

Technical analysis for beginners

PART 1

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Budapest 28 January 2006

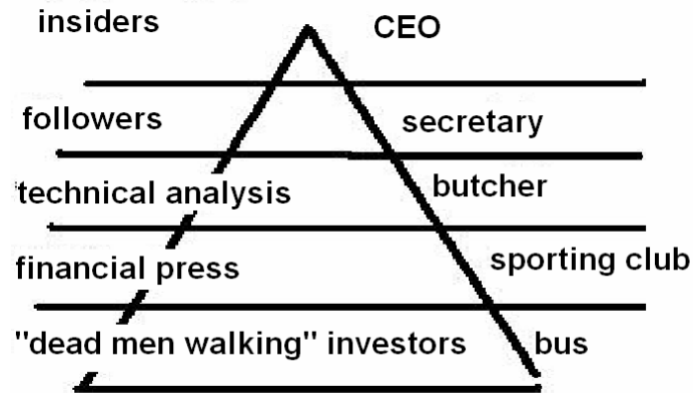
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PRINCIPLES OF TECHNICAL ANALYSIS

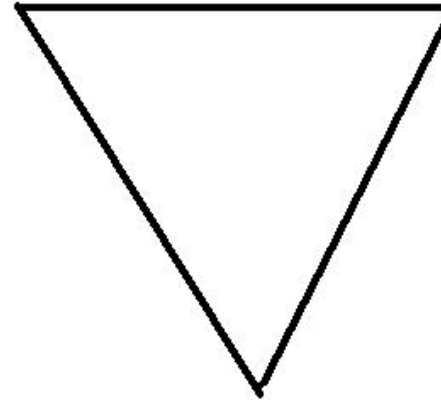
Mambo Jumbo in technical analysis: selling illusions. It is very difficult to define what is technical analysis and in what it is different from econometrics, technical trading, scalping or day trading. Technical analysis is mostly regarded as a “woodoo practice” by institutionals and academic world but recently the attitude is changing.

Definition of trend and congestion: everybody agree on the fact that markets move in trends. When there is no trend there is congestion. How to define trend ? Higher highs and lower lows. Trendlines. Channel. Regression.

How imitation works



Return on investment



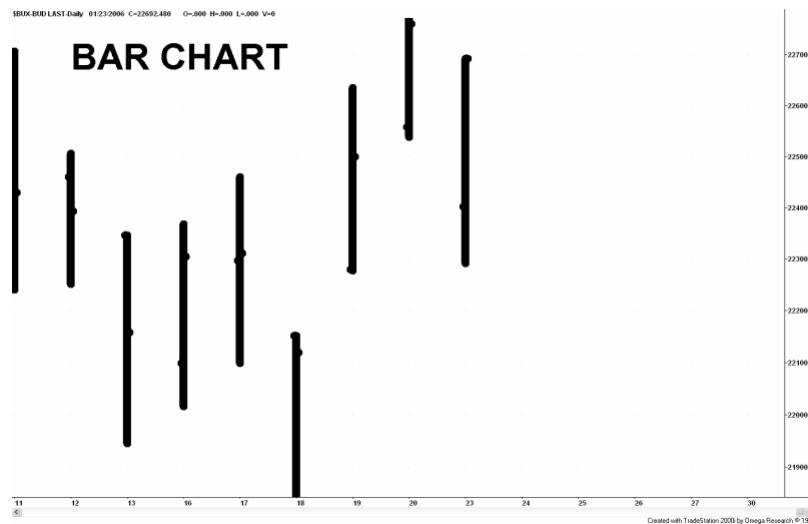
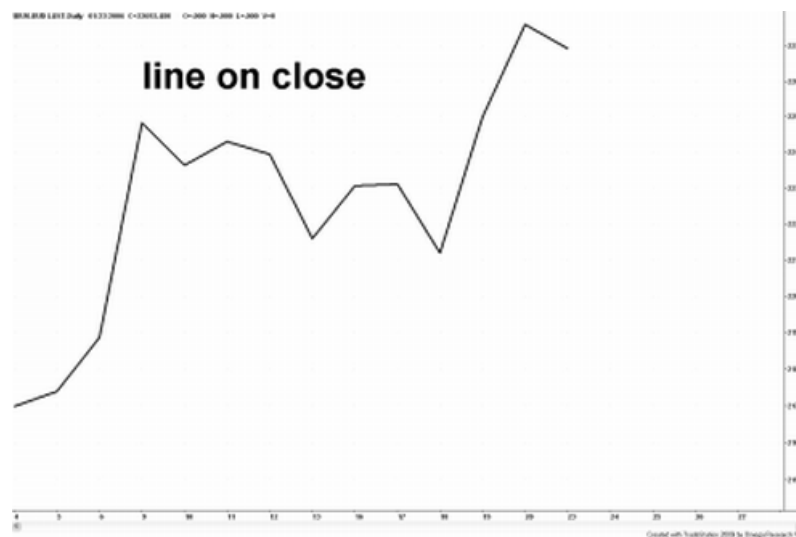
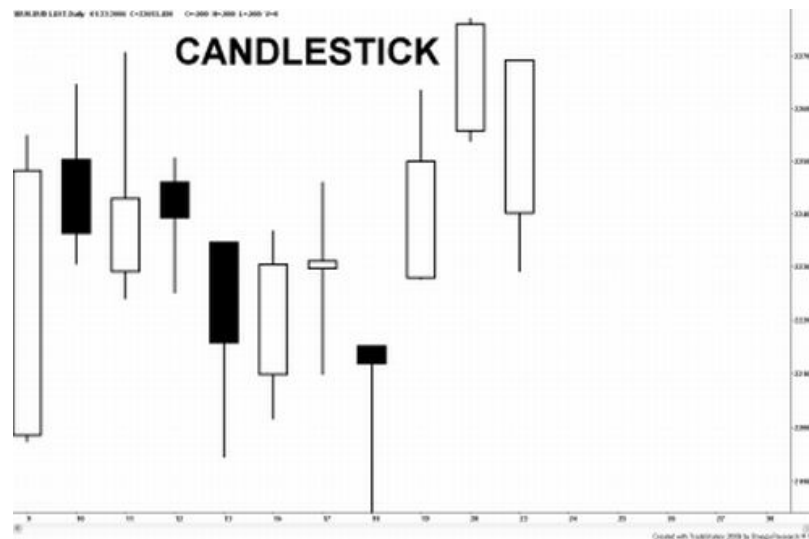
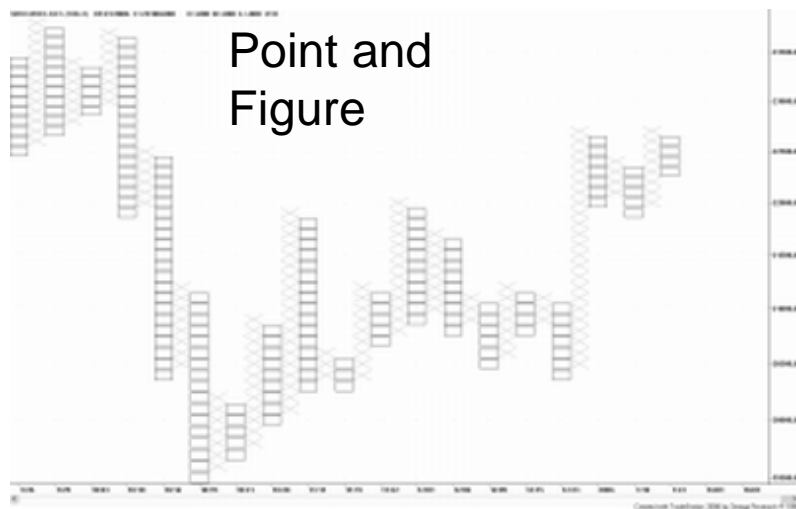
But have you ever thought ...

Why are you currently doing your job ? Before becoming a dentist did you make projections, forecasts, statistical research about the health of people in the futures ? How many times they will wash their teeth, how much chocolade they will eat, how much they will smoke, etc. etc. ?

1) Inheritance

2) chance

3) imitation



What is support and what is resistance Support become resistance and the reverse

The most comprehensive and easy going book on technical analysis is

John Murphy, Technical Analysis of the Financial Markets, Wiley&sons

You can download a chapter on “classical reversal and continuation patterns” from

<http://www.lombardreport.it/uploads/filenews/Murphy.pdf>

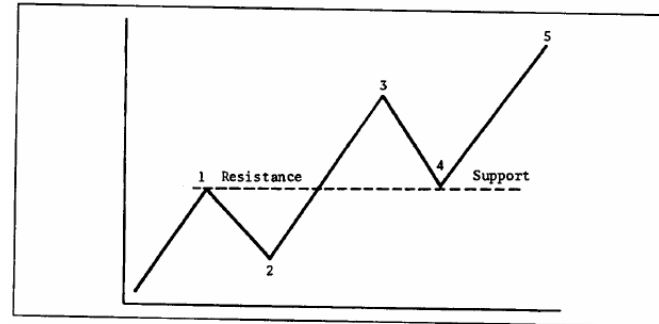


Figure 4.5a In an uptrend, resistance levels that have been broken by a significant margin become support levels. Notice that once resistance at point 1 is exceeded, it provides support at point 4. Previous peaks function as support on subsequent corrections.

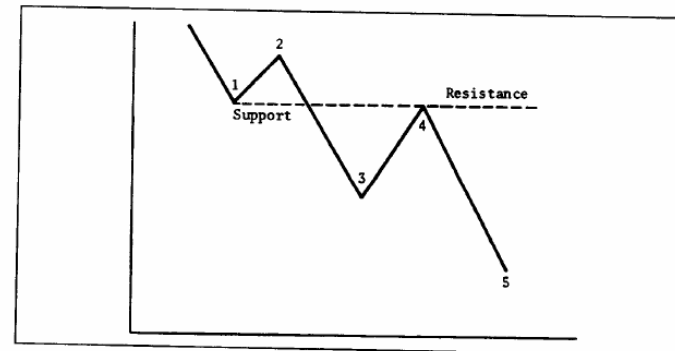
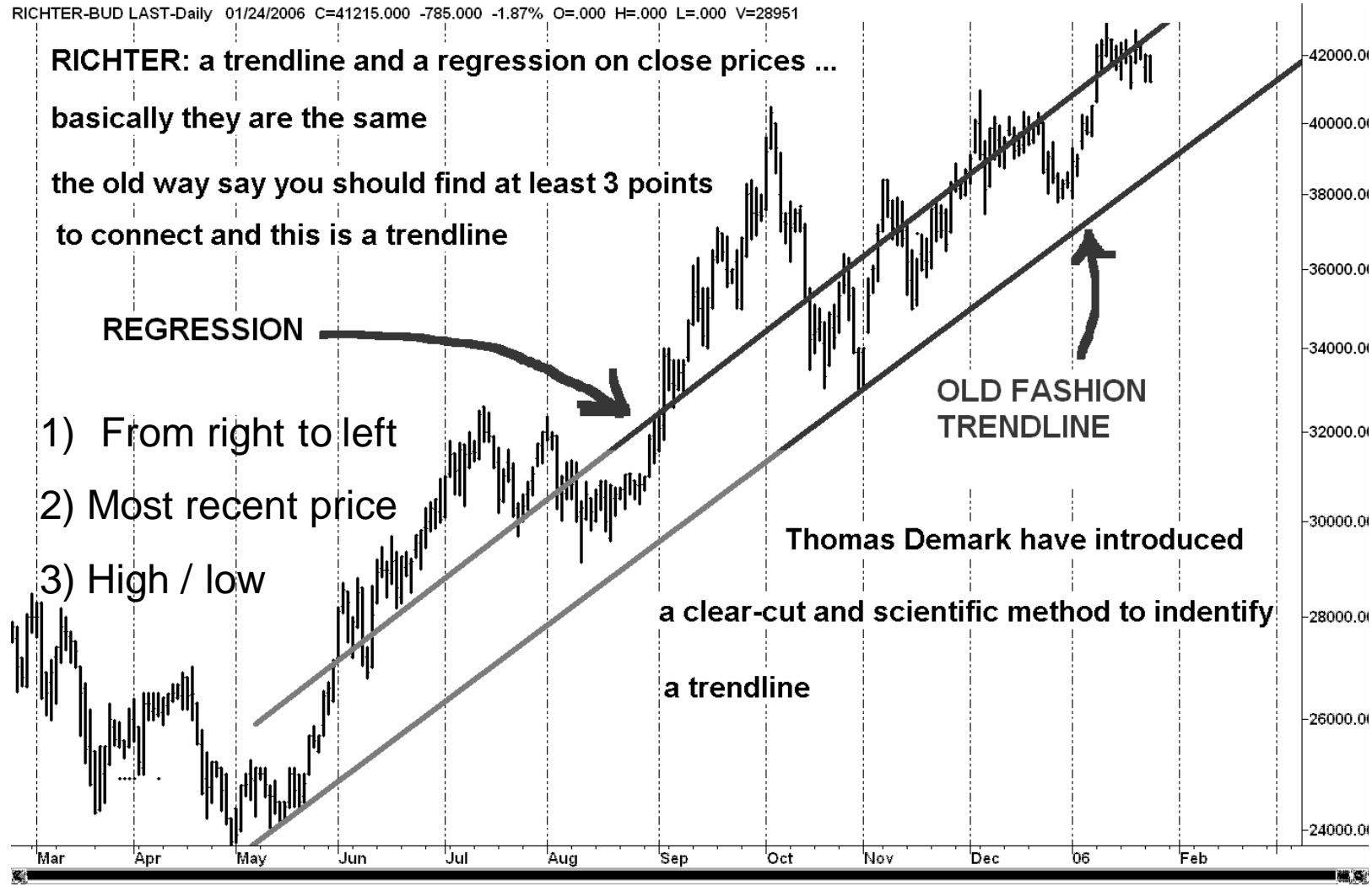


Figure 4.5b In a downtrend, violated support levels become resistance levels on subsequent bounces. Notice how previous support at point 1 became resistance at point 4.

Trendline: the old good trendlines of the past times ...

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THOMAS DEMARK TRENDLINES

1. Trendline are drawn on TD Point leve 1, 2, 3 etc. A TD Point High is a true high, that is the high of the bar or the close of the previous day if this close > high. The reverse for true low (TD Point Low). TD Point High Level 1 means that should be at least 1 high before the TD Point High Level 1 < high and another high on the followin bar < TD Point High
2. The trendline is drawn only on the 2 most recent TD Points
3. There are 3 Qualifiers for intraday entry in case of a breakout of a trendline
4. The are rules for cancelation of the pattern on the day following the breakout
5. You should take the entry only if in the direction of the major trend

THESE ARE OBJECTIVE RULES YOU CAN PROGRAM !



DOUBLE TOP / REVERSAL KEY

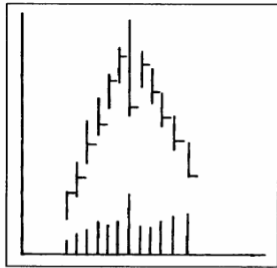


Figure 4.22a Example of a top reversal day. The heavier the volume on the reversal day and the wider the range, the more important it becomes.

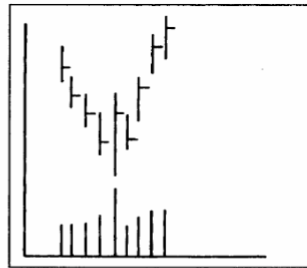
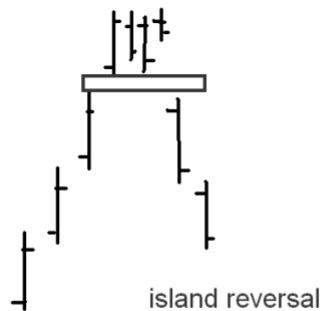
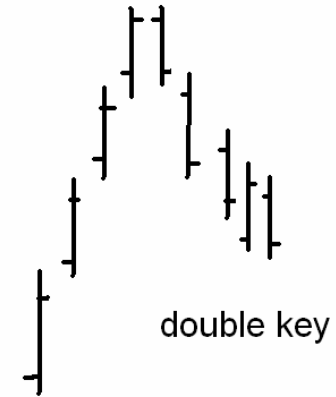
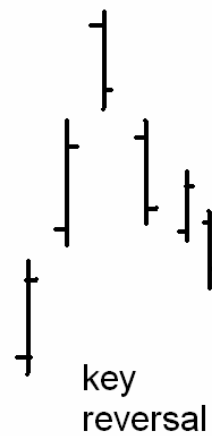


Figure 4.22b Example of a bottom reversal day. If volume is especially heavy, bottom reversals are often referred to as "selling climaxes."



GAP

They can be a trap (on illiquid stocks) or an opportunity (on liquid stocks)

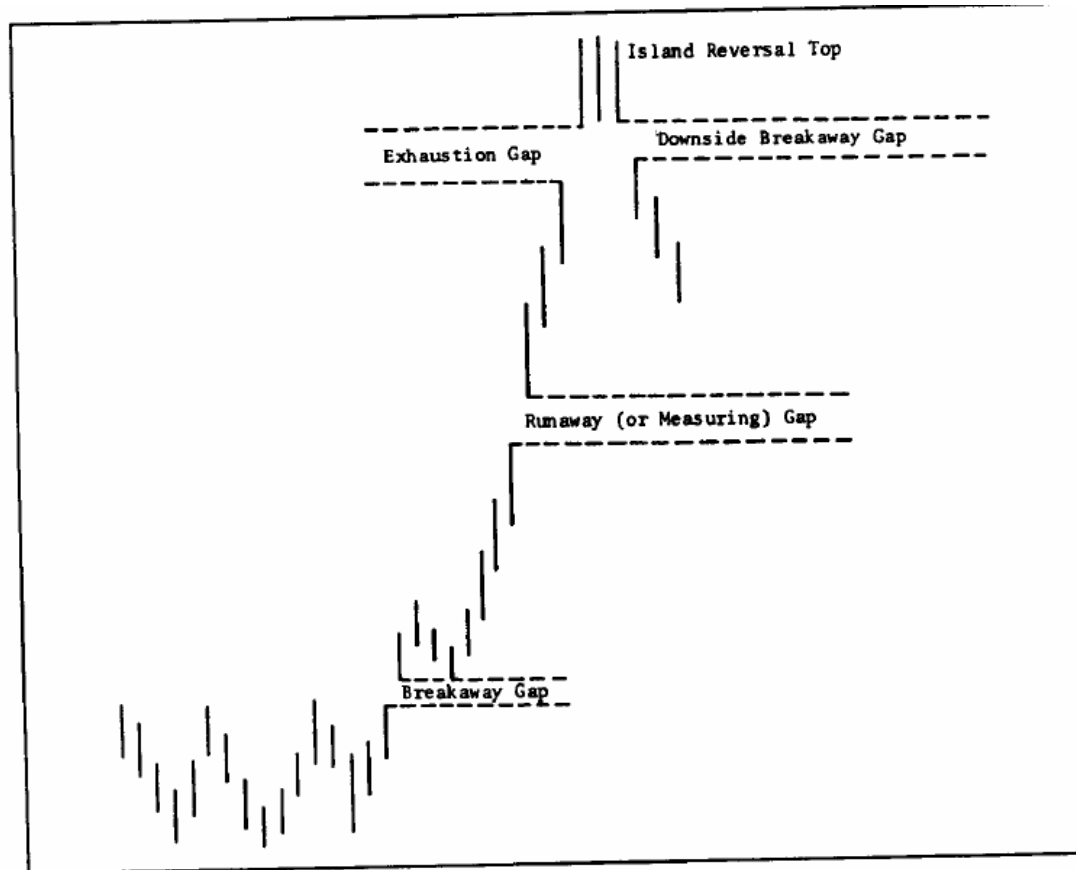


Figure 4.23a *The three types of gaps. The breakaway gap signaled the completion of the basing pattern. The runaway gap occurred at about the midway point (which is why it is also called the measuring gap). An exhaustion gap to the upside, followed within a week by a breakaway gap to the downside, left an island reversal top. Notice that the breakaway and runaway gaps were not filled on the way up, which is often the case.*

Pivot point for trading intraday

$$\text{Pivot} = (\text{Low} + \text{High} + \text{Close} + \text{Open}) / 4;$$

$$\text{Resistance1} = (\text{Pivot} * 2) - \text{Low};$$

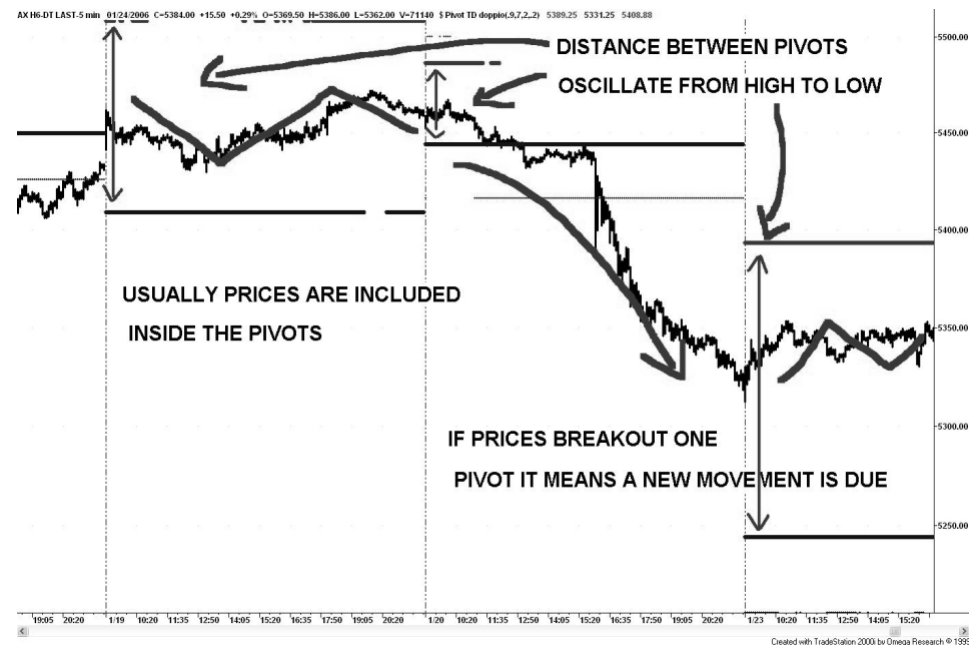
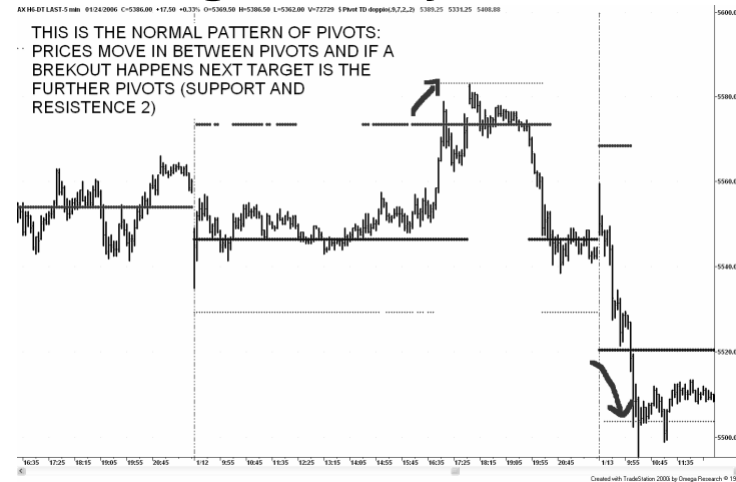
$$\text{Resistance2} = \text{Pivot} + \text{Range};$$

$$\text{Support1} = (\text{Pivot} * 2) - \text{High};$$

$$\text{Support2} = \text{Pivot} - \text{Range};$$

The trading logic of pivot is double-face:

1. Buy the pivot low and sell the pivot high
2. If the pivot low is broken downside then probabilities are for a downmove, if the pivot high is broken to the upside probabilities are for an upwardmove



Orb: opening range breakout by Toby Crabel

ORB: An Opening Range Breakout (hereafter called ORB) is a trade taken at a predetermined amount above or below the opening range. When the predetermined amount (the stretch) is computed a buy stop is placed that amount above the high of the opening range or a sell stop is placed the same amount below the low of the opening range.

STRETCH: the stretch is determined by looking at the previous ten days and averaging the sum of the differences between the open for each day and the closest extreme to the open on each day.

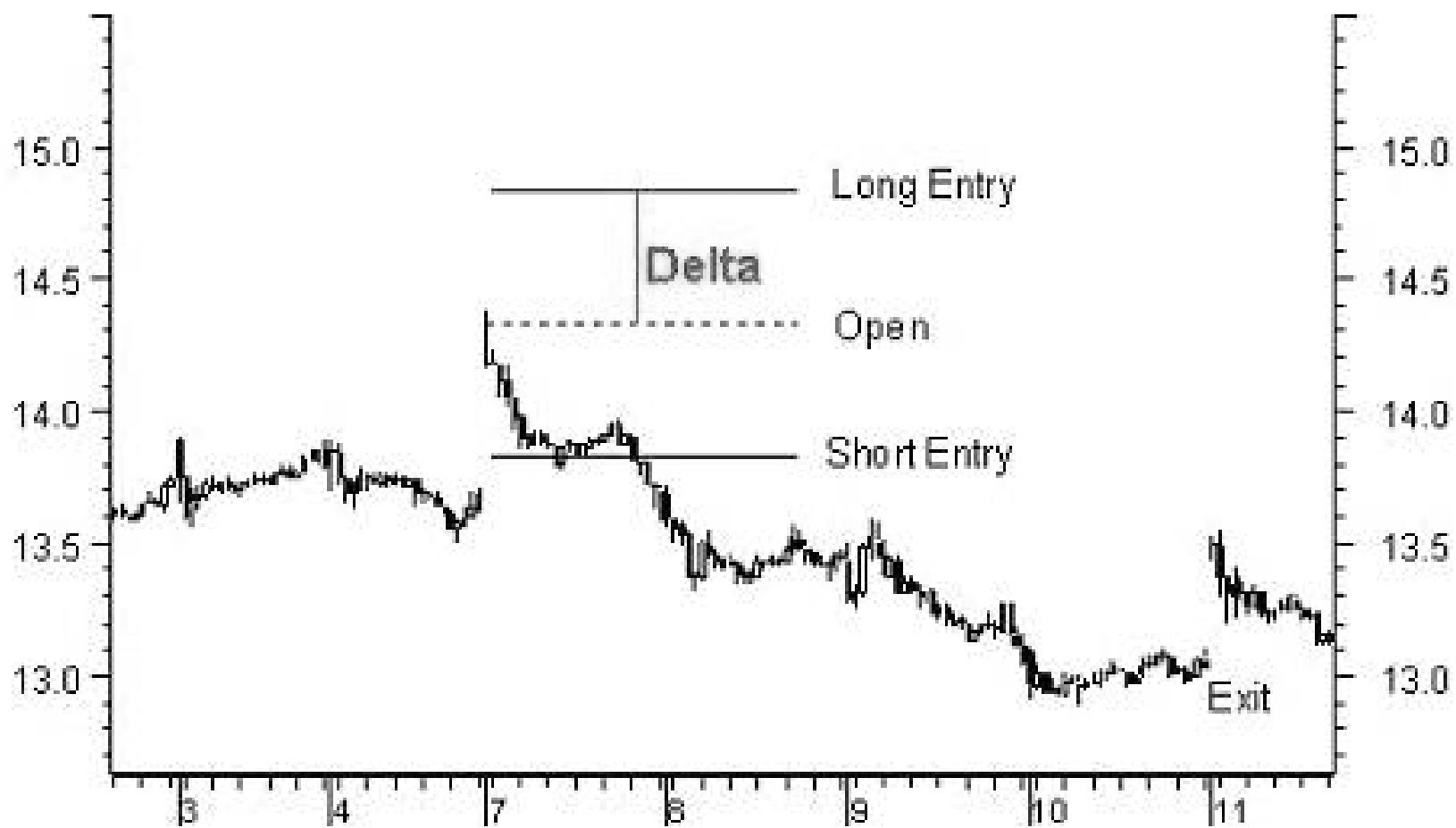
In Easy Language format:

$$\text{Stretch} = \text{Round}(\text{Average}(\text{minlist}(H-O, O-L), 10));$$

EARLY ENTRY: an EE (Early Entry) is defined as a large price movement in one direction within the first five minutes after the open of the daily session. This is an ideal price action when using an ORB entry. The open should act as one extreme. There are two kinds of EE:

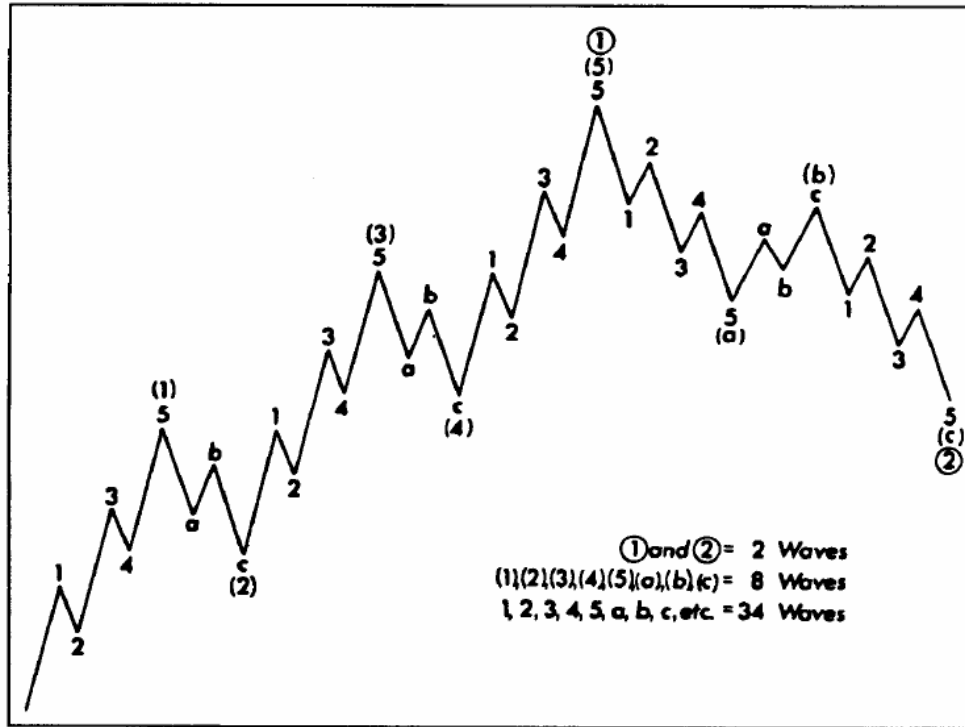
EE1: the first five minutes unit has a larger range than normal (norm is roughly defined as the average of the preceding ten days' first five minutes ranges, i.e. you calculate the average range of the first 5 minutes bars of the last 10 days). Open of the day is on one extreme of the five minutes bar and the close of the five minute bar is on the opposite extreme (i.e. for long positions you have the open which is placed let's say in the first 5% of the range and the close which is set in the last 5% of the range). The second five minutes shows and equal thrust in the direction of the first five minute period (i.e. for long position it is a positive bar which has the open which is placed let's say in the first 5% of the range and the close which is set in the last 5% of the range). For short positions you have negative bars.

EE2: is extremely powerful and is characterized by an excessively large range in the first five minutes, quite possibly bigger than the previous twenty day's first five minute periods, i.e. you calculate the average range of the first 5 minutes bars of the last 20 days.



Woodoo & Wizards

Elliot Wave Theory



Fibonacci series: 1,1,3,5,8,13,21,34,55, 89,144 ... etc

1. The sum of any two consecutive numbers equals the next higher number. For example, 3 and 5 equals 8, 5 and 8 equals 13, and so on.
2. The ratio of any number to its next higher number approaches .618, after the first four numbers. For example, 1/1 is 1.00, 1/2 is .50, 2/3 is .67, 3/5 is .60, 5/8 is .625, 8/13 is .615, 13/21 is .619, and so on. Notice how these early ratio values fluctuate above and below .618 in narrowing amplitude. Also, notice the values of 1.00, .50, .67. We'll comment further on these values when we talk more about ratio analysis and percentage retracements.
3. The ratio of any number to its next lower number is approximately 1.618, or the inverse of .618. For example, 13/8 is 1.625, 21/13 is 1.615, 34/21 is 1.619. The higher the numbers become, the closer they come to the values of .618 and 1.618.
4. The ratios of alternate numbers approach 2.618 or its inverse, .382. For example, 13/34 is .382, 34/13 is 2.615.

FIBONACCI RETRACEMENTS: 38%, 62%, 78%,

FIBONACCI PROJECTIONS: 1,27%, 1.38%, 1.62%, 1.78%

Gann

GANN AND FIBONACCI FAN LINES

Charting software also allows the drawing of *Gann* and *Fibonacci* fan lines. *Fibonacci* fan lines are drawn in the same fashion as the speedline. Except that Fibonacci lines are drawn at 38% and 62% angles. (We'll explain where those 38% and 62% numbers come from in Chapter 13, "Elliott Wave Theory.") *Gann* lines (named after the legendary commodity trader, W.D. Gann) are trendlines drawn from prominent tops or bottoms at specific geometric angles. The most important Gann line is drawn at a 45 degree angle. Steeper Gann lines can be drawn during an uptrend at $63\frac{3}{4}$ degree and 75 degree angles. Flatter Gann lines can be drawn at $26\frac{1}{4}$ and 15 degree lines. It's possible to draw as many as nine different Gann lines.

Gann and Fibonacci lines are used in the same way as speedlines. They are supposed to provide support during downward corrections. When one line is broken, prices will usually fall to the next lower line. Gann lines are somewhat controversial. Even if one of them works, you can't be sure in advance which one it will be. Some chartists question the validity of drawing geometric trendlines at all.

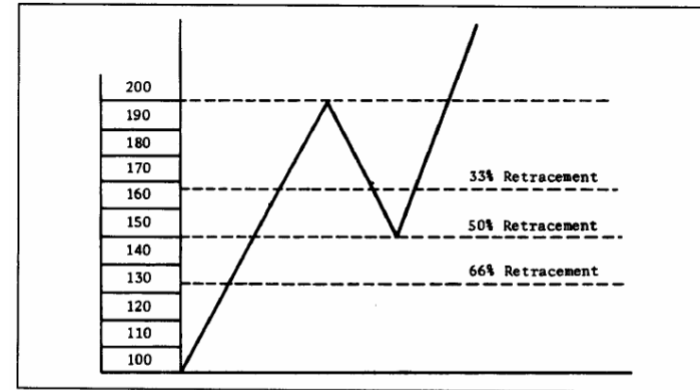


Figure 4.20a Prices often retrace about half of the prior trend before resuming in the original direction. This example shows a 50% retracement. The minimum retracement is one-third and the maximum, two-thirds of the prior trend.

Students of W. D. Gann are aware that he broke down the trend structure into eighths— $\frac{1}{8}$, $\frac{2}{8}$, $\frac{3}{8}$, $\frac{4}{8}$, $\frac{5}{8}$, $\frac{6}{8}$, $\frac{7}{8}$, $\frac{8}{8}$. However, even Gann attached special importance to the $\frac{3}{8}$ (38%), $\frac{4}{8}$ (50%), and $\frac{5}{8}$ (62%) retracement numbers and also felt it was important to divide the trend into thirds— $\frac{1}{3}$ (33%) and $\frac{2}{3}$ (66%).

Indicators & Trading Systems

Indicators are useless except:

1. Money Flow
2. Demand Index
3. Accumulation / Distribution and other variations
4. Relative Strength stock / index
5. Channel Breakout
6. New High / New Low
7. Historical highs / lows
8. CANSLIM by William O'Neil "How to make money in stocks"

In any case an indicator will never tell you something you cannot perceive watching the naked charts. Indicators are a first step towards trading systems. But a trading systems with only indicators is aimed to failure. Trading systems work on innovative idea based on pattern recognition.

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