The Benefits of Technical Analysis
What is Technical Analysis?

It is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends.
Charts

The **bar charts** show the open, high, low and close prices.
Charts

In the **line chart**, only the closing price is plotted for each successive period.
Charts

Candlesticks

• A wide portion of the bar (called the body) measures a distance between the open and the close.
• A thin line (called the shadow/wick) shows the time frame’s price range from the high to low.
• If the close is higher than the open, the real body is white (positive).
• If the close is lower than the open, the real body is red (negative).
• You can do everything with a candlestick chart that you can do with a bar chart.
Charts

Candlesticks
Rationale

There are three principles on which the technical analysis approach is based:

1. Market Action discounts everything
2. Prices move in trends
3. History repeats itself
Rationale

Principle 1: Market Action discounts everything

Probably the cornerstone of technical analysis.
Only if the full significance of this idea is fully understood and accepted, only then, everything else that follows makes sense.
Rationale

Principle 1: Market Action discounts everything

Factors that affect the value of a currency:

- Balance of Payments
- Productivity and natural resource allocation
  - Interest rates
  - Inflation
  - Economic growth
- Government and central bank manipulation
- Political conditions
- Money supply

...are actually reflected in the price of the currency.
Rationale

Principle 1: Market Action discounts everything

Factors that affect an asset’s price, like

- Fundamentals
- Inflation
- Interest rates
- Political stability
- Psychological issues

...are actually reflected in the market price!
Rationale

Principle 1: Market Action discounts everything

Conclusions:

- If prices are rising, for whatever specific reasons, demand must exceed supply and the fundamentals must be bullish (good news). If prices fall, the fundamentals must be bearish (bad news).
- The technician is indirectly studying fundamentals.
- The charts do not in themselves cause markets to move up or down.
Rationale

Principle 2: Prices move in trends

- Unless one accepts the premise that markets do in fact trend, there’s no point in reading any further.
- Most of the techniques are trend-following.
- A trend in motion is more likely to continue than to reverse (this is an adaptation of Newton’s first law of motion).
Rationale

Principle 3: History repeats itself

- Since the patterns (like head and shoulders) have worked well in the past, it is assumed that they will continue to work well in the future.
- They are based on the study of human psychology, which tends not to change.
Technical vs Fundamental Analysis

Both of these approaches attempt to solve the same problem, which is to determine the direction prices are likely to move.
The Fundamental Approach

• Examines all of the relevant factors affecting the price of a market in order to determine the intrinsic value of that market.
• If this intrinsic value is under the current market price, then the asset is overpriced and should be sold.
• The fundamental studies the causes of market movement.
• The fundamentalist always has to know why.
The Technical Approach

• Studies the effect of the market movement and believes that the reasons, or the causes, are unnecessary.

• The technical approach includes the fundamentals.

• Chart reading becomes a shortcut form of fundamental analysis. The reverse, however, is not true.
Technical vs Fundamental Analysis

The problem is that the charts and fundamentals are often in conflict with each other, because:

- Market price tends to lead the known fundamentals.
- While the known fundamentals have already been discounted and are already “in the market”, prices are reacting to the unknown fundamentals.
- Market price acts as a leading indicator of the fundamentals.
Technical Analysis Advantages

1. Flexibility and Adaptability

- The chartist can easily follow as many markets as desired, which is generally not true of the fundamentalist.
- The chartist can rotate attention and capital to take advantage of the rotational nature of the markets.
- Most fundamentalists tend to specialize only in one group.
- The chartist has the “big picture”.

Trading Forex and CFDs is risky
Technical Analysis Advantages

2. Applied to Different Trading Mediums

- It was first applied to stock markets and later adapted to futures and forex.

Technical principles apply to:

- Interest rate markets
- Foreign currencies
- Hedging processes
Technical Analysis Advantages

3. Applied to Different Time Dimensions

The same principle applies:

- For the intra-day (tic-by-tic)
- For day trading purposes
- For trend trading the intermediate or long-term trend (weekly, monthly and yearly charts)
Technical Analysis Advantages

3. Applied to Different Time Dimensions

Trading on the monthly chart (long term)
Technical Analysis Advantages

3. Applied to Different Time Dimensions

We can look for a trend on the weekly chart (medium term)
Technical Analysis Advantages

3. Applied to Different Time Dimensions

We can look for a trend on the daily chart (short term)
Technical Analysis Advantages

4. Can play a role in Economic Forecasting

- If someone observes the charts of commodities, they can predict the strength or weakness of the economy.
- US dollar and foreign currency futures also provide early guidance about the strength or weakness of the respective economy.
Criticism on Technical Analysis

a. The Self-Fulfilling Prophecy
The use of most patterns has been widely publicized in the last several years.
Many traders are quite familiar with these patterns and often act on them in concert.
This creates a “Self-Fulfilling Prophecy”, as waves of buying or selling are created in response to “bullish” or “bearish” patterns.
b. Chart patterns are almost completely subjective

- No study has yet succeeded in mathematically quantifying any of them.
- They are literally in the mind of the beholder.
- People can’t criticize charting for being so objective and obvious that everyone will act in the same way at the same time (thereby causing the price pattern to be fulfilled) and then also criticize charting for being too subjective.
- Even if most technicians did agree on a market forecast, they would not all necessarily enter the market at the same time and in the same way.
- Traders would rely heavily on charts until their concerted action started to affect or distort the market.
• When this happened, they would either stop using the charts or adjust their trading tactics.
• Bull and bear market only occur and are maintained when they are justified by the law of supply and demand.
• An indication that a forecasting technique is accurate, is that it has become so popular so as to influence events.
c. Can the past be used to predict the future?

- Every known method of forecasting, from weather predicting to fundamental analysis, is based on the study of past data.
- Chart analysis is just another form of time series analysis, based on a study of the past, which is exactly what is done in all forms of time series analysis.
- The use of past price data to predict the future in technical analysis is grounded in sound statistical concepts.
d. Random Walk Theory

The academic community claims that:
Price changes are “serially independent” and that
Price history is not a reliable indicator of future price direction

• How do supporters of this theory explain the persistence of trends, in all markets, if prices are serially independent, meaning that what happened yesterday, or last week, has no bearing on what may happen today or tomorrow?
• How do they explain the profitable “real life” track records of many trend following systems?
• How would a buy and hold strategy fare in the commodity futures markets where timing is so crucial?
e. Efficient Market Hypothesis

- Very similar to the technical premise that market discounts everything.

- Supporters believe that markets discount quickly all information and there’s no way to take advantage of that information.

- The basis of technical forecasting is that market information is discounted in the market price long before it becomes known.
• A process appears random and unpredictable only to those who do not understand the rules under which that process operates.

• A number of leading American universities have begun to explore Behavioral Finance which maintains that human psychology and securities pricing are interrelated.

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