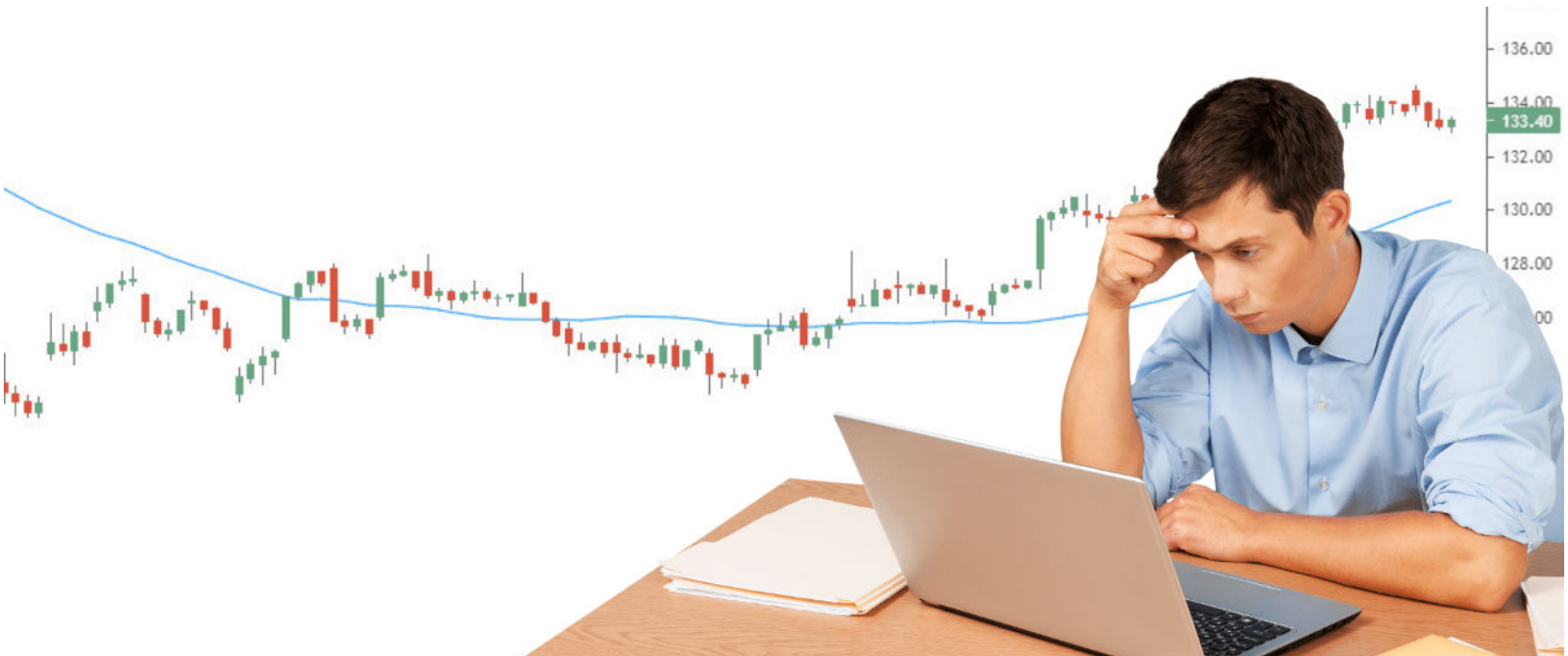




Stock Markets Guides


Author: Dylan Soiza

Technical Analysis of Stocks Trading Guide



Technical analysis is a trading practice that seeks to employ various strategies to analyze assets and locate investment opportunities. It does this by evaluating information such as statistical price movement or traded volume.

One of the fundamental pillars of technical analysis is the premise that past trading activity and the price fluctuations of a particular security or asset class can provide traders with an insight into the future of that security's price movements. Traders can then use these indicators and insights as part of their trading strategy to effectively enter and exit from their positions in a profitable manner.



This post goes through the foundations of technical analysis and the various strategies that you can employ to successfully trade the stock market.

Technical Analysis for Beginners

Technical analysis is becoming increasingly popular with new investors. This is partly thanks to the advancement of trading platforms and charting packages.

The term technical analysis might sound especially intimidating to the novice investor, and getting to grips with the basics of technical analysis can prove to be a particularly daunting task.

At its heart, technical analysis is simply the study of price movements in a particular security. Traders use various data points in chart patterns to predict whether the price of a security will go up or down.


Technical analysis can also be a handy tool to help traders manage their risk when opening or closing their positions.

Thanks to the transferability of the skills and strategies, traders can use technical analysis on any security that has historical chart data. In other words, if what you are trying to trade in has a chart that shows you the past prices of that security, you will be able to use technical analysis to predict whether the price of that security will go up or down in the future.

At this point, you might be wondering, why does technical analysis work, and what are its limitations? The data provided by historical price charts are a visual representation of market psychology. After all, investing is not the study of finance; it is studying what people do with their money.

Traders worldwide are examining the same price charts and data points and using the same techniques to determine price movements. This makes technical analysis a self-fulfilling prophecy where stocks increase or decrease in price because vast numbers of traders have examined the same information, come to their conclusions, and made their trades accordingly.

This collective trading can therefore influence the price of a security.



The main limitation of technical analysis is the short-term nature of the discipline. Traders using this technique are using data points to predict price movements in the short term.

This practice can be effective in the following minutes, hours, or even days following an analysis. However, with every passing minute, the probability of a trader's conclusion being profitable becomes less and less probable.

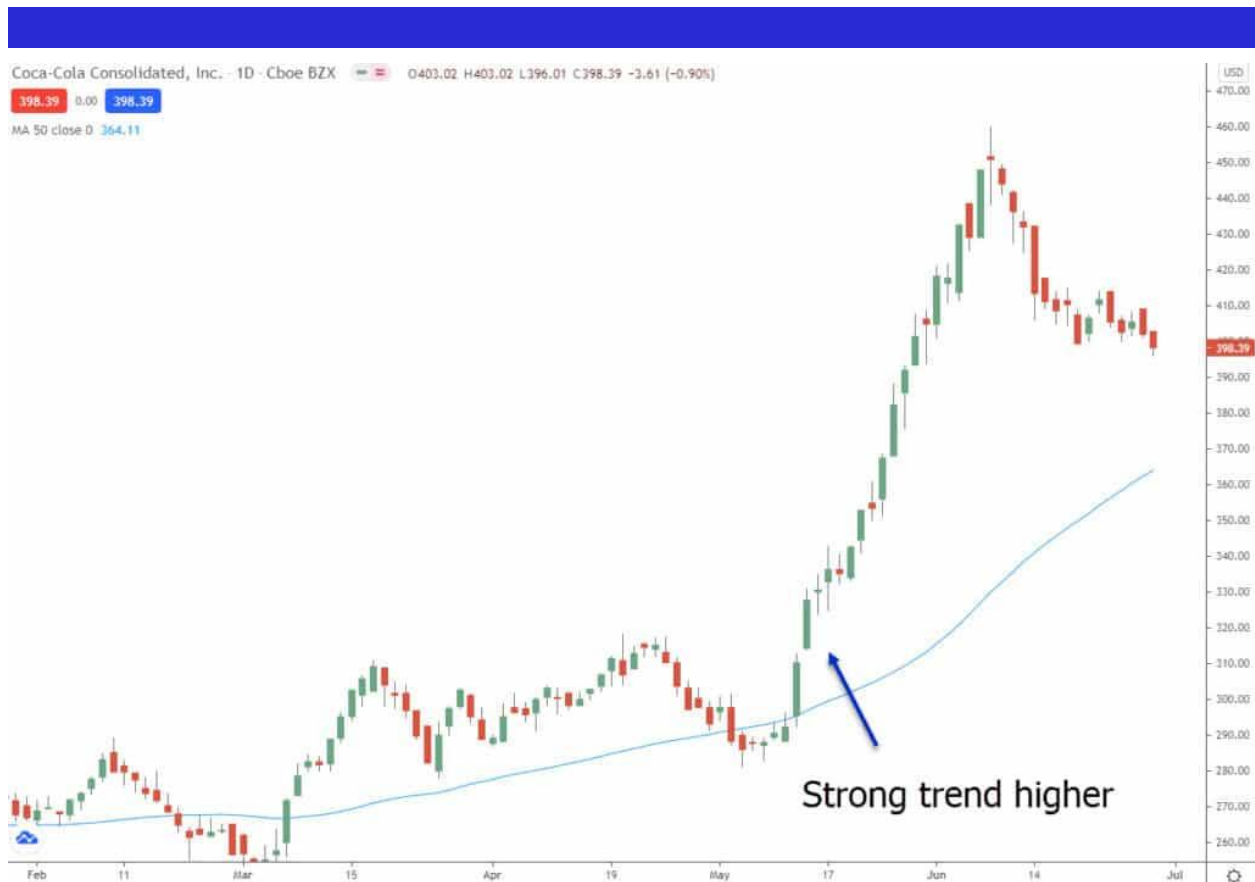
It is a relatively simple endeavor to predict the price of an equity 5 minutes from now based on technical analysis. However, it is near impossible to use these same techniques to predict the price of an equity 5 months from now.

Technical Analysis in the Stock Market

So, how can you use technical analysis in the [stock market](#)? To predict price movements in the stock market, technical analysts look at a broad range of indicators.

Some of these are as follows;

- 1) Price trends.
- 2) Chart patterns.
- 3) Volume.
- 4) RSI.
- 5) Moving averages.
- 6) Support and resistance levels.




These indicators can assist traders in predicting high probability price movements.

Price trends refer to the general direction the price of a stock is heading. For example, if the price of a stock is mainly falling with only a few inconsistent gains, this is believed to be a downward trend. If the opposite is true, then it is considered to be an upward trend. If the stock stays relatively level, then it is said that the stock is trading sideways.

Chart patterns follow on from trends. As a stock trades on the stock market, it leaves a pattern on a chart that outlines the price movements.

These movements create patterns that technical analysts can interpret based on historical data. For example, when pattern A presents on a chart, it is probable that the stock price will increase because historically stocks have had a higher probability of rising when pattern A presents itself.

Volume refers to the number of shares that are being traded. When the volume on a stock is high, it means that many shares are being traded. When volume is low, it indicates that few shares are being traded.



RSI stands for Relative Strength Index. It provides traders with information about whether a stock is overbought or oversold and indicates bullish or bearish trends.

Moving averages are calculated to assist traders in smoothing out [price data](#) over a specified period of time by creating a constantly updated average price for that time period.

Moving Average Convergence Indicator (MACD) is primarily used for trading trends and momentum. It outlines the relationship between two moving averages off a stock's price. It provides technical signals which tell traders when to buy or sell a stock.

Support and resistance levels are used to indicate when the price of a stock will either stop falling or stop rising. Typically, when a stock hits a resistance level, it will stop rising in price and begin to fall. The opposite is true when a stock hits a support level; it will stop falling and begin to rise.

Fundamental vs Technical Analysis

If technical analysis is the study of price charts and data points, what is fundamental analysis? Fundamental analysis involves examining the company's financial statements to determine the fair value of the business based on metrics such as sales, revenue, and net profits.

These two supposedly opposed schools of thought are the main ways most traders approach investing and trading. Both these methodologies are used to research and forecast future trends in stock prices, and, as with any school of thought, both have their supporters and adversaries.

The obvious question is, which one is best? The debate over the relative merits of fundamental and technical analysis is an ongoing one.

Supporters of either methodology often denounce the merits of the other and regularly misunderstand that both of these two trading philosophies have their place.

In general, technical analysis is far more useful for short-term trades or attempting to time the market when entering or exiting from a position. Fundamental analysis is the polar opposite; it can and should be used when entering positions to hold them over a period of months or years.

Here are some of the pros and cons of each type of analysis.

Fundamental Analysis

Analysis based on a company's financial position brings several advantages, the most important of which is that it provides investors with an idea of what the company is actually worth.

This information is invaluable for long-term investing. By knowing what the fair value of a stock should be, you can make asset allocation decisions that significantly reduce your risk in the event of a market crash. In the stock market, the biggest profits are made by those who are right when the rest of the market is wrong. This can only be achieved through fundamental analysis.

However, fundamental analysis is highly time-consuming, and it is important to be realistic about its limitations.

Most of the information for fundamental analysis is widely available on the internet, and so to gain a competitive edge with fundamentals, investors would need to find unique datasets that are not available to most investors. Fundamentals tell investors next to nothing about what might happen in the short term. Short-term price movements and stock volatility can not be predicted by searching through financial statements.

Technical Analysis

If one of the failings of fundamental analysis is that it is highly time-consuming, then the major advantage of technical analysis is the speed with which investors can analyze stocks.

Technical analysts can examine more stocks and draw ideas from a larger nexus, increasing their potential to profit.

In the short term, price movements in a stock are affected by factors that fundamentalists do not consider.

The effects of market sentiment, market psychology, and larger forces such as supply and demand can all be seen by examining price charts. Technical analysts can then use this information quickly to enter and exit from their positions with a high probability of profitability.



That said, just like fundamental analysis, technical analysis does have some failings. Chief among these failings is the subjective nature of the analysis.

Technical analysis relies on the judgment of the individual trader and using charts to determine price action is regarded as more of an art than a science. As a result, technical analysis often yields a lot of ambiguity. Two different analysts can arrive at two different conclusions when looking at the same stock and chart pattern.

As a result of the subjective nature of the analysis, technical trading setups have a relatively low success rate (approximately 60%). They, therefore, require a large number of trades to operate profitably.

Some believe that fundamental and technical analysis are these two competing parties, but this is a foolhardy notion.

The reality is that technical and fundamental analysis are two sides of the same coin. Typically in trading, technical analysts ride the coattails of fundamentalists. These situations become especially noticeable in times of crisis and uncertainty.

For example, the March 2020 lows in the US markets were caused by the fear and panic of the Covid-19 pandemic. Eventually, equities prices reached unjustifiably pessimistic levels, at which point value investors begin to pick up the shares at a discount. This is when technical analysts move into a stock or commodity to ride the uptrend caused by fundamentalist capital.

Is Price Action the Same as Technical Analysis?

In short, price action is the movement of a stock's price plotted over a period of time.

Price action forms the basis of all technical analysis. Popular indicators in technical analysis such as moving averages and RSI are calculated using price action. Therefore, price action is intimately entwined with technical analysis, and one can not be done without the other.



Whether price action is the same as technical analysis is largely a question of semantics. Since to conduct technical analysis, one needs to be aware of price action, the simple answer to this question is to say “yes and no”.

Popular Technical Analysis Indicators

Here we will discuss in more depth some of the indicators we mentioned earlier in this post.

RSI

As detailed above, the RSI indicates whether a stock is on a bullish or bearish trend.

The basic function of RSI is to measure how quickly traders are bidding the price of the stock up or down. The RSI plots the results on a scale of 0-100. Readings below 30 generally indicate that the stock is oversold, while readings above 70 indicate that the stock is overbought.




Some traders consider it a buy signal if a stock's RSI moves below 30 as this indicates that the stock has been oversold and is ready for a bounce. Traders may also consider an RSI above 70 to be a signal to close their positions as it indicates that the stock has been overbought and is likely to correct. That said, it is important to consider the wider context of a stock's trend before making a decision.

The primary trend is an important factor to consider when attempting to read indicators such as RSI properly.

For example, an oversold reading on the RSI of a stock that is trending upwards is likely much higher than 30%, and an overbought reading on the RSI during a downtrend is likely to be significantly lower than 70%.

Moving Average

We noted that moving averages are used to provide traders with an average price over a period of time. This is a popular tool for technical analysts as the average can be adjusted for



different periods, meaning that it can be used for trades that vary from 5 minutes to several months.

Moving averages help to indicate a potential trend and also where the support and resistance levels are.

Let's look at a 50 day moving average. Assume company A is in an uptrend currently trading at 51\$ per share with a 50 day moving average of 50\$ per share. This indicates to traders that there is a lot of support at 50\$ per share and that the share price will likely bounce once it hits 50\$ per share.

However, company B is on a downtrend. Its share price is currently at 49\$ per share with a 50-day moving average of 50\$ per share. This 50\$ average acts as resistance which means the share price of company B is likely to move down once it hits that 50\$ resistance.

The price of a share does not always keep to the moving average support or resistance levels. The share price may fall through support levels into lower lows or breakthrough resistance levels to reach higher highs.

Moving averages are calculated on historical price data, which means that nothing about it is predictive. As a result, moving averages can be random. There are times when the market respects the moving average indicators and other times where it simply does not. This is where it is up to the individual trader to assess the stock and determine how much credence should be afforded to this particular indicator.

Moving Average Convergence Indicator (MACD)

Much like moving averages, the MACD is an indicator based upon historical price data and, as a result, suffers much of the same limitations.

Traders use the MACD to indicate when there may be a change in a stock price trend.

In short, when the MACD crosses above 0, it is considered to be a bullish indicator, i.e., the price is about to go up. When the MACD crosses below 0, it is considered a bearish signal, i.e., the price is about to go down.



How to Use Technical Analysis in the Stock Market

In this section, we will examine four popular strategies that technical analysts use when trading the markets.

Trends

Trend trading is a strategy where traders use the available indicators to try and determine the direction in which the market is moving.

Trend trading is based on the premise that markets have an element of predictability in them. By analyzing the available data, a trader can forecast what will happen in the future.

Generally speaking, there are three types of trends, upwards, downwards, and sideways. The most popular indicators used to identify trends are the RSI and moving averages.

Moving averages such as the 50-day/200-day moving average are especially useful for trend traders as they help indicate in which direction the market is moving. If the price is above the moving average, it indicates an uptrend, and if it is below, it indicates a downtrend.

As we noted earlier, the RSI indicates when a stock is overbought or oversold. The RSI is useful in helping trend traders determine when a trend has matured and is due for a reversal. It should be noted that markets can remain overbought or oversold for extended periods, and the RSI does not indicate that the trend will change immediately.

Ranges

Range trading is a relatively simple trading strategy.

Assume that stock A is trading sideways between 90 - 100\$ a share. A range trader will attempt to purchase shares as close to 90 as possible and then sell these shares as close to 100 as possible.

Range traders will rinse and repeat the strategy until they believe the stock is no longer trading within that range.

Support and resistance levels are critical indicators for range traders as they help traders outline the price range a stock is trading in.

Price bouncing between high and low of range



Candlestick Patterns

Candlestick patterns are used to identify and predict future price movements.

A candlestick is a way of displaying information about price movements. Candlestick charts can be used over different time periods, including "daily", where each candlestick represents a single day's trading.

Each candlestick has three basic features. The body represents the open and close range for that particular time period. The wick details the intra-day high and low. The color details the market's direction (green indicates a price increase, red indicates a price decrease).

Many candlestick chart patterns can provide traders with many insights into the market and help them identify trading opportunities.

Six bullish candlestick patterns that every trader should be familiar with are:

1. Hammer.
2. Inverse Hammer.
3. Bullish Engulfing.
4. Piercing Line.
5. Morning Star.
6. Three White Soldiers.

Six bearish candlestick patterns that every trader should be familiar with are:

1. Hanging Man.
2. Shooting Star.
3. Bearish Engulfing.
4. Evening Star.
5. Three Black Crows.
6. Dark Cloud Cover.



Volume

This type of trading strategy requires you to pay particular attention to the wider market forces of supply and demand.

As we mentioned above, volume refers to the number of shares being traded. If there is a lot of buying volume, i.e., many shares are being purchased, this indicates that the price is very likely to go up. However, if there is a lot of sell volume, then the price is likely to fall.

Volume traders look at volume and attempt to determine which way a stock will move by assessing how much volume is being traded and whether it is buying or selling volume. For example, assume company A typically has a volume of 5000 - 7000 shares being traded. Suddenly, 10 minutes after the market opens, there is a spike in volume, and 80,000 shares are purchased. This would indicate that the stock is about to rise due to the number of shares that are being purchased.

Technical Analysis of Stock Trends

Finding trending stocks before the rest of the market is never easy, but it can be a potent part of your investing strategy.

Now that you know the basics of indicators and are aware of some of the strategies technical analysts use to trade the markets, the next step is to identify a stock trend to trade. How do technical analysts identify stock trends?

Since the stock is trending, then by definition, you can not be the first investor in the stock, but there are various strategies you can employ to ensure that you get into the stock early and can ride the trend to a profitable exit.

One of the simplest strategies is to keep an eye out for unusually high volume in a stock. Traders can find high-volume signals on most stock screeners. You should look for stocks with a 10 day average volume of at least 150% more than the longer-term average.

Many technical traders also seek to identify trends using moving average indicators. The most common is when the price of a stock breaks above its 100-day moving average. The basic premise of this strategy is that there is some catalyst causing a spike in investor interest that may push up the stock price.

Lastly

Regardless of whether you trade using fundamentals or technical analysis, the more factors being considered when opening or closing a trade, the more likely the trade will yield a profitable result.

Stock trading is an art, not a science. If it were a science and an established set of protocols that worked without fail, the number of billionaires on Earth would begin to increase dramatically.

Successful trading is about making high probability trades in a focused and disciplined manner whilst consistently evaluating your risk and exposure. The bulk of successful traders take a wide variety of technical and fundamental factors into consideration when deciding whether to open or close a position.



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