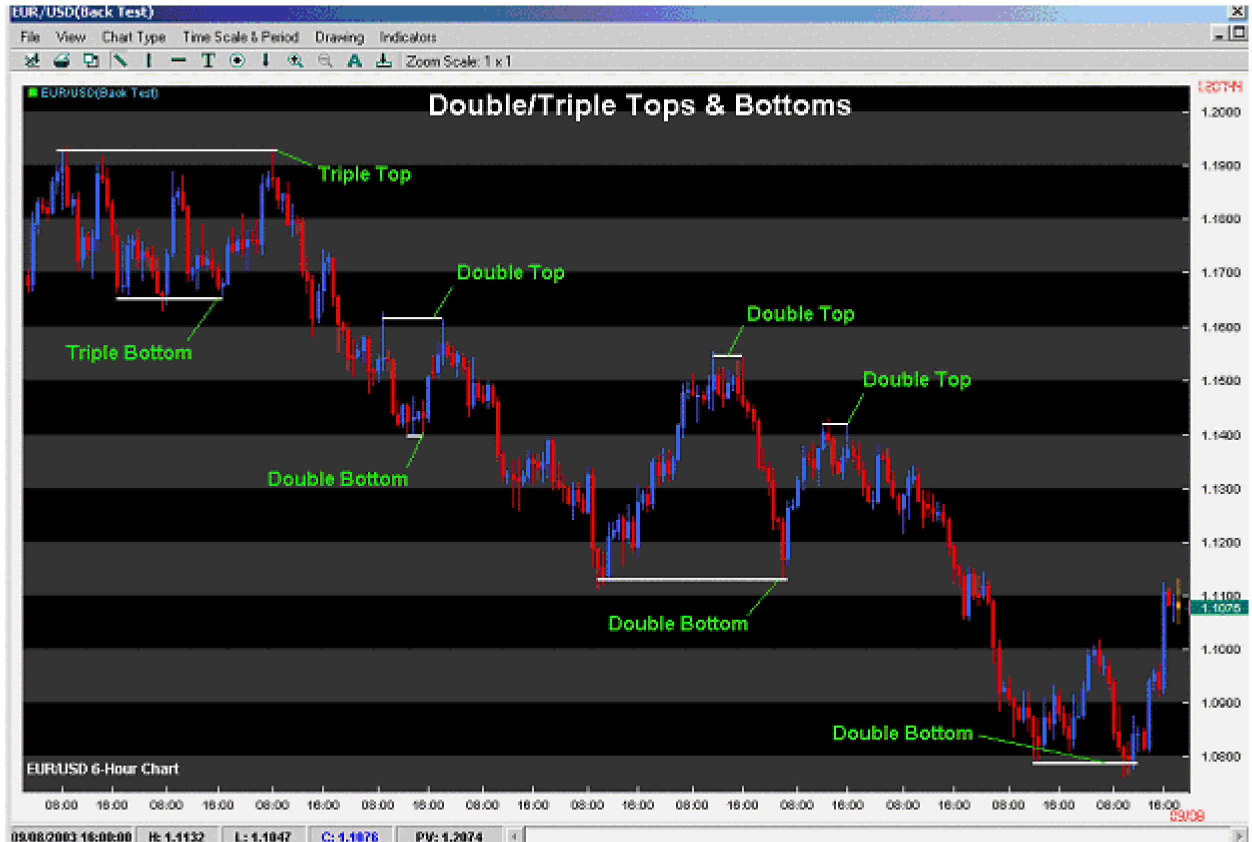
The following chart illustrates typical Double/Triple Top & Bottom patterns on a EUR/USD 6-hour chart.

Double or Triple Tops and Bottoms

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